

ЭКОНОМИЧЕСКИЕ НАУКИ

UDC 336.025

DOI 10.52928/2070-1632-2021-56-5-2-4

**PROSPECTS FOR ENSURING THE FINANCIAL SECURITY AND STABILITY
OF THE BANKING SYSTEM OF AZERBAIJAN USING THE PRINCIPLES
OF THE BASEL ACCORD (BASEL II)***Ph.d., TAHIR GARAYEV**(Azerbaijan State University of Economics (UNEC), Baku, Azerbaijan)*

The article discusses some aspects of the application of the developed Basel II principles to improve measures to ensure financial stability and security of the banking system of Azerbaijan. The advantages of using this agreement and the effectiveness of its application within the banking system of Azerbaijan are considered.

Keywords: bank, risk, Basel II, sustainability, financial security.

Today in the research-based writings, there is a lack of attention for the financial integrant of the security of the banks. The appearance of the financial system demanded a lot of problems. And we can consider the financial security of the banking system as the one of the main problems. It relates to the continuous experience of leakage of confidential data, the existence of external and internal menaces and several other risks. In the framework of an uncertain economic conditions, the matters of financial security management are getting more serious and significant.

The development and improvement of the banking sector in our country is shaped by global trends. Today, all companies, especially banks, have an urgent need to find new ways of cost-effective, risk-reducing and safe management policies.

Formation of a financial security system, that ensures the security of data and assets, and financial resources, of the bank are getting more relevant among the issues of protecting the bank's operations both from internal and external menaces. We may categorize such important safe and efficient points as: downturn of risks, capital adequacy, profitability growth, liquidity maintenance, loan repayment purveyance, etc. [3].

A stable and efficient banking system is the basis for the development of the national economy. To ensure financial stability and security in order to increase the stability of the banking system, it is necessary to exercise banking control over their activities. The main method for the ensuring of the financial security of banks and the whole banking system of the state is the realization of the functions of banking regulation and supervision by the Central Bank of Azerbaijan. The implementation of banking supervision will allow, in the event of losses, to ensure an assessment of financial stability, maintain the necessary liquidity ratio to meet obligations, prevent credit risk, operational risk, market risk, and the risk of liquidity loss. The Basel II Accord or agreement is the document that can regulate the attributes of the formulating and execution of above-mentioned purposes of the central bank, that also includes guidance for management of banking risks [6]. The Basel Committee on Banking Supervision, which operates under the Bank for International Settlements, was established in 1974 by the central banks of the "big ten" countries (USA, Germany, Great Britain, Belgium, Italy, Sweden, Canada, France, the Netherlands, Japan) [4]. In order to ensure the soundness of the banks the share of risky assets in total capital should not exceed 8% based on the principles of the Basel Accord, published in 1988.

We can make a brief overview of Basel II provisions and bring alternatives for application of its main points for the upgrading of the governmental maintenance of financial security of the banking and its system in Azerbaijan. The Basel II Accord or agreement was adopted by the Banking Supervision Committee back in 2004. Basel II Accord – a very important document in terms of stimulating effective risk management in banks, that uses instruments to reduce credit risk, creating a system based on quantitative risk assessment by banks themselves, and, consequently, creating a trustworthy banking system that ensures financial stability [5].

It is just an supplement to oldest editions that was included on the capital agreement [1; 5]. The desideratum for improvement of the newest version was caused by the decision of the Committee to remove some of the defects of the oldest version like capital adequacy (addressing risk), supervision issues and etc. The stated defects should be removed by the new viewpoint that covers Basel II. It is called supervision based on risk assessment. The new version of the agreement is divided into three logical parts or pillars:

1. Market discipline. This component complements the previous two. It boosts regulation as distribution of data facilitates the evaluation of the bank by other market players to assess the underlying details and information on the risk exposure, capital, scope, risk assessment processes, and on the capital adequacy of the financial institution – bank [9].

2. Capital calculation (minimum capital requirements). It contains a methodology for calculation of the capital minimum requirements for credit, market and operational risk. The value of capital adequacy remained unchanged – 8% [9].

3. Supervision. This part produces postulates for structuring of the control on risk management. Also, the matters for purveyance of clear and obvious reporting of banking institutions to the authorities and other interested sides were improved and reincluded [9].

They all are firmly connected and cannot be contemplated or used separately. The application of the mentioned purveyances can impact in a positive manner on the level of financial security of bank. The precious improvement must be considered the diversification of the list of risks that are appraised within the minimum capital requirements calculation. The specificity of modern banking organizations reclines in the fact that they function in the terms where the boundaries between banks and other financial institutions are faded.

Nowadays banks engaged in attracting deposits and issuing loans within the country, and at the same time they function in the international financial market, finance their funds in other countries, etc. The record of risks that banks face grown from time to time, that reduces the level of financial security of banks [7]. So, therefore, it requires implementation different principles for control and policing of their tasks.

The execution of Basel II provisions may generate comprehensive swaps on national economies. We can define 3 impact levels of Basel II [1; 6]:

- Intra-bank. There will be changes in the risk management system addressing risks of different groups of borrowers reflected in the credit policy. Implementation of Basel II principles takes high costs. According to some estimations the costs for implementation will be about 40–120 mln EUR in large western banks. For small banks it is reduced [8].

- Sectoral. This case will affect to the entire banking system, as well as directly about the clients of banks. The new lending rules will force banks to give priority to clients with high credit ratings. The competitions for a high credit rating client between banks will intensify and may cause to a decrease of their return on loan. And in such scenarios some banks may be forced to make changes in their development strategy and start looking for another new market niches.

