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GLOBAL AND NATIONAL TRENDS IN SUPERVISION REQUIREMENTS FOR FINANCIAL INSTITUTIONS

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Abstract

The article reveals the process of formation and development of international institutions of regulation and supervision of credit and other financial organizations in accordance with the acts of the Basel Committee on Banking Supervision (BCBS). The results of the development of the banking system are reflected in line with the implementation of the principles and directives of BCBS. The authors note that the importance of both international risk management standards and the supervisory requirements of BCBS is that no large financial institution, regardless of nationality (including Russia). The purpose of stress testing is also revealed in identifying unlikely large potential losses in stressful conditions, when normal market conditions stop working. It is shown that in Russia, the tendency to centralization in the system of state regulation will continue both in the short and long term – including the regulation and supervision of the activities of financial organizations. The authors believe that the greater the centralization of functional component in a system, the more catastrophic systemic risk caused by the actions of the banking system regulator. In modern Russia it is applied to the entire financial system. Many countries demonstrate the magnitude of the manifested systemic risks and their consequences for an individual, organization and territorial entity. It is proposed to revise the policy of accelerated implementation of the requirements of international financial institutions with the strengthening of the legal framework for protecting the interests of Russian financial organizations in Russian and international financial markets.

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Keywords: Institution, supervision, capital, centralization, concentration, trend.

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1. Introduction

The state of regulation of the Russian financial market, including its banking sector, raises certain questions in the context of Adam Smith’s theory, who recommended ensuring low government costs for collecting taxes and maintaining tax apparatus – administrative expenses for managing tax system and tax compliance should be minimal (Smith, 2007). He proposed the principle of tax economy, which consists in reducing tax collection costs in the direction of streamlining the taxation system, but in order to rationalize the banking system, the Basel Committee on Banking Supervision (BCBS) also declares today that "... there is a compromise between the level of protection that the supervision provides and the cost of financial intermediation – the lower the risk tolerance for banks and the financial system, the more likely the more intrusive costly supervision that ultimately have a negative impact on innovation and the allocation of resources» (BCBS, 2011). This message is so fundamental and relevant for modern Russia that it requires revealing the genesis of the activities of this international financial institution.

2. Problem Statement

In 1974, the heads of the central banks of the G10 member countries created BCBS, which was charged to ensure the organization of the development and implementation of common supervisory requirements and methods for regulating banking activities in the banking system of the G10 member countries. The provisions of BCBS documents until 2010 were advisory in nature, and its activities focused on the formation of tools, methods and mechanisms for "early response" to the problems of the functioning of national banking systems. Since 2010, BCBS has focused primarily on addressing disadvantages in the activities of national banking supervisors, and BCBS supervisory agreements themselves have become directives for national supervisors and commercial banks. Nowadays BCBS supervisory directives also provide the integration of the banking systems of the member states of the European Union (EU). It is necessary to note that the development of BCBS supervisory directives today is carried out in the mode of joint work of banking communities and banking supervisory authorities not only in G10 and G20 member countries, but also in many other countries.

3. Research Questions

The main documents of BCBS, adopted by this organization over 45 years of activity, include the following four normative acts.

1. The New Basel Capital Accord or Basel I was adopted in 1988. For the first time, it contained the formulations of the requirements for bank total equity as “a reaction from the banking community and supervisors to cases of major losses and bankruptcies of financial intermediaries” (BCBS, 2001). The key idea of this agreement was to create a mechanism to control the adequacy of the bank total equity by regulating its credit risk. By the end of 1992, more than 100 countries had joined Basel I requirements (Larionova, 2018). The Russian Federation joined the BCBS standards in 1997, with the publication in 1996 of Instructions No. 1 “On the Procedure for Regulation of the Activities of Credit Organizations”

The main provisions of Basel I were: the determination of an acceptable financial position of a bank, measured as the ratio of equity to total assets weighted for credit risk (≥ 8 %); the determination of

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credit risk by weighing the value of the asset using five risk weighting factors (0; 10, 20; 50 and 100%); the division of bank total equity to tier one capital (equity and declared reserves) and tier two capital (additional capital).

However, despite these innovations in banking practice, the Basel I agreement contained a number of drawbacks, namely: other also significant types of banking risks were not taken into account; it had a simplified gradation of credit risk; the capital requirements of the bank did not ensure the financial stability of commercial banks and the stability of banking system. That was the reason for the adoption in 2004 of an updated agreement – Basel II.

