A NEW APPROACH TO FINANCIAL REGULATION AT THE EUROPEAN LEVEL

Ioana Laura VALEANU[*]

Abstract: *With the recent financial and economic crisis onset, a fragility of the financial system became apparent, under the form of a series of vulnerabilities and failures with a strong destabilizing impact on the economy. In this context, a new approach to financial stability has outlined itself, pleading for a more extensive financial regulation and macro-prudential supervision, complementary to the micro-prudential one. The objectives of this article are to highlight the context and need for a new financial regulatory framework and underline the main problems of the banking system the new European regulations addresses.*

Keywords: financial regulation; financial stability; banking system
JEL Classification: G00; K20

Introduction

With the onset of a major economic crisis, efforts focus particularly on developing solutions for treating its consequences. But more than that, it is extremely important to understand the causes and mechanisms creating triggers and therefore, solutions to prevent the accumulation of economic and financial vulnerabilities potentially highly destabilizing.

The recent crisis was mainly triggered by vulnerabilities and failures of the financial system. In the pre-crisis period the global financial system has developed into a fast but unsustainable rhythm, becoming increasingly interconnected and increasing the systemic risk. In this context the need for a paradigm shift in terms of financial regulation and risk management emerged. It was therefore argued for a more stringent and extended financial regulation for completing the micro-prudential objectives with the macro-prudential ones.

An important part of regulations or initiatives for financial regulation aimed at the banking system as a central element of the financial system, covering four major areas: lower the risk of bank failures, reducing systemic risk and pro-cyclicality of the system, the creation of an effective resolution and management of bank bankruptcy and mitigation of the risks of banking institutions of *too big to fail* type.

[*] Ph.D Candidate, Alexandru Ioan Cuza University of Iasi, e-mail: ioanalauravaleanu@yahoo.ro

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1. Context, need and objectives of the new financial regulatory framework

If in the 1960s, according to Keynesian theory, the main goal pursued was best represented by a compromise between inflation and unemployment, with the second as a priority in the 1980s, when inflation reached very high levels, there was a change of direction, and fighting inflation became a priority. Currently, we are witnessing a new financial paradigm shift, the need for a new approach to macroeconomic objective represented by financial stability being a priority. The extent of the recent economic crisis and its effects still persisting, showed that monetary stability and the micro-prudential supervision does not automatically lead to a stability of the financial system.

The financial system has an extremely important role to the real economy, this ensuring financing investment opportunities, contributing to the accumulation of capital and improving the distribution of risk in the economy. Also, the contribution of the financial system on economic growth must not be neglected. A healthy functioning of the financial system will contribute to sustainable economic growth, but its poor operation will lead to an artificial economic growth and financial vulnerabilities and imbalances accumulated will inevitably create the conditions for triggering a financial and/or economic crisis.

In the previous years before the onset of the recent global financial crisis, the financial system developed into a ferocious pace, but in an unsustainable way, significantly outpacing developments in the real economy. The risk of an imminent financial collapse, many economies faced once the crisis initiated, has highlighted the urgent need of thinking of macro-prudential measures that ensure the efficient functioning of the financial system, to effectively manage and prevent buildup of excesses and imbalances, therefore to reduce systemic risk and ensure financial stability.

The lack of concrete measures to address the issue of financial stability, pre-crisis, was probably based on the belief that economic and social consequences of financial instability can be managed and removed later. However, recent economic and financial crisis has highlighted the need to create a framework for action and instruments in order to mitigate systemic financial vulnerabilities, and not simply to manage or eliminate their consequences.

More and more views converge on the fact that without abandoning the objective of monetary stability, financial stability should be a central objective, alongside economic growth and labor, in order to avoid future financial and macroeconomic imbalances, extremely difficult or even impossible to absorb, such as the recent ones. So far, at the level of macroeconomic policies and new financial regulation framework the term *"financial stability"* has become, justifiably, a leitmotif.

The new approach to the financial stability pleads for the completion of micro- prudential measures with macro-prudential ones and the expansion of the scope and instruments for the monetary authorities to dispose of, as pro-cyclical capital requirements, compulsory reserves and dynamic provisioning. It also requires a closer and more effective cooperation between central banks and supervisory authorities (Larosière, 2009, p.51). The new function of the monetary and prudential supervisory authorities constitutes a completion of the monetary policy and micro-prudential supervision exercised by central banks.

