TITLE A NEW ARCHITECTURE OF THE BANKING SYSTEM

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Abstract: The present thesis is meant to be a study which intends to define a different architecture of the banking system and the way this architecture could replace the actual system. The new type of banking system identifies itself with a new type of relation between banks and depositors and creditors, on one hand, and on the other hand, between banks and borrowers. This new kind of relation implies a change of both the administration of the liquidity within the banking system, and of the assessment and the management of the risks. The main concern of the new system is to strengthen the protection of the depositors/creditors and to give them the liberty to decide over the risks they are taking. The new system also deals with the increase of the stability in all the areas concerned.

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Key words: banking system, risks, depositors, liquidity, financial crisis

1. OVERVIEW

This exposure is a proposal for a new architecture of the banking system and of the way it could be implemented. Given the role played by the banking system in both the historical, as well as in recent economic crises, it would be beneficial, in my opinion, the identification and the study of viable alternative for a redesign of the old system, instead of the attempts to strengthen its supervision.

The new proposed architecture is identified with a new type of relationship, on one hand, between the banks and the natural persons or companies with excess of liquidity and, on the other hand, between banks and entities who want to cover their liquidity deficit. This new type of relationship entails changes to the risk assessment, accountability and risk management, liquidity management, banking supervision etc. The approach focuses on increasing the freedom in making decision of depositors and protect their interests as well as on increasing the system stability.

As it is well known, the precursor of the banking system was the safekeeping of valuables entrusted by depositors. Thus, the banking system was built on trust that the holder of liquidity may dispose anytime, in full, of the amounts deposited. This assumption is no longer always verifying in practice today or shows a high degree of uncertainty. If the cornerstone of functioning of the banking system is affected, it is necessary, in my opinion, a redefinition of the system.

2. PROPOSAL FOR A NEW BANKING SYSTEM

Assuming that risks cannot be eliminated, the new approach aims only a more accurate identification of risk owners, a real-time correction of the value of bank assets if the risk materializes, along with a better remuneration of assets. At the same time, the new approach leads to remodelling the surveillance system.

In my opinion, the proposed architecture deals with all material issues that led to the outbreak of the last financial crisis, namely inadequate risk assessment techniques, moral hazard, the accumulation of systemic risk, too big to fail, liquidity crisis, local supervision of financial groups with international and global activities, lack of cross border resolution tools etc.

In the recently adopted measures established in order to strengthen the regulation and supervision of banks, can be found some of the elements proposed in the new architecture, but they do not provide the same functionality as the one to be presented (assuming losses by creditors through bail in resolution schemes, Liikanen, Volcher, Vickers proposals etc.).

In order to ensure coherence and consistency, we shall define participants as creditors (the depositor and creditor status does not exist, they are placed on an equal plan) and debtors, as any entity benefiting from a bank financing, no matter under what title is done. Thus, it is proposed the transition from the system through which banks, in order to obtain profit, places the funds raised from accepting deposits or from borrowing and they undertakes to repay at maturity, regardless of the collection of amounts invested, in a system where, through a central authority, funds are allocated directly by the creditors to debtors and the banks would perform only the management of the relationship between them.

Passing the credit risk to the creditors is a natural step in my opinion, in the context of the last financial crisis which shows that banks cannot cover losses caused by the dramatic reduction in the value of assets and of the repayment capacity of debtors, finally, the lenders bear the risk anyway, without deciding on risks they are taking and without be partners to the profits previously recorded. Illustrative examples are cases when depositors were part of the bail in procedures and it is the situation regulated now through the new Bank Recovery and Resolution Directive. So, the functioning of the banking system depends on the assumption of losses by the creditors.

The same creditors bears indirectly the risk also in the case of using public funds to rescue the banking system, in which case are affected, unfairly, the taxpayers, which are obliged to participate in rescuing the savings of creditors, although they may not hold investments in the banking system.

