University "St. Kliment Ohridski"-Bitola
Faculty of Security-Skopje

INTERNATIONAL SCIENTIFIC CONFERENCE

RESEARCHING SECURITY: APPROACHES, CONCEPTS AND POLICIES

Volume V

Skopje

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www.fb.uklo.edu.mk

ISBN 978-608-4532-77-4

МЕЃУНАРОДНА НАУЧНА КОНФЕРЕНЦИЈА

БЕЗБЕДНОСТА КАКО ПРЕДМЕТ НА ИСТРАЖУВАЊЕ - ПРИСТАПИ, КОНЦЕПТИ И ПОЛИТИКИ

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2-3 Јуни 2015, Охрид

Том V

СКОПЈЕ, 2015

INTERNATIONAL SCIENTIFIC CONFERENCE

RESEARCHING SECURITY: APPROACHES, CONCEPTS AND POLICIES

2 - 3 June 2015
Ohrid, Republic of Macedonia

Volume V

SKOPJE, 2015

Издавачи:
Универзитет „Св. Климент Охридски“ Битола
Факултет за безбедност – Скопје

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Печати:
АД „Ван Гог“ - Скопје

Адреса на издавачите:
Факултет за безбедност
1000 Скопје
П. Фах 103
тел: 022546211

Универзитет „Св. Климент Охридски“
1ви Мај б.б.
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тел: 047223788

Publishers:
University “St. Kliment Ohridski”- Bitola
Faculty of Security- Skopje

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Print:
“Van Gog” - LTD Skopje

Address of the Publishers:
Faculty of Security
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GLOBAL SECURITY AND SECURITY COOPERATION

UDK: 338.23:336.74]:336.71.078.3(497.7)

REDEFINITION OF MACROECONOMIC AND MACROPRUDENTIAL POLICY AND BASEL III CONCEPT

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ABSTRACT

As an essential tool proceeding the objective function in the period before the global economic crisis (2008), the focus of central banks and monetary policy has been to provide price stability over the policy interest rate. This led to emphasizing the role of the credit channel on monetary policy impact of the economy through the quantity of reserves and return-bank credit to the real sector. The exception to this rule was the policy of double pillar of the ECB, which paid special attention to the amount of credit in the economy. The regulation and supervision that were focused on individual financial institutions and markets as well as measuring their impact on the funding stability, were largely ignored. Given the enthusiasm for financial deregulation, the usage of prudential regulation for countercyclical purposes was considered improper interference in the functioning of credit markets. Simultaneously, with the positions of sharp political limitations, the power of the impact on fiscal policy was substantially underestimated. The global economic crisis has imposed the need of reshaping the macroeconomic policy. According to the determined objectives of macro-prudential regulators, macroprudential elements which are infiltrated in BASEL 3 concept are necessary to be fully implemented by the end of 2019. This paper, through the methods of induction and deduction, historical analysis and the comparative method, provides an overview of the latest developments in macroeconomic and redefined macroprudential policy, offers proposed measures and tools for

operating the criteria of Basel 3, and illustrates the case of Republic of Macedonia in compliance with the aspect of the banking sector with the new capital standards of Basel 3.

Key words: *global economic crisis, central banks, monetary policy, fiscal policy, regulation, supervision, interest rates, credit channel.*

1. INTRODUCTION

Economic thought, within numerous panel discussions, theoretical and empirical analysis, underscores that pro-cyclical behavior of financial institutions is recorded, especially the banks. In fact, financial institutions take greater risk during economic booms and later, in periods of economic downturns become too aversive to risk, which displays their pro-cyclical impact. The existence of moral hazard and simultaneously the idea that some financial institutions are too big to fail, and the recorded failure of the institutions to recognize the broader negative externalities of their behavior, do not lead to the need to redefine the macroprudential and macroeconomic policy. In the past six years, macroprudential policy is trying to deal with the definition of the level of capital rates that financial institutions will have to keep in their reserves, as well as other capital requirements aimed at financial institutions that take too much risk; with the challenge to co-ordinate traditional politics and the available regulatory tools in the best possible way; and with the need to design better automatic stabilizers. And still the ultimate goals are in direction of achieving stable output gap inflation (Blanchard et al., “Macroeconomic Policy”). ECB recently launched Macroprudential Research Network (MARS) aimed at establishing a conceptual framework, models and tools that will improve the macroprudential supervision in the EU.