In retrospect, during the period before the onset of the recent economic crisis, namely the period between the late 1980s and 2007, known as the "great moderation", central banks based their monetary policy strategies on the assumption that the monetary stability leads automatically to financial stability, accordingly, both contributing to sustainable economic growth. The "great moderation" was a period of strong economic optimism, during which many economists considered that a fundamental problem of macroeconomics, the prevention of the great depressions, had been resolved (Lucas, 2003, p.1). In contrast to previous decades, the "great moderation" was characterized by low (2%) and relatively stable inflation rate globally. However, it seems that the objective of monetary stability does not automatically lead to financial stability.

With the economic crisis the vision of the effects of monetary policies and their relationships and financial stability as a whole has been called into question, outlining the growing number of opinions that argue that the situation of calm that characterized the period before the crisis had destabilizing effects on the financial system and the economy or that monetary stabilization policies can foster the development of speculative bubbles and other financial imbalances.

According to the new vision, the monetary stability between 1990-2000 was favorable to the accumulation of vulnerabilities that have jeopardized the financial stability by encouraging excessive risk taking by banks and businesses, and decision makers responsible for economic policy and authorities responsible for regulating prudential measures have underestimated the systemic risk (Blanchard *et al.*, 2010, p.11). In these years, the companies based their expectations on a low level of inflation, which caused excessive manifestation of a sense of economic security and confidence-taking resulted in the acceptance of increasing levels of risk and unsustainable debt contracting.

The situation presented above was analyzed by H. Minsky, in the 1990s, highlighting the so-called "paradox of tranquility" (Minsky, 2011, p. 417). According to the author, a financial crisis has its origins precisely in economically favorable times when businesses are stimulated by low interest rates and economic growth to borrow. This is somehow rational in terms of individuals, but looking ahead it is irrational because debt gets to be excessive and contagious. When there is a tightening of

monetary policy, raising interest rates make debt previously contracted become unsustainable. The 2007 *subprimes* credit crisis can be included in this category of events.

An important factor in the buildup of financial vulnerabilities is the credit evolution, which, after a certain level, favors the development of large scale speculative operations. Relevant here are banking and currency crises manifested in the early 80s in several countries with emerging economies, stock crises manifested between 1987-2000 in countries with developed economies, the systemic crisis in Japan in the 80s, the *subprimes* crisis in 2000, when there was a simultaneous excessive growth of stock market and real estate assets and the credit market .

Given the influence of excessive credit growth on the creation and development of speculative bubbles, and therefore the negative impact on financial stability, a number of recommendations have been proposed, that credit developments be subject to more rigorous supervision.

Along with the excessive credit growth in the period before the economic crisis, there was a rapid and unsustainable growth of financial securitization, banks resorting more and more to "financial market" to the detriment of funding based on attracted bank deposits (European Central Bank, 2011, p.7). The securitization diminishes its traditional function of redistribution of liquidity that loans should meet and produces negative effects regarding the assessment and risk-taking by banks, because this type of operation allows banks to increase the level of lending without completely assuming all costs related to initiated loans.

As a consequence of securitization, the financial intermediation chain has become more complex and longer. So, the traditional banking sector distributes the initiated loans at the beginning of the intermediation chain to the unregulated parallel bank sector, the so-called *shadow banking*.

Securitization produces negative effects regarding the assessment and risk-taking by banks, because this type of operation allows banks to increase lending without completely assuming all the costs related to initiated loans. Banks artificially relax lending conditions because securitization transactions allow the transfer of risk assumed by loans to other financial agents. Given these vulnerabilities, the new financial regulatory initiatives also should concern the creation of a supervisory framework for the shadow banking sector.

Also, another important issue that concerns the financial sector is the systemic risk. Although the systemic risk is not an new economic issue as systemic crisis manifested throughout the whole economic history, an amplification of the systemic risk can be identified starting with the 70s, which marked the beginning of a period of intensification of financial globalization, basically manifested by the increasing of the complexity of operations and financial instruments, the interconnection of

financial markets and the development of transnational financial institutions and large banking groups.