2. The principles for Sound Liquidity Risk Management and Supervision (BCBS, 2008) in the first version were adopted by BCBS in 1997 and have been revised several times. In the process of developing and adopting this document, a set of 29 fundamental principles of effective banking supervision was formed and ranked in two groups. The principles of the first group (from No. 1 to No. 13) reveal both the content of supervisory powers. They include their duties and functions, as well as the essence of effective risk supervision and early intervention and actions of timely supervision. The second group includes 16 principles (from No. 14 to No. 29) that disclose the content of banks' expectations from banking, prudential standards and requirements for banks. Such a grouping of principles made it possible to single out: what the supervisor should do itself and what it expects from banks.

The current version of this BCBS document has increased the fundamental principles of effective banking supervision by four principles (from 25 to 29 principles). The increase occurred, firstly, due to the division of the first principle into three separate ones: the principle of duty, purpose and authority (No. 1); the principle of independence, responsibility, provision of legal protection (No. 2); the principle of cooperation and interaction (No. 3). Secondly, the addition of two new ones: the principle of corporate governance (No. 14) and the principle of disclosure and transparency (No. 28).

This document notes that banking supervision should help create an effective and competitive banking system in the country that meets the needs of the population in good quality of financial services at an affordable (reasonable) price. The disadvantages in the corporate governance of banks can have serious consequences for both a particular bank and the entire banking system. The importance of information disclosure and transparency in maintaining confidence in banks was emphasized, allowing market participants better understanding of bank risk profile and thereby reducing market uncertainty regarding financial stability of banks.

The basic principles of banking supervision and their assessment criteria take into account a wide range of banking systems existing in the world practice in the direction of the development of the concept of proportionality of regulation and supervision of credit organizations. The proportional approach reflects the proportionality of regulation and supervision with risk profile and systemic importance of a wide range of banks (from large international to small depository institutions), which allows assessing the level of compliance of the regulator's activities with the Basic Principles of Effective Banking Supervision.

3. Basel II: The International Convergence of Capital Measurement and Capital Standards – A Revised Framework) (BCBS, 2004) was adopted in 2004 and is a three-component standard introducing minimum capital requirements (based on Basel I), supervisory procedures and market discipline.

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BCBS within Basel II proposed two approaches to calculate credit risk: standardized and based on external credit ratings of rating agencies and alternative approach (IRB Approach) for measuring credit risk based on a four-factor mathematical model, which allows determining expected and unexpected losses.

In Russia, the provisions of Basel II standard began to be introduced into the banking sector in the summer of 2010, while already in the fall of that year BCBS offered the national supervisory authorities and banks new agreements, called Basel III. The Bank of Russia issued Letter No. 192-T, dated December 29, 2012, which introduced into the banking practice “Methodological recommendations for implementing the approach to calculating credit risk based on internal ratings of banks”.

In order to improve the quality of risk management in banking and the stability of the entire financial system of the country, Basel II contained new (in comparison with Basel I) methodological recommendations in the field of banking regulation, such as: the creation of a system of balanced calculation of regulatory capital that is more sensitive to banking risk; significant expansion of arsenal of tools in order to reduce credit risk; the introduction of capital requirements for operational risk; significant expansion of powers of supervisory authorities; the requirements for comprehensive disclosure by banks of their information and the methodology they use.

It was expected that the introduction of these innovations will have, on the one hand, the most significant impact on a sharp increase in the quality of risk management in most banks increasing attention to one of the significant risks of commercial banks – operational risk. On the other hand, there is a noticeable impact on medium and small banks and other non-bank credit organizations in both developed and developing markets. Unfortunately, the implementation of Basel II standards had a greater negative effect on the economic development of countries and global economy, provoking a new wave of instability in banking and other financial national and global markets – the global financial crisis of 2008–2009 was partly provoked by the requirements of the international standard Basel II for banks and banking systems in most countries.

It was during the beginning of the last global financial crisis that the G20 member countries changed the format of their forum. As a result, since 2008, a summit was held at the level of heads of state, and before this year only annual meetings of finance ministers and heads of central banks were held. World banking practice at the end of the 2000s showed the failure of the Basel II directives in the fight against new phenomena in a market economy, but, on the contrary, the situation in the monetary sphere of the developed and developing economies of the world was exacerbated despite the measures taken to modernize the regulation of bank capital adequacy. Their sustainability remained doubtful.

As a result, BCBS in September 2010 proposed a new set of standards called Basel III for the banking community and central bank managers.

4. Basel III: A global regulatory framework for more resilient banks and banking systems (BCBS, 2010) was adopted by BCBS on September 12, 2010 (approved at the G-20 summit in Seoul), and was adopted in an updated version it on February 20, 2012. This document is a set of standards that strengthen capital requirements and introduce standards for bank liquidity requirements. BCBS developed this document to mitigate Basel II's flaws, which manifested itself especially during the financial crisis of 2008–2009. The provisions of Basel III, in contrast to the provisions of Basel I and Basel II, do not

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represent recommendations, but the requirements for banking activities, significantly enhancing capital requirements and introduce new requirements for bank liquidity. The improvement of the quality of banking risk management is considered as the main goal in this document – a mandatory requirement to improve risk management systems and information security.

