Chapter 3
Prudential Rule and Its Effect on Banking Risk Management in the Case of Chinese Banks

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ABSTRACT

The capital structure and regulatory process are the most important elements that identify decreased risk taking by financial institutions. This study aims to investigate the influence of banking regulatory processes on banking risk. The authors propose to test certain number of regulatory mechanisms, which may have an impact on banking risk. For this, they employ a sample composed of 20 Chinese banks over the period from 2010 to 2022. The results obtained can contribute to understanding the nature of the relationship between certain parameters and regulatory structures on the risk of insolvency. First, this chapter demonstrates that there is a statistically unimportant negative nexus amongst the first regulation of capital indicator and risk taking, however for the second regulation of capital indicator we remark that has a positive and important impact on the risk enchanting. The authors can confirm that capital regulation is a crucial indicator in banking risk. Then, they recommend that the supervision utilized by banking regulation must be strengthened by internal banking mechanisms.

1. INTRODUCTION

The banking industry is certainly one of the greatest structured activities in the world. This should undoubtedly be recognition of the weight of banks in all economies, of their economic role, and a broad and acute perception of the economic and social costs that a major crisis in this sector would entail. In fact, banks perform essential missions that we have highlighted in terms of liquidity assurance, debtor control, and information production.

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The supervision of the banking sector is principally based on the coexistence of three major pillars, deposit insurance, capital-based regulations, and the existence of an investor of final resort purpose attributed to central banks. Additionally, the first two methods of regulation appear to be complementary. Indeed, deposit insurance systems with fixed premiums encourage banks to take risks and deprive the sector of market discipline. In general, the inability to correctly price deposit insurance premiums call for additional regulation by equity. This last requirement allows for the amortization of larger losses and thus limits, all other things being equal, the risk of insolvency.

The link amongst risk management and bank performance has established substantial theoretical consideration (Athanasoglou et al., 2008; Brissimis et al. 2008; Fiordelisi et al. 2013; McNulty and Akhigbe 2017). These studies pressures the significant role of (1) credit, (2) liquidity, (3) capital, (4) operational and (5) market risks in correlation to traditional banks' financial profitability.

Mitigation of agency challenges has continually been a worry in the banking industry. Banks have always presented this agency problem specific to this banking sector. The agency's dilemma always demonstrates itself in the reality that deposit insurance supports administrators to improve risk, which transforms into decreased inducements for depositors to implement market discipline to decrease this risk (Nguyen et al., 2018; Riabichenko et al., 2019; Derbali, 2020)

In fact, regulation mainly utilizes two governance processes to regulate extreme risk-taking: the requirement for minimum capital and regulatory control (Santos, 2001). According to the banking governance literature, the high level of capital and regulatory control are the factors that can reduce risk taking Hunjra et al. (2020) and Haddad et al. (2020). Thus, the advent of the Basel II accords has greatly enhanced the accumulation of equity capital and strengthened the market discipline exercised by shareholders and capital holders. This market authority is also measured as a governance process which helps regulators in the control of banking risk taking.

Despite these observations relating to the bank capitalization standard, that relating to compliance with prudential ratios affects economies in general more directly under Basel II. The methods for determining the capital ratio (ratio of capital and risk-weighted assets) adopted immediately from 2010 animated the discussions. These methods are standard weighting (already used under Basel I) and that based on internal ratings or the probabilistic weighting method (rating). It has been deduced that regulatory capital generally becomes pro-cyclical (Mishkin, 2010; Goodhart et al., 2004), when prudential regulation is supposed to respond to the routine risk management and market risk assessment using new weighting methods.

This paper tries to examine the regulation of capital, and its influence on risk insolvency. We will attempt to investigate the impact of the process of capital regulation on risk taking. In fact, the regulation of capital (minimum capital necessity and regulatory difficulty) could indicate the motivation of regulators and their capability to successfully examine and regulate the bank's capital. To analyze the external governance mechanisms of banks and their influence on risk taking, we utilize a sample composed of 20 Chinese banks, during the period of study from 2010 to 2022. The involvement of this study is to investigate the instruments of capital regulation as well as their influences on the risk taking for the case of Chinese banks with utilizing new regulation indicators as the minimum prerequisite of own funds and the pressure regulatory mechanisms which are the main factors of capital regulation.

Our work is organized as follows: a second section which examines a review of the literature on research hypotheses. Then, we present the research methodology in section 3, and we expose the model specification in section 4. Section 5 presents and exposes our empirical findings. Finally, we conclude in the section 5.

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