THE LIMITS OF BASEL II ACCORD

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Even though the present Basel II Settlement has many advantages like: more transparent and detailed bank information, the rating systems, the internal models of evaluation for risks, the three pillars which represent a whole, an equitable bank competition, the actual financial crises revealed the limits of Basel II framework. The disadvantages of Basel II Accord revealed by the international crises can be: the internal rating method of risks evaluation is so complex, that is very difficult to be applied by countries in East and Central Europe, the responsibilities for bank supervisors are very high and the capital markets are full of innovations, Basel II is more sensitive to risks than Basel I, but not enough, because reputation risk, systemic risk and strategic risk are not operational risk. This paper analyses these shortcomings, the economic effects of the nowadays financial crisis and also the necessity of a new Basel III, which has to include more risks.

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In general the banks don't have to engage in transactions, in which the risks can not be identified and controlled in an efficient manner. Each risk an institution of credit deals with must be identified, supervised and limited its' effects.

In the 1980s, because of the critical changes of interest rates, produced by the inflationary process and by the energetic crises, because of the significant changes of the exchange rates after the abolishment of the Bretton Woods system and because of the intensification of competition on the financial services market, the instability becomes a characteristic of the environment in which the banks are operating. In this new situation, the bank's vulnerability and the number of bankruptcy increases. The Basel I Accord in 1988, emerged because of the banks insolvency in the 1980s, has lead to the banking system's recovery on the account of the minimum capital adequacy. The Accord has also concurred to the international banking system's stability due to the harmonization of international banks' practices and because of the elimination of disloyal bank competition. The stipulations of Basel I Settlement didn't have an imperative character, they were just merely given as a guide, but they were adopted by the majority of banks.

The risks on the international market are evolving and they are affecting the banks' activity, in 1996 the Basel I Settlement was amended by the incorporation of market risk next to the credit risk in estimating the adequacy capital.

The Basel II Accord adopted in 2004 has a more flexible character, offering to the credit institutions the freedom to choose their own methods of risk evaluation, but conserves the key elements of Basel I Settlement, respectively the minimum of 8% capital adequacy.

The Basel II Settlement has many advantages like:

- the credit institutions take into consideration the operational risk next to the credit risk and market risk;
- the global risk approach;
- the internal rating systems;
- a market discipline based on the transparency principle and a detailed reporting offering relevant, credible, opportune, comparable and comprehensible information;

- an increased competence for supervision authorities;
- the creation of a solid bank industry;
- contributes to the harmonization of bank practices between East and West Europe;
- an equitable bank competition;
- the three pillars represent a whole unit;
- the internal methods of risk evaluation determine, that the weighting coefficients with which every risk asset is being evaluated, are not the same for the whole banking sector, but the are being established individual, by each institution, so that the risk is evaluated much more accurately, and the situations in which capital requirements are overestimated are being eliminated. So the banks will have more money for giving credits, and they will have to make up fewer reserves.[388]

The Basel II Convention introduces in the standard approach of credit risk *an accessory forfeit* for credits given to the institution with an inferior rating. So, if the Basel I Accord the minimum requirement was 100% from the exposure, in the Basel II for B – ratings the weighting coefficient is 150%. *The exposure classes and the weighting coefficients for credit risk increase from 4 to 8 categories*: 0%, 10%, 20%, 35%, 50%, 75%, 100%, 150%, which allows to detect more accurately the credit risk based on the nature of investment for each bank. The weighting coefficients for each risk do not depend only on the class in which is being placed the exposure, but also on the credit quality, determined by the ratings given by the external evaluation of credit/clients institutions.[389]

The banks, which will make the most of the New Settlement will be the ones that seriously invest in the risk management and the ones that know to choose the right risk management method based on the result of analyses made. In other words, the promotion of the internal risk management models will represent the banks' success key in developing the credit activity and managing the risks.

The implementation of Basel II Agreement has revealed its' limits, like[390]:
- the implementation implies high costs regarding the training of staff, IT, especially for countries in Central and East Europe;
- the discrimination between bank (small and large banks);
- fewer loans for countries in the transitional period, especially for banks and companies with low rating;
- the increase of the bank concentration degree through fusions and acquisitions between banks in the system;
- the variation of interest based on the quality of the credit applicant.

Due to its' complexity, the IRB method becomes very difficult to implement for banks, which don't have a superior level of "culture" in credit risk management, so the standard approach appears to be the only credible option for banks in Central and East Europe. "In Romania this process is easier because the whole banking system is owned by West Europe Banks, which passed this test, so they will be able to facilitate the transition of the subsidiary to the new capital requirements. In some cases the mother banks will provide their own internal risk evaluation models."[391]

"The main shortcoming of Basel Committee Settlements, known as Basel II Accord is to suggest solution for bank capital adequacy, based on the risk profile of bank's assets starting from a given situation of credits, which a banks has in its portfolio. Another approach which can help banks to protect themselves against credit risks is based on a thoroughness company's analysis and not on

388 http://www.sfin.ro/articol/bancile_ezita_sa_treaca_la_basel_ii.html?