Basel III strengthened all three components of Basel II, and first of all it strengthened component 1 – the tightening of capital requirements, new liquidity requirements and the introduction of financial leverage.

In the Russian Federation, the requirements of Basel III are implemented in stages. This is evidenced by the Regulation "On the Methodology for Determining the Amount and Assessment of Sufficiency of Own Equity (Capital) of Credit Institutions (Basel III") adopted by the Russian banking regulator on December 28, 2012 No. 395-R .

If initially the time frame for the transition of banks to Basel III requirements was determined in 2013–2019, then later these time frames were revised. It is expected to complete this transition by 2022, including the Russian Federation (Bank of Russia, 2018).

Since 2013, such countries as Australia, Hong Kong, India, Canada, China, Mexico, Saudi Arabia, Singapore, Thailand, Switzerland, South Africa, Japan began to introduce Basel III requirements for bank capital in their banking system, and since 2014 such countries as EU, USA, Russia and some other countries started to introduce it. It is necessary to note that the requirements of Basel III were originally calculated only for large systemically globally significant banks (G-SIB) – the largest banks in the USA, Great Britain, Germany, Switzerland, Japan, China, France, Spain, the Netherlands and Sweden serving foreign economic relations (Borisov & Kondrat, 2016). Today, even after the implementation of anti-crisis measures in the United States, the enlargement of American transnational banks continues, but the problem of their financial stability remains unresolved (Shmigol, 2018).

Nowadays, the main goal of BCBS is to formulate common standards for banking supervision, capital adequacy, and risk accounting for national authorized bodies with their subsequent adaptation to their legislative and executive acts.

Stress testing is considered to be a predictive tool for risk management, which allows simplifying the process of the determination and achievement of the goals included in the strategy and policy of a commercial bank. It is necessary to note that the role of this tool after the last global financial crisis has increased significantly in banking supervision. In 2009, BCBS published The Principles of Effective Stress Testing and Supervision Practices, later called the Principles of Stress Testing 2009 (BCBS, 2009). It is necessary to note that until 2010, the recommendations for the use of stress testing within the framework of Basel I and Basel II were valid, but with the adoption of Basel III the situation changed dramatically.

Basel III aims to transform national banking systems and ensure their long-term stability. Therefore, banks that are not able to comply with Basel III requirements are subject to withdrawal from the banking and other financial markets, and banks that comply with Basel III requirements must focus on equity and, if necessary, use their additional reserves.

Many experts (Kurguzov, 2011) consider Basel III as a serious action in modernizing the activities of banks and the entire banking system of the country, as these requirements allow banks: increasing

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liquidity and reducing the share of inefficient capital; improving the quality of capital and reducing the need for excess capital; adjusting the business models being implemented. Meanwhile, according to the calculations of leading international financial, economic and research organizations, there is a negative impact of Basel III requirements on the financial stability of credit organizations and the stability of the credit and the entire financial system of developed and developing countries (Larionova, 2018; Shmigol, 2018). It is important to note that the purpose of stress testing is to identify the unlikely major potential losses in stressful conditions – when normal market conditions stop working.

In 2014, BCBS created the Stress Testing Network (STN), which was later called Working Group of Stress Testing (WGST). Today, BCBS recognizes two programs for supervisory stress testing: the first one is based on the top-down method, from supervisor body to credit institution, and the second one, based on the bottom-up method, from credit institution to supervisor body. The top-down method proceeds from the fact that at first the supervisory authorities accumulate information from banks, and only after that they evaluate the effectiveness and efficiency of these banks under stress, based on their own models and scenarios. The bottom-up method in stress testing is as follows: first, supervisors send their scenarios and leadership to credit institutions, which they use in their own models, and then reports are generated with the results of stress testing, which are sent to supervisors (BCBS, 2017).

There is no doubt that supervision stress testing programs should cover all the risks of a bank in a stressful situation. Banking supervisors in developed and developing countries continue to increase the resources allocated today to improve supervisory stress testing of both of these types. Banks are less and less perceiving stress testing solely as a procedure to ensure regulatory compliance.

The importance of international standards for risk management and BCBS supervisory requirements is that no large financial institution, regardless of nationality (including Russia), in the context of globalization cannot ignore their position without the risk of deterioration conditions of their activities (Tsakaev, 2012).

