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Regulating Banks Based on Foreign Experience

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Abstract: The article identifies current problems related to the introduction of foreign experience in regulating the activities of commercial banks in the Republic of Uzbekistan and develops scientific proposals aimed at solving them.

Keywords: Federal Reserve System, Board of Directors of the Federal Reserve Bank, Federal Open Market Committee, monetary policy, discount policy, open market policy, REPO operation.

Introduction. One of the current issues is the study of the experience of developed countries in regulating the activities of commercial banks. The Strategy for Reforming the Banking System of the Republic of Uzbekistan for 2020-2025 envisages increasing the share of assets of banks without state ownership in the total assets of the banking system from the current 15 percent to 60 percent by 2025, increasing the share of liabilities to the private sector in the total liabilities of banks from the current 28 percent to 70 percent by the end of 2025, and attracting at least three strategic foreign investors with the necessary experience, knowledge, and influence to the capital of at least three banks with state ownership by 2025[1].

As a result of studying the experience of developed countries, there are a number of urgent problems related to the regulation of the activities of commercial banks. In particular, while a simultaneous reduction in the refinancing rate and the required reserve rate serves to increase the liquidity of commercial banks and stimulate aggregate demand, a simultaneous reduction in these rates reduces the ability of commercial banks to lend and leads to a decrease in aggregate demand.

Literature analysis. The US Federal Reserve System (FZT) actively uses discount policy and open market policy to regulate the activities of commercial banks within the framework of monetary policy.

Loans provided by the US FZB at a discount rate are made in three types. Primary (main) type loans can be provided only to reliable depository institutions for a certain period of time (usually a few hours) or for a longer period depending on the situation. In order to determine the reliability of these depository institutions, the HFZB regularly monitors and rates their financial condition. Depository institutions consider these loans mainly as a reserve source of financing and do not use them for other purposes.Since this first type of loan is considered the main source, it is called the “discounted rate” in the US FZB lexicon.Secondary type loans are provided to stable depository institutions, and their discount rate can be 50 percentage points higher than the discount rate provided to reliable depository institutions, and in some cases, even higher depending on the situation. The term of this type of loan is up to one day. In order to determine the stability of depository institutions, their financial condition is constantly monitored and

assessed based on ratings. These loans are attracted in order to prevent liquidity shortages. They cannot be used to finance the assets of depository institutions.

The third, namely seasonal type of loans is provided to small depository institutions to prevent seasonal imbalances in their credit and deposit operations. In this case, these depository institutions must clearly justify the circumstances inherent in seasonal fluctuations. Typically, such institutions serve economic entities operating in the agricultural sector or in areas with tourist potential. The discount rate of this loan is equal to the market rate[2].Loan conditions. According to the legislation, depository institutions (banks) that have deposit accounts subject to mandatory reserve requirements, as well as US banks operating as branches or agencies abroad, can also use these discount loan funds on the same terms. Discount credit funds are provided on the basis of certain collateral conditions. Any assets that meet regulatory standards can be taken as collateral. In particular, highly liquid securities, debt obligations, etc. are among them[3]. HFZB must fully ensure the right to own and dispose of this collateral. If necessary (in the event of default), this collateral can be used to cover discount window loans. The collateral received must be free from the obligations of the institution providing the collateral.The US Federal Reserve offers a certain price (price) for assets accepted as collateral. This price represents the price of the collateralized asset, slightly below its market price, and this is done, of course, in order to protect against a fall in the market price of the collateralized asset.Since the discount policy in the US Federal Reserve is one of the most important tools (instruments) of monetary policy, the main goal set for the US Federal Reserve under its influence is to achieve coordination of a system of measures taken to promote maximum job creation, maintain a stable price policy, and ensure a moderate long-term interest rate[4]. This instrument is mainly aimed at ensuring the balanced state of the Federal Reserve Fund as a supply factor and exerting its influence on the supply of money and credit to the economy.

