

IDENTIFICATION OF POSSIBLE SOLUTIONS FOR REDUCING THE VULNERABILITY OF THE REPUBLIC OF MOLDOVA BANKING SYSTEM THROUGH THE BASEL III

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Abstract:

The article discusses the standards of banking regulation Basel III, the process of their introduction into the practice of the Republic of Moldova banking supervision. The author compares the current mandatory standards of the Republic of Moldova banks and the indicators recommended by the Basel Committee on Banking Supervision, analyzes the possible consequences of the use of Basel III for the Republic of Moldova banking system in terms of reducing systemic risks. The features of the application of these rules in the EU are considered. Possible changes are projected as a result of the implementation of Basel III in the banking system and national economy.

Keywords: *banking regulation, Basel III, commercial banks, backbone banks; financial risks, vulnerability.*

JEL classification: *G21, G28, G38*

Introduction

The banking system is an essential element of both the national and international economies, since it performs the most important functions of accumulating and redistributing capital, simplifying, streamlining and accelerating payments, thus ensuring uninterrupted and continuous production of goods and services, stimulating investment activity, demand and consumption. The stability of the banking system is necessary to ensure the effective development of other sectors of the economy and economic growth in general. In this regard, it is important to prevent the occurrence and development of crisis phenomena within the banking system in order to avoid their spread to other sectors of the economy, which, in turn, necessitates the control and optimization of the risks to which it is exposed.

The international nature of banking creates the possibility of its removal to a certain extent from the control of national banking supervisory authorities. In this regard, there was an objective need to coordinate the efforts of the supervisory authorities of various states to regulate banking activities and create an international banking supervision system.

The main task of the Basel Committee is the introduction of common standards in banking regulation. To this end, the Committee develops directives and recommendations for the regulatory authorities of Member States.

Basel III is a response to the global financial crisis of 2007–2009. Analyzing its causes, experts as one of the main reasons identified failures in the prudential regulation of financial intermediaries. The Basel Committee on Banking Supervision (BCBS) has agreed on reforms to "strengthen global rules on capital and liquidity in order to ensure greater banking sector sustainability."

Description of the Problem

The new standards are a reform of capital and liquidity regulation at the international level, aimed at strengthening the banking sector, improving its ability to withstand shocks arising from financial and economic stresses regardless of their source, as well as strengthening banking regulation and supervision.

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While Basel III is in the process of being accepted for execution by national regulatory authorities, the focus moves to the area of implementation - determining the degree of influence on business processes and planning the transition to new standards. Already, there are signs that the implementation of the generally accepted system will have its own characteristics depending on jurisdictions. Although the transition period looks quite long, financial institutions are not recommended to focus only on the deadline for the completion of the implementation scheduled for 2019 - they should be ready to demonstrate stability of capital and liquidity in advance and meet deadlines in the course of implementation.

Thus, it is important to understand how implementation at Basel III will reduce the vulnerability of the banking sector in the Republic of Moldova.

Methodology and Data

The purpose of this work is to study the standards of banking regulation Basel III, the study of the process of their introduction into the Republic of Moldova practice of banking supervision, as well as the forecast and evaluation of the results of their use for the Republic of Moldova banking system. The methodological basis of the article was the legislation and regulations of the National Bank of Moldova. The basic provisions on the principles of modern banking regulation were also used. Scientific articles on the application of Basel standards in Moldovan and foreign banking practice were studied, and the results of economic research conducted by the National Bank of Moldova were used. The following research methods were used: analytical, historical-legal, comparative-legal, predictive.

Results

Banking activities are always associated with a number of risks, many of which are devoted to the study of scientific papers. There are various understandings and classifications of banking risks. From a mathematical point of view, risk is the likelihood of an unfavorable outcome. In economic terms, risk is the level of uncertainty in predicting a result, an element of uncertainty that may affect the activity of a business entity or the conduct of an economic operation; the opportunity to suffer from any form of loss or damage, the likelihood of incurring losses from commercial activities (Lavrushin, 2009, p. 353).

In recent years, an increasing interest in risk management systems in various sectors of the economy has been observed all over the world. It is noteworthy that, in accordance with the results of a study conducted by an international company Ernst & Young, financial risks are recognized as the most significant (Cooper, 2008, p. 22).

Risk management, as a rule, begins with a classification, on the basis of which measures for their optimization are subsequently developed. From this point of view, the most rational is the classification of risks to which institutional financial intermediaries are subject, including commercial banks, proposed by Coopers & Lybrand in the "Generally accepted risk management principles" study published in 1996. In accordance with this classification, the following risks are highlighted: Market risk (stock risk; currency risk; interest rate risk), Credit risk, Operational risk, Liquidity risk, Business event risk (Schinasi, 2005, p. 7). In our days, we can state the importance of systemic risk in the banking sector.

