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REGULATION OF THE BANKING SECTOR – BETWEEN THE NEEDS OF THE MARKET AND THE RISKS OF OVER-REGULATION

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Abstract: *The crises of the 21st century have imposed to rethink the international regulatory and supervisory framework of the banking sector, in order to strengthen the banking risk management and restore trust in the banking system. Basel III came as a response to the global financial crisis of 2008. The compliance to the new international prudential regulatory standards it is considered necessary and beneficial. This ensures the international coherence of regulations, aspect that is so necessary in the age of globalization. Likewise, by complying with the minimum prudential requirements, the temptation to relax certain regulations in "good times" is avoided and thus the costs of a possible crisis is reduced. In the process of complying with international regulations, the authorities must evaluate the costs and benefits of each decision, in order to evaluate the needs of the market, the impact and the potential risks. Likewise, it is important that each regulatory initiative to be clearly communicated to the financial institutions, but also to the general public, in order to achieve the intended effects.*

Key words: *regulation, over-regulation, de-regulation, Basel III, cost-benefit*

JEL CLASSIFICATION: G28 GOVERNMENT POLICY AND REGULATION

INTRODUCTION

The global financial crisis of 2008, followed by the sovereign debt crisis in the European Union in 2012, highlighted the weaknesses of the financial sector, implicitly of the banking system. This required the rethinking of the international regulatory and supervisory framework of the banking sector, in order to strengthen the management of the banking risks and financial crises. (Nucu, 2011)

The crises of the 21st century dismantled the concept of the "invisible hand" enunciated by the economist Adam Smith in the 18th century. According to Smith, the markets have the ability to self-regulate and state's intervention should be limited. Many economists have realized that the society we live in is no longer characterized by that strong moral spirit specific to the 18th century. In our days the bank management has a high risk appetite and letting financial sector to self-regulate is a mistake.

Thus, the concept of the guardian state or the theory of state interventionism supported by the economist John Maynard Keynes is becoming more and more current. Keynes "considers that spontaneous market mechanisms are not sufficient to achieve basic objectives" and that "the state must play a corrective role". (Angelescu, 2012)

The legitimacy of regulation as an act of authority is itself a controversial subject. The question is how far the regulation should intervene, and how the state should intervene.

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BANKING REGULATION – DEFINITION AND OBJECTIVES

We will start by defining some theoretical aspects regarding the banking regulation.

"Banking regulation is defined by the set of laws and norms applicable to banks in their activity". Depending on the reasons underlying their application, three classes of banking regulations can be distinguished:

a) economic regulation - aims to ensure that banks mobilize resources and grant loans under conditions of economic efficiency;

b) prudential regulation - it aims to guarantee the efficient allocation of resources, to minimize the risks that banks assume and to ensure the stability and financial health of each bank and of the banking system as a whole. In other words, the purpose of prudential regulation is to reduce economic regulation (economic deregulation).

c) monetary regulation - aims to maintain the stability of the external and internal value of the national currency, through the control exercised over the total liquidity of the banking system.

THE EFFICIENY OF THE BANKING REGULATIONS

To demonstrate the necessity and benefits of imposing a new regulation, it is important to calculate the efficiency of the regulation. It must be analyzed the costs of establishing and administering the regulation, its benefits, but also the systemic coherence of the regulation. Regarding the costs of the regulation, they must be lower than the benefit brought by the implementation of the regulation. Estimating the effectiveness of regulation it is necessary to take into account not only the financial dimension, but also the social impact. (NBR, 2012)

Coherence refers to the situation when the decision to regulate the banking system imposes (de)regulations in other related areas as well, such as financial and capital markets, consumer protection, etc. Coherence is ensured not only when new regulations appear, but also in case of deregulations. Thus, it is necessary to identify not only the impact of the regulation that will be removed, but also the consequences of the regulations that remain in force. (NBR, 2012)

The internationalization of financial services also requires another type of coherence, between national regulatory regimes. This coherence ensures efficient and coherent management of systemic risks and of regional/global financial crises.

