

THE BANKING SECTOR UNDER FINANCIAL STABILITY

COMPLETE VOLUMES ON THEORY AND PRACTICE OF FINANCIAL STABILITY

- Volume 1: Understanding Financial Stability
- Volume 2: The Banking Sector under Financial Stability
- Volume 3: The Corporate, Real Estate, Household, Government and Non-bank Financial Sectors under Financial Stability
- Volume 4: Economic Areas under Financial Stability
- Volume 5: Tools and Techniques for Financial Stability Analysis

Praise for *The Theory and Practice of Financial Stability*

Indranarain Ramlall's proposal is a great attempt at giving a comprehensive view of financial stability from a theoretical, practical and policy perspective. It aims at providing future students with the tools to understand the framework in which financial stability is assessed and understood today by international organisations and central banks across the world. To my knowledge, this is the only book that covers such a wide range of topics related to financial stability. It, therefore, has the potential to become a good reference book on the topic. I believe that Indranarain Ramlall has made a great proposal to provide a 'big picture view' on financial stability. I look forward to reading the textbook!

Celine Tcheng, Central Bank of France

Financial stability has become a major concern for central banks, after the 2008 global financial crisis. More and more research is tackling topics regarding the role of the financial system in macroeconomic models and the implementation of macroprudential policy. Therefore, a comprehensive overlook of financial stability issues, such as the one offered by *The Theory and Practice of Financial Stability* can prove particularly useful for experts working in the financial system, central bankers included. The textbook covers a diverse set of topics from policy matters to risk assessment analysis.

Elena Banu, Central Bank of Romania

This book is a comprehensive work on one of the most actual topics in the aftermath of the Great Recession. It covers a wide range of topics on financial stability complementing theoretical frameworks with practical examples.

Starting with a conceptual description on financial stability, the book overviews a history of the major financial crises and Basel regulation rules. Particularly useful is an inquiry of the financial stability perspectives across different asset classes and economy sectors. Another beneficial feature of this book is a complete oversight of stress testing methodologies.

The book is a thorough compilation of topics on financial stability and definitely deserves a place on the bookshelves of central bankers, government and private institutions' officials.

Vaidotas Sumskis, Bank of Lithuania

Dr Indranarain's book is an actual textbook for interpreting interrelations between all aspects and sectors of the international economy and will surely be a highly useful tool for credit institutions, investors, practitioners as well as academics. From a Central Bank's point of view this book provides an integrated approach to macroeconomic environment and the interactions between the various factors and an actual tool for assessing and measuring leading circumstances and indicators that affect financial stability and may cause vulnerabilities.

Vasiliki Vlachostergiou, Central Bank of Greece

This is a monumental work! I didn't find anything missing. I think it will be useful for students, economic and finance professionals and policymakers.

Christophe Andre, OECD

Financial stability was always a priority for financial sector regulators and it has surpassed other objectives since the global financial crisis. Given various complexities associated with the financial stability and rapid developments over time, existing literature tends to deal with specific aspects of financial stability. It is very difficult to get a comprehensive book dealing with the wide range of concepts, different segments of financial sector, ever increasing variety of financial instruments and regulations associated with financial stability. The current book is a very good attempt to fill this gap through its comprehensive coverage of almost the entire gamut of financial stability related topics. This book should be useful for financial sector regulators, related ministries in the governments, researchers, multilateral institutions, other financial sector stakeholders and general public who are interested to know the complexities of the financial sector and financial stability.

Ajay Prakash-an expert in Financial Stability

THE THEORY AND PRACTICE OF FINANCIAL STABILITY
VOLUME 2

THE BANKING SECTOR UNDER FINANCIAL STABILITY

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List of Acronyms

ALCO	Asset Liability Management Committee
ALM	Asset Liability Management
BIS	Bank for International Settlement
CAMELS	Capital, Assets, Management, Earnings, Liquidity and Sensitivity to market risk
CAR	Capital Adequacy Ratio
CCAR	Comprehensive Capital Analysis and Review
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DTI	Debt to Income
EAD	Exposure of Default
EaR	Earnings at Risk
ECB	European Central Bank
EDF	Expected Default Frequency
EL	Expected Losses
ESRB	European Systemic Risk Board
EU	European Union
FSB	Financial Stability Board
FSC	Financial Stability Committee
FSIs	Financial Soundness Indicators
FSOC	Financial Stability Oversight Council
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
G-SIBs	Global Systemically Important Banks
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRB	Internal Ratings-based
KRIs	Key Risk Indicators
LCR	Liquidity–Coverage Ratio
LGD	Loss Given Default
LTV	Loan to Value
NBFIs	Non-bank Financial Institutions

xx *List of Acronyms*

NPLs	Non-performing loans
NSFR	Net Stable Funding Ratio
PD	Probability of Default
RAM	Risk Assessment Matrix
RWAs	Risk-weighted Assets
SCAP	Supervisory Capital Assessment Program
SIFI	Systemically Important Financial Institution
SMEs	Small and Medium Enterprises
SPV	Special Purpose Vehicle
UL	Unexpected Losses
VaR	Value at Risk

