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RESEARCH ARTICLE

Banking regulation. Lessons and challenges

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Abstract

The financial crisis (setting in since 2007) focuses attention on the regulation, while the self-regulated market shows imperfection at the market. In the last decades the deregulation was the key-word, but nowadays everybody desires for new rules and regulations. The article tries to present this complex subject regarding the banking regulation. There will be demonstrated the pros and cons concerning the regulation, the practice regarding the actual regulation and the possible solutions as regards the developing.

Keywords

deregulation · liberalization · regulation · capital requirement · procyclic behaviour

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1 Introduction background of the crisis

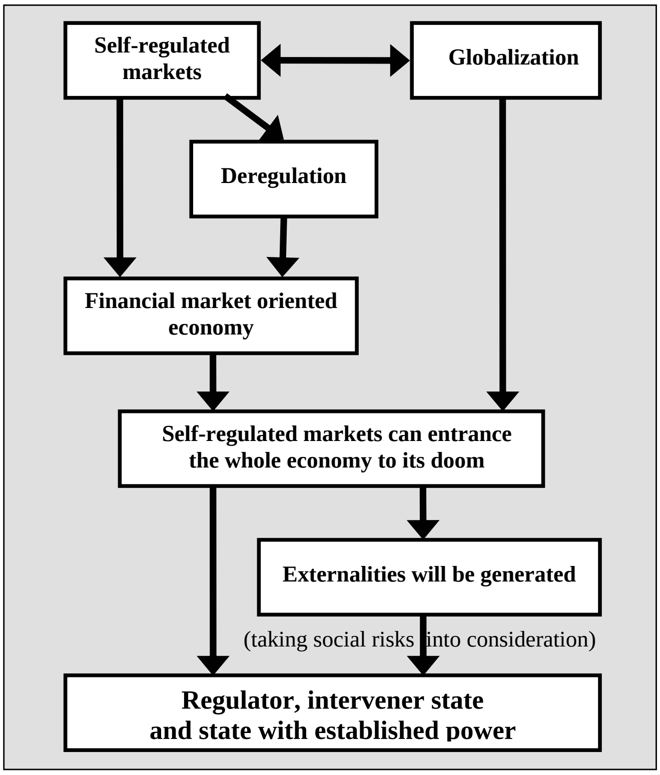
Last years we could observe a recession in all sectors of the economy all over the world (from the USA over Europe to Asia as well). Certainly all countries began to face the problems, but the signs and the level of difficulties are fairly different.

The signs of the crisis extended from sector to sector. Economists forecasted the arrival of the economic crisis based on the periodicity of economic growth and recession as well. Earlier there has never been such a long prosperity in the world as it was until nowadays. The crisis could not have been avoided, but the proportion, the degree and the period of the problems and disadvantages were influenced by the direct efficient causes.

Thirty-forty years ago dollar could not be exchanged for gold; therefore the floating rate of exchange was introduced in most countries. Twenty-thirty years ago the world tried to regenerate itself after the crisis due to the oil-price-explosion. In the nineties prosperity took wing, so the privatization, globalization, liberalization and deregulation could gain ground. So the rules of the neoliberal principles governed the economy and world. We emphasize the word: govern, since the solution seems to be the governance as well, but governance by the governments and not by the market itself. But keep in mind: a modern and global economy cannot function without credit and financial institutions.

Recognizing the signs, facing the facts, analyzing the processes and progresses and looking for the solutions are the most important tasks at the beginning of the crisis. The financial system is the nervous system of the economy; therefore the economic crisis takes steps to the financial crisis as well. This Fig. 1 shows the correlation of the processes.

As Stiglitz said the American economy was admired by the nations of the world and the American economists suggested giving power to the markets. Now this period has been closed and there is no respect for America and the American model, since they think that they have to suffer for America(n model) [7]. The high level of consumption in America was maintained by resources of the mortgage credit that was financed by the savings of the Middle and the Far East. The Americans have to reduce their consumption to the level of their income. Nev-



Source: Own figure

Fig. 1. From self regulation to regulation

ertheless, the participants of the American financial sector have to accommodate themselves and their approach. "The majority in America did not vote to throw out the capitalist baby with the bankers' bathwater" [6]. The above mentioned economists summarize the main conclusions of crisis regarding (mostly) the American market, society and getting a solution to find the way out.