BASEL III – NEW BANKING REGULATORY FRAMEWORK

In response to the crisis that started in 2007 and lasted until 2009, the new Basel III standards appeared. These imposed a more rigorous prudential regulatory framework, new capital and liquidity requirements and new corporate governance standards, being seen by most economists as a re-regulation of the banking sector. Gradually, most countries have modified their national legislative framework according to the requirements imposed by Basel III. They promise to restore confidence in the banking system.

Next, it will be analyzed the main regulatory lines imposed by the Basel III Agreement and the necessity for their implementation.

Capital and liquidity requirements

The stability and safety of the banks and of the entire banking system starts from the capital of financial institutions. A high level of capital adequacy demonstrates the ability of the banks to manage and redistribute available cash flows. (Jora, 2010)

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Thus, Basel III was oriented towards raising the capitalization and liquidity requirements of the banks, in order to increase their solidity and to reduce the risk to not be able to honor their obligations.

What must be emphasized by the regulators is the double effect of these regulations. More equity means more security, but it also means lower rates of return. But, once the function of financial intermediation is essential for the markets functioning, the increase in profitability requires the increase in income; it means the increase in banking services rates. In other words, when society wants more security of financial services, it must also assume a higher cost of them.

Likewise, imposing higher liquidity thresholds means less financial intermediation activity. Institutionally speaking, it is a reduction of the social function of banks. Economically speaking, it's a reduction in the financing of the real economy, therefore a reduction in economic growth, thus making it more difficult to get out of the recession. In other words, if we want more liquid banks, we will have lower risks of not being able to withdraw our deposits whenever we ask for them, but we will bear the cost of a reduced economic growth. (NBR, 2012)

- **Lending regulations**

The re-regulation of the banking lending refers to the introduction of limits and conditions in lending. The purpose of such regulations is to ensure economic growth, or this is the public interest purpose of financial intermediation. Lending means, or at least should mean, the full cycle completed with the repayment of money. That lending is likely to support the recovery of the economy. It is in the public benefit and in the private benefit of the parties not to stimulate the granting of unsustainable credits, because this deepens the recession, by wasting resources.

The criteria are usually established at the national level, and can aim at limiting a person's total indebtedness, introducing more drastic criteria regarding the advance and duration of a loan, respectively stressing the ability to pay installments depending on income risk, interest rate risk and foreign currency risk. (NBR, 2012)

- **Regulations regarding business ethics and remuneration mechanisms**

If previously business ethics was considered an individual, religious or secular cultural dimension of the trader, and that the remuneration mechanisms belong to the self-regulation of the market, the abuses of bank managers and the imbalances induced on the market by these abuses have changed the vision of the regulators. The classical vision according to which the trader's activity on the market will usually be ethical because otherwise the market would reject him has proven to be an erroneous one.

Bonuses established according to such a criterion as the volume of loans granted, regardless of their risk of default, can generate serious crises. Thus, it was necessary to introduce regulations by which bankers' incentives and bonuses to be linked to the long-term interests of the institution, by relating them to the bank's longer-term performance. (NBR, 2012)

- **Regulations regarding the macrostability**

The National Bank of Moldova defines financial stability as "the state of the economy characterized by the absence of major imbalances, which could lead to systemic crises, to the inability of the financial institutions to carry out uniform operations or to the collapse of financial markets. This condition is essential for the functioning of the national economy. Financial stability is maintained by regulating current and potential risks, implementing macro prudential instruments to prevent the accumulation of systemic risks and by ensuring the population's trust in the financial system." (NBM, 2019)

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The retrospect of the crises from different countries and different times shows that, of all economic crises, banking crises leave behind the highest levels of public debt. Thus, it is considered that the prevention of financial instability is less expensive option in the medium term than leaving the evolution to the rules of the market. This involves the application of various preventive intervention tools on banks whose situation risks is unsustainable, such as last-resort financing, capitalization, takeover on the market or transfer of assets and/or liabilities, creation of bridge banks, temporary nationalization. All this presupposes important decisions regarding the source of financing - shareholders and obligors, the banking industry or the public budget, as well as the establishment of better corporate governance mechanisms - the rescue is done to re-launch the business, and not to lead it to another bankruptcy. (NBR, 2012)