2.DEFINITION AND OBJECTIVES OF MACROPRUDENTIAL POLICY

Most of the macroprudential tools are related to the regulation of banks' capital but it is important to highlight the fact that most of short-term debt in the obligations of the banks has been identified as a major source of vulnerability. (Brunnenmeier et al. “Financial Regulation”). The main objective of macroprudential policy is limiting systematic financial risk through analysis of the financial system as a whole and its interactions with the real economy and managing a set of prudential tools and instruments that are specifically assigned to the macroprudential authorities. Two goals for macro prudential framework can be distinguished: 1) to increase the resilience of the financial system and 2) to limit the growth of financial cycles. To achieve the first objective, it is necessary during the boom to build buffers that would be put into operation during recessions. For achieving the second objective it is necessary that the created buffers act automatically for limitation of the amount of credit and price boom in the expansion as well as their increase during the recession. Observations are that the capital created buffers will have to increase significantly before they can refrain from credit expansion, because the capital is plentiful and cheap in good time, i.e. in the period of economic expansion and vice versa. During the period of boom, the financial system can miss the chance to build up enough capital and liquidity buffers, although during this period it is an easier and less expensive thing to do. For this purpose, macroprudential strategy will have to rely on the strengthening of existing policies and instruments, in order that they can effectively and sustainably limit credit growth and asset price boom. For this purpose it is necessary that monetary and fiscal policy complementary and proactively play their role.

3. THE ROLE OF MACROECONOMIC POLICIES ON MACROFINANCIAL AND MACROECONOMIC STABILITY

Historical analysis suggests that during the credit boom and pricing boom, fiscal positions seem unrealistically pink. In fiscal policy it is necessary to apply the same principles that apply to macroprudential framework: to build buffers i.e. budget surplus in good times and budget deficits in times of economic recession. Before crisis, in the most advanced economies the ratio between financial and monetary stability was seen as a fairly simple interaction and they started with basic postulates that price stability is sufficient to ensure macroeconomic stability and the monetary stability should be achieved by an independent central bank closely determined by a two-year inflation target. Recent global recession has shown that this paradigm is too narrow. The crisis has imposed the need for serious consideration of the role of monetary policy in dealing with price bubbles as its further order. The following conclusions on the implementation of this policy are included (Filipovski, "Financial Regulation"):

• There are inherent difficulties to identify bubbles in the price of assets because many of the leading indicators can create false signals. It is therefore necessary to establish a comprehensive analysis of their cause;

• It is expected that the concerns about macrofinancial stability will withdraw the need from the monetary policy to expand its mandate to introduce policies in order to deal with bubbles in the prices of resources;

• The uncertainties associated with identification of the bubbles indicates the immoderate respond to interest rate i.e. of monetary policy, as well as the avoidance of answers based on a strict rule;

• To avoid triggering the moral hazard, responses of monetary policy to prevent the bubbles should be symmetrical: focused on cracking of the bubbles and their generators and to do this in cooperation with macroprudential policy;

• When it is possible to determine that the bubbles of the price of assets are endogenous, i.e., are generated by monetary policy, then the generator itself can shoot the bubbles;

• On methodological level, there is a need to build a model that will include several variables: monetary (monetary aggregates, nominal interest rates), financial (credit growth, stock parameters, domestic investment) as well real variables (real GDP growth per capita, state of payment balance, labor productivity, demographic structure).

Regarding their thinking of macroprudential policy, two key causes of the regulators were: how to deal with the problem “too large financial institutions to fail” (Too-Big-To-Fail) and how to overcome the pro-cyclic “before the crisis” regulation. Macroprudential regulation takes a broad view and is concerned not only with the system important banks but also with non-banking financial institutions. Possible regulatory measures which would prevent the creation of “too large to fail’ institutions include:

• Higher capital and liquidity requirements that will build stronger buffers;

• Taxes and duties that will internalize the costs associated with systemic risk;

• Restrictions on the size and scope of banking activities by limiting combination of traditional banking with riskier activities like proprietary trading in securities and activities typical of the private equity and investment funds;

• drafting so-called wills or plans for proper cushioning in case of insolvency, which would discourage excessively complex business models and internalize the costs of possible failure of the institution.