This article provides an overview of the milestones in banking regulation, summarizes relevant criticism on and the weakest points of control, and mentions the effects the financial crisis has on regulation and touches upon new requirements and challenges. Nevertheless there are some open questions. What will also happen during the crisis? What have happened during the crisis to institutions not applying CRD/Basel II? Do they have enough capital for the necessity improvement as regards the reduction because of the crisis? Could the CRD/Basel II earlier and broader application have helped regarding the depth of the financial crises? Is appropriate the capital requirement maintaining liquidity, solvency and profitability? We try to reply to them.

2 Necessity of the banking regulation (The magic triangle. Conflicts of solvency, liquidity and profitability.)

2.1 Bank as the special company

Given their roles in the economy – as financial intermediaries -, banks have for decades been regulated significantly more rigorous than those of other corporations. After the gold standard, in which banks were handling money, evolved a credit based monetary system, where money is a payment promise by banking system. Cash is by central banks and money as deposits is by commercial banks. In the case of a bank failure deposits are perished and on the other hand payments and settlements are endangered. This system is the circulation of an economy. Accordingly, disruption in this system – same as a stroke for a person – triggers serious problems. A stroke in the payment system may be caused by a technical error either the illiquidity of a bank or the insolvency of an institution. Banks have a key role in the operation of payment system, which is the reason they are supervised and controlled by the government.

The essence of supervision is to obligate credit institutions to considerate and prudent operations. Banks do not only maintain the liquidity of the economy, they finance the different economic activities as financial intermediaries. Meanwhile they take and transform risks and their earnings arise from this risk management process. These profit oriented institutions provide public services as well (operation of monetary system). Primarily they strive for profitability and not to serve commons. If banks, taking part in payments and settlements, provide besides the typical commercial banking services investment and other financial services (universal banking) their prudent operations will be endangered. Additionally not only the owners / shareholders expect higher and higher profits from them, but the prudential regulation is based on the same logic as well. Banks need to increase capital to expand risk taking and to enhance their earnings. The source of capital is profit since the source of profit is risk taking. Consequently the general good (sound money by safety payments and settlements) is endangered by greed and concerning is profits. Banks, due to their liquidity and lender function, are able to enforce their interest one-sided.

2.2 Arguments for deregulation – free banking

The two pillars of regulation are represented by the government's safety net and prudential control. While the former stands for measures and guarantees such as the national banks' lender of last resort function or the institutions of deposit insurance, the latter comprises requirements on risk assumption, capital accumulation, asset concentration and liquidity. With regards to regulations on banking – in terms of methods and extent of control – there has been an ongoing debate amongst economists for decades [3]. Advocates of the so-called *free banking*[1] believe that the regulation of banks – similarly to the way other industries and sectors operate – could be left to the market. In the core of their argument are those conscious bank managers who are perfectly aware that the key to long-term profitability is to retain client confidence, which in turn calls for a "conservative" lending policy and the maintenance of adequate levels of capital and liquidity. In addition, they raise attention to moral risk factors inherent to regulation – especially government guarantees and aids. This reasoning is due to the fact that

[1] The standpoint of free banking advocates can be best understood through the works of Kevin Dowd.

the management of a given bank may very well be inclined and willing to undertake riskier investments in the hope of higher returns. Such managers may consider risks as opportunities of potential gain, which could indeed have a positive effect on both the bank's profitability and shareholder wealth, while securing the managers' positions and bonuses as well. And whenever there is "trouble" – when an investment or exposure plummets – they can all anticipate support from the central bank, functioning as a last resort. This methodology and its inherent moral risks jeopardize, through interbank relationships and by means of the adaptive behaviour of depositors and other account holders, the stability of both the economy and the financial system. Individual issues, therefore, may bear an impact on the liquidity and reputation of other banks and could even lead to an overall loss of trust in the banking system as a whole. It is exactly the transmission of problems; this high level of exposure to contagion is what *those promoting regulation* are against. As Calomiris (1999) [2] also states, the elimination of negative effects and externalities resulting from the bankruptcy of a bank – or from a crisis in the banking system – come at such high costs that it is the government's obligation to take whatever measures possible, in order to minimize the likelihood of a bust taking place. In addition, advocates of regulation like to point out that without legal regulation, market participants could never be fully confident about having corporate governance of banks that is able to subsume their profit maximization goals to safe operation and reasonable risk assumption.