The specific feature of the practice of using the discount window is as follows. If depository institutions (banks) are unable to meet their short-term (overnight) funding needs in the Federal Reserve or similar markets, they may use this discount window of the HFZB. The loan received by depository institutions is recorded in their balance sheet account in the HFZB. The rules governing the use of the discount window are established on the basis of US Federal Reserve legislation and regulations approved by the US Federal Reserve Board of Governors. After the provision of collateral, loans are made at the appropriate interest rate (discount rate) established by the US Federal Reserve. This discount rate is subject to review and change. The average interest rate formed as a result of such transactions between depository institutions is called the Effective Federal Funds Rate (EFFR). The SFFS is determined primarily through the market mechanism, but since the open market operations of the Federal Reserve can influence it, a target rate for the FFS (Federal Funds Rate Target) is formed.

The Federal Reserve uses two types of REPO transactions:

1. Straight REPO.

In this case, the Federal Reserve sells securities to commercial banks with the condition of repurchase.

2. Reverse REPO.

In this case, the Federal Reserve buys securities from commercial banks with the condition of resale.

The specific features of the US Federal Reserve REPO transactions are as follows:

*The Federal Reserve carries out REPO transactions with primary dealers (commercial banks) who are participants in government securities. These banks have a high reputation and extensive experience in the securities market, which ensures the speed of REPO transactions.

*The Federal Reserve carries out REPO transactions with Government securities (in order to avoid conflicts of interest, the Federal Reserve does not carry out purchase and sale transactions with securities of private companies);

*The Fed determines the actual supply of reserves by obtaining information from the U.S. Treasury about the expected level of its deposits with the Fed;

*The Fed's open market operations managers study the opinions of commercial banks acting as primary dealers on the state of the securities market every business morning. The study of these opinions makes it possible to predict the fluctuations of securities prices during the day.

*The Fed's open market operations specialists contact the Monetary Policy Department of the Board of Governors and compare their forecasts of the demand for and supply of reserves in the market with the forecasts of this department. As a result, a plan of action in the securities market is developed[5].

Experts from the International Bank for Reconstruction and Development have proposed the following indicators characterizing the level of problem loans:

- the level of reserves intended to cover losses incurred on loans (the upper normative level of this indicator is 1.0%);
- the moderate level of overdue loans (the upper normative level of this indicator is 3.0%);
- the permissible threshold level of overdue loans (the upper normative level of this indicator is 5.0%)[6].

According to A. Forrest, in order to increase the accuracy of assessing the probability of default of clients who have received loans, it is necessary to divide clients into groups based on unified criteria for their creditworthiness[7].

Research results. In the practice of the Federal Open Market Committee (FOMC), it is an important institution that mainly determines reserve requirements and the federal funds rate, and through them coordinates the supply and demand of the economy for financial resources (money, loans).

Although this institution is not directly authorized to determine the discount rate, it is of decisive importance in its formation. Its conclusions and proposals are studied by the Board of Directors of the US Federal Reserve, and the appropriate decision is made.

In 2004, the Basel Committee proposed a new approach to assessing credit risk, called the "standardized approach" (Table 1).

Table 1. Standardized approach to credit risk assessment [8]

Credit rating	AAA AA –	A+ A –	VVV+ VV–	VV– dan past	Reyting siz
Risk level	20%	50%	100%	150%	100%

As can be seen from Table 1, according to the standardized approach, the level of credit risk is determined depending on the credit rating of the client who received the loan: the higher the client's credit rating, the lower the level of credit risk. According to the standardized approach, loans with a risk level of 150% appeared. That is, the risk level of loans issued to clients with a credit rating below VV is 150 percent. The risk level of a loan issued to a client without a credit rating is set at 100%. In the countries of the European Union, including Germany and France, the standardized approach recommended by the Basel Committee on Credit Risk Assessment in the Basel-II standard has been adopted in banking practice. In this approach, the level of credit risk is determined depending on the credit rating of the borrower. According to this approach, the higher the sovereign credit rating of the borrower, the lower the risk level of the loan granted to him. For example, the risk level of loans granted to governments and central banks of countries

with sovereign credit ratings from AAA to AA is zero, the risk level of loans granted to credit institutions in these countries is 20 percent, and the risk level of loans granted to legal entities is 20 percent.

