TREATMEANT OF LARGE EXPOSURES REGIME IN MACROPRUDENTIAL APPROACH VS MICROPRUDENTIAL – THE REPUBLIC OF MOLDOVA EXAMPLE

Victoria COCIUG[47], PHD
Denis MALENDRA[48], PhD(c)

Abstract

Banking service market challenges managing compliance costs in the same time, and diversifying in front of the clients through innovation of products and services, which needs a higher level of analysis to be adequately compliant and to ensure a profitable and sustainable model of business.

Moreover, Moldovan credit institutions are facing a challenge in managing their balance sheets through the perspective of assets quality and rising incomes and with the consolidation of banking sector tendency, which induce the need of adaptation for all market players.

In this context, the demand for products with big values and risks from the clients are restricted by prudential norms are being ready to be adopted. For this reasons, this article aims to study how the norms regarding the treatment of large exposures limits the capacity of lending, and to gain bigger profits for small and medium banks, thus the regulations favor big banks and creating even a bigger disruption on a competitive market.

Keywords: Bank regulation, large exposures, credit risk

JEL classification: E58, G21, G28

Introduction

The banking sector from The Republic of Moldova recently passed through a local crisis, which ended with one billion US dollars' theft and the failure of three banks, one of them being a systemic important bank. One of the key lessons from this financial crisis is that, banks not all the time consistent measured, aggregated and controlled exposures towards one counterparty or a group of related persons in their balances and their operations, but the National Bank of Moldova didn't manage identify them at the right moment, when the losses were still possible to recover. From this reason, prudential supervisory norms where tightened, and treatment of large exposures came into supervision sight, generating the squeeze for small and medium bank lending activity.

During the history there were examples of banks failure due to concentration of exposures to a single party (for instance: Johnson Matthey Bankers from The Great Britain from 1984, Korean baking crisis from 1990). Regulation of large exposures were developed as an instrument to limit the maximum losses which can suffer a bank in case of a sudden failure of a counterparty, not affecting the banks solvability.

The necessity to estimate and to limit the volume of large exposures for the banks over their capital was recognized by the Basel Supervisory Committee. Especially, in 1991, Basel Committee revised the practices and issued a guide for supervising large exposures.

The regulating framework of large exposures fulfills the Basel Committee standards for capital adequacy for risks, because this is not specifically projected for protecting the banks from big losses which result from an instant counterparty failure. Especially, minimum capital (on Pillar 1) requirements of regulation Basel framework implicit assume that banks shall have a granular infinite portfolio, and mainly none of a concentration form is considered in computing capital requirements.

Contrary to this hypotheses, idiosyncratic risk due to large exposures towards counterparties can be present in banks portfolios. Although, the supervisory process (Pillar 2) adjusting concentration risk can be done by diminishing this risk, these adjustments are harmonized in different

[47] *National Institute for Economic Research, Chisinau, Republic of Moldova, v.cociug@mail.ru.*
[48] *National Institute for Economic Research, Chisinau, Republic of Moldova, denismalendra@gmail.com.*

jurisdictions, and are projected to protect the bank against huge losses from the failure of a counterparty. For this reason, the Committee concluded that the framework for capital adequacy to risks is not enough for a total attenuation of micro prudential risk from large exposures which are reported to banks resources. This framework needs to be fulfilled with a simple framework for large exposures which will protect banks against dramatic losses caused by an instant failure of a counterparty or a group of related persons.

Macro Prudential Approach Versus Micro Prudential Approach in Risk Treatment

In Bank for International Settlements concept, macroprudential treatment of regulation and financial supervision have two important features. Firstly, this approach focuses on financial system overall and has the objective to limit the episodes of financial instability, whereas these can have negative consequences upon real economy (losses from PIB). The objective aims following to limit the possibility of collapse of an important part of the financial system and reducing the costs regarding risk diminishing. In the same time, because the system integrates separate elements, which have a strong relationship between them, it is necessary to follow all bank risks to identify the exposure impact for each of them upon the system overall.