The debate between free bankers and advocates of regulation has been going on for decades, yet regulation does exist and is in a process of continuous evolution. Nevertheless, the dispute is but unnecessary, as regulators in the past few years have shifted towards the market: they are now aiming to launch and utilize, based on general consensus, legislation that better suits the risk profile of institutions and is based on the best practice of banks with the most experience in risk.

2.3 Milestones of bank regulation

The past few decades have seen significant changes in the financial sector worldwide. After the '80s the deregulation of financial services industry enhanced the paradox between the requirement of financial stability and institutions' profit oriented behaviours. The financial deregulation – whose culmination was the repeal of Glass-Steagall Act in the US – resulted that financial institutions are allowed to provide more and more services (for example: insurance and speculation in investment sector) for their higher and higher profits. This could trigger crisis in banking system and its consequences – primarily the absence of confidence in financial institution and in the legal currency – may occur currency crises.

Increases in both the turnover of money markets and the cross-border flow of capital, technological development as well as the expansion of financial services available have resulted in the amplification of risks that financial institutions are now willing to take. Parallel to this, the number of bankruptcies had risen during the last third of the 20th century. All these events called for regulation that, instead of earlier, quantitative rules (such as the interest rate cap), is based on the risk undertaken. Creating a new foundation for control was attributed to the Basel Committee on Banking Supervision (BCBS)[2]. In 1988, within the framework of the Basel I Capital Accord and as one of the results of the Committee's work, the so-called 8% Cooke-ratio, or capital adequacy ratio, was established.[3] This accord links the credit risk assumed by banks and the capital level of credit institution (capital requirement of credit institutions). While ensuring the convertibility of the balance sheet items and off-balance sheet items, these were weighted by different risk weights (0, 20, 50 and 100%). So minimal capital requirement of credit institutions was defined in 8% of the sum of risk-weighted asset items. This relationship is expressed by the capital adequacy ratio, which is the fraction of own funds and the sum of the risk-weighted asset items. This capital accord of 1988 represents – by the emergence of the concepts of solvency margin and capital adequacy ratio – the basic pillar in prudential regulation.

Basel I considered credit risk to be the bank's principal risk, although from the late '80s onwards it was becoming clear that, due to the propagation of off-balance sheet items and different derivative-transactions, the role of market risk is also significant. In 1993, the Basel Committee formulated a proposal to define funds to be raised in order to cover market risks inherent to the banks' trading activities on the money- and capital markets. The need for a separate management of portfolios and portfolio-elements that are affected by market risk was put into focus. For this purpose, the trading book is used, which – just as its name suggests – includes repurchase securities and derivatives (purchased for trading). In 1996, the Basel Committee amended the Recommendations on market risk with the opportunity for credit institutions to define capital adequacy based on internal models.

Ever since its establishment, the Basel I has been target to many criticism and the need for its refinement has been getting more and more support from both financial institutions, supervisory authorities and regulators. Most of this criticism had to do with the weights applied at the calculation of risk-weighted asset items, since these weights only served to indicate that an item was riskier than another, instead of actually showing that an activity with a 100% risk weight carries five times as much risk as the one with a 20% risk weight. A great shortcoming of the Basel I Accord was that it failed to take into consideration the advantages that result from diversification. Moreover, the notable 8% is originated the empirical experience of crises in the

[2] Standards formulated by the Basel Committee are only recommendations, thus each country is entitled to adopt them to their respective legal system and practice at their own discretion. Agreement by BCBS mentioned in the article have been adopted, at least in part, by every country in the world – including the US, Japan, Canada and the members of the EU.

[3] Named after Peter Cooke, the first head of the Committee. Cooke-ratio, Cooke-Committee.