To counteract the problem of procyclic reglation, regulatory response is focused on several areas:

• Countercyclical design of capital requirements including taxation of financial institutions more in boom times and less during the economic downturn;

• Correction of the loss that will be included in the expected credit losses, when determining the profits;

• Reduction of the pro-cyclical impact level on bookkeeping value for financial institutions (especially when market liquidity is changing dramatically);

• The introduction of corporate governance which will include compensation schemes for managers of financial institutions which create excessive risks and favoring short-term versus long-term profitability.

When it comes to interaction of macroprudential policy over policy interest rates, expectations are that the mitigation cycle of the interest rates will depend on the success of macroprudential policy in restricting the credit boom and price: interest rates will increase more during boom and will decline less in recession. Example of the necessity of complementary action of macroprudential policy with other macroeconomic policies is the situation with capital inflows. Namely, capital inflows into emerging market economies can create strong upward pressure on domestic inflation and credit ranking and rise in the prices of assets. In this situation, the implementation of macroeconomic policies is essential, including monetary, fiscal and foreign policy in order to protect the domestic financial stability. In such conditions, the role of macroprudential policy would be to prevent excessive risk-taking by the domestic financial system. However, the use of macroprudential policy should not mean delayed tightening of monetary policy. On the measures of capital, controls are required to be seen as the last resort and as a safety valve in extraordinary circumstances. The longer the controls are left in place; the greater are the chances of side effects. One of the new offered macroprudential tools is taxation of international lending (Korinek, "Hot Money").

4.SUGGESTED MEASURES AND RECOMMENDATIONS FOR IMPLEMENTATION OF MACROPRUDENTIAL POLICY

In order to comprehensively and radically create and deploy macro-prudential strategy that will be complementary to other macroeconomic policies, there is a possibility that a policymaker in one area can have veto power on other policies; or members of the body for creating and deploying monetary and macroprudential policy could have folded membership. Analogously, requests for consultation can be channeled; there are also requirements to notify other authorities before the final decision-making, requirements for providing information and opinions, signing of MoUs or similar instruments. Because of the need for independence from political cycles, central banks have a central role in this part (Caruana, "SAARC Finance"). There is no consensus in literature about whether monetary policy, banking regulation, and supervisory functions should be combined with one central bank or whether individual institutions can do it. Some researchers (Blanchard et al., "Macroeconomic Policy") argue that there are three main reasons which favor the idea that the current trend of separation of decision making for these two policies may have to be canceled. The advantage of monitoring the macroeconomic trends makes central banks obvious candidates for macroprudential regulators. The centralization of macroprudential responsibilities within the central bank will avoid problems of coordination of activities. One different view of the funding stability starts from the view that the origin of financial instability lies not so much in the infection but the exposure to systemic risk through time, which is closely linked to the business cycle (Borio, "Macroprudential Framework"). According to this view, the risk is fundamentally endogenous and reflects the interaction between the financial system and the real economy. While exploring the systemic risk arising from the financial system two directions have developed, one of which focuses on measuring the systemic risk, while the second is to assess the systemic importance of individual financial institutions. Here are some tools for quantifying the financial instability and systemic risk: indicators of financial distress based on the balance condition, market indicators; early warning indicators (tend to predict events that will happen in the very near future), indicators based on vector autoregression -vars models (these are flexible tools for predicting and monitoring the transmission of shocks in the economy, describing the dynamics of the financial system as well feedback to macroeconomics) and macro stress tests (used to define the answer to the financial system of unusually large exogenous shocks). Regarding the analysis of systemic importance of individual financial institutions, a group of researchers (Acharya et al., "Financial Markets") considered that the contribution of individual financial institution is commensurate with its size and the percentage of loss. They suggested introducing of taxes that will be designed for each financial institution and will be determined by the expected marginal deficiency (EMD) of each institution. EMD of a financial institution can be interpreted as a contribution to that institution for a dollar systemic risk. Lo, in "Systemic Risk" proposes establishment of a new independent agency to collect data about market prices, balance sheet and off-balance sheet assets and liabilities of US financial institutions, including the banking sector in the shade, in order to monitor liquidity and capital coverage of the banking system in the United States; also to carry out correlation of asset prices and measure the sensitivity of portfolio investment to changes in economic conditions. Sibert in 2010 indicates that similar agency in the euro area is necessary to collect similar data. He also points out that such data will have limited use because it will more allow measuring of the symptoms rather than the causes of financial distress since that systemic risk is not well understood and that would cause difficulties in the interpretation and measurement of the interconnectedness of network effects. To ensure proper database which would enable researchers and regulators to analyze systemic risk, Brunnermeier 2009 offers regular (quarterly) data collection for the risk of partial equilibrium, sensitivity of the risk market and sensitivity of liquidity regulated financial institutions. A group of researchers (Gauthier et al., "UK Mortgage Debt" 2010) found that macroprudential capital allocation mechanisms have reduced probabilities of individual banks as well as likelihood of a systemic crisis by about 25%, which indicates that the macroprudential capital buffers significantly improve financial stability.