In the context of an already globalized economy, in which crises propagates fast, whatever the nature or triggers, generating significant reduction in assets values (in the way of reduced future cash flows, both from collaterals and from voluntary cash flows of the debtors) it may not be credible anymore that the global banking system, by itself, can cover these losses and reimburse the amounts raised from creditors. Accordingly, creditors must take the risks directly and transparently, while obtaining income from savings placed, without intermediaries. The increase and decrease in the value of investments made by creditors will follow in real time the increase and decrease in the value of the financed debtors, with respect to the total cash flows generated, without generating accumulation of risks. However, considering the globalization and the use of cashless payments, any person who initiates a payment or is the recipient, becomes creditor and therefore bear the risk of losing or reducing financial assets, without option.

The practical way in which could be implemented such a system of risk-taking by creditors involves the creation of multiple entities and changing the relationships between current participants.

In my opinion, it is necessary to shift the assessment of risks from the entity that seeks for profit, from the borrowed assets, to the entities having as main objective ensuring the financial stability.

It should be noted that the proposed system does not eliminate the deposit guarantee schemes, which may be initiated, and the creditors, who want to give up a part of their return for covering any reductions in value of investments, can make voluntary contribution. Moreover, the new framework of resolution issued at the EU level is based on ex-ante contributions of the banks and on passing losses on the creditors in bail-in procedures, so it will be no major differences. The only difference would be making direct contributions from creditors who wish to cover the risks they take and not by indirect contribution, bank - creditor.

Thus, while reducing banks' responsibilities and structures, the system requires at least three new entities/authorities, i.e. an authority for assessing the credit risk of debtors, a central authority to manage the central account and a collateral valuation authority, each having tasks defined in order to protect the interests of creditors, as presented below:

2.1. The Authority responsible for assessing the credit risk. The authority will assess the repayment capacity of debtors and the probability of default. This will assign ratings to debtors, according to a unitary system that will enable creditors to know the debtors and to opt for a higher yield for high risks taken or low yields for low risks. If the funding is at the system level, general, without regard to the rating of the borrowers, the yield can be determined according to the projected evolution of the profitability of the system (based on a general probability of default).

This authority shall determine at the time of funds withdrawal, the yield obtained by creditors, corrected with the potential losses associated to financed risk class or to the whole banking system, depending on the initial choice. Consequently, the new system will provide a better return to creditors since they receive all the incomes from the lending activity and they are remunerating only the portfolio management services provided by banks.

At the same time, in the situation of worsening of the economic situation, which would lead to an increase in losses above the return obtained by creditors, they will support in real-time a correction of assets value, without leading to the accumulation of risks and possible to a unfair distribution.

The existence of this authority will lead to the implementation and enforcement of lending standards and prudential policies more efficient than in the current system. Thus, an authority with a high degree of expertise can define a unique evaluation system, by adopting best practices in credit risk-taking, superior to any system defined at the individual bank. This will lead to the elimination of conflict of interest between profitability objectives and risk management. The existence of a single rating for each debtor is not in any conflict with the objectives of strengthening the single market and free movement of capital.

Under this authority it may be more accurately anticipated macroeconomic developments that may impact the credit risk, it may be limited or stimulated the lending of certain economic sectors, for example, based on macroeconomic evolutions, much more effective than at individual bank level or through macropudential policy tools etc. The unique rating approach eliminates differences, which appears in the individual assessment at the bank level, which led to uncontrolled risk taking (good debtor versus bad debtor), depending on the individual assessment of each bank. The quality of a debtor can only be unique, the rating system must only ensure the allocation of a rating that reflects as closely this quality. However, the existence of a central authority whose purpose is to ensure financial stability will remove by default any inherent conflicts existing in banks between risk control, remuneration of management and maximizing the profits for shareholders. Thus, the single rating will reflect much better the real quality of debtors, the maximum funding limits that can be approved for them, differentiated according to the pattern of the activity or of the transaction and in accordance with the mix of eligible collateral. The implementation of such an authority at national/regional level, in my opinion does not raise particular problems, meaning in effect a transfer of personnel and expertise from the banking system and the central banks / other entities to the new authority.

