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ACTUAL STAGE OF DEVELOPMENT FOR BASEL II AND EFFECTS ON ROMANIAN FINANCIAL SYSTEM SOUNDNESS

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Abstract

This article draws attention to the actual stage of Basel II implementation in Romania and its effects on financial system stability. An overview of the Basel I and II Accords and their possible future outcomes are debated. Some significant features of the law that approves Basel II framework in Romania are taken into discussion.

Key words: Basel I and II Accords, financial system stability, bank capital, loan loss reserves, minimal capital requirement, Central Bank, commercial banks.

1 Introduction

The European Union enlargement entails the harmonization of the Romanian legal framework with acquis communautaire, procedure that assume continuous transformations and revisions. Connected to financial sector, in European Union, there are legal acts correlated with Basel II, such as Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

Basel-II brings some important changes in international banking management risk referring to banking regulation, providing a range of options for determining the capital requirements for credit risk and operational risk. The Basel II also represents a significant change in the methodology for the determination of minimum capital requirements for banks.

The first reunion of the Basel Committee on Banking Supervision took place in Basel during 1974 with the participation of delegates from National Banks of G7 (USA., Japan, Canada, Great Britain, France, Germany, Italy) and Switzerland, Sweden, Netherlands, Belgium and Luxembourg. The foundation for Basel-II was Basel-I Accord, emerged in 1998, which also represented, at that time, a change of view referring to banking prudential rules. The primary objective was to find some feasible solutions in order to raise the strength of international financial system. Initially, implementation of this settlement took into discussion only the international banks from G-10, but later, Basel-I was accepted in 120 countries all over the world.

Actions related to the implementation of Basel-II in Romania imply many challenges for commercial banks and Central Bank [Georgescu, 2006, 2]. Also, some author's opinions suggest that most of the banks should assume, in first stages of the implementation, the simple option for capital requirements.

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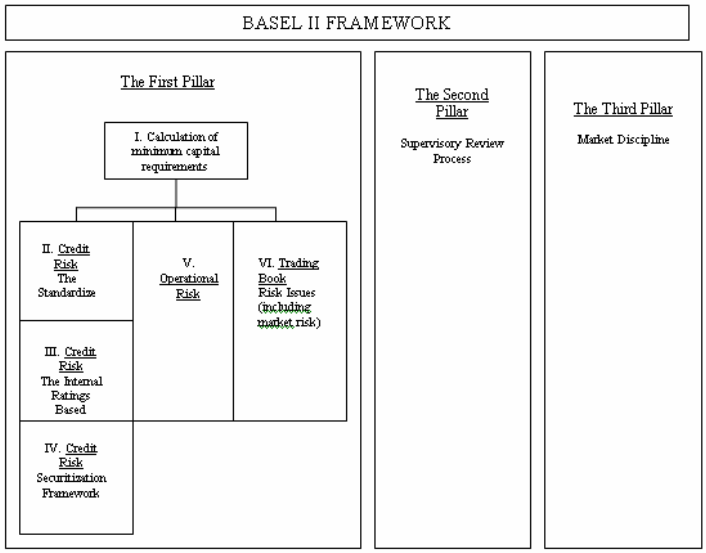
2 Basel II Accord – an overview

The main objective of the Basel-II is to strengthen the stability of the international banking system concerning better risk management, by bringing regulatory capital requirements more in line with bank good practices. This implies credit capital requirements to be significantly more risk sensitive and it is possible to achieve by introducing an operational risk capital charge. The changes related to Basel-I appeared because of several problems that became increasingly obvious over time, such as:

- *lack of sufficient risk differentiation for individual loans;*
- *no recognition of diversification benefits;*
- *unacceptable treatment of sovereign risk*
- *some incentives for better overall risk measurement and management.* [Stephanou, Mendoza, 2005, 3-4]
- *few distortions related to cross-border lending* [Ford, Sundmacher, 2007, 3].