'80s. Due to deregulation and liberalization as well as convertibility, payment system and capital have changed. It is obvious that in a dynamic environment and in different financial models with different risk the suitable extent of capital adequacy could not be standardized. As the new millennium was approaching, the need for renewing the prudential regulation emerged.

1999 saw the birth of the first version of the new capital accord – the Basel II –, which only became finalized by 2004, based on suggestions and comments received from numerous participants in global finance. Instead of representing uniform concepts of the regulators, this new accord is built on the best practice of institutions providing the most outstanding performance. It also provides a greater level of freedom for banks in their assessment of capital requirements by the applicability of own experiences, internal models and methods.

Basel II. is based upon the following pillars:

- Minimum capital requirements in reference to credit-, market- and operational risk
- Supervisory review
- Market discipline

With reference to risks defined within the first pillar – that is, to credit-, market- and operational risks –, institutions need to define their regulatory capital. Depending on their own risk assessments and management profiles and levels of development, banks may choose from different capital adequacy calculation methods, so they can use either internal models to determine exposures and necessary capital. A common feature of methods is that, as opposed to earlier practices, they provide a more accurate snapshot of risks, whereas differences can be detected in the levels of standardization, that is, what are those risk parameters (probability of default, loss given default etc.) that can be defined by the bank and there are constant. The second pillar of the new accord deals with the expansion of scope and responsibility of supervisory authorities. These authorities are required to review the banks' processes of capital adequacy calculation on a regular basis, as well as their risk positions and the ratio of calculated capital requirement versus the risk assumed. The third pillar aims to enforce market rigor and lower the asymmetry in the spread of information amongst market participants. This is resulted in the widening of the range of information to be made public and the aspects of disclosure requirement were changed too. By amplifying the effects of one another, stipulations of the three pillars motivate institutions to operate more transparently and securely and utilize more advanced methods of risk management, thereby allowing for more effective regulation.

Based on the Basel rules, the Capital Requirements Directive[4] (CRD) was adapted in summer of 2006 and the contents of it are applicable to all EU member states. Its regulations became effective as of January 2008 only in part, as some of its provisions took force in January 2009. The United States has opted for a limited application of the new regulation (Basel II): only its ten largest – internationally active – banks are required to utilize the most advanced (internal ratings-based) methods for the calculation of capital.

[4] The Capital Requirements Directive comprises Directive 2006/48/EC and Directive 2006/49/EC.

3 Regulation regarding the globalization and Basel

3.1 Globalization, deregulation and conflicts of them

The economies of scale, the efficiency and the aim for the best possible solution have been developed to the level of globalization. These processes and the mechanisms (as the supply-demand) were self-regulated; this means that markets are self-regulated. Since the processes can regulate it, the rule of legislation was eliminated, deregulation emerged. Overproduction and over-supply in one sector generate themselves in all others too and after the boom the production in the sectors reduces. The financing demand reduced from sector to sector, so the possibility and the amount of the profit in the financial sector radically fell down. Therefore banks began to find other solutions to finance firms and retail at a higher level of risk as well and to realize profit.

The excessive, fast and polished-off deregulation of the financial sector enabled the bubbles to be born. In addition to it, the controls in the application of the existing rules in the financial legislation was remiss. The role of the supervisory authorities came up for discussion, but the opinions of experts are same, that the supervisory authorities cannot be blamed for any element of this financial crisis. The supervisory authorities took measures to reduce the risks and increased transparency, but their possibilities were at a minimum level. The legislation was basically permissive and based on the neoliberal principles inadequate.

The leverage appears through the subsidiaries, cross border merges, acquisitions and investment portfolios. The subsidiaries suffer and suffer losses because of the financial instability of the parent undertaking. The cross border merger and acquisition presents the same problems, but the different economic environment can influence the general effect.

The full repercussion of the financial crisis triggered by bad mortgages in the United States is still unclear, but the unforeseen effects already include an unstoppable demand for greater transparency in financial markets and for better regulation. Rasmussen [5] phrased the two main milestones of the possible way escaping from crisis.