Research (Gertler and Karadi, “Unconventional Monetary Policy”, 2009) found a way how the use of macro-prudential tools may affect the conduct of monetary policy within the new Keynesian adapted DSGE model. As a macroprudential tool they take lump-sum taxation and / or subsidy to the banking sector, which can be used to affect the amount of capital banks in order (as required) to stimulate or inhibit the national credit growth (Galati and Moessner, “Macro prudential policy”).

MACROPRUDENTIAL THREAD OF BASEL 3

Basel 3 represents primary strengthening, and in some cases a radical change in the global capital standards. That, together with the introduction of global liquidity standards, will determine the essence of the global financial-reform agenda (Nikolovska Vrateovska, “Macroeconomic and financial stability”). N'Diaye in “Countercyclical macroprudential policies” found that the binding countercyclical prudential regulation will affect the reduction of production fluctuations; reducing the risk of instability and financial risk of the system; and will provide the monetary authorities to achieve anti-inflation targets with smaller adjustments to interest rates. New measures and instruments (BIS, “Basel Committee on Banking Supervision Reforms”) framed in Basel 3 areas that cover: capital, liquidity and large financial institutions are:

I. Capital

Pillar 1

- Capital

*Quality and level of capital***:** Greater focus on common equity. The minimum will be raised to 4.5% of risk-weighted assets, after deductions;

*Capital loss absorption at the point of non-viability***:** Contractual terms of capital instruments will include a clause thet al.ows–at the discretion of the relevant authority–write-off or conversion to common shares if the bank is judged to be non-viable. This principle increases the contribution of the private sector to resolving future banking crises and thereby reduces moral hazard;

*Capital conservation buffer***:** Common equity comprising 2.5% of risk-weighted assets, bringing the total common equity standard to 7%. Constraint on bank’s discretionary distributions will be imposed when banks fall into the buffer range;

*Countercyclical buffer***:** Imposed within a range of 0-2.5% comprising common equity, when authorities judge that credit growth is resulting in an unacceptable build-up of systematic risk.

- Risk coverage

Securitizations: Strengthens the capital treatment for certain complex securitizations. Requires banks to conduct more rigorous credit analyzes of externally rated securitization exposures;

Trading book: Provides significantly higher capital for trading and derivatives activities, as well as complex securitizations held in the trading book; introduction of a stressed value-at-risk framework to help mitigate procyclicality. A capital charge for incremental risk that estimates the default and migration risks of unsecuritized credit products and takes liquidity into account;

Counterparty credit risk: Substantial strengthening of the counterparty credit risk framework. It includes more stringent requirements for measuring exposure; capital incentives for banks to use central counterparties for derivatives and higher capital for inter-financial sector exposures;

Bank exposures to central counterparties (CCPs): The Committee has proposed that trade exposures to a qualifying CCP will receive a 2% risk weight and default fund exposures to a qualifying CCP will be capitalised according to a risk-based method that consistently and simply estimates risk arising from such default fund.

- Containing leverage

Leverage ratio: A non-risk-based leverage ratio that includes off-balance sheet exposures will serve as a backstop to the risk-based capital requirement. Also helps to contain system wide build up of leverage.

<u>Pillar 2</u>

- Risk management and supervision

Supplemental Pillar 2 requirements-Address firm-wide governance and risk management; capturing the risk of off-balance sheet exposures and securitisation activities; managing risk concentrations; providing incentives for banks to better manage risk and returns over the long term; sound compensation practices; valuation practices; stress testing; accounting standards for financial instruments; corporate governance; and supervisory colleges.