2.2. The Central Account. The central account, which should be administered by a central authority (central bank, the supervisory authority etc.) will manage the funds belonging to depositors. The funds, although placed in commercial banks, which will continue to be the interface with creditors, will feed the central account and will not be at banks disposal. Funds will only be revealed as being taken by a certain bank, without being at its disposal. Through this account will be managed the account deposits and the withdrawals of funds, operations of receipts and payments, it will be allocated amounts for lending and also monetary policy objectives will be met. The Central Authority would allocate in a controlled manner available resources for lending to debtors, according to the mandate and policies given by the credit risk assessment authority. The banks that will manage the creditor - debtor relation, would only implement the effective allocation of funds to debtors.

It is not desirable that the proposed approach be seen as a re-introduction of the concept of clearing bank, the central pillar being the taking of risks by creditors, the cash management being only a subordinate objective. Also, it is not desirable that the approach be seen as a huge securitization, although it may have some similarities.

2.3. The Collateral Valuation Authority. The tasks are obvious, the need to create this authority derives from transforming the banks from risks evaluators and credit risk takers to simple managers of the relationship between creditors and debtors. Due to the fact that banks does not take the credit risk, they cannot play any role in the assessment of collaterals, a process that requires an independent authority that protects the rights of creditors. The establishment at national/regional level of such authority does not also raises, in my opinion, significant problems.

Considering the above, the role of banks will be reduced. They will obtain returns from the management of loan portfolios and from the current account transactions, payments, receipts, services provided in mandate etc. By defining credit standards and maximum amounts of funding allocation for each potential debtor and also by the controlled distribution of resources from the central account will be eliminated the moral hazard and financing activities that may have speculative character.

The lending operations will be directed exclusively to the real economy. As all funds raised will be subject to real-time control of the central account, any investment or lending activity, apart from these resources, can be made by banks only from own funds or under an express mandate of potential investors, not being creditors.

Performing all the lending operations and the payments operations through central account (regardless of the bank where the account holder is domiciled) will be useful for the credit risk assessment authority in the rating allocation process. The debtors activities become more transparent, while increasing market discipline.

Reducing the role of banks to the three central authorities defined above would lead to elimination of the risk related to the too big to fail (applies to institutions of any size) and performing the lending and current account operations through the central account would allow a rapid relocation to other banks of the debtors operations.

However, the existence of the central account would eliminate or at least mitigate liquidity crises, if it is implemented only at national level. Withdrawal of loans granted by creditors to the banking system, and in fact to the debtors, it would not make sense. Obtaining a yield differentiated according to the risk taken and above the inflation rate, by placing liquidities in the banking system, would have an effect of increasing the liquidity of the system, reducing the differences in yields compared to other types of financial investments, more risky, non transparent or conducted on non-regulated markets.

The access on the banking system would be much easier, given that capital requirements for credit risk would be eliminated, obviously with the maintenance and remodelling of the requirement for other risks, and linked to the existence of the necessary capabilities and platforms for credit portfolio management and for the performance of the other authorized operations. The easy access will not lead although to lower standards, since for the managing of loan portfolios the banks will compete, the quality of the process being essential.

3. Conclusions

The proposed system is identified through creating added value, primarily for owners of liquidity, namely the creditors, which supports the risks of their placement into the banking system and secondly for bank shareholders, whose role will be reduced to the intermediation of the relationship creditor - debtor.

In conclusion, the shift to a system where those who hold liquidities will bear the risks, being adequately remunerated may have a longer period for implementation, or will be required by other crises, but, in my opinion, will surely occur. Perhaps the practical implementation of the new type of banking activity, as it is proposed above, may not provide the best representation of the principles presented, but certainly can be refined and reshaped to fit to the primary objective of financial stability.

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