The neoliberal economics are based on self-regulated markets and laissez-faire principles. Overproduction, credit expansion, extreme indebtedness etc. were not able to adjust and recover the market processes. The power relations of global economy and resource allocation in the world were modified. Earlier Brazil, China, India and Russia were only developing countries and they were at the periphery of the world economy. Nowadays these countries are influential for the global economy. At the same time the confidence in credit institutions was broken. It is important to say it loudly, since the liquidity crisis and the liquidity risk were reduced and avoided, but the confidence should be restored. The financial and governmental help were significant and inescapable, but the confidential crisis is not rejected. Publicity and transparency seem to be banality, but are the only possibility to rebuild trust in the financial sector and the financial institutions. The appropriate information should be available in time and in a correct and suitable way. Therefore publicity and transparency should be promoted in the financial sector as well.

The states bear a part in the financial sector as owners only. It should be changed. The position of the states should be altered from owner to regulator. Legislation should be comprehensive and expansive. The main point is taking into account global financial risk. This means that the possibility of mutability should be inserted into legislation as well. If the global market or a sector or only one (observable) part of a sector changes significantly then the financial institutions have to adjust it either it is advantageous or not. There are several general rules for risk management. These would be regulated in detail and in a more controllable way. The credit limits would be rigorously restricted.

3.2 Critics and challenges

By giving them a larger elbow room for the allocation of capital requirements, the main goal of regulation is to motivate credit institutions for the highest possible level of risk assessment. This allows for the strengthening of the banks' risk sensitivity and their sense of responsibility regarding risk assumption. Related to the higher level of risk assessment and management is the goal of reinforcing stability in the financial sector, which is to be reached by enhancing the transparency of the functioning of institutions and by the deployment of a stricter supervisory control.

The above-mentioned sounds very specious and, as the main objectives for regulation and supervision, can be applicable even in today's financial turmoil. The question is how and by what means can risk consciousness, corporate governance, prudent and transparent operation and an alert supervisory body be made possible. That is to say, the Basel II – as well as the CRD – has several shortcomings. In the following, we summarize some of them.

The scope of Basel II focuses attention on internationally active banks. The scope of CRD contains all credit institutions and investment firms. The main reasons are saving the competition and since in Europe the credit institutions are mostly universal institutions, therefore this extended scope could not be avoid.

As the crisis evolved it has become clear that some institutions do not possess adequate capital levels that are in proportion with respective risks assumed. One part of it is the inaccurate risk weights and the absence of enough prudent rules. Another part of it is that the new prudent rules (Basel II) were not applied widespread. Nevertheless according to the Basel Committee, one of the most critical areas is that risks related to trading book items are accounted for and covered inadequately. This was further enhanced by the spreading of complex financial instruments (CDOs)[5] that were less transparent and harder to appraise and qualify, thus increasing the risk of the institutions and financial system. With reference to the assessment and management of market risk and the definition of its capital requirements, the Basel II brought upon little, if any, change in comparison with prior regulations. For instance, it failed to deal with securitization that appeared in the activity of credit institutions in large volume and had a key role in the deepening of the crisis. In this area, the Committee is proposing the introduction of different restrictive measures – such as subjecting securitization to certain terms and conditions – and an increase in both transparency and disclosure obligation. The CRD descends some particulars regarding the securitization, but the circumscription, the definitions and the methods are not eligible and adequate. Accurately, the products, the leverage, the rules and the practice have changed during the preparation of the CRD and the last version could not represent the necessary content and correlation. Furthermore the CRD is a compromise of 25 member states. These countries are so different that many times the last version of the directive contains contradictions and inconsistency as well. Unfortunately, regarding the securitization the CRD has to face this case.

Another main defect of the regulation is that it excessively focuses on individual institutions, whereas the disclosure of system risks remains in the background. The application of stress tests allows for the analysis of system risks, within the frames of which the effects that large-scale and extreme fluctuations of market/financial variables (such as the drastic drop in real estate prices) have on portfolios and on the exposures of institutions, can be observed. Such stress tests could have been conducted also for liquidity risk, in order to find out the consequences of price increase and the exhaustion of interbank sources. If supervisory authorities and regulators had paid particular attention to liquidity risk, they could have prepared for the assessment and management of this lack of trust and liquidity that emerged in interbank markets around the globe [4].