- Macroeconomic. What specific consequences the economy of a country will experience? Well it is a concern that depends on many factors. Mainly this is influenced by the state policy (the degree of state intervention in the economy, features of the national banking system supervision, etc.).

So, the newest version will refine the dispensation of capital between banks. It will fundamentalize and boost the economic growth. Also, the spared capital can be applied to increase lending in case if regulatory capital requirements are lowered. That will have immediately affected on GDP growth [7].

Control and maintenance over the financial sector, on the base of Basel II Accords will be working on more risk-responsive information, which will bring up procyclicality of the newest rules. And during rehabilitation, the regulatory capital will be reduced as well as the perceived credit risk either. The quality of assets that ensures the protection of the capital will increase. It will let out funds that can be employed for lending needs of economy, and this will stimulate and impulse to even prominent and considerable economic growth rates. But when the economy is most in need of money, at the stage of recession, the credit risk increases seriously. And that will lead, that the capital requirements will upturn and the volume of bank lending will downturn. This existing problem pushes the Basel Committee recommend banking industry to use ratings that addresses the cyclical improvement and development of economies as a premise for estimation of asset quality [7]. In addition, the execution of Basel II forms a downturn in the level of financial security of banks and a real menace of systemic banking risks [1]. The reasons are:

- Several methods of quantitative estimations of credit and other risks are presented to banks. The main point that distinguishes them are complexity and accuracy of the valuation. Some small banks that do not have qualified personnel, choose the simplest methods, and, as a result, that will lead to the formation of loan portfolios with lower quality. Big banks mainly use the most progressive methods, and, as a result, that will lead to the formation and maintenance of loan portfolios with high-quality [7]. Such situation, will bring a real menace to the stability of the banking system. There is an uncertainty for the banks that use simple techniques – whether will they be able to adjust their loan portfolios. And by the way, the bankruptcy of any of the banks will carry the menace for a crisis of mistrust and circumspection on the part of depositors.

- Basel II proposes the principle of “origin” regulation as a basic principle for the supervision of international banks and their subsidiaries. The home country controller needs to manage the banking group on an integrated basis and negotiate with the host country controllers. Such a presentation will form a conflict of interest. First, host country controllers will assign most of their competences to home country controllers. Secondly, they pursue to be liable for the sustainability of the national banking sector;

- In order to extend the activities in the field of retail lending and mortgage, Basel II goes on with generating new stimulus and motivations for banking institutions. [7] But for countries where the share of consumer loans in portfolios is already high enough such stimulus creates certain problems.

We can state that the above possible consequences of the application of Basel II provisions will affect to all states, since they relate to any economy. From all of the above, we can come to the following conclusions on the impact of Basel II principles to the level of financial security of local banks in Azerbaijan:

- The execution of most advanced risk management methods will be received by local banks. Also the potential incentives for enhancement of risk management qualities will be implemented by them. The bank will need less regulatory capital if the more perfect the risk management system in a bank exists. [2] The financial stability and security of the banking will increase, the resistance to external menaces will be improved.

– Intensification of the propensity towards mergers and acquisitions of banks will go on. Small and medium banks will be intensively involved into such processes, due to the forced implementation of simplest risk assessment methods. That will require for a serious upturn in the volume of regulatory capital. This will have both positive and negative impacts on the level of financial security of the banking system [7].

– This requires Central bank of Azerbaijan to correct and adapt the fundamentals of monetary policy and controlling. This requirement comes out of the high procyclicality of the newest rules and regulations, considering the principle of controlling of subsidiary banking structures depending on the country of origin. The overall strengths and menaces for the financial security of banking will depend on efficiency of Central Bank.

As a conclusion, we should stress that any economic component is an integral part of the financial security. Financial security is responsible for prevention mostly of financial menaces, carried out through tactics and strategy. The basic set of measures, and we can say main pillar for ensuring of financial security is and will be the effective capital structure and accomplishment of liquidity, stability and maximum solvency by banking institution. That's why it is undoubtedly important to meet the requirements of Basel II Accord in order to be able to challenge modern threats within the Azerbaijani economy, considering that within the international economic vulnerability and foreign policy, many banks faced with incapability to meet the capital adequacy requirement in order to finance the defaults on loans. Azerbaijan is not going to abandon the transition to global standards. On the contrary Azerbaijan should intensively get integrated in order not to be deprived of the opportunity to compete with other countries. But it is required and persistently recommended to banks or group of banks to form and design not quantitative, but working qualitative instruments for sustainability matters that are aimed at the final result.

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Поступила 17.03.2021

ПЕРСПЕКТИВЫ ОБЕСПЕЧЕНИЯ ФИНАНСОВОЙ БЕЗОПАСНОСТИ И СТАБИЛЬНОСТИ БАНКОВСКОЙ СИСТЕМЫ АЗЕРБАЙДЖАНА С ИСПОЛЬЗОВАНИЕМ ПРИНЦИПОВ БАЗЕЛЬСКОГО СОГЛАШЕНИЯ (BASEL II)

Т. ГАРАЕВ

В статье рассматриваются некоторые аспекты применения разработанных принципов Базель II для совершенствования мер по обеспечению финансовой устойчивости и безопасности банковской системы Азербайджана. Рассмотрены преимущества использования данного соглашения и эффективность применения его в рамках банковской системы АР.

Ключевые слова: банк, риск, Базель II, устойчивость, финансовая безопасность.