Recent systemic financial crisis caused a significant number of initiatives regarding the improvement of prudential mechanism at the European level. European legislative proposals have focused on countercyclical regulations to be applied by the banking supervisory authorities and on measures meant to reduce the negative economic consequences caused by moral hazard or the size and complexity of some too large financial institutions (*too big to fail* issue).

The recent financial crisis highlighted the influence of large systemic financial institutions and, in particular, the failure of such institutions regarding the financial stability on the whole. Faced with the imminent risk of bankruptcy of some major financial institutions, governments and central banks may adopt a neutral position or intervene to save the concerned institutions. None of these options is risk free. In the first case, the failure of systemically important institutions can trigger a financial and economic meltdown, while the second case involves losses suffered by banks to be paid by taxpayers, instead of shareholders and creditors, which, moreover, leads to further increase the moral hazard.

The proposals for prudential regulation at European level came in logic continuation of the work of the Basel Committee (Basel III). Thus, the focus has been on expanding qualitative and quantitative capital requirements on the limitation of the financial leverage and reducing the liquidity risk (Basel Committee on Banking Supervision, 2010). If we consider the liquidity risk, the recent crisis has revealed an insufficient approach to this issue. Also, before the crisis there was an underestimation of the destabilizing impact of maturity mismatches and of the dominating appeal to short-term funding to the detriment of long-term financing arrangements. The recent economic crisis initially manifested itself through a liquidity crisis. This situation has threatened the stability of banking systems and led central banks, in their capacity as lender of last resort, to carry out massive injections of liquidity into the system.

Another reform aimed at creating an European financial supervision system composed of national and European authorities responsible for micro- and macro-prudential supervision. The newly created European authorities with responsibilities for micro- and macro-prudential supervision are: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA).

2. Reform of the banking sector at European Union level

The recent financial and economic crisis has highlighted a number of failures and vulnerabilities of the banking system, with considerable negative consequences on financial and economic stability as a whole. In response to this situation, new initiatives regarding the financial regulation have targeted four major directions: decrease bank failures risk, reduce systemic risk and the pro-cyclicality of the system, effective resolution and management of cases of bankruptcy and mitigation of the risks posed by *too big to fail* institutions.

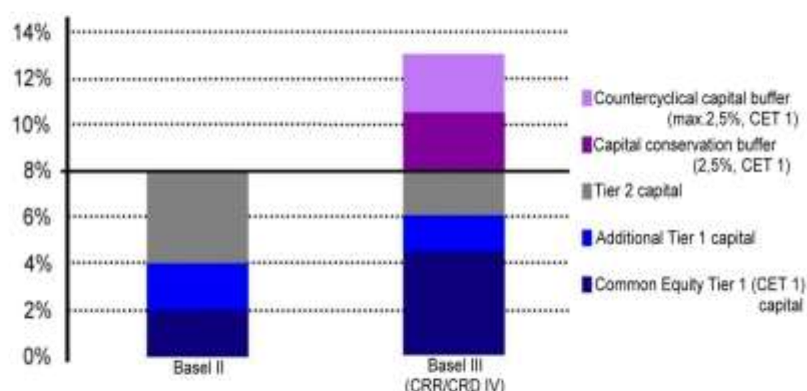
In terms of ensuring a greater stability and resilience of the banking institutions during various economic and financial shocks, new financial rules provide a qualitative and quantitative improvement of standards with respect to some indicators, such as capital requirements, liquidity and leverage.

The establishment and fulfillment of minimum capital requirements have a major role at the micro-prudential level, creating high immunity for banks to financial shocks, but also at the macro – prudential level, significantly reducing instability and contagion risk in the financial system, with obvious effects on the entire economy.

The serious financial problems that most banks were faced during the economic crisis showed that banks did not have enough capital to allow absorption of losses, a reassessment of regulatory capital requirements being necessary (Carmasi and Micossi, 2012, p. 8). Also, earlier minimum capital requirements proved the limits regarding the ability to provide useful information on the fragility of the financial situation of a bank so that effective corrective action can be taken to avoid worsening the situation.

