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Regulations Regarding Financial Stability for Banking System

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Abstract

Taking into account the significant transformations that financial systems have suffered, we may say that financial stability stands for one of the latest challenges of the contemporary economies. From this point of view, my paper deals with a brief synthesis of conceptual approaches on financial stability, as well as on the European and national framework for financial stability regulation. Besides, I highlight the importance of the financial stability measures stipulated by the regulations in force.

Keywords: Economic Stability, Financial Stability, Prudential Regulation And Surveillance, Monetary Policy, Systemic Risk, Risk Of Exposure, Bridge-Loan Bank

Financial Stability. Conceptual Approaches

Economic stability implies avoiding too large oscillations upon economic activities, high inflation and excessive variability of exchange rates and financial markets. Such instability may cause uncertainty and discourage investment, impede economic growth and development and it can affect social welfare.

The concept of financial stability is a complex one. Literature and economic practice have not shared yet a common opinion on financial stability.

Thus, some authors¹, such as J. Chant considers that “ financial instability refers to the outlook of financial market that affect or threat with affecting economic performances through their impact on the financial system. Moreover, A. Crockett defines financial stability as “the absence of instability”, more precisely as “a situation where economic performance is not potentially impacted by asset price fluctuation or the incapacity of financial institutions to fulfil obligations”. F. Mishkin considers that “financial instability occurs when the shocks from the financial system interferes with the flow of information in such a way that the financial system is no longer able to perform its functions and to harness its resources towards the most productive destinations”.

As for the National Bank of Romania, in the Report on the Financial Stability, drew up for 2006, defines financial stability as “a feature of the financial system that enables it to face systemic shocks

¹ Cerna S. et. al. (2008). “Financial stability”, Universitatii de Vest Printing House, Timisoara, p. 9.

on a durable basis and without major damages, to allocate efficiently financial resources in economy and to identify and successfully manage all the risks ”.

Financial Stability Indicators

In literature, there are a range of indicators of analyzing and assessing financial stability.

Thus, the external sector distinguishes itself through: the flow of capital, public debt, total external debt, real exchange rate, trade balance, the rate of economic growth, interest rates etc. For the financial sector, we have: growth of credit volume, the variation of the monetary multiplier, loans received by banking institutions from the Central Bank, efficiency of securities, inflation rate etc.

Among the multifarious systems of indicators highlighted in literature, the following ones prevail:

- system of indicators conceived by IMF (*Financial soundness indicators*);
- *stress-tests*;
- early warning systems);
- other quantity methods of analysis and assessment of the financial stability.²

The system of indicators elaborated by IMF is the so-called *Financial soundness indicators*” (IMF, World Bank, 2003; IMF, 2006). This system was conceived to provide a macroprudential analysis in order to strengthen financial stability.

As indicators of financial stability according to IMF, macroprudential analysis uses such indicators as: capital adequacy, asset quality, incomes and profitability, liquidity, sensitivity to the market risk, difference between active and passive interest, difference between the maximum interbank interest and the minimum one.

In regard to macroprudential analysis, financial pressure resistance tests are used. The tests are tools designed to analyze the financial system from the *forward-looking* perspective to be able to assess the impact of the uncertain macroeconomic phenomena. Thus, resistance tests of contribute to increase the effectiveness of the prudential supervision. In this context, there are used the following indicators of the banking caution: capital adequacy, equity, stability, quality management, and gain profitability, liquidity and sensitivity to risk.

Together with the financial stability indicators, resistance tests are also used in order to assess the impact of potential shocks on health financial systems.

The advantages of using tests of strength and financial stability indicators reflect the risks related to the market, such as: interest rate related risk or the risk of the exchange rate.

Early warning systems make a synthesis of the necessary data to identify the credit institutions that are exposed to risks, thus forecasting possible crisis during certain future period.³

Crisis simulation (stress-test exercise) stands for the evaluations of the financial situation of a bank when identifying certain severe risk facts that could affect financial performance, capital volume, and, worse, even its existence (Bank of International Settlements, 2009).

The current financial crisis has revealed some errors in stress-test systems of banks, in four areas:

- The way of using crisis simulations and their integration in the operative management of risks;
- methodology of used crises simulations;

² Cerna S. et. al (2008). “*Financial stability*” Universitatii de Vest Publishing House, Timisoara, p.79.

³ Lutton T. (2006). “*Early Warning Systems*”, IMF-NBR, Seminar on Financial Stability Issues”, Romania, November 7-9.

- used scenarios;
- crises simulations related to certain risks and banking products.⁴

Approach on Financial Stability in Romania

The National Bank of Romania plays an intrinsic role in maintaining financial stability, considering its responsibilities as prudential monetary authority. In this context, BNR accomplishes its tasks both by regulating and prudentially monitoring the institutions under its authority, as well as by setting up monetary policy measures and efficiently operative systems of payments and reimbursements.