According to Barth et al. [1], one of the main problems regarding the Basel guidelines is that these seek to substitute (replace) the markets by means of utilising complicated methods. Adapting these complex methods presents significant costs to – especially smaller and mid-sized – banks. The problem turns back to the trouble of the scopes. The scope of Basel II contains only the internationally active banks, therefore the application of the complex methods cannot be inconvenience. The CRD is applied to all credit institutions and investment firms, but the basic model was adapted to the larger institutions. Moreover, it shifts a greater level of responsibility to supervisory authorities as well, since their effective operation calls for employ-

[5] Collateralised Debt Obligation.

ing supervisory professionals possessing an overall, yet detailed knowledge of different methods of risk assessment and capital requirement calculation. Overly complicated rules and methods may obfuscate the attention from assumed risks in concern (as seen in the LTCM crisis in 1998). Another objection highlights a contradiction of the Basel II accord in that, although a system of regulations applicable on an international scale, it is to be implemented and supervised on a national level. Therefore, instead of considering the mitigation of system risks in the banking system as of primary importance, it focuses on the detailed presentation of methods suitable for the assessment of capital requirements and ignores the necessity for a supervisory entity of a cross-border jurisdiction.

The different rules in the countries cause problems at supervision of the cross-border financial groups and conglomerates. In EU this contradiction is more significant, since the CRD is applied compulsory, but it contains many permissive rules. Therefore the national legislations can be different enough. Since in EU the CRD disposes of supervision on a consolidated basis, but the different rules can complicate the practice of this supervision. The responsible supervisory authority is the authority of the parent institution, but the applicable law regarding the subsidiary is the law of subsidiary's country. The European Commission and regarding some cases the supervisory authorities would like to reduce the number of the national discretions, but the governments of the Member States oppose the integration, because they would not like to reduce the possibility of the decision.

The CRD in the states of the European Union applies the rules of disclosure which is the 3rd Pillar of CRD. There are special rules for credit institutions and investment firms, since these institutions manage the customers' funds, debits and resources. The new rules of the 3rd Pillar in CRD obligate the disclosure rules to the public. Much information is available from the institutions. These are new rules, so the comparability and history of the information are inadequate, but in a few years it will be solved. This is significant, but the regulators need to do more. Nevertheless, the role of it would be important regarding the subprime mortgage lending as well. Since this is a new rule it is not established that it has a power regarding the institutions, but the possibility of the retardation emerges concerning the subprime mortgage lending. For example if the investor could know much more about the institution and the particular transaction as regards the background of the SPV then the investor who is the final risk taker of the repacked credit could decide the realization of these information.

The role and the application of the special purpose vehicles (SPVs) would be sharpened. Since the SPVs issued promissory notes collateralized by their structured securities which were issued originally, the level of leverage is too much and the real collateralisation is problematic. The activity of the SPVs would have to be limited and controlled deeply.

We are talking about the necessity of the regulation and we emphasized the significance of changing in the approach of regulation level. Nevertheless we have to underline the opposite statement and process to it as well. The liberalisation and the deregulation has been criticized by us, but the raison d'être is unquestionable. For example the short selling was wanted to forbid, but the primary function of this type of transactions is important and basic in the life of financial sector.

It could be listed as one of the causes of the financial crisis that supervisory authorities – along with numerous market participants - were not aware of the composition and risk of structured products, thus they were unable to mark out the key points of supervision: exactly what, in what aspects, and with what tools should be examined when analyzing the risk exposure of institutions. This is why it is of crucial importance that, in the future, a greater emphasis should be attributed to the cooperation between market participants, regulators and supervisory authorities, in addition to making requirements on structured products more rigorous. It is essential that institutions are involved not only in the opining on draft recommendations but in the uncovering of problems as well, for they may provide useful advice that could contribute to the maintenance of risks between manageable levels.

In addition to the above, several other deficiencies and needs for change have been formulated against legislative provision currently in effect. This, however, do not necessarily mean that soon we will be studying the draft of a Basel III, yet it serves as ample proof that regulation must adjust to changes in its operational environment.