Thus, it is considered that macro prudential approach is contrary with micro prudential approach, because the object of micro prudential approach is to limit the institutional risk failure (idiosyncratic risk), despite of its impact upon overall economy. In the other words, this objective aims to protect the customers (deponents). We consider, that the contrast between micro and macro prudential is wrong, these objectives have a unique genesis, they fulfill each other, because the macro prudential approach treats aggregate risks as being dependent from a collective behavior of financial institutions (partial endogenous), meaning the individual sum of risks.

At the same time, applying the instruments for macro prudential supervision without considering the micro prudential component is noxious for the banking sector, proved fact by regulating and supervising of large exposures. Actions taken at the overall level can have unwelcome results applied at the level of financial institution. For instance, it is rationally for an individual bank to strengthen its lending standards in a period of recession and these standards shall be adequate its capacity of losses absorption after exposure to various risk categories.

In case when common standards are developed, without taking into calculus banking system polarization, and all the banks will proceed uniform in their application, it can lead to a drastic limiting in lending, with a negative impact upon economic activity, which will lead to an additional deterioration of their loans portfolios (Crockett, 2000).

Also, the positive effect of applying macro prudential supervision is that about stability of financial system through some dimensions: (1) diversifying the risk among the system, and (2) evaluating risk in time. (Caruana, 2012). In frame of the first dimension *(„cross-sectional dimension")*, it is important to pay the attention to common exposures of financial institutions as an element of systemic risk. These common exposures can occur in case when institutions are closely interconnected or are exposed to the same risks. In case of close linkages among banks, due to important mutual exposures, problems of an individual bank can affect more banks or the system overall.

The second dimension, implies the risk evolution in time, it is related to the fact that systemic risk can be worsen by the interaction from financial system or through linkages between financial sector and real economy. These interactions amplify the movements of economic cycle (procyclicality) and can create financial instability. In the period of economic compassion, reducing the risk perceptions, increasing of leverage ratio, a high liquidity level on the market, increasing the assets prices, all these can lead to an artificial increasing in banking balance sheets, including large exposures. Banks following to obtain the profits on financial markets are losing in their vigilance and crowd their assets with risk elements, concentrated on a segment, on a debtor or an instrument. In recession periods, the process operates in other way, but excessively, generating the financial pressures.

The instruments of macro prudential policy that can be in this situation consist from establishing of contra cyclical capital buffers and a dynamic provisioning. Contra cyclical reserves of capital can be formed in favorable economic periods, over the necessary risk level, being used in contraction periods of economy to absorb financial pressures. With regarding to a dynamic provisioning, the principle which underlies this is that provisions are made in basis of some estimations of expected losses, which makes the balance sheets less sensible to economic cycle fluctuations.

For attenuating the systemic risk contagion, it is important that in frame of the macro prudential approach to be used micro prudential instruments calibrated in function of the institution importance in frame of the financial system. However, in this case unifying applied prudential instruments upon all elements from the system will led to a polarization of financial market from the competitiveness perspective and creating the imbalance on the segment of products offered to clients.

