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FINANCIAL STABILITY IN EU BEFORE AND AFTER THE CRISIS

Case studies

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Abstract

The financial crisis has caused huge problems in the European financial systems, problems whose solutions often involved the use of public money. In this way the lesser evil was chosen, namely the accumulation of public debt and the emergence of possible situations of moral hazard, as opposed to the negative effects of a major economic and financial disaster. In such circumstances, the need for a new framework for financial stability, this time at an European level, similar in some respects to that of the monetary policy, is fully justified. This paper proposes a critical and applied analysis of the main changes implemented in the European framework of regulation and financial stability, in response to the recent crisis.

1. Introduction

Financial stability is a priority to be pursued by any economic model. A sound financial system has the potential to do much good in an economy,offering holders of economic resources the possibility to invest themsafely and offering potential entrepreneurs easy access to finance and thus to the resources needed to create new jobs and wealth. At the same time, a financial system vulnerable to lowest economic fluctuations of any kind, including of external nature, creates many negative effects on an economy by preventing access to needed finance and has even the potential to block the natural course of economic activities and create a state of general panic. For this reason, authorities around the world pay a great importance to the financial systems in which they operate, and this translates by a more careful regulation and supervision than in other economic sectors. The extent to which the state should be involved in the private financial activity and the extentit should to let the markets decide alone is a very debated issue both in economic science and in the political and civil society.

Firs of all we must clearly define what we mean by financial system. In principle, the financial system represents all institutions, public or private, whose work involves financial intermediation in all its forms. These include banks, non-bank financial institutions, insurance companies, investment funds, pensionfunds and the authorities governing them. The central bank is an actor who has a special role by the fact that although it can be in some cases a very active player in the financial markets, its main objectiveis not profit, but to ensure and maintain price stability. In many states, including the Eurozone and Romania, the central bank has supervisory functions of commercial banks in those economy, thus having an equally important role in maintaining financial stability.

The financial crisis has shown how vulnerable all financial systems are and how difficult it can be to stabilize them, trust being the most valuable asset a financial institutioncan have. The world seems to be in a consensus that the crisis must determine significant changes in the mainstream economic models and, due to the fact that it first erupted in the financial systems, this sectors represent one of the areas where these changes should be implemented.

Having as a premise the idea of benefits of a common and freemarket, the European Union is an economic area slightly atypical in that the fiscal policy is, for the most part, the responsibility of each Member State government and the monetary policy is common in most states (in EuroArea), but not all. At least until the financial crisis, financial stability was the responsibility of each individual Member State, whether it was part of the Eurozone or not. This last feature seems to be one of the main changes proposed as long-term solutions by European policy makers,which translates in introducing a single supervisory mechanism (SSM) and creating the European Banking Authority (EBA).

This paper is divided into four parts and proposes a critical analysis of the main changes already introduced or under implementation in the European financial stability. After the introduction, the second chapter is dedicated to the presentation of the main features of the European financial system, focusing on what in the authors' opinion generated the crisis or favored its negative effects. The third chapter proposes an overview of the proposed and implemented changes at the European level in order to ensure long-term financial stability. In addition to the administrativechanges, otherwise important, this chapter will also presentthe core changesin the financial accounting and regulation, namely theBasel III agreements and the changes in prudential and corporate governance. Chapter four is dedicated to conclusions.

2. The European financial systems before the financial crisis

The European Union was created in the early 1990s by the Treaty of Maastricht and has its roots in a political and economic idea of the early twentieth century concerning the advantages of a common European market that contributes to economic development and political stability on the European continent. A common market in the financial sector caused an intensification of financial flows between Member States, which led naturally to the idea of unifying economic policies, especially those ofmonetary nature. In 1993, the Maastricht Treaty established and outlined the Eurozone and the European Central Bank, a project that was implemented in 1999. In principle, all European Union countries should join the Eurozoneat some time, however the Maastricht treaty explicitly providessome exceptions to this obligation only for the UK, Denmark and Sweden. However, accession to Eurozone is up to each Member State. Currently, the European Union comprises 28 member states, 13 of them joining after 2005 and comprises of 18 Eurozonemembers.