Modern researchers note that the banking sector has the largest share in the financial system of the Republic of Moldova. This problem is relevant not only for our country, but also for the world community as a whole: the Basel Committee on Banking Supervision (BKBN), established in 1975, has been developing the best tools for assessing and controlling risks in the banking sector for a long time. It includes representatives of the largest banks and financial supervisors and regulators of the leading countries of the world. During its existence, BKBN has developed a significant number of recommendations on banking regulation. The standards of banking regulation developed by him in accordance with the adopted agreements can be divided into the following groups:

- 1) the development and introduction of uniform standards, the creation of an international system of banking regulation;

2) development and introduction of criteria and requirements for national banking supervision and regulatory authorities, development of recommendations on the organization of credit and operational risk management systems;

3) the introduction of more stringent requirements for banking capital to ensure the stability of the banking sector and limit the redistribution of risk between different levels of national economies.

The international agreement on capital measurement and capital standards, known as Basel I capital agreement, signed in 1988, contributed to improving the efficiency of financial regulators by developing and introducing new methods for assessing the risk in the banking sector based on capital adequacy requirements. The establishment of mandatory standards for capital adequacy later became the basis of all banking regulation, so the first Basel agreement can be considered the most successful innovation in the practice of banking regulation.

In the course of the practical application of the first recommendations of the BKBN, new areas have been identified that require increased monitoring by the banking supervisory authorities. There was a need to improve the control and risk management systems (credit, operational and market) at both the state and intrabank levels. As a result, the Basel II agreement was adopted in 2004, supplemented in 2006 and 2009 (Basel II.5), which spelled out in detail the requirements for internal control and risk management systems in commercial banks. This document, which includes the basic algorithms for calculating market, credit and operational risks, according to its creators, was supposed to encourage banks to develop their own internal risk management systems. However, he also had "bottlenecks" that did not allow for the full implementation of the innovations envisaged in countries with different levels of economic development. Hidden defects of the agreement that do not take into account all the features of working with derivative financial instruments, off-balance sheet activity and the active use of tools such as securitization indirectly contributed to the development of the mortgage crisis, which later spread far beyond the banking sector.

The purpose of the third agreement (Basel III) was to eliminate the shortcomings of banking regulation, which were revealed by the crisis of 2008–2010. In the new requirements, the emphasis is placed on large, systemically important banks, as their national economies depend on their stability and risk tolerance and the global financial system.

According to the decision of the Basel Committee on Banking Supervision, the proposals for Basel III have two main objectives:

- strengthen international capital and liquidity standards in order to create a more sustainable banking sector;
- improve the ability of the banking sector to cope with the effects of financial and economic crises, thereby reducing the risk of the spread of these problems from the financial to the real economy (Turner, 2015, p.121).

To eliminate the identified deficiencies in banking regulation, the Basel Committee adopted a number of reforms, with the help of which it is planned to enhance the effectiveness of risk management systems and corporate governance in general, as well as to increase the transparency of information disclosed by the bank.

The Basel III standards set new capital requirements for commercial banks and its structure: banks' own funds are divided into two levels. It is assumed that the main burden falls on the capital of the first level, which includes the base and additional capital. The value of the first of them is strictly regulated, its minimum value is 4.5%, it includes the following components:

- 1) ordinary shares;
- 2) retained earnings;
- 3) share premium for ordinary shares.

Also in the calculation of the base capital in certain cases stipulated by the standards of Basel III, adjustments may be made for deferred tax payments, investments in own shares and other assets similar in economic content.

The additional capital of the first level consists of assets combined by a single criterion for converting and writing off for losses; there is no separate minimum value criterion for this indicator, but the standard of sufficiency for the first level capital is 6%.

Basel III provides for the creation of a countercyclical capital buffer and a capital conservation buffer. The first of them is designed to curb credit activity during periods of economic recovery and stimulate it during a recession, the second - to maintain capital at the required level of distribution of profit spending to cover losses during a recession. Modern researchers have noted that the use

of increased capital requirements provided for by new standards has given its results: in the absence of the negative effect on the economy expected by some experts, the banking sector of the euro area (with the exception of Banca Monte dei Paschi di Siena), which now has more high capital stock and more able to absorb economic and financial shocks than it was in 2014 (Turner, 2015, p. 122).