Preface

Most economies in the world are characterised by a bank-based financial system, that is, the financial intermediation process is mostly performed by banks. It is therefore critically important to undertake a full-fledged analysis of the banking sector with respect to financial stability risks. By virtue of many issues being involved in the banking sector, a whole book is altogether being devoted to the banking sector in this series of five books on financial stability. Readers will appreciate from the reading that banks are unique in their nature—they assume higher risks on the back of borrowing short and lending long while they are endowed with lower capital buffers, explained by a low equity to total assets ratio. Balance sheet analysis of banks becomes a key element in financial stability risk assessment. Sources of banks' funding also pose risks to financial stability. The more banks resort to short-term wholesale funding, the higher are the risks to financial stability should a shock manifest.

Regulatory frameworks are also being given due consideration with focus on Basel III as a major advancement in dealing with the shortcomings which prevails in the US Subprime crisis of 2007. To bolster capital of banks, Basel III came up with countercyclical capital buffer and buffer for systemically important financial institutions. In the same vein, not only capital, but liquidity concerns were also given prominence following the introduction of two key liquidity ratios, namely, the net stable funding ratio and the liquidity coverage ratio. Another key regulatory issue tackled by the authorities pertains to host-home cross-border banking supervision in view of abating regulatory arbitrage.

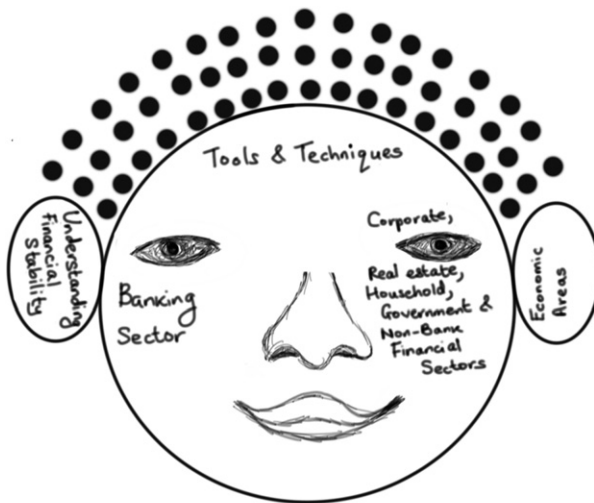
At the end of the day, there appears to be a growing consensus among policy-makers, academicians and researchers that a bank-based financial system may exacerbate the detrimental effects of a crisis. The rationale is based on the notion that should banks be affected, then, this unleashes a squeeze in loanable funds as to cut short the level of borrowings and investments by economic agents such as households and corporates. Consequently, the non-banking sector should also be given prominence as they can intervene to substitute for the fall-back in lending by banks to ensure that no curtailment in the level of economic activities. The book also focuses on microprudential and macroprudential regulation. On the same wavelength, different risks which impact on banks are covered in a comprehensive manner along with different risk maps.

The book has been written as a reference material to cater for the needs of both new and experienced professionals such as central bankers, researchers, economists and policy-makers who are involved in the field of financial stability. As a matter of fact, many central banks now have a financial stability unit or a department but so far there is no textbook which weaves through the various aspects of financial stability. Central bankers can use the book to beef up the analytical part of their financial stability reports by incorporating new tools of

assessments. The book appeals to courses/programmes on financial stability as provided by Yale School of Management (Macprudential Policy or Financial Stability Regulation/Master of Management studies in Systemic Risk), Goethe Business School (Financial Stability and Regulation/Executive Education course) and Florence School of Banking and Finance (Banking and Financial Stability course). To date, there are no textbooks or referenced materials which undertake an intensive and coherent approach to financial stability. For example, there is no such framework as to how financial stability, as a process, should be performed. This book attempts to provide all key issues in a highly comprehensive and critical manner. In that respect, the book is expected to be widely used worldwide, both by professionals and researchers.

The author expects the book to be particularly useful to economists, policy-makers, researchers and students in the sphere of financial stability in the banking sector. As at date, there is no textbook on financial stability which weaves through all aspects of financial stability-from theory to practice. This series of five books on financial stability attempts to fill in such a vacuum. Comments and suggestions can be made to i.ramlall@uom.ac.mu/iiramii3@gmail.com. The author seizes this opportunity to thank an anonymous referee from the London School of Economics for his suggestions and reviews made by professionals from central banks and reputable organisations.

Dr Indranarain Ramlall
June 2018



Financial Stability as a field of its own.
Dr. I. Ramiah 20/09/18