Large Exposures Treatment in the Republic of Moldova

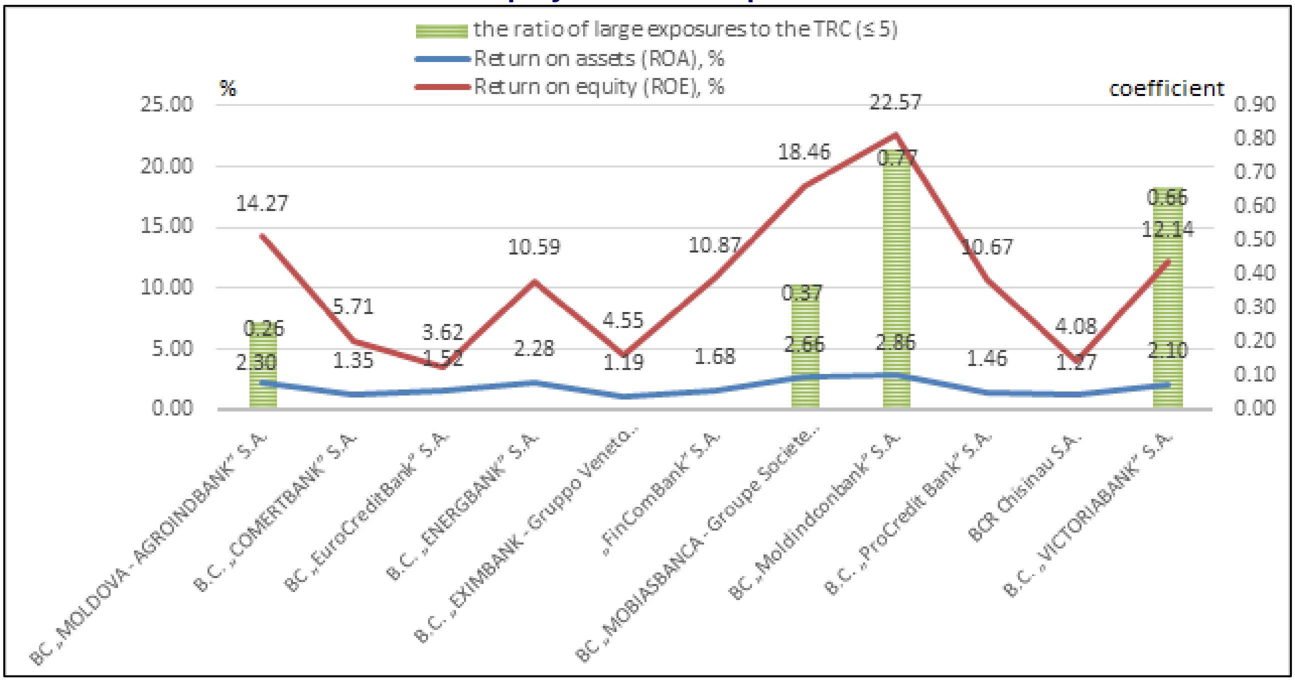
At the moment, in The Republic of Moldova the regime of large exposures is treated through the Regulation on "large" exposures of the National Bank of Moldova, which has the micro prudential approach. "Large" exposures are defined as "net exposure to a person or a group of related persons, amounting 10 percent or more from the total regulatory capital of the bank".

According to this regulation, the bank can to assume a net exposure to a person or to a group of related persons not more than 15 percent from its total regulatory capital. In the same time, the sum of all net outstanding loans granted to ten persons, including groups of related persons, which are the first net loans debts minus all the provisions and conditional commitments, shall not exceed 30 percent from the total loan portfolio of a bank and its conditional commitments related to those 10 persons.

Applying of this limit led to polarization of Moldovan banking sector. Thus, from 11 active banks, only 4 banks are granting credits, which can be framed in normative limit of large exposures – these are the big 4 banks from the system.

This way the priority to big banks was created in granting investment loans, small banks have to explore the retail segment. However, in absolute amount, consumers credit segment is riskier and more expensive to follow than credits granted to a smaller group of debtors, but in a smaller value.

Figure 1 - Relationship between large exposures and banks return on assets and return on equity from The Republic of Moldova.