Basel III provides for the use of financial leverage as a regulatory indicator. In this role, there is a leverage - the ratio of basic capital (tier one capital) to assets Bank (assets on the balance sheet, investments in derivative financial instruments, securities financing operations and off-balance sheet accounts). The minimum value of this indicator is set at 3%. The use of leverage allows us to estimate the level of debt burden on capital. From January 1, 2018, this indicator is planned to be introduced for all countries of the Better Community Business Network (BCBN) participants. The standard is intended to curb excessive imbalance between capital and assets and provides an additional level of protection against risk measurement errors, taking into account the overall risk (Lavrushin, 2009, p. 224).

The Basel III standards also include a change in the liquidity requirements of commercial banks. Two indicators are introduced: the short-term liquidity ratio and the long-term net stable funding ratio (the first indicator reflects the bank's ability to continue its operations for 30 days during the crisis period, the second - the bank's ability to function during the year under stressful conditions of restricting capital market access). Modern researchers have noted that there are some contradictions in the mechanism of application of these indicators, which raise doubts about the effectiveness of their application. For example, it is questioned that the instruments included in the calculation of the short-term liquidity indicator have their highly liquid characteristics during the crisis period, when they have to play the role of a certain "safety island" that allows them to hold out in a stressful situation, which complicates the task of evaluating the effectiveness of new tools minimizing the systemic risks of the banking sector and increasing its stability (Turner, 2015, p. 124).

The implementation of the Basel III proposals is divided into stages until 2019, when the completion of the process is expected. The timing of the introduction of new banking regulation standards in a given country depends on the position of the national regulator. The timing of implementation and the basic requirements of the new standards are presented in Table 1.

Table 1

**Minimum requirements for the composition of capital and the period of their introduction
(in% by January 1 of the relevant year)**

Indicators	2015	2016	2017	2018	2019
Equity share	4.5	4.5	4.5	4.5	4.5
Backup buffer	0.625	1.25	1.875	2.5	2.5
Share capital + buffer	4.5	5.125	5.75	6.375	7
Capital adequacy ratio	8.0	8.0	8.0	8.0	8.0
Capital Adequacy + Buffer	8.0	8.625	9.25	9.875	10.5

Source: BIS, 2010.

Under normal business conditions, in a situation where financial institutions are able to assess and predict their risks, a much lower level of capital is required for the stable operation of banks. But in a situation where the risks are rated incorrectly, the recommended "Basel III" "airbag" will be clearly not enough to maintain stability and liquidity. Suppose that if a retail bank did not even work with mortgage loans that collapsed the financial system in 2007–2009, then it could easily face a sharp increase in the percentage of loan default (BIS, 2010).

The establishment of higher requirements for commercial banks in general, and for systemically important banks in particular, leads to the improvement of the banking system and cleansing it of unscrupulous participants, which ultimately will increase confidence in the banking system, including small and medium-sized banks. Increasing confidence in smaller banks will allow the latter to increase liabilities by attracting deposits and expand lending opportunities, which will lead to an increase in financing of real investment projects.

Conclusions

Thus, the issue of fulfilling the requirements of Basel III takes on special significance in the realities of the modern Republic of Moldova economy, in which, against the background of international economic sanctions and the instability of the foreign policy situation, many banks face the impossibility of fulfilling the requirements of the capital adequacy ratio to finance potential defaults. Innovations are aimed at increasing the capital intended for financing outstanding arrears (in other words, first-level capital, which was raised in addition to its value, also due to the formation of a conservation buffer), against the background that the requirements for second-level capital, on the contrary, have decreased.

The purpose of applying the Basel III standards in Republic of Moldova is to bring the banking regulation and supervision of the Republic of Moldova in line with international standards in this area. In addition to strengthening banks' resilience to stressful situations, this will allow the Republic of Moldova banks to increase their credit ratings and be full participants in international financial relations. The development of the banking sector of Republic of Moldova is the key to successful investment and trade operations at the international level.

Future Directions

The new ideology suggests that during the period of the financial and economic crisis or in anticipation of increasing uncertainty in the economy, it is necessary to abandon the ideology of bank capital management and the creation of financial reserves to maintain liquidity and financial stability of credit organizations. These measures will not be able to protect the bank from default and bankruptcy. In times of crisis, prudential supervision also loses effectiveness, since violations of mandatory standards are often not associated with a low level of management or the criminal behavior of the management of a credit institution.

Tighter regulatory measures will reduce risks for the banking system and make it more resilient to external influences. Thus, the National Bank of Moldova, on the basis of agent-based modeling, investigated the impact of increased banking supervision on the structure of the banking system. It was found that in the long run it is more beneficial for the economy than maintaining relatively low regulatory requirements. Conscientious banks benefit from the implementation of tighter regulation policies, healthy competition develops, the financial stability of the banking system increases, lending to investment projects develops, which contributes to economic growth.

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