389 Economic Tribune number 28 of 16th July 2008, pag. 81-82

390 Ana Popa, Laura Giurcă Vasilescu, The Possible Implications of Introducing Basel II in Romania, The Annals of University of Oradea – Economic Science, 2005, Section Finances-Accountancy-Banks, pag. 280

391 http://www.sfin.ro/articol/bancile_ezita_sa_treaca_la_basel_ii.html?

adequacy of capital to the risk profile of bank assets considering the necessary cash-flow, the necessary of liquidity established by mutual agreement for the repayment of credit and interest, taking into account two components: **depreciation and net profit.** The relation between self-financing and the necessary cash-flow constitute a necessary premise for the protection consolidation against credit risk, for the bank and also for the company, their main concern being the repayment of credit and interest and the owners to achieve the expected gain." [392]

The second Pillar of Basel II Agreement called supervisory review increases very much the responsibility for the financial supervisor. The supervisors must examine the methods used by bank to record, process and monitor the relevant information. As the banks have the freedom to choose their own strategies, also the supervisors have the power to refuse them, based on their own judgment. This may lead to a conflict between supervisors and banks. Beside that, the second Pillar implies a huge qualification for supervisors, in the condition in which the capital markets are full of innovations. "In fact, given the present ability of banks to generate and introduce financial innovations constantly, supervisors will have to be permanently updating and upgrading their skills"[393]. Implementing Basel II in developing countries will encounter many obstacles, maybe the most important will be granting the supervisors enough freedom, resources and competence.

The rating agencies were born in The Unites States of America at the end of 19th century and the beginning of 20th century, and the most famous are Standard and Poor's, Moody's and Fitch IBCA. Another deficiency of Basel II is the placement of rating agencies in the center of the new regulation of risk management, which doesn't represent the optimal solution, even though it seems the most viable at this moment. I say this because the presence of rating agencies in Europe has developed in the 1990s, recently compared to USA. In countries in Central and East Europe the presence of rating agencies was felt after the fall of the communist regime, but they are few compared with countries in West Europe.

Mugur Isarescu the governor of National Bank of Romania in the presentation *Nine Lessons from the Nowadays Financial Crisis* presented on 14th of April 2009 asserts the following: "The global crisis has its origins in The United States of America on the mortgage market, being triggered by the sub-prime loans crisis. The exuberant liquidity together with the financial disintermediary, excessive deregulation have led to the present financial crisis. The consequences of this excessive liquidity have been the low interest rates and their low volatility, so the appetite for assets with high benefits has increased. Therewith appears a weaker lookout of the market investors. The degree each economy is affected by this crisis depends on its vulnerability. The nine lessons to be learned are:

1. *The low level of inflation does not represent an enough condition for the assurance of financial stability on long term.* Usually the crisis is triggered by a high inflation, the main source of financial instability. The exception consists in that the present crisis appeared after two decades of low and stabile inflation, which coexisted with excessive liquidity. So the financial intermediary model has changed from *originate and hold to originate and distribute.* The monetary policy, regulation and financial supervision must pull together efficiently, which hasn't happened in the last years.
2. *At certain periods regulation and supervision fall behind the markets.* The markets always find a way to innovate because the economic agents are always competing with each other for satisfying a real need. The innovation process is so dynamic and sophisticated, that the ones who regulate and supervise the markets can fall behind.

392 Marcel Ioan Boloș, The Consolidation of Credit Risk Protection in Banks – The Necessary Ratio of Cash-Flow Banks – Companies Self-Financing, pag. 1-25

393 http://www.ie.ufrj.br/eventos/seminarios/pesquisa/basel_ii_a_critical_assessment.pdf

3. *In the European Union are missing some institutions.* The EU should create a new institution The European Risk Systemic Council, which purpose should be to collect information regarding risks and macro prudential vulnerabilities from each financial sector of EU. The Council will issue warnings about risks and will adopt recommendations of economic policy. Another institution is The European System of Financial Supervision with three authorities: The European Bank Authority, The European Securities Authority and The European Insurance Authority.
4. *The financial incentives in private companies are not correlated with risk management.* The financial incentives should be better correlated with shareholders' interest and the whole company's profitability on the long term.
5. *People forget about crisis in the heyday and neglect the creation of crisis management mechanisms.*
6. *International Monetary Fund has given a huge role, after being criticized for not foresee the Asian Crisis.* The nowadays financial crisis reveals that in difficult moments we need an institution, which has an imagine of each economy on the globe. The IMF has an experience for at least five decades in investigating the members' economies, today 185 countries, and this experience is not easy to accomplish.
7. *The expansion measures must be accompanied from the beginning by exit strategies.* The launching of anti crisis measures must be accompanied by the creation of credible exit strategies, which are necessary now for assisting the financial sector and launching again the global demand.
8. *It is important avoiding macroeconomic disequilibrium and following a sustainable economic growth based on a substantial degree of structural reforms.*
9. *The Euro Adoption can not be substituted by adjusting policies.*

The last two lessons are for emerging economies."

