Chosen Aspects of the Present Economic Imbalance in the Banking Sector

Assoc. Prof. Ing. Jaroslav Belás, Ph.D.
Tomas Bata University in Zlín
Faculty of Management and Economics
Czech Republic
Phone: 00421903446776
Mail: belas111@gmail.com

Summary: The banking system is a part of economic system in each country and represents an important part of the finance system. Its organization depends on the political and historical aspects, customs, traditions and economical specifics of the given country.

The main role of the finance sector is the distribution of finances between the subjects that have monetary resources and subjects that do not have them in sufficient amount.

The current finance and economical crises has revealed the weaknesses of the banking system and its regulation and demanded massive financial injections aimed on support of the banking sector practically in all important countries of the world.

The commercial banks do business with *the money* of their depositors that they gain on the financial market. The motive of speculation in the context of liquidity preference from the side of the individual economical subjects represents an important factor for creation of imbalances in the banking system. The intensive pressure of the bank stockholders on the performance of the system means, that the banks take an unhealthy portion of risk with the money of the depositors, often break laws and regulatory rules and apply low level of corporate moral. The motive of profit frees many participants of financial markets of rationality and restraints, what causes them to be very labile.

The regulation of the banking sector, which is based on the risk estimations and on setting an appropriate minimal capital adequacy ratio (*Basel II.)* clapped- out. On the present time is discussed the new framework of *Basel III.*, which however non – carries fundamentally new approaches to the regulation of banking sector.

The banking system contains systemic risk and sources of future imbalances, this is why the visions and dreams of many economists and politicians about a long-term stability of the banking system are not rational.

Key words: money, banks, banking sector, economic unbalance, regulation.

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Introduction

The world economic crises reminded the economists, politicians and the public in the world of the thesis about the vulnerability of the banks and the banking sector, it destroyed not only the existing regulatory mechanism but also the naive visions of the possibility that a stable banking sector can long-term exist in the conditions of market mechanism together with the false illusions about the almighty power of money, or isolated monetary world.[1]

The banking system (system of relations, institutions and rules between the banking and non-banking subjects in the given economy – banks and institutions, depositors, debtors, regulatory authorities, other participants of the system) realizes on the finance market a whole series of different financial products and services (deposits, loans, payment transactions, investment products, etc.) and in this process it is exposed to many economical and non-economical factors, this at the end causes *the presence of economical imbalances* in the system.

1. Macroeconomic aspects of existence of the economic imbalance in the banking sector

The basic determinant and the most important precondition for an effective and stable banking system is its *trustworthiness*.

The financial system, which most important part is represented by the commercial banks, is extraordinary dependent on the *public trust* because it transforms the precious monetary capital to its optimal use and can exist only if there is a sufficient number of economical subjects willing to entrust its savings and sufficient number of economical subjects willing to rely on the financial system in case of money shortage. [11, p. 981]

The building of trustworthiness of banking system represents a demanding task for the government, regulatory authorities and the management of the commercial banks. The sector trustworthiness is strongly influenced by the actual condition and perspective development in the *economy*, because we cannot expect a performing and healthy banking sector in a stagnating economical system, considering the fact, that the banking sector gains resources especially from the subjects in the real economy and uses them mainly to finance the needs of individual sectors of the real economy.

The trustworthiness of the financial system depends on the relevant economical indicators of the given economy performance, quality of the given banking sector and perception of the government economic policy. There is also an unquantifiable and unpredictable parameter that strongly determines the performance of the banking system. This parameter is the attitude and expectations of the individual economical subjects.

$$\text{Trust} = f(E, EG, G, P, R, Ex, P) \qquad (1)$$

where:
E – actual performance of the given economy,
EG – perspective of economical growth,
G – perception of the government economical policy by the system participants,
P – performance of the banking sector,
R – existing international and local risks in the banking sector,
Ex – expectations of the individual economical subjects (households, companies),
P – preference of the economical subjects.

In the context of building of trustworthiness plays for the banking system an important role *the monetary and fiscal policy of the state*, because

[1] Separation of the financial economy from the real economy can be considered as an important reason for creation of the world economy crises.

it creates preconditions for future economical growth of the country with respective impacts on the whole society.[2]

Recently there is increasingly more criticism of the central banks for their share on the creation of the world economic crises (monetary policy, bank regulation) or for the mechanisms used to reduce its impacts. In this connection is appropriate to point out, that the major share on the behaviour of the commercial banks carries the *political system,* the ideas and the efforts of its participants regarding the impacts of the monetary policy on the real economy. To be fair it is necessary to state, that the monetary policy of the central banks in the time of crises with the goal to increase the liquidity of the banking sector through low interest reference rates, is „the best from the wrong solutions".