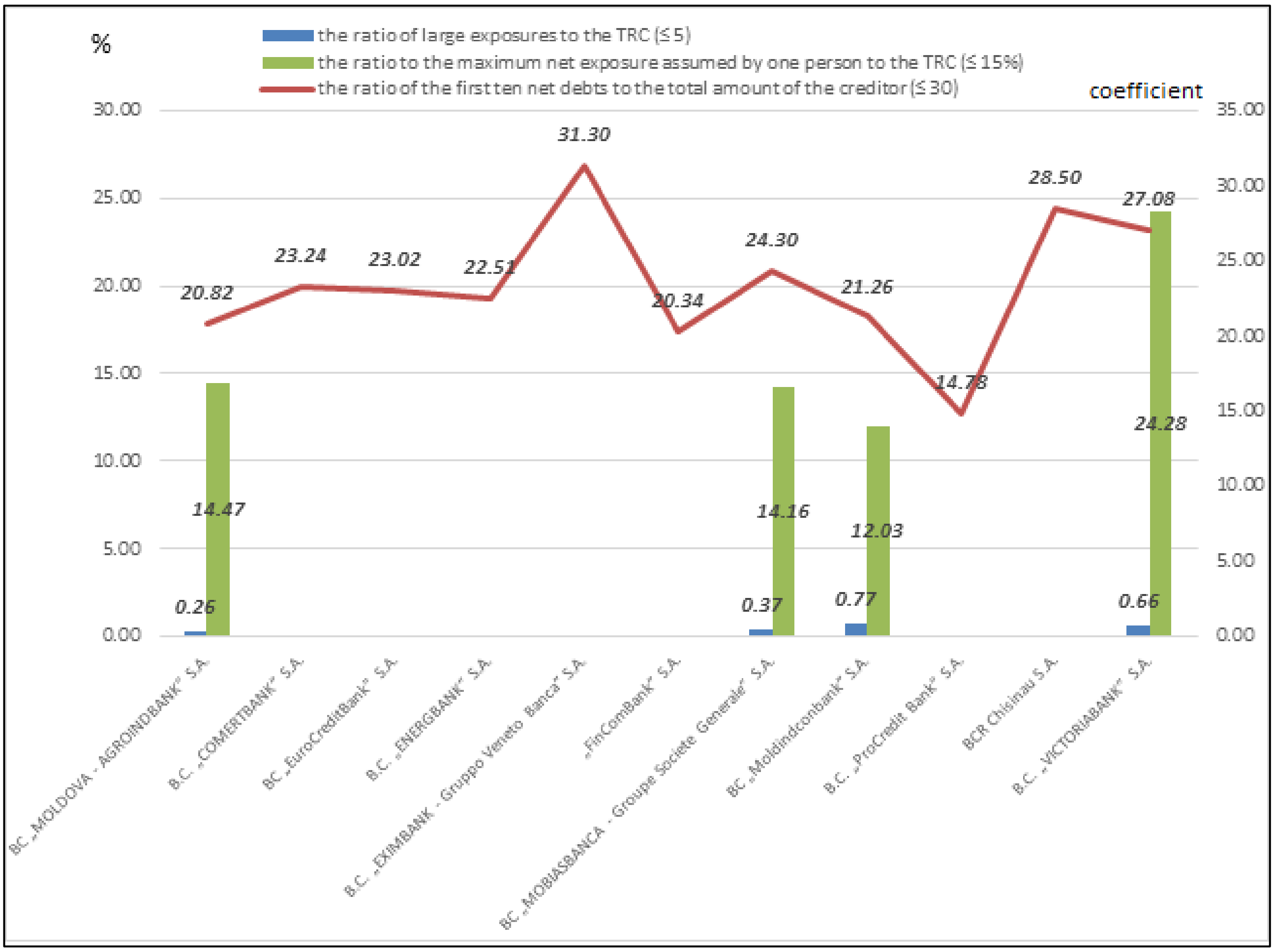


Source: Made by the authors in basis of data from http://www.bnm.org.

Market polarization of banking services due to limits of large exposures creates additional possibilities to gain profits for banks which practice loan granting in significant values. From the figure nr.1 we can see a direct relation between the possibility of crediting of corporate clients and return on assets (ROA) and return on equity (ROE). For other banks this opportunity is unreachable, the created situation led to imbalance through potential debtors, forming a small group of big clients, which will be refused by small or medium banks in lending in order not to violate prudential limits.

In the same time, we can remark that maximum limits of large exposures were not reached by the banking system overall, even by the banks separately. Thus, a minimum threshold of 5 percent from TRC, large exposures on the system overall reached almost 0.22, but the most exposed bank registers 0.77 (figure 1). This fact is due to some rigid micro prudential requirements, which make those macro prudential requirements almost inapplicable.