The present financial crisis demonstrated that the banking system has not been well capitalized, there has not been enough banks to absorb the capital losses of bankruptcy institutions. The response of USA and Great Britain Government demonstrated the existence of capital deficit.[394]

"The effects of international crisis have expanded over the Romanian economy. However, considering the direct impact, the banking system was less affected because is has not been exposed to toxic assets, also due to the administrative and prudential measures implemented by The National Bank of Romania. Indirectly the international financial crisis, and especially its consequence – the recession in developed countries – has expanded over the economy in Romania through many channels. Through the commercial channel, the export slows down. Through the financial channel, the access to external financing is limited, so the credit load is restricted and appear difficulties in external private debt service. Through the exchange rate channel, the cutting down of external finance is being reflected in devaluation of national currency. Through the trust channel one can see the withdrawal of investors from East Europe countries. The effect was the panic moments and the speculative attacks on the monetary-currency market, like the ones in October 2008 in Romania, which needed the NBR's intervention."[395]

The Basel II Agreement in the context of the global financial crisis is better than Basel I Agreement, being more sensitive to risk, but not enough. The Basel II Accord takes into consideration a new risk, the operational risk. Basel II defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, including legislation risk. The shortcoming is that reputation risk, systemic risk and

394 http://www.asil.org/files/atik.pdf

395 Mugur Isarescu, International Financial Crisis and Challenges for The Monetary Policy in Romania presented on 26th of February 2009, pag. 1-11

strategic risk are not operational risk, so they are not taken into consideration, even though they are striking on the capital markets.

Another critique regarding the Basel II Accord refers to the large banks and financial aggregations, which adopt advanced capital adequacy approach will have greater benefits than small banks, constrained to apply the standard approach for capital adequacy. The foreign banks in developing countries by applying Basel II Agreement will give loans to the most solvent debtors, and the other debtors with a less attractive situation can borrow money from local banks. This aspect can create problems for SME in accessing loans. [396]

In the article *International Financial Crisis and Challenges for The Monetary Policy in Romania* presented on 26th of February 2009 Mugur Isarescu affirms that: "On the short term the main challenge is finding the solutions to reestablish the trust of investors and consumers. On the long term, the main challenge is to adjust the principles which guide the international financial system reform, regarding transparency, improving the regulations for security accountancy, the assurance of adequate market, companies and financial products settlements, the assurance of financial markets integration (regarding market handling and fraud) and intensification of cooperation between world's financial institution (the modernization of management structures of IMF and World Bank)….In Romania, the answer to the contrary effects of crisis can not be similar to the one on the other European countries or to USA. There are a few differences between the Romanian economy and these economies, which not allow the copy of measures implemented there. The Romanian economy has a deficit of current account, which indicates the dependence on external finance."

To pass well over the international financial crisis, a leverage ratio should be added to Basel II Accord. "This leverage ratio should be applied as a complement to the risk-weighted capital requirements. It ensures a minimum capital buffer that protects banks against unexpected losses and underestimation of risk. As we have learned from the current crisis, the failure of risk models may quickly turn banks that seem comfortably capitalised into poorly capitalised banks. Adding a leverage ratio to Basel II will reinforce banks' capital and strengthen capital regulation." [397]

The current global crisis has proved the limits of Basel II Accord. In my opinion in the nearest future the talks will be about a new agreement, maybe a Basel III, which has to take into consideration more risks that affect the banking system. Other risks can be: liquidity risk, as we know this risk can easily cause insolvency and the interest rate risk. Why these two risks, can we ask ourselves?

The answer is simple: thanks to the international financial crisis we face a lack of liquidity. The banks have problems in the repayment of loans, they are being forced to make many echelons and modifications for the date of payment for loans. The initial plans for banks, when the credits were given have changed. As a precaution measure in October 2008 the credit rhythm in Romania was significantly reduced. Many banks were forced to increase their operation commissions or to introduce new ones in order to compensate the lack of liquidity.

The financial crisis has contributed to the creation of a vicious circus: the banks haven't given credits so easily, and the companies confronted themselves with problems in collection of receivables. The firms couldn't borrow loans in a short time, they couldn't pay their providers on time, and also the liabilities to the budget, many seizures were introduced, and may providers faced insolvency. In Bihor county can one notice the slow rhythm of development for real estate projects, and the bankruptcy of societies.

Nowadays we face unemployment. One can also notice the efforts of National Bank of Romania, which tries to maintain the financial stability, the inflation, the exchange rate. In the spring of

396 http://www.ibase.br/userimages/FLGG%20-%20Mario%20Tonveronachi.pdf

397 http://fmg.lse.ac.uk/upload_file/1147_Hildebrand.pdf

2009 the loans were launched, but the credit conditions are pretty tough (high commissions and interest rates, a closer client monitoring, a very good financial situation).

Another risk which Basel III has to take into consideration is the interest rate risk. In general in the credit contract the interest rate in variable. Nowadays there are few banks, which accept a fix interest rate in the credit contract. Why I say this? The situation on the global market determined an increase in the cost of resources, so the interest rate risk has increased. The interest is formed form the cost of resource and the risk margin. No bank will accept an interest lower or equal with the cost of resource.

The fame of o bank once gained is does not represent a risk, but loosing that fame can turn into a risk any time.

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