The risk level of loans granted to governments, central banks, credit institutions and legal entities of countries with sovereign credit ratings below V– is 150 percent. It is one of the main indicators characterizing credit risk in the activities of commercial banks and is an indicator of the level of reserve provisions intended to cover losses on loans. The generally accepted standard level of this indicator in international banking practice is 1.0 percent.

Table 2. Lending Authority in US Banking Practice [9]

Loan limit	Secured loans	Unsecured loans and overdrafts	Loans to insiders	Loans to bank employees
The upper limit of loans set by legislative documents	Bank's loan committee	Bank's loan committee	The Bank's Board of Directors	Executive Committee
5 million USD	Regional Loan Committee and two regional presidents	Regional Loan Committee and two regional presidents		
2 million USD	Regional Loan Committees	Regional Loan Committees		
500 thousand USD	Regional Presidents	Regional Presidents		
250 thousand USD	Loan Inspectors	Loan Inspectors		

Table 2 shows that as the loan amount increases, the scope of authority of regional presidents narrows, and the scope of authority of loan committees expands. The decision to issue loans in the amount of 5 million US dollars is made by regional loan committees. The issue of issuing loans in the amount of 250 thousand US dollars is decided by loan inspectors.
The issue of issuing loans to insiders is approved by the bank's board of directors. This is because, according to the principles of effective banking supervision developed by the Basel Committee, a commercial bank does not have the right to issue loans to insiders on preferential terms.

Therefore, the board of directors is obliged to control loans of any amount issued to insiders. In the USA, the Central Bank uses the CAMELS rating system to assess the quality of assets of commercial banks (Table 3).

Table 3. Criteria for assessing the quality of commercial banks' assets in the "CAMELS" rating system [10]

Rating	Criteria
1 – strong	**Up to 5%**
2 – satisfactory	**5% - 15%**
3 – average	**15% - 30%**
4 – marginal	**30% - 50%**
5 – unsatisfactory	**More than 50%**

Table 3 shows that in the CAMELS rating system, the quality of commercial banks' assets is assessed on a scale from 5 to 50 percent and more than 50 percent.

In this case, the quality of assets is determined by dividing the amount of assets at risk of a commercial bank by the total capital and multiplying the result by 100 percent.

Banks with an asset quality indicator above 50 percent are included in the fifth category and their asset quality is assessed as unsatisfactory. Fines are applied to banks whose asset quality is assessed as unsatisfactory.

Conclusion. We have formulated the following conclusions related to foreign experience in regulating the activities of commercial banks:

The results of a study of the experience of developed countries have shown that the national loan capital market allows us to determine the market prices of deposits and loans of commercial banks, and the Central Bank has the opportunity to assess the supply and demand in the market in order to influence their prices. The Central Bank also participates in the loan capital market with its credit resources. Ensuring the balance between the Central Bank's mandatory reserve policy and refinancing policy is one of the directions for improving the practice of using monetary policy instruments. In order to ensure this balance, it is necessary to ensure that their levels change in a similar way. This is because a decrease in the Central Bank's refinancing rate increases the liquidity of the banking system and reduces interest rates on commercial bank loans. A decrease in the Central Bank's mandatory reserve rates also increases the liquidity of the banking system. Because the funds generated as a result of the reduction in the required reserve ratio appear in the “Nostro” correspondent accounts of commercial banks. Also, the reduction in the required reserve ratio allows commercial banks to increase the interest rates paid on term and savings deposits. This leads to an increase in deposits in banks and, accordingly, to an expansion of their lending capacity. Thus, the same effect is achieved when both monetary instruments are reduced. Therefore, it is advisable to ensure that they change in a similar way to each other.

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