<u>Pillar3</u>

- Market Discipline

Revised Pillar 3 disclosure requirements: The requirements introduced relate to securitization exposures and sponsorship of off-balance sheet vehicles. Enhanced disclosures on the detail of the components of regulatory capital and their reconciliation to the reported accounts will be required, including a comprehensive explanation of how a bank calculates its regulatory capital ratios.

II. Liquidity

Global liquidity standard and supervisory monitoring

Liquidity coverage ratio

The liquidity coverage ratio (LCR) will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario that is specified by supervisors.

Net stable funding ratio

The net stable funding ratio (NSFR) is a longer-term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable sources of funding.

Principles for Sound Liquidity Risk Management and Supervision

The Committee's 2008 guidance *Principles for Sound Liquidity Risk Management and Supervision* takes account of lessons learned during the crisis and is based on a fundamental review of sound practices for managing liquidity risk in banking organisations.

Supervisory monitoring

The liquidity framework includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both bank and system-wide level.

III. SIFIs

In addition to meeting the Basel III requirements, global systemically important financial institutions (SIFIs) must have higher loss absorbency capacity to reflect the greater risks that they pose to the financial system. The Committee has developed a methodology that includes both quantitative indicators and qualitative elements to identify global systemically important banks (SIBs). The additional loss absorbency requirements are to be met with a progressive Common Equity Tier 1 (CET1) capital requirement ranging from 1% to 2.5%, depending on a bank's systemic importance. For banks facing the highest SIB surcharge, an additional loss absorbency of 1% could be applied as a disincentive to increase materially their global systemic importance in the future. A consultative document was published in cooperation with the Financial Stability Board, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.[1] European Central Bank was designed to help policy makers in operationalization of macroprudential policy, which is based on: a) the ability to determine the appropriate timing for activation or deactivation of the instrument; b) the effectiveness of the instrument to achieve the stated political

[1] BIS (2013)- *Basel Committee on Banking Supervision Reforms-BASEL 3,* BIS, 2013

goal and c) the performance of the instrument in terms of analysis and cost-benefits.

The underdevelopment of the Macedonian financial system and conservativeness and traditionalism of Macedonian banks (as dominant in the total assets of the financial system with participation of high 85.5% in 2012 (НБРМ „Финансиска стабилност”)) were the main pillar of defense crisis. In the sources of funds for Macedonian banks dominated deposits of the natives while the level of capital adequacy in the last decade has continually been over the 8% minimum from the adopted Basel capital requirements. Although the deadline for implementation of the new international capital standards imposed by Basel 3 was initially in 2019 and announced that it will move in 2016, inclusive June 2010, all banks in Republic of Macedonia comply with the new capital standards. In this section banks have capital adequacy over 10.5% at all times and only six banks had rates of capital adequacy ratio above 30%.

CONCLUSION

To overcome the negative international spillover of bank failures international regulatory framework is required that will treat this matter and distinguish the role of regulation of the host country and the regulations of the country of origin of the capital and patterns of bank resolutions. New ideas in terms of locating the regulatory responsibility in international banking relate to reallocing the responsibility of the host country to the country of origin, and abandoning the practice of opening a branch (branches) and on its place to introduce mandatory subsidiarization (opening bank branches in the host country, whose activities will be regulated by the host). In trying to operationalize the criteria of Basel 3, a number of practical tools have been proposed, exposing stylized scenarios, application of alternative approaches that seek to connect systemic risk analysis and selection of instruments and the use of "transfer maps" - astylized presentations how changes in the macroprudential tools are expected to contribute to the goals of macroprudential policy. Redefining macroprudent and macroeconomic policy as a reaction positive action to global policy makers, once again the thesis that the current regulations and macroeconomic strategies are unjustifiably marginalized is confirmed. Financial statements have impact on institutions on macroeconomic and financial stability. Thus, remains the need for closely monetarysing respect and implementation of the new Basel 3 requirements and standards, the need for regional networking and regional exchange of information by national regulators, harmonization and unification of fiscal policies among member states of the European Monetary Union, as well as providing complementarity between macroprudential, macroeconomic and fiscal policy at the level of national economies.

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