JGPG (2016) 5: 141-143
DOI 10.14666/ 2194-7759-5-2-012

COMMENTS

The Happy Hellenic Republic: Introducing new regulatory framework

Tigran Hakobyan

Abstract This document presents a proposal for a new regulatory framework for the financial sector of the Happy Hellenic Republic (HHR). The recently elected government has managed to fully repay its external debt, has abandoned the euro and issued a new currency, the Happy Midas Drachmae (HMD).

Keywords New regulatory framework - Financial sector - International financial convergence Liquidity virtue cycle.

JEL Classification E02, O43

Introduction

In this context of macroeconomic stabilization, given the high amount of reserves and the nascent Euro Area recovery, it is expected that over the following years the HHR economy will receive a strong capital inflow, which will further boost economic activity and thereby the financial sector. The experience of the international financial crisis has proved that the consequences of a self-reinforcing liquidity crisis can be devastating and has exposed the limitations of the regulatory framework implemented before and during the crisis. Thus, in order to avoid excessive risk taking by financial institutions over this future expansion period, it is necessary to create and implement a sound financial regulatory framework, in our case a liquidity management framework.

Scope of regulation

Within the globalized economy, in which financial linkages between countries are becoming more interrelated, the implementation of any new financial regulatory framework should be consistent with the internationally accepted principles for the financial sector. Therefore, in designing a new regulation for HHR, it is necessary to determine a new set of rules, which leads to convergence of HRR financial sector to international standards. In this sense, we base this new framework on the "Principles for sound liquidity risk management and supervision" outlined

by the Basel committee in September 2008 and the subsequent Basel III recommendations.1 We would like to state that the rules that are to be put forward concern banks (credit institutions), however, we recognize the fact that these liquidity management guidelines may also be used to define liquidity risk management protocols for non-bank financial institutions. The rules we propose will deal with the building of a comprehensive risk management framework that is subject to regular review by internal and external supervisors. These rules will seek to avoid the cataclysmic damage that can be caused by a reversal of the liquidity virtue cycle due to unlikely but strong liquidity shock events leading to a downward spiraling liquidity crisis.

Underlying Risk Methodology and Liquidity Risk Measures

In our proposed guidelines, the Liquidity Coverage Ratio (LCR), as introduced by Basel III, will be replaced by a new LCR based on the Projected Liquidity Exposure (PLE) and the Counter Balancing Capacity (CBC) as proposed by the findings of Fiedler (R. Fiedler, Liquidity Risk Corporation). The definition of High Quality Liquid Assets, as per the Basel III definition, will also be used in the calculation of the PLE. Regarding funding stability over a longer period, the Net Funding Stability Ratio (NSFR) calculation methodology remains the same, however the weights in the Available Stable Funding (ASF) and Required Stable Funding (RSF) calculations may be changed on a situational basis. Precise changes to risk-weights should be discussed in more detail in cooperation with the Hellenic Central Bank and other national competent authorities. In this new framework, the central bank in its supervisory role will be granted further responsibility and authority in order to determine the regulatory accounting standards to be reported by financial entities, financial projection models with different kind of scenarios and which will be subject to stress tests. It is the opinion of the authors of this proposal that the methodology and procedures for these financial models, its forecasts and stress tests be determined by the central bank, who due to its overview of the macroeconomic outlook and its economies of scale is in a better position than individual financial entities to determine which are the relevant variables and likely scenarios.

However, there should be a strong and continuous interaction between the central bank and the risk management representatives of individual entities. On the one hand, this should allow the risk measurement tools to be adapted to specific problems faced by different kinds of banks. On the other, this will generate a learning process where the representatives of individual institutions incorporate the liquidity risk view of the central bank and where the central bank gets to know the risk management challenges and practices that are specific to entities operating in different sub-segments of the financial industry. In this sense, liquidity risk management plans should be designed with respect to the individual bank's liquidity risk tolerance, as well as the bank's systemic importance to the HHD economy. Said risk tolerance should be reviewed and assessed on a regular basis in cooperation with any relevant competent national authorities. In addition, financial institutions should develop a contingency funding plan consistent with their risk preferences and results of stress tests and scenario analysis. Finally, the risk management regulations should be accompanied by the implementation of a Fund Transfer Pricing System to determine the cost of funds to clients based on an incentive compatible mechanism to limit risk taking throughout different banking units.

1 Basel Committee of Banking Supervision: Principals of Sound Liquidity Risk Management and Supervision, Bank of international settlements bcbs 144, September 2008;
Basel Committee of Banking Supervision: Basel III: International framework for liquidity risk measurements, standards and monitoring, Bank of international settlements bcbs 188, December 2010

Minimum Requirements (LCR and NSFR) must be reported on a daily basis. On a monthly and quarterly basis financial institutions should report their financial statements following a standardized account breakdown determined by the central bank. Also to be reported on a monthly and quarterly basis are their minimum liquidity requirements and liquidity gap analysis by currency as well as an update of the financial model introducing data of current financial statements update and macro-financial projections provided by the central bank. Financial institutions should develop stress and back tests using the general methodology outlined by the central bank and including specific scenarios agreed on between individual institutions risk managers and the central bank representatives. These results should be accompanied by a document containing an analysis of the results and an evaluation of the strengths and limitations of the contingency funding plan based on these results. Finally, on an annual basis, banks should present annually aggregated version of data presented on a higher frequency basis as well as a report explaining any changes in the business plan and the associated adjustments to the contingency funding plan. Banks should also report their results to market participants, to a reasonable extent, allowing the participants to assess the soundness of the liquidity risk management plan implemented.

Impact on the Financil System, the Real Economy and Interactions with other Countries

The proposal aims mainly at directly reducing funding liquidity risk and minimizing the probability of a bank's exposure to stressed liquidity scenarios. However, due to the close linkages between funding and market risk, the proper implementation of this framework will reduce liquidity risk as a whole. As this framework is designed to be consistent with supervisory standards agreed on by the Basel Committee, it will also encourage a convergence of the Hellenic financial system to international standards and norms.

Regarding macroeconomic effects, appropriate implementation of this regulatory framework will limit excessive risk taking and reduce the likelihood of adverse liquidity shocks, which end up affecting the exchange rate and real economy. However, the measures proposed should be discussed in detail with the Hellenic Central Bank and any other relevant competent national authorities, including those in charge of macro policy design, in order to allow coordination of policy implementation, considering its consequences for the financial system and the real economy.