Following the economic and financial crisis of 2008, which proved inadequate earlier financial regulations, a new Basel Accord (Basel III) was agreed in 2010. According to this new agreement, and at the level of EU legislation, improvements in terms of capital requirements were produced. The Directive on minimum capital requirements (CRD IV, adopted in 2013), brings quantitative changes by introducing two types of additional capital requirements represented by the capital conservation buffer and countercyclical capital buffer so, the overall level of capital requirements, can reach, in certain economic and financial conditions, a 13 % of the risk weighted assets, but also qualitative changes by increasing the minimum level of Tier 1 capital from 2% to 4.5 % (see Figure 1).

Figure 1 - New CRD IV capital requirements compared to previous standards



European Commission, May 2014, *Economic Review of the Financial Regulation Agenda*, p.59

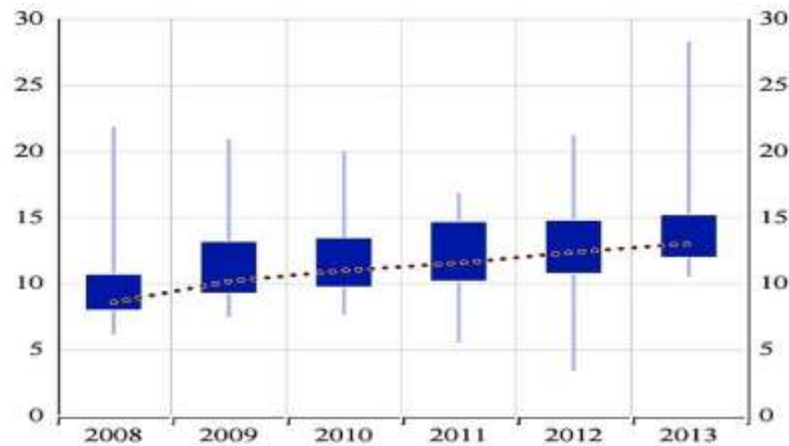
Yet still, the calculation formula for capital requirements remains a complex one, by keeping the benchmark risk weighted assets. Although the establishing of the level of capital according to the risk assets is considered to have the advantage of discouraging the taking of very large risks, this has not been demonstrated by the recent economic history.

In terms of reducing the pro-cyclicality of the financial system, the new legislative framework introduces two additional capital requirements, to be adjusted according to specific economic conditions. The first indicator is the capital conservation buffer which requires banks to create additional funds that can be used under conditions of economic and financial stress, and the limits of the bumper can vary within a range that reaches the maximum value of 2.5% depending on the business cycle evolution.

The second indicator is the countercyclical capital buffer which enables national competent authorities to require banks to increase capital buffers above the minimum requirements of Tier 1capital (common equity Tier 1) consisting of common shares, retained earnings and reserves up to 2.5% or even more under certain conditions, in times of increased lending. This provision is to be implemented by the competent authorities according to specific national conditions and circumstances. The stated aim of this measure is to prevent risks to the banking system posed by excessive and unsustainable credit growth.

Given the relatively recent entry (2013) of the legislative package CRD IV, which regulates matters concerning capital requirements, and gradual implementation of new regulations, until the beginning of 2019, it is still early to assess the effects of the new measures. However, we can see progress in terms of improving bank capital levels for some European banks, even if some still need significant adjustments to balance sheets (see Figure 2).

Figure 2.Recent improvements in bank' capital ratios in euro area



Source: ECB (European Central Bank), October 2014, *Banking Structures Report*, p. 25

To enhance the resilience of banks, especially in a situation of economic crisis, capital requirements are not sufficient to ensure adequate solvency and ability to absorb unexpected losses of the bank, but a strong liquidity base is also important. A bank needs, complementary to other elements, a strong liquidity position and efficient management of cash flows in order to cope with a crisis in the financial market.