Nevertheless there is a main problem of the Basel II namely the lack of extension to all over the world. The implementation of Basel II is not compulsory, but the concerned countries committed themselves to the introduction. Unfortunately the member states of the EU have entered into force the new legislation based on Basel II, but the other countries defer to step. On the one hand this difference destroys the competition. On the other hand more rigorous rules can defend the institutions, their counterparties and clients against the deepening of the financial crisis. In Hungary we believe the advantages of the implementation of the new capital requirement.

3.3 Credit rating agencies

There are interesting characters of the present events: the external credit rating agencies. Credit rating is used by the banks, the investors, the companies and all participants of the capital market. Users know that there are differences in the credit ratings and analyses were made for order (sometimes in addition it was rating shopping) or individual initiated by the agency. At the same time credit rating agencies had to modify the grades of securities and issuers from investment category. The market was and is full of mortgage notes and their transformation in the securitization. The scandals regarding credit rating agencies and their analyses prejudice the trustworthiness of them. Instead of it the reliability and credibility are (one of) the most important elements of stability in the financial sector.

The basic pillar of one part of the CRD is the rating of the external credit rating agencies (ECAI). The standardized approach is based on the rating of the ECAIs, but the trustworthiness of them has been fallen down. The re-establishment of the trustworthiness is avoidless, which is based on the regulation of them. Till then the supervisory authorities have great responsibility, since the doubtfulness would not be spread to the user of the products of ECAIs (to financial institutions using standardised approach).

The credit rating agencies would be and will be regulated. The European Union has been planning the concept of the legislation for them for years. Now the negotiations with the USA are progressive, so the principles of the new EU directive for the credit rating agencies are sketched. The credit rating agencies will have to give more information about the analyzed financial construction. They will have to publish their system of consideration and analyses. Independent experts would be sent into the supervisory board and the agencies would not have licences to give advice, since the classification and the counsel exclude each other.

So the role of governments is determinant. The governments (and supervisory authorities where they have regulatory power) have to take steps and have to enforce new important acts and degrees. Time is an important factor, so delay can cause further damage.

3.4 Procycle behaviour

An increasing demand against banking regulation is to ease its procyclical effects. In the case of an overheated economy, regulation often generates further expansion, just as it can further deepen the crisis during a recession. According to Zsámboki [9] banks are optimistic in period of boom, thus they are prone to lending besides lower (possibly overvalued due to a bubble of assets prices) collateral requirements and lower risk premiums as well as they do not cover enough their expected losses by provisions. During a "bust" period these problems are emerged. Banks have higher provision obligations which influence their profitability and capital level. Additionally institutions cut back their lending activities; even the high quality clients (with low probability of default) may not be financed. Due to this phenomenon the banking sector enhances the economic downturn and could trigger even a credit crunch or a system wide crisis.

Regulation, therefore, has a clear impact on economic growth and financial stability, thus it is significant to know the ways and the tools that are used by us for coordinating the risk assumption and operation of institutions.

3.5 Discussion of Takenaka's reform suggestions

Takenaka in his article [8] presents eleven reforms that can block the tendency of financial markets to stampede:

1 adjust capital ratios to the level of lending measurement

2 benchmarks without a herd behaviour

3 mark-to-market rules on the duration of liabilities

4 leverage limits taking into account the funding cycle

5 extend suitability rules to all financial sector

6 enforce cross-country consistency

7 experiences at regulators and at regulated institutions

8 eliminate conflict of interest in the business models of rating agencies

9 professionalize external directors

10 consolidate settlement of OTC trading and credit default swaps

11 standardize cross-border collateral arrangements.