To expect a rational economic behaviour by politicians[3] regarding fiscal and monetary[4] policy is with high probability incorrect and unappropriate. This confirms the actual situation in Greece, Ireland, Slovakia and other European countries (about many of them we do not have relevant information yet).

The budget making process, where the holder of budget activities defines the priority subjects and financial needs and subsequently searches for resources even if the price is unsuitable economical solution and also the way of their use (e.g. priority to satisfy the needs of chosen society groups at the expense of other groups based on the irrelevant factor of actual political power) is economically irrational, not effective and represents a considerable source of present economical imbalances in the financial system. The politicians make artificial and imbalanced interventions into the economical system and deform the system (e.g. scrap page scheme for automobiles, subsidy of building saving products and mortgages or other forms of economically unjustified preferences of chosen population groups, etc.).

The economical performance of a country and the economical growth determine substantially the parameters of the banking system and the expectations of economical subjects. The income of the household creates potential preconditions for the growth of banking sector due to the rise of savings in the system and demand for loans, shocks in the economy have usually intensive impact on the propensity to savings and cause large problems for the banks in connection with the recovery of the money and increasing risk.

During the decision when and how much to save are the households considering usually several factors: income amount, intended target of saving, expected part of income that will be put aside in the form of savings (propensity to savings). Overall is valid, that the volume of the household savings is growing with the income. The families and individuals with higher income have higher propensity to save and lower consumption (in absolute numbers) compared to families with low incomes [11, p. 226].

The savings creation process cannot be strictly defined, because beside the economical factors (growth of the economy, income, prices, interests) there are also noneconomic factors (psychological, social, subjective – taste, mode, expectations, traditions) and at the same time there are many contradictory factors (recently in the Slovakia there is a trend of higher propensity to savings in the poorer regions).

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2 Current financial situation in eurozone confirms the primary intensive presence of given factor.
3 At the beginning of the crises in the USA were wrong decisions of politicians and Federal Reserve System.
4 Proclaimed thesis about independency of central banks has substantial discrepancies.

Potential possibilities for creation of savings in the economy can be expressed through the *savings function:*

$$Sx = f(E, I, Pc, I', G, T, F)^{5} \quad (2)$$

where:
Sx – savings,
E – state of economy,
I – income of the economical subject,
Pc – price level and its dynamics,
I′ – interest rate,
G – guaranties for the depositors,
T – subjective factors (taste, mode, expectations, traditions),
F – other (e.g. psychological factors).

A dominant part of the active banking businesses is usually primary oriented on the *financing of corporate needs*. The financial decisions of the companies are influenced by the priority target of the company activities (maximal possible return on capital) and usually by the factors that are not exactly measurable, they interfere with considerable portion of uncertainty and risk, what causes the financial management of the companies to take inadequate risks financed through loans. The loan business of the corporate clients is extraordinary risky, tight connected with the individual phases of the economical cycle and even sophisticated methods of the corporate risk assesment (bank rating models) cannot protect the banks from intensive credit risk.

Rose [10, p. 604-605] defines two characteristics of the consumer loans: *they are sensitive to economical cycle*[6] and *not elastic to interest rate*[7]. This supports the hypothesis of irrational behaviour of this segment. In spite of it the experiences from the times of crises in the slovak banking sector confirm, that the credit risk of the retail clients is lower compared to the corporate.

The commercial banks do business with *the money* of their depositors that they gain on the financial market. *The money* fulfils important *functions in the economical system*, by this means it influences the life of each and every economical subject. The extent of influence is correlated with the type of the given economy, and currently the money has strongly breached the borders of national economies, its importance is *internationalized* and influence is global.

Money can be percepted *in several ways*. Without doubts it is in the first place an economical category, it was created and work in economical sphere, but at the same time it is also a social, philosophical, psychological category and the influence is crossing the whole society and the life of each individual in it.

The possibility of possessing the money in great volume and its use for various subjective purposes (increasing the life standard of an individual, vision of luxurious way of life, reaching the life dreams, etc.) determines significantly the behaviour and actions of the individual, his psychological characteristics, appetite for consumption of financial products and services.