One of the vulnerabilities demonstrated by financial institutions during the recent crisis has been the insufficiency of liquid instruments as cash or assets that can be quickly and with minimum costs turned into capital. A feature of banks consists in the frequent mismatch between short-term funding (deposits or funding through interbank loans) and long-term investments (bank loans). Therefore, banks are inherently unstable and vulnerable to crises of confidence in the financial market, resulting in massive cash withdrawals by depositors or complete and immediate refund applications from creditors in the short term. In these circumstances, when the economic crisis outburts, many banks would have failed without the support provided by central banks and interventions through state financial aid .

Even with massive injections of liquidity into the system, the liquidity crisis persisted.

Within the European Union, regulating liquidity before the crisis was not uniform, some states having implemented some quantitative standards for liquidity, while others not. Tools such as deposit guarantee schemes and lenders of last resort, accounted solutions for reducing the risk of massive withdrawals of liquidity. Basel III introduces a number of international standards regarding bank liquidity. Setting standards and liquidity requirements would have some effects (by increasing

liquidity reserves and lowering the maturity mismatch) as the reduction of excessive interconnection inside the financial system and the mitigation of systemic liquidity risk. As concrete solutions to improve the liquidity position of banks in the future two liquidity ratios were introduced: LCR - Liquidity Coverage Ratio and NSFR - Net Stable Funding Ratio.

In addition to capital and liquidity requirements, new regulations introduce the financial leverage as an additional indicator of bank capital adequacy. Financial Leverage is basically the ratio of own funds held by a bank and its total assets and shows the extent to which a bank is prepared to meet its financial obligations in the long term. Thus, reducing excessive leverage is required to maintain an optimal level of solvency of banks.

Under the European law, the financial leverage is addressed as a complementary instrument to capital requirements for the strengthening of the prudential regulatory framework. The new requirements regarding financial leverage aim at preventing unsustainable debt accumulation and its negative effects on the stability of the banking system. It is intended that, unlike the necessary capital requirements, which are set depending on the riskiness of bank assets, the leverage effect should not involve risk assessments, but be based on accounting data, without further adjustments. From this point of view, the new regulations on leverage would represent an additional measure that can diminish vulnerabilities posed by risk based models as possible manipulations thereof.

While important steps were taken towards a new legislative framework in order to enhance the stability of the financial system and to prevent future major failures of this system with a destabilizing effect on the entire economy, the risk of failure for certain financial institutions will still exist. It is important to develop a concrete framework for recovery as well as resolution for banks, so as to minimize the impact of a failing financial institution on the real economy and public finances.

The need for new approaches to bank resolution was imposed by the recent economic crisis, which highlighted the inability of the competent authorities to identify in due time the fragility of some banking institutions and to manage in a coherent and efficient way any bank failure. In conditions of economic crisis and the risk of collapse of the banking system, due to a large number of bank failures, governments were forced to find a compromise between the decision to save the financial system and protect taxpayers' money. Any of these decisions involve significant costs. The recent economic crisis, maintaining a minimum level of stability of the financial system and avoid an economic collapse were considered priorities, even if this decision had a negative impact on European public finances. Financial support offered to financial institutions, especially banks through state aid was of 1.5 trillion euros.

At the European level the issue of bank recovery and resolution is regulated by a *Directive for a framework for the recovery and resolution of credit institutions and investment firms* (BRRD, adopted in 2014 and entered into force since January 2015). This Directive establishes a common framework of rules that allow the competent authorities to intervene preventively to restore the viability of a financial institution if it faces financial difficulties and to manage the failure of a bank in a consistent manner, avoiding the disturbance of the economy and the use of public funds while protecting depositors against losses.

Regarding the costs of a bank undergoing a process of recovery or resolution, the new regulation aims them to be borne primarily by the shareholders and creditors of the bank, following the internal recapitalization (bail-in) and, subsequently, financed from resolution funds.

Measures to strengthen the solvency of banking institutions by imposing new capital requirements and liquidity as part of the legislative package CRR/CRD IV measures on the recovery and resolution of the bank, as part of the directive BRR aims at reducing the likelihood of bank failures and the impact these could have on the financial system and the economy. However, these measures are not sufficient to solve the problem of systemically important financial institutions and eliminate risks that these institutions pose to the financial and economic stability. Systemically important financial institutions represent large banking groups that are universal banks, which usually combine commercial banking and investment banking activities within a single entity or a group of interconnected entities.