In conclusion, the new Basel III Agreement aims to strengthen the stability of the banking system, by applying demanding standards aimed to improve the capacity of the banking system to absorb shocks from the economic and financial sector, as well as to reduce the risk of contagion from the financial sector to the real economy. (Walnut, 2011)

"The new standards are aimed to improve risk management, increasing the transparency and publication requirements for the banks, as well as solving the problems of the systemic banks. The measures impose, first of all, more demanding standards for banks regarding capital adequacy, liquidity requirements and leverage, the main aim being to reduce the negative effects of financial crises." (Walnut, 2011)

The major difference compared to the previous agreements is represented by the much expanded scope, the measures being both micro-prudential (targeting the individual risks of the banks) and macro-prudential (targeting the entire banking system). (Walnut, 2011)

Alignment with the requirements of European Union regulations requires the Moldovan banking system to move from compliance-based supervision to risk-based supervision. The domestic banking sector requires a systemic coherence of NBM regulations and a strengthening of its intervention capacities. Licensed banks must strive to reduce the risks of non-compliance and be prudent in their business decisions and strategies.

BUSINESS CYCLES AND REGULATORY DECISIONS

Economists K. Rogoff and C. Reinhart made a statistic of numerous economic cycles that took place throughout the world over the last centuries. It is noted that "the prudential regulation-deregulation cycle overlapped with long economic cycles worldwide. After the Great Depression of 1933, there followed a long period of regulation until the early 1970s, the main landmarks being fixed exchange rates, the Glass-Stegall Act in the United States, which provided for the separation of the activity of commercial banks from that of investment banks and the establishment of guarantee schemes of deposits." (NBR, 2015)

In 1971, amid the gold crisis, the international monetary system switches to floating exchange rates. Thus, a phase of deregulation is entered, by applying the principle of free markets. The main landmarks of this period are given by the liberalization of the London financial market and the repeal of the Glass-Stegall Act in the USA, along with the adoption of legislation that allowed the formation of financial conglomerates in America. The end point of this period was the Great Recession of 2007. (NBR, 2015)

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In 2009, the Korean economist Joshua Aizenman presented an interesting approach to the regulation of the financial sector, considering both over-regulation and de-regulation as paradoxes of financial regulation. Because de-regulation is usually done in "good times" and over-regulation comes after crisis situations, it turns out that de-regulation can very often turn into over-regulation. In Aizenman's view, excessive, rapid de-regulation, or increasingly relaxed regulations over a long period of time, can increase the costs of a potential crisis. "Enforcement of minimum standards of prudential regulation and disclosure will lead national regulators to refrain from excessive de-regulation in good times” argues Joshua Aizenman in his paper. (Aizenman, 2009)

Thus, it is important that the banking regulation to be analyzed not only in the context of actual financial circumstances or in an extreme financial circumstances. The regulatory process must be aimed at obtaining an improved legislative framework, aimed at increasing confidence in the sector, orienting financial intermediation, strengthening the stability of the financial system by reducing systemic risks, protecting consumers and reducing financial crimes.

CONCLUSION

Although we are in an era of the market economy and private property, and the lack of state interference in the economy is an important value of democracy, the economic crises of the past years have led supervisors to intervene. The current crisis raised, against the financial environment, a whole series of ethical accusations, and claimed the authority to regulate what had been considered the founding value of capitalism, but seemed to have been lost.

However, because over-regulation often slows down the financial intermediation, the bankers see it as a risk for their activity. Thus, although de-regulation trends are attested in the financial sector, it is important that all decisions are passed through the cost-benefit analysis and examined from the perspective of different scenarios.

To avoid over-regulation, regulators analyze European directives from the perspective of needs and relevance for the local market. But it is important to respect the minimum prudential requirements imposed by the international framework, otherwise there is a risk that the relaxation of regulations in the "good times" will lead to a crisis with a possibly much higher cost.

It is important for regulators to determine the cost of new regulations and to communicate the need and long-term benefit of these regulations to the society and to the targeted financial actors. Likewise, the consistency is required when it is decided to impose new regulations or to de-regulate the sector.

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