The motive of speculation in the context of liquidity preference from the side of the individual economical subjects represents an important factor for creation of imbalances in the banking system. The intensive pressure of the bank

5 The households create usually the largest amount of savings in the economical system and the saving creation is natural to it considering the taken risks. The corporate sector is primary oriented on reaching of other goals and creation of savings is a secondary effect of its activities.
6 In the time of expansion public expectations are usually too optimistic and this is why the households run extremely into debts.
7 The consumers are more interested in the amount of monthly instalment then in the interest rate.

stockholders on the performance of the system means, that the banks take an unhealthy portion of risk with the money of the depositors, often break laws and regulatory rules and apply low level of corporate moral. *The motive of profit (tight connected with the money) frees many participants of financial markets of rationality and restraints, what causes them to be very labile*.

2. The internal aspects by creation of economical imbalance in the bank system

An important specificity of the commercial bank activity is its *balance structure,* where clearly the foreign resources are dominating, especially from households in form of small deposits, with which are financed the corporate needs. The commercial bank does business with money of its depositors on its own account and risk, at the same time it tries to maximize the *leverage effect*.

The atypical balance of the commercial bank represents an important problem for the bank management and also *a political problem,* because a collapse of a big bank, or any commercial bank can cause a turmoil in the society. Dominant share of foreign money is a typical characteristic of the banking business. Paradoxically, the more own resources the bank would have, the less it would be performing. But if an industry or commercial enterprise would have a similar balance structure, a commercial bank would not grant it a loan for sure.

The commercial bank balance is compared to non-financial enterprises *atypical and strongly asymmetrical*, it is typical for the system and at the same time represents the most important *systemic risk* in the banking[8], because a bank transforms the money guaranteed by the state to risky corporate loans or bond investments (the asymmetry in the security of financial resources) and its own financial participation is minimal.[9]

The asymmetrical model of the commercial bank balance in combination with high concentration rate of the sector determines the existence of other imbalances in the system (e.g. asymmetry of the information and asymmetry of the economical power).

The banking is *strictly regulated* business section. The priority target of the regulation is *the restriction of the systemic risk* (decreasing the uncertainty of chain payment inability of the banks, freeze of deposits and interruption of cashless transactions in the economy). *The systemic risk* is a negative externality, the crises of the banking sector and bank collapse threatens the public trust, harm the trustworthiness of healthy banks, have negative impact on the trustworthiness of the currency and trust of the investors in the given economy, what results at the end to lower country rating [1, p. 63-65].

A regulatory authority is generally the *central bank*. The basic argument for this approach is the *tight connection* between the monetary and fiscal stability and the *existing systemic risk in the banking* [6, p. 194-198]. The arguments against the combination of regulatory competencies and the responsibility of the central bank for the monetary policy: because of the worries for financial stability can the central soften its monetary policy, loss of trust to the central bank as regulatory enforcer can threaten the trustworthiness of the monetary policy. The regulatory actions through which the central bank does the

[8] It is obvious that no bank can be fully protected from depository attack.
[9] Simplified we can say, that bank do business with foreign resources and their own resources serve only for risk coverage.

regulation of the owner rights, can determine a *higher risk of political pressure* on the independency of the central bank monetary policy. There are reasons for splitting the function of the last instance creditor from the supervisory obligation, because there can be a situation where the central banks tries to intervene to advantage of a bad bank with the target to hide poor quality of the bank supervision execution, this means presence of two authorities can add quality to the decision making process.

The regulation of the banking sector is based on the risk estimations and on setting an appropriate minimal capital adequacy ratio (*Basel II.),* the future negative impacts on the profit of the bank should be covered by the equity of the bank.

In connection with the creation and impacts of the world financial and economical crises are more intense presented the opinions about a fail of *Basel II*. *Král'* [7, p. 107-114] presents an opinion, that the primary target of *Basel II*. rules is not achieved and the construction of this rules, processes and the whole mechanism is prooved to be incomplete, imperfect and in combination with the implementation and control algorithm also wrong and for the future not working and not acceptable, because it creates a world financial crises. The reality has shown that all internal and external ratings of the commercial banks and rating agencies have failed especially in the risk assessment of sub-prime mortgages and their derivates and also has failed the control mechanism of the central banks. The *Basel II*. rules misfunctioned in two main areas: factual correctness of the individual methods (models for risk assessment, internal risk checks of the individual products in the commercial banks and rating agencies) and the organization mechanisms of their implementation (the control function in the system has failed). Paradox is that the *Basel II*. rules itself (obviously pro-cyclical) are in obvious contradiction with the main target (e.g. advanced methods of risk assessment evidently leads to decrease of bank equity, but their calculations are not transparent and can be strongly subjective, this cannot be considered as increase of security in the banking sector, etc.).