We can agree with points 2, 3, 5, 7, 8 and 10. Relative reference indices should not be used as a benchmark. The benchmark should be based on the efficiency, as indicated in point 2. Takenaka says regarding point 3 when an institution relies mostly on long-term liabilities then the assets regarding the mark-to-market principle need not be strict and frequent, but in the event of short-term liabilities the assets would be strict. The statement is not disputable. The capital market rules extend broadly customer protection through the adequate amount information and prospectus rules. These principles would be extended to other parts of the financial sector as well, as it is said in point 5. Point 7 determines the power of the experiences. The regulator investigates and supervises the institutions, but without real and accurate experience the results are uncertain. Therefore professional experience has to be obtained by the supervisor. One possibility is a 6 months skill in one or two financial institutions. In Great Britain there is a similar programme and the supervisory authority significantly supports the skills and the acquirements at financial institutions. As mentioned above, sometimes the rating agencies work to issuers, so the trustworthiness of analysis and the category is more than doubtful. The rating agencies must publish the qualifying process. Point 10 is a trivial statement and the market participants have been waiting for it for a long time.

Point 6 is true and false in one. The European Union is a typical example for it. The single market and the EU legislation support and enable to reach the consistency in the financial market, but it is sometimes only dream-world. The EU legislation contains many permissive rules (the typical phrase: the institution may apply), so sometimes the final version of the text and the implemented legislation are far from the ideal version.

The establishment of point 11 is important and true, but the implementation can be queried. The rules are not uniform and one part of the legislation without the whole (at least which belongs to that) legislation cannot be fully standardized.

Point 9 has two contrary opinions. It is true that external experts can see the company and the processes unbiased, but the calling and the commitment are missing.

Point 4 talks about limits regarding leverage. The principal is that the leverage limits of the financial institutions should be increased when the economy is in recession. In our opinion the liability of the decision and the determination of the leverage level are not contractible. The levels and the measurements are relative and the reaction of the forced limit can cause greater problems than the original effort. The same thoughts come up regarding point 1. The time of the reaction is unknown, but slow. The supervisory authority has to recognize the tendency and has to react on the effects as well. The financial institutions are the adverse parties, but the information is on at them. Therefore foreshow is doubtful and the chance of the accurate estimation is low.

4 Conclusions
A new wave of regulation?

Bringing up the liability of the bank sector is meaningless. Time and again the antibank-opinions (opinions against banks) restart especially at the period of crisis. Under these circumstances Brecht is citable, since the foundation of the bank is a more aggravated criminal offence than the bank robbery. The banks as the profitability companies (based the procyclic behaviour) do their best and they give credits during the prosperity, but they keep back the credit supplement during the recession. If the excepted return reduces taking consideration into the traditional bank services, than the financial innovations, constructions of the pilot-game and the moral hazards for the costs of the public benefit.

The better regulation is a key element of the European Union and the principles of its legislation. Therefore we do trust that the better regulation (which tries to reduce the unnecessary obligations and rules) and the anti-neoliberal opinion (the governments have to intervene to the automatic operation of the self-regulated market) will be balanced and effective.

The supervisory authorities have to co-operate concerning the cross-border groups and activity. The regulators (if they are the governments) have to work together with the supervisory authorities and market participants, since the practices and the knowledge are divided among them. Furthermore it could help the faster revival and reinforce the confidence in the financial sector as well.

Regarding the credit institutions the regulators at international level would have to calibrate the methods and the approaches again. It could be that another ratio or index can represent more adequately the financial safety net concerning the prudential regulation. The new approaches should insert to the models that one approach does not fit for all, therefore they have to pay attention to different institutions, activities, countries, economic and financial environment.

The regulation of the banking operation is not enough. The liberalization in other parts of the financial sector influences the banking sector as well. The deregulated capital market presented some deficiencies, since the short selling, the structured products and other transactions belonging to the derivatives causes many problems and much loss for the market participants, supervisory authorities and regulators as well.

The leaders of the Group of Twenty (G 20), in London summit, agreed to strengthen financial supervision and regulation, whose deficiencies were one of the main causes of crisis. They emphasized the need of greater consistency and systematic cooperation between countries towards restores financial stability. According to the agreement of the G20 regulatory oversight should/will be extended to credit rating agencies. International practices/guidelines/standards are desirable to eliminate the conflicts of interest (issuers and not investors pay for ratings) and to ensure the understanding rating decisions. The higher transparency, their accountability are desired by market participants. In addition the profitability as one of their major principles is also worth considering.

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