Basel-II entails a three - divided approach to bank capital regulation. First, it represents a comprehensive set of rules designed to measure the risks in banks' portfolios and to produce minimum capital requirements. Second, it refers to a supervisory review process setting out the role of bank supervisors in ensuring that the new framework is correctly executed. Third, it contain disclosure requirements to induce banks to make available more information about the key risks in their books with the objective of improving bank accountability and market monitoring.

Described from other point of view, the new Accord consists of a broad set of supervisory standards to improve risk management practices, which are structured along three mutually reinforcing elements or pillars. Pillar 1 concentrate on minimum requirements for credit and operational risks. Pillar 2 provides guidance on the supervisory oversight process. Pillar 3 requires banks to publicly disclose key information on their risk profile and capitalization as a means of encouraging market discipline. [Stephanou, Mendoza, 2005, 6] This structure should be ordered in a figure like the one below:



Adapted from Basel Committee on Banking Supervision: [***, International Convergence of Capital Measurement and Capital Standards, 2004, 25]

Fig. 1 Basel II Agreement – The Pillar structure

As seen above, slightly more than 80 percent of the body of the public description of the policy pillars [Bank for International Settlements, 2006] is devoted to discussion of Pillar 1. Because of that, the bulk of the research and discussion relating to Basel II has focused attention on the capital-regulation features of Pillar 1.

The overriding goal of the proposed Basel II Accord is to bring capital requirements more closely in line with the actual risk of banks' assets. The Basel Committee is proposing three alternative approaches:

1) a standardized approach, which increases risk sensitivity compared with the current approach by introducing further risk buckets;

2*)* the internal ratings based foundation approach, which gives banks the opportunity to use internal risk measurement techniques;

3) the internal ratings based advanced approach, which extends the possibilities of banks to use internal risk measurement techniques. The framework should provide banks with incentives to improve their risk management techniques. [Weder, Wedow, 2002, 9]

The risk weights under the Standardized Approach are shown in the table below:

Tabel nr. 1 – Risk Weights under the Standardized Approach

Investment Grades			**Speculative Grades**				**Unrated**
	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	Below B-	
Sovereigns	0	20	50	100	100	150	100
Banks[a]	20	50	100	100	100	150	100
Banks[b]	20	50c	50c	100[c]	100	150	50c
Corporate	20	50	100	100	150	150	100

a) Sovereign rating based.
b) Own rating based.
c) If original maturity less than or equal 3 months, one rating category lower.

Source: Basel Committee on Banking Supervision (2001b)

As exposed in the table, banks determine the required minimum capital of lending by applying the risk weight that corresponds to the borrower's rating and then multiply the risk weight by the usual 8 per cent minimum requirement of capital. For this reason, a sovereign rated BBB would be assigned a risk weight of 50 and a risk weighted minimum regulatory capital requirement of 4 per cent. Given the large number of borrowers without ratings, the Basel Committee introduced a further bucket for unrated borrowers. Given the lower risk weights in the unrated bucket, critics have pointed out that borrowers will have no incentive to obtain ratings and that there exists an incentive for regulatory arbitrage towards riskier but unrated borrowers. [Weder, Wedow, 2002, 10-12, 30-31]

Concerning the other two pillars, there is a presumption regarding supervisory-process pillar discretionary supervision is preferable to policy rules, but in fact, this pillar could well have negative consequences for bank safety and soundness. In some respects, the market discipline pillar represents a step forward, particularly for participating countries with less developed banking systems. In some author's opinions, Basel II – Third Pillar effects are still uncertain: Basel II provides an incomplete scheme for promoting market discipline. Also, aside from promoting regular releases of certain types of information, the market-discipline pillar actually would do little to promote stronger market discipline in banking in nations with well-developed banking systems [VanHoose, 2007, 2-3].

There are some disapproves related to actual stage of the Basel II Accord referring to possible limitations of the proposed models related to credit risk, which take into discussion one single risk factor for further estimations.