Figure 2 - Framing of macro prudential limits of large exposures by banking system from The Republic of Moldova.



Source: made by the authors in basis of data from bnm.org.

Even in conditions of overregulation, The Republic of Moldova assumed the commitments to implement the new Basel III agreement, which comes with a macro prudential treatment of large exposures regime, meets some difficulties in their application.

In conformity with art. 395 of Regulation 575/2013 of European Union large exposures will be divided over eligible bank capital, after application of credit risk mitigation techniques, the banks cannot have an exposure to a client or a group of related persons which value exceeds 25 percent of its eligible capital. Additional to this, the new regulation framework will impose banks to make additional reserves of own funds for large exposures.

In the same time, if we analyze capital adequacy ratio, which shall be not less than 16 percent and it is regulated by the Regulation on capital adequacy ratio, on the sector overall, we can see that this indicator is twice bigger than the established normative.

In this context, application of respective norms will lead to an additional need of capital, which being randomly implied, could determine the diminishing of banks interest regarding loan granting, representing a challenge for banking industry to make profits. This could lead to a constrain of exposures and changing of business model of banks, guiding banks to offer less risky services, without financing businesses in real economy. A sudden passing to new capital requirements (from Basel I to Basel III) in the first stage, highlights the necessity of bank system capitalization, being welcomed a gradual transition.

Conclusions

The maximum vulnerability at a negative market evolution in the short run is retrieved at the level of banks with a big level of nonperforming loans (NPL) in the total portfolio. Solving of these problems depends not on the regulators but on the initiatives of banking institutions. Thus, micro prudential approach, especially what comes from the inside of the bank has priority towards outside established limits. Banks are more competent in estimating of their own exposures, while a unique approach can lead to an insufficient risk capital, limiting to the main source of capital rising – profit.

A different approach of regulating systems shall be done in function of banking sector development. In many emerging markets, at the national level, inclusively in The Republic of Moldova, it is necessary a harmonization of regulatory framework regarding "large exposures", which can allow a clear and objective classification of debtors (retail and corporates) firstly by their quality and them by their exposures dimensions. Because the risk of one persons or a group of related persons can be monitored with less expenses than a risk of multiple small loans, through application of diversifying approach of large exposures can be created premises for a better administration at the internal level.

Bibliography

Caruana, J. (May 8, 2012). Interconnectedness and the Importance of International Data-sharing. Lecture presented at the 3rd Swiss National Bank – International Monetary Fund Conference on the International Monetary System, Zürich.

Crockett, Andrew (2000), "Marrying the Micro- and Macro-prudential dimensions of Financial Stability," remarks before the Eleventh International Conference of Banking Supervisors, September 20–21 (Basel)

Jian Cai, Anthony Saunders, Sascha Steffen. (2015). Syndication, Interconnectedness, and Systemic Risk. September 17, https://www.bis.org/events/confresearchnetwork1510/steffen_paper.pdf

Marrying the macroand microprudential dimensions of financial stability. (2001) BIS paper nr. 1, https://www.bis.org/publ/bppdf/bispap01.pdf

Park Yung Chul. (October,2006) A macroprudential approach to financial supervision and regulation: conceptual and operational issues. https://www.imf.org/external/np/seminars/eng/2006/macropr/pdf/YungChul.pdf

* * *, Regulation of "large" exposures. Approved by the Decision of the Council of Administration of the National Bank of Moldova no. 240 from December 9, 2013. Official Monitor of the Republic of Moldova no. 17-23/97from January 24, 2014. Available at: http://bnm.md/en/content/regulation-large-exposures-approved-dca-nbm-no-240-december-9-2013#art1.

* * *, Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012. Available at: http://eur-lex.europa.eu/legal-content/en/TXT/?uri=celex%3A32013R0575.

* * *, Supervisory framework for measuring and controlling large exposures. Standards. Basel Committee on Banking Supervision. March 2013. https://www.bis.org/publ/bcbs246.pdf