Concerning Russian legislation on financial regulation,, first of all, it is necessary touch upon the issue of the latest Federal Law “On the Central Bank of the Russian Federation (the Bank of Russia)” – the law on the mega-regulator in modern Russia, where banking regulation and banking supervision are reflected in Chapter 10 (Articles 56–76), and also provides the legal basis for regulation, control and supervision in the field of financial markets (Articles 76.1–76.9).

4. Purpose of the Study

A modern trend in the international practice of the regulation of the activities of financial organizations is the transition of a significant number of developed and developing countries to proportional regulation and supervision. This is due to several factors: the increase in the number of financial organizations and their diversity; the growing complexity of regulation of these financial organizations; the resource limitation of the activities of supervisory authorities; the decrease in the level of the competitive environment in the financial markets due to the unification of the requirements of supervisory authorities (Nikulina & Bravorets, 2017). Therefore, in the framework of this article, we set a purpose to reflect the observed global and national changes in the supervisory activities of central banks and other regulators of financial markets.

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5. Research Methods

During the course of the identification of relations and interdependencies, the methods of system analysis were used, namely, the methods aimed at the use of intuition and experience of a specialist – the methods of expert assessments. Analyzing the content of supervisory requirements for each of the four BCBS documents, the abilities of the association method were used. When comparing different versions within each of the four BCBS documents, the possibilities of the binary comparison method were used. Comparing Basel I, Basel II, and Basel III, the authors used the capabilities of the preference vector method.

6. Findings

International experience shows that the key principle of risk-based supervision is the concentration of the resources of regulator in organizations with the maximum amount of risk or the scale of activity. There is no doubt, that the concept of proportional regulation and risk-based supervision in Russia should underlie all the criteria for the evaluation of the activities of credit institutions and non-credit financial institutions in the country, but its national format should be formed with a balanced view of the observed trends in the supervisory requirements of international institutions.

In Russia, both in the short and long term, the desire for centralization in the system of state regulation will continue including regulation and supervision of financial organizations. The adoption in September 2013 of the mega-regulator model of the financial market in Russia is one of the strongest arguments in favor of this position.

However, we can assume that the current model of regulation and supervision for modern Russia under the conditions of digitalization of public relations will nevertheless be transformed in the direction of decentralization (vertical and horizontal). Moreover, in a vertical projection, the decentralization of regulation and supervision will be carried out in the direction of the return of a part of the authority to the regional structural divisions of a regulator (from the head office of the Bank of Russia to the Main Departments, and from the main departments to the Bank of Russia branches in the constituent entities of the Russian Federation). In a horizontal projection the decentralization of regulation and supervision will be carried out in the direction of restoring regulators by sectors of the financial market – banking, insurance and stock.

Taking into account federal state system of modern Russia, the effectiveness of regulation and supervision will also depend on the level of decentralization of certain authority of regulation and supervision between the Bank of Russia (federal regulator) and the highest executive body of a constituent entity of the Russian Federation (regional regulator).

The financial system of modern Russia demonstrates adherence to the ideas of international institutions. Russia gradually becomes incorporated in international regulatory and supervisory trends. The Bank of Russia is tightening its capital requirements for financial institutions and is striving to create a model that protects the financial sector of the Russian economy from external crisis shocks. The measures taken by the Government of the Russian Federation and the Bank of Russia on fiscal and monetary regulation, according to the Federal State Statistics Service, provide some stability to the domestic financial market (in terms of exchange rates, inflation, etc.) and positive (albeit not high) dynamics of Russian economy.

7. Conclusion

On the one hand, in compliance with the policy of proportional regulation and supervision of the activities of financial organizations, there is the increase in the centralization of regulation and concentration of capital in the sectors of national financial market (banking, insurance, stock). On the other hand, there is the decrease in competition between market participants, the decrease in the level of employment and a drop in the real incomes of population, the deterioration in the quality of life of Russians and an increasing gap in income levels between the high and low paid categories of workers. These trends are accompanied by the increase in the level of harmonization of Russian financial legislation to the requirements of BCBS and other international financial institutions.

It is important to realize that any excessive centralization leads to the occurrence and growth of the possibility of systemic risk. The greater the centralization of functional component in a system, the more catastrophic the systemic risks caused by the actions of system regulator — in modern Russia, it is applied to the entire financial system of the country. The modern global financial system and national financial systems of many countries demonstrate the large scale of the manifested systemic risks and their consequences for an individual, an organization, a territorial entity, a country and the world as a whole.

To conclude with it seems necessary to suggest to understand and adopt of the formula (plot) of the behavior of countries with developed large economies (such as the USA, China, Germany, France and the United Kingdom) for building and implementing a model of state regulation and supervision in the financial sphere of activity, which is most conducive to the development of their national economy.

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