The key elements of the proposals *The Basel Committee on Banking Supervision* is issuing for consultation are the following: the quality, consistency, and transparency of the capital base will be raised. For example, under the current Basel Committee standard, banks could hold as little as 2 % common equity to risk – based assets, before the application of key regulatory adjustments. The Committee is proposing to strengthen the capital requirements for counterparty credit risk exposures arising from derivatives, repose, and securities financing activities. The Committee will introduce a leverage ratio as a supplementary measure to the Basel II risk – based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. This will help contain the build up of excessive leverage in the banking system, introduce additional safeguards against attempts to game the risk based requirements, and help address model risk. The Committee is introducing a series of measures to promote the build up of capital buffers in good times that can be drawn upon in periods of stress. A countercyclical capital framework will contribute to a more stable banking system, which will help dampen, instead of amplify, economic and financial shocks. The Basel Committee is introducing a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio too. [2, p. 2-3]

On the present time is discussed the new framework of *Basel III.*[10]

It seems, that *Basel III. is Basel II.* plus some lessons learned from the word market crisis. It seems that regulators are very good at dreaming up all kinds of solutions, but are less able to enforce them. They want to rein ambitious, highly motivated bankers by introducing all kinds of rules and whatnot, but they are fighting a losing battle. This process of banking regulations is like putting a lame pussycat in a cage with a lion.

A specific characteristic of the banks is the existence of *safety net* that involves *state guarantees* for the banking business in the form of deposit insurance, central bank as *creditor of the last instance* and the doctrine *too big to fail*. [8, p. 200]

The presence of the last instance creditor is an admission of the market imperfectness, because the solvent banks do not have the possibility to gain liquidity on the interbank market due to the loss of own trustworthiness can the market be illiquid, or for particular bank can the resources be inaccessible. The primary use of this function assumes the author in case of larger banks in connection with the doctrine *too big to fail*. [9, p. 451-452]. In case of big banks we can assume, that the own trustworthiness attribute must not be fully considered in the bank management, because too big banks can fall for *moral hazard*.

The current finance and economical crises has revealed the weaknesses of the banking system and its regulation and demanded massive financial injections aimed on support of the banking sector practically in all important countries of the world.

Currently the *European commission* in connection with the impacts of the financial crises is preparing legislative propositions in the area of *crises management of the bank groups*, it discuss the *preventive instruments* (currently in time, when bank fulfils the regulatory requirements, an obligation to create methods for solving a crises situation), *instruments for solving the bank crises and change in the bank groups bankruptcy* (phase following the collapse of a bank).

The European commission is preparing proposals for adjustment of *guarantee schemes* not only in the area of deposit protection but also regarding the financing of bank rescue. It is considering a complex European fond where all banks would contribute. These contributions should be used to rescue the commercial banks threatened by the crises (financing of rescue with market means). At the same time there are attempts to create a legal platform to cover the finance institutions by *public means* in case of private means shortage. These ideas are to some extent compatible with the initiative of American administration. The most important US finance groups should pay *a responsibility tax for the financial crises*.[11] It is considered also a restriction of market share for a financial institution with the target to prevent a creation of subjects, which collapse would seriously impact the public budget *(too big to rescue)*.

[10] The draft of Basel III. regulations include: tighter definitions of Common Equity; banks must hold 4.5 % by January 2015, then a further 2.5 %, totaling 7 %. Banks will be required to hold a capital conservation buffer of 2.5 % by January 2019. A countercyclical buffer within a range of 0 % – 2.5 % of common equity or other fully loss absorbing capital will be implemented according to national circumstances. The buffer will be phased in from January 2016 and will be fully effective in January 2019. Systemically important banks should have loss absorbing capacity beyond the standards announced today and work continues on this issue in the Financial Stability Board and relevant Basel Committee work streams. Total Regulatory Capital Ratio = (Tier 1 Capital Ratio) + (Capital Conservation Buffer) + (Countercyclical Capital Buffer) + (Capital for Systemically Important Banks) [12]

[11] The Hungary approved a law about separate bank taxation. In Slovakia is the opposition initiating the approval of similar law.