According to the rules of market economy, any company must meet certain standards of efficiency and competitiveness required by the market in order to exist and function in an economy. Failure to comply with these standards leads inevitably to the exit from the market / bankruptcy of the institution, without a major impact on the sector in which they operate or the whole economy. Due to the mechanism of self-regulation of markets, resources and factors of production available from the bankruptcy of an enterprise will be directed to other areas to ensure their efficient use. But these laws are not always applied to institutions in the banking system. This mechanism is justified by the complex interrelationships and connections in the financial system through which the bankruptcy of a single large banking institution can destabilize the entire system. Such arguments were at the basis of the decisions of many states to grant substantial financial support to those banks considered too big to be allowed to fail. Major banking groups benefited from an important part of the sums granted by governments and central banks as financial openwork state.

Since the 1970s, complementary to the trend of deregulation of financial markets, a relaxation of restrictions on the activities undertaken by banks took place. There was a broad consensus that the

diversification of activities and financial services offered by banks produce significant economic positive effects and contribute to sustained economic growth globally. The financial risks associated to the rapid universal bank expansion were underestimated, considering that the market discipline, the diversification of activities and financial services, and innovations in risk management are effective safeguards against such risks.

The economic crisis has forced a reevaluation of the ratio between costs and benefits of universal banks, through their involvement in proprietary trading activities and other activities on the securities market. In the period preceding the crisis, most banks have redirected much of the resources to trading portfolios due to reduced financing costs. The amplification of the complexity of banks deteriorated the market discipline and the increase of interconnections determined the amplification of the systemic risk and contagion risk at the level of the entire financial system. Imposition of separation of certain banking activities is deemed necessary to mitigate the above risks, but also to prevent future situations where bank losses are supported with public money.

This type of reforms is not an absolute novelty, Glass-Steagall Act in the USA, represents a precedent in this regard. This law provided clear separation of investment banks from savings banks but was repealed in 1999. But for most countries, especially European ones, such restrictions on universal banks represent a novelty.

The aim of structural reforms of the banking system is to delineate certain financial activities deemed important for the real economy so that it is possible to protect them against risk arising from financial activities with a high degree of risk. An important issue raised by this type of regulation is to determine the boundary between different banking activities. In principle, this limit is drawn roughly between activities considered "commercial" and those considered "investment" in order to restrict the universal bank model.

In Europe, the structural reform of the banking system, which is still in the co-legislative process, is based on the Liikanen report. This report concludes that for banks whose trading activities on own account or other activities with high risk have a very high share of total activities, a separation of this category of activities by creating a separate legal entity within the banking group is a necessity. (Liikanen, 2012, p.99).

A proposal of European legislation on structural reform of the banking system provides a wide enough area of application, at least compared to other initiatives in this area (eg. Volcker Rule, Vickers Reform) because it prohibits both trading activities and those of market making, but it is less restrictive because it allows this category of activities to coexist with other activities within the same group, if done in separate subsidiaries. In terms of limiting the risk of contagion in the group, the

proposal provides that subsidiaries comply with the requirements of individual capital and liquidity, and the transactions between these entities take place under market conditions. In the co-legislative process it is possible that this reform undergo a series of changes.

Conclusions

Macroeconomic and financial imbalances arising from the unhealthy functioning of the international financial system, and also the serious implications of the recent global crisis imposed the necessity of a new approach on financial regulation and supervision. At the European level, in line with international trends, a series of draft laws in the financial and banking sector in order to enhance the resilience of banking institutions to mitigate and better manage systemic risk and therefore to avoid accumulation of imbalances and of excesses in the system to be manifested later by a severe financial and economic crisis have been initiated.

New initiatives to regulate the banking system at the European level, targeted four major directions: risk decrease of bank failures, mitigation of systemic risk and pro-cyclicality of the system, the creation of an effective resolution framework and management of cases of bank failure and the diminishing of the risks that *too big to fail* institutions assume.

However, financial regulation, in order to mitigate pro-cyclicality and instability of the financial system should target not only the traditional banking system. It also requires an expansion of the regulatory framework to the increasingly broader *shadow banking sector*, which previously was not subject to regulation and prudential supervision.

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