At the same time, it is necessary to identify risks and vulnerabilities of the financial system, as the appearance of systemic malfunctions and an incorrect assessment of the risks and inefficient allocation of capital can disrupt the stability of the financial system and economic stability.

The European Systemic Risk Board (ESRB) defines systemic risk as “the risk of disruption to the financial system that can generate serious negative consequences for the internal market and the real economy.” The severity of systemic risk is evaluated by quantifying the impact on consumption, investment and economic growth.

Systemic risk refers to the risk of exposure generating unexpected macroeconomic shocks, and the risk of propagation of effects caused by the increase of imbalances over time. Exposure refers to the wider spread of an idiosyncratic and exogenous shock, out of the financial system.

A challenge to the financial stability of Romania lies in the existence of the risk of disturbing the evolution of process related to financial disintermediation in the European financial loan institutions which affects the financing of the real sector of economy.

The sovereign debt crisis has had considerable influence on limiting mutual exposures between credit institutions, which has led to an imbalance related to the liquidity of the system of distribution.

Another risk to the financial stability of Romania is the slow economic activity performed in the foreign trade partner countries. The economic sluggishness in the European Union is influenced by the tax adjustment measures on economic activity, which is reflected in the slow economic growth.

Evolutions of the European Framework for Financial Stability Regulation

The European Union's requirements related to the management of financial crises have imposed the existence of an agreement for cooperation between the Central Bank, the Ministry of Finance and the national authorities entitled to supervise the financial system to prevent and manage potential problems with systemic impact. Subsequently, after signing the agreement for cooperation in the field of financial stability and crisis management (2007), the National Committee for Financial Stability has been established.

In order to maintain financial stability and resume sustainable economic growth, the coordination of economic policies has been reconsidered as follows: strengthening public finance sustainability, strengthening financial support at the European level, and increasing the flexibility of European funds (European Financial Stability Facility).

⁴ Negoita A. (2010). “Rolul simularilor de criza (scenariilor de stress-test) in activitatea de management al riscurilor si in evitarea unei noi crize”, *Economie teoretica si aplicata*, Vol.XVII, nr. 2(543), pp. 5-24.

Solvency II Ordinance represents a project of harmonization at the European level of the evaluation standards related to the capital demand and risk administration demand for insurance companies.

For Romania, the implementation of Solvency II could not generate any turbulence in the financial markets or the banking system, because the credit institutions do not attract financing through debt securities on the capital market.

CRD IV package includes both a proposal for a regulation concerning the prudential requirements of credit institutions and investment firms, as well as a proposal for an Ordinance on the access to the credit institution activities as well as their cautious supervision.

The tools required by CRD IV are:

- National adjustment of the requirements of capital related to the loans secured with real estate;
- Raising requirements for additional capital with Pillar II;
- Establishing capital reserves for covering macroeconomic risks.

CRD IV package refers to the adoption of some **standards of unitary liquidity** within the European Union: LCR (Liquidity Coverage Ratio) and NSFR (Net Stable Funding Ratio).

Regulation of the Legislative Framework Regarding the Financial Stability in Romania

The legislative framework applicable to credit institutions was filled by the introduction of stabilization measures that can be adopted by the Central Bank in the case of banks in difficulty.

Thus, in 2012, the existing legislative framework through G.O. 39/1996 related to establishment and functioning of the FGDB, edited and completed by G.O. 1/11.01.2012 regarding the modification and completion of some legal acts in the field of credit institutions; E. G. O. No. 99/2006 concerning credit institutions and capital adequacy has been completed with the introduction of stabilization measures as tools that the Central Bank can use under the terms of the potential risks related to financial stability.

The Measures for Financial Stability⁵ are:

- Total or partial transfer of the assets and liabilities of an credit institution to one or more eligible institutions;
- Involvement of Deposit Guarantee Fund in the Banking System (FGDB) as delegate administrator or shareholder;
- Transfer of assets and liabilities from a loan institution to a bridge loan bank that is constituted for this purpose.

In accordance with the new legal provisions, the bridge loan bank is a credit institution having as sole shareholder the FGDB that is constituted to take the assets and the liabilities of the credit institutions in difficulty, then later on being sold to a third party, accepted by the NBR. Thus, the bridge loan bank must ensure the maintenance of a low risk in performing its activity, and an eventual extension will be cautiously performed.

Starting with the international financial crisis and up to the present, the Romanian banking system has maintained stable being well capitalized and owning important reserves of liquidity. NBR has hardened prudential supervision and regulation so that in Romania it was not necessary to use

⁵ Report on financial stability, NBR, 2012.

public funds to support banks in difficulty. During this period, recapitalizations were consistent, which means bank liquidities about 325 million euro in 2009, 650 million euro in 2010, 280 million euro in 2011 and 550 million euro in the first half of 2012.

Conclusions

Financial stability is the result of the appropriate attitude towards market conditions (mainly economic actors-shareholders, managers) and regulatory, micro-supervision and macro-prudential authorities. Ensuring financial stability is a natural concern, and lately a priority for central banks, which is located in the heart of the financial system.

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