Note of the Guest Editors Special Edition on Risks in the Banking Industry

This special issue of the journal *Essays on Economic Policy (Ensayos sobre Política Económica-ESPE)* is dedicated to risk-management in the banking industry. At the moment we chose to debate this subject, the world economy was in crisis, and questions abounded on what lessons might be learned for improving institutional financial risk-management as well as that for the regulatory and supervisory agents in the financial sector. The response to our invitation was well received. A significant number of outstanding essays were submitted, from which we selected six for inclusion in an initial debate at a seminar held at the Luis Ángel Arango Library in Bogotá on October 29, 2010. Leonardo Gambacorta, from the Monetary and Economic Department of the Bank for International Payments (*BIS*) contributed to the seminar with an in-depth presentation on the risks of low interest rates over prolonged periods of time.

The recent worldwide financial crisis underscores a fundamental problem with the global economy: current regulatory agencies are incapable of following the pace of financial innovations. Some of the lessons gleaned from the crisis include the need to design a more adequate global financial architecture and to implement systematic risk-management in the banking industry, in accordance with the evolution of the financial system. The articles that make up this special issue of the *ESPE* journal —which were presented in their preliminary versions at the seminar— contribute to providing answers on bank risk-management issues, with emphasis on emerging economies, such as Colombia´s.

The work by Arango, Posada, and Tamayo proposes a macroeconomic model that includes a market for mortgage credit that seeks to provide explanations for some of the important events that brought about the recent financial crisis and recession in the United States. In their model, the cycle for real asset prices generates proportional movements within financial and economic cycles, thereby bringing about an excessive rise in asset value —above its stationary state value— thus generating economic vulnerabilities. When these factors accrue, the probability of financial crisis multiplies —even more so if adverse shocks strike asset prices—. The simulations carried out by the authors show that it may be advantageous to include long-term asset price deviations as a norm in central banks´ monetary policies as a means of fostering financial stability.

Londoño´s methodological article searches for methods that can be used to improve the metrics for financial institutions. Towards this end, he proposes using the Conditional Autoregressive Value at Risk (CAVaR) as a valid empirical approach to establish real VaR metrics, applicable not only to market risk, but for compliance with banking regulations, as well. Indeed, his document offers an empirical rule to better understand the performance of the Colombian stock market´s (*IGBC*) general index.

Along these same lines, Melo and Granados analyze market risk-management regulations established by the Colombian Financial Oversight Agency (*Superintendencia Financiera de Colombia*). They specifically deal with how Colombian government regulations establish market risk-management among monitored entities through value at risk (VaR). According to the authors, Colombian regulators omit relevant aspects when calculating VaR. In spite of the fact that the Financial Oversight Agency suggests using the square root rule to calculate VaR at multiple periods based upon the VaR of one day, the validity of this rule is not clear. Furthermore, the authors point out that compulsory backtesting does not completely evaluate VaR performance, due to the fact that it does not prove compliance with all the relevant properties involved in obtaining precise VaR and CAVaR estimates. As a result, Melo and Granados signal the need for financial entities to carry out adjusted tests on additional models beyond those which are currently made mandatory by law.

The paper by León and Mora studies the relationship between Colombian credit default swaps (*CDS*) and the *COLCAP* index of the Colombian stock market (*BVC*). The authors find that an inverse relation exists between *CDS* and *COLCAP* performance, similar to what is found in most European countries. Consequently, statistical evidence reveals that when the country´s default risk increases, investment capital flow into *BVC* listed companies decreases —a result which is to be expected—.

Authors López, Tenjo and Zárate study bank risk channel performance, which has recently been identified in the literature on monetary policy transmission mechanisms, and its performance in relation to monetary policy in Colombia. They find that a significant relation exists between persistently low short-term interest rates and greater risk-taking by financial entities in Colombia. A reduction in interest rates has asymmetric effects on new credit and on existing credit: as incompliance increases for the former, it decreases for the latter. Furthermore, the intensity and importance of bank risk channel depends upon the unique characteristics of banks and their customers, as well as upon the phase of the economic cycle, at a given moment.

We bring this issue to a close with Osorio´s article in which she proposes a model to improve macroprudential regulations. Her two-period general equilibrium model attempts to explain the recent international financial crisis. The model —which assumes rational expectations— includes the possibility that agent default may be observed. The resultant equilibrium is characterized by the phenomenon of contagion, wherein non-payment begins in the mortgage sector and then spreads to the remaining

sectors of the economy. The author proposes capital metrics for regulators of the financial system which would reduce leverage in the banking sector and would lead banks to internalize their losses when customers fail to meet their obligations.

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