The regulation caused by social and political aspects determines at the same time the existence of *state guaranty* for the banking business and the commercial banks do business (take risks) on own account with foreign money guaranteed by the state. With time a *private-public hybrid* was created and at the end the citizens are responsible for the bad management of the (big) banks.

The visions, positions and opinions of some liberal economists about *exclusive private ownership* of commercial banks are in this context not reasonable and could be accepted just in case, that the banks would voluntary give up the current system of state guarantees and informed the public about it, or would create an own robust and functional guaranty systems.[12]

The opinions of government on *additional forms of regulation* (e.g. regulation of income for the top managers, possibility of additional bank taxation[13], etc.) are in this context reasonable[14] up to some extent and in connection with the negative impacts of the world financial and economical crises we can assume, that under the public pressure the politicians will create significantly higher pressure by their implementation.

Conclusions

The banking sector has build in a series of systemic risks and other partial determinants of economical imbalances, at the same time it is dominantly influenced by a tight connection to the real economy.

The market is systematically generating a speculative motive and encourages the banks to maximize the profitability of their equity through unlimited expansion. The profitability of equity is directly proportional to the leverage effect resulting from systematic pressure on minimization of own equity of a commercial bank and in case of extremely low values can the banking turn into a riskless business with foreign resources. [1, p. 63-65]

The leverage effect in combination with the basic motive of business and asymmetrical balance of a commercial bank represents an important source of economical imbalances in the system that should be eliminated through administrative form of regulation. The possibility to eliminate the motivation of stockholders to maximize the profit through a regulation was prooved to be non functional.

It was confirmed, that even the sophisticated systems of the risk management cannot protect the banks from serious problems if they fall for the vision of maximal profit. They cannot substitute a common sense and rather than by model should the risk be assessed by human judgment based on experiences from the times of several economical cycles.

Search for optimal extent of regulation is a big art, because too much regulation can slow down the development potential of the banking sector, regulation and implementation of strict rules leads to the attempts of the banks for a workaround of this rules by legal means, what creates a permanent fight between the fine tuning of the rules and their avoiding.

12 The existence of state banks is directly proportional to the political culture governing the given country.

13 German chancellor A. Merkel stated, the banks should accept the responsibility and carry the consequences for the creation of financial crises. Not to have all burden for the solving of situation on the government of the individual countries, they should contribute a part of the income from transactions to a mutual fund.

14 Economically reasonable form is building a guarantee systems rather then additional taxation, eventually strengthening the equity amount in the commercial banks balances.

The globalization of economy is substantially affecting the character of financial institutions especially from the point of regulatory attempts to subordinate them to international rules and agreements, it offers a lot of various ways, how to avoid the regulation and effective supervision, because there are no universally valid worldwide rules, on the contrary even uniformly formulated documents have different territorial implementation.

Based on the predominating trends in the banking regulation considering the actual development in the European economy, fundaments and specific characteristics of the banking business we can assume, that the trend of strong regulation of the banking sector with special accent on the safety of the commercial banks business in the European and the world zone will continue.

In spite of the conviction of the regulatory authorities, that the optimal approach is especially the regulation of the bank capital adequacy in relation to the risk of the banking operations, it will be necessary from the regulatory side also in bigger extent to exercise other aspects from the area of responsible, professional and moral execution of the bank management functions.

The relative impunity of the bank management for the bad management, too intensive pressure of the stockholders and the commercial bank management on the performance of the bank without regard on interest of its clients, inadequate high incomes of the top management during the moral hazard realization[15], workarounds for the regulatory rules, or own principles of cautious bank business, unawareness and low professional level of some part of the bank employees are all factors that should be eliminated in relation to possibility of creation of crises in the future.

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[15] If the government must finance wrong decisions of the commercial bank top management, it should also possess the right to limit the incomes of the top managers. It seems that in the times of liberal approach it is coming an age of limits, what proves also the activity of european government in this area. The ECOFIN council has approved in its meeting from 7.10.2008, that the national governments will have the possibility to replace the management of a financial institution and can intervene in the area of rewards for the top management.

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