3 Basel II Accord in Romania – the stage of implementation and prospective consequences

The main objective fulfilled in Romania by the end of year 2006 regarding law implementation of the Basel II Accord refers to O.U.G. no. 99/2006 on the capital adequacy of investment firms and credit institutions, that transpose the content of Directive 2006/49/EC. In 2007, the Law no. 227/2007 approves, with adjustments, O.U.G. no. 99/2006. At this ample project had been engaged Romanian authorities from financial sector supervision, such as Romanian National Bank, Romanian National Securities Commission, The Ministry of Public Finance and also the banking community [***, Nota de fundamentare, OUG 99/2006, 3].

The essentials of these Acts can be summarizing as follows:

- the risk levels related to minimum capital requirements and own funds;
- the approaches that can be used by credit institutions in their adequacy for capital requirements;
- the conditions and the techniques for reducing the risk in determination the minimal capital requirements;
- the options in order to determine capital requirements related to securitization process;
- the ways for clarifying market risk, counterparty risk, exchange risk and others;
- the requirement for market transparency – the credit institutions are obliged to make public all information related to their activity;
- the way for the supervision related to National Bank of Romania, including consolidated supervision;
- the rules related to credit institution consolidation.

During 2007, there are some projects associated with the Basel II implementation process related to: the procedure for recognition of external institutions that evaluate the credit risk - ECAI (External Credit Assessment Institutions), the methods for understanding of the new regulation framework COREP (Common Reporting) and FINREP.

It is considered that the Basel II Framework should determine a better soundness of the Romanian financial system. In actual stage, the Romanian credit institutions hesitate to adopt it, because of the high cost that should be supported. These higher costs[1] frightened the banks, which consider that future profit could be affected. It is believed that Basel II will reconsider the actual situation related to banking supervision. Related to this subject, Mugur Isarescu, the Governor of the National Bank of Romania, declared with the occasion of the 60th Edition of the International Banking Summer School that "the migration to Basel II is the most important event in banking supervision" [Serban, 2007, 1].

The adoption of the Basel II Accord in Romania offer future possibility for banks and credit institutions to implement ratings from External Credit Assessment Institutions and the dissemination of this information will reduce the effects of adverse selection and moral hazard [Dardac, Moinescu, 2007, 2] that affect the accuracy of the financial system. In actual phase, banks and other credit institutions had changed the lending procedure that should determine the decrease of credit risk.

Major obstructions for the implementation in Romania of the Basell II Accord are related to the financing dilemma and the effects correlated with its adoption, which is a also a difficulty in all Eastern Europe emerging countries. It is considered that the major costs associated to Basel II advanced model implementation would not be compensated by the benefits.

Basel II implementation in Romania could lead to some advantages such as: the increasing confidence in Romanian financial system, because of the capitalization improvement, more efficient determination of firms' financial situation and the reduction of

banking risks. But, on the other way, there are some hindrances linked with poor infrastructure, for instance the absence of: performant internal banking models, extensive databases, internal rating systems and important rated companies. [Trenca, 2007, 35]

4 Conclusions

The European Union enlargement necessitates the harmonization of the Romanian legal framework with the European structure, procedure that assumes continuous conversions and adjustment. This legal framework contains in European Union some Acts that are correlated with Basel II. In Romania, by the end of year 2006, regarding law implementation some important laws had been adopted.

The development of solid and coherent legal framework related to prudential supervision that is linked to European directives and the regional cooperation between banking institutions would determine the proper beginning of financial system supervision.

It is considered that the Basel II Framework should determine a better soundness of the Romanian financial system but, in actual phase of development, the Romanian credit institutions hesitate to adopt it, because of its high cost. The rules from Basel II Framework will obligatorily be applied with the beginning of 2008, strengthening the Romanian financial system.

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Notes

1. Estimated costs for implementing Basel II at banking level are estimated between 5000 and 100 000 thousand Euro. [Tudorache, 2007, 1]