Despite the existence in the Treaty of some provisions on fiscal and budgetary policies which Member States should pursue (budget deficit below 3% of GDP and public debt below 60% of GDP), fiscal policies are left to the discretion of each government, almost all Member States systematically violating these limits in the period before the 2008 financial crisis. [Huidumac C., Popa A. C. (2012). The European crisis and its consequences. *Proceedings of the 6th International Management Conference "Approaches in Organizational Management" 15-16 November*

2012, Bucharest. Retrieved from http://conference.management.ase.ro/archives/2012/pdf/17.pdf.]

Before the crisis,the financial stability was in the responsibility of each Member State, with only some small European cooperation mechanisms in this area through the Committee of European Banking Supervisors (CEBS). This should have create concern because the financial stability and reliability means that household and other economic operators savings are kept securely in financial institutions. Basically, the value of money was ensured by the ECB in the euro area byproviding and maintaining price stability, but the safety of those savings were in the responsibility of each Member State. Another problem stemmed from this situation and brought with financial crisis was the thankless situation in which the European Central Bank was forced to choose between price stability and financial stability in the short term. Each Member State of the European Union and the Eurozone had their own rules regarding the regulation and supervision of financial systems, some opting for stricter rules and others for more deregulation and more lenient capital requirements. However, the crisis has shown that the main vulnerability of these countries, but also some for some outside the Eurozone, was given primarily to derivatives purchased from international markets and not from the specific activity carried out within their economies. At least in the Eurozone, the financial crisis has led to some redistribution of resources from the most stronger members in financial terms to the most vulnerable ones in order to avoid negative externalities that a widespread collapse of financial institutions in a particular part of the Eurozone would be able to create to the whole area.

Member States outside the Eurozone also had their own rules and responsibilities in ensuring financial stability. As not being part of the Eurozone they didn't benefit from substantial support from the ECB or the European Commission, but instead they could calibrate their monetary and fiscal policy measures to exit the financial crisisas quickly and with fewer problems as possible. With the exception of Great Britain, the main vulnerability of these states were not the financial instruments purchased in the US financial markets, but rather the dependence on external financing which was massive in the years before the crisis.

One of the ways in which we can analyze the vulnerabilities of a financial system is by looking to external risks, i.e. the comparison of external balance sheet assets and liabilities. Figure 1 below highlights this gap by analyzing the major differences between deposits (foreign assets) abroad of EU Member States outside the euro area and loans from foreign banks. It is noted that most of these states had a similar trend: with the EU and liberalization of capital accounts significant funds of foreign capitalwere obtained, often beyond the natural capacity ofeconomies that are still under developmentto absorb. This money led to an explosion of prices in real estate assets and the strong growth in consumption. In most cases, the loans were granted in foreign currencies to commercial banks in the respective States thus creating an additional risk of exposure to exchange rate variation. Many commercial banks have preferred to pass on this risk to consumers who needed credit lines, a situation favored by the significant differences in monetary policy interest rates used by countries outside the Eurozone (were typically higher as this countrieswere still struggling with inflation). This tendency was strong in a short span of time between joining the European Union and the outbreak of the global financial crisis. The crisis has rapidly changed the rules and initiated a rapid process of deleveraging in the developed countries. This is not necessarily a bad thing because it tends to lead to balance and to better financial stability, but at the outbreak of this process, in full crisis, this created serious problems for governments and monetary authorities in those economies.

All these issues were highlighted in the financial crisis of 2008. The first reaction of European states was to protect their financial systems by all possible means, primarily by ensuring a sufficient level of liquidity. The crisis has shown how important is the confidence of economic actors in the financial systems. Even if a bank fulfilled the criteria of solvency and capital requirements imposed by Basel II agreements, at least at the beginning of the crisis, liquidity was the indicator that determined the survival or bankruptcy of a bank. Most European banks passed through the financial crisis well despite the fact that many have turned to public money, in various forms, to maintain afloat. One country stands out among the rest as a failure in this regard, and this is Cyprus. The main banks in Cyprus have failed although the country is in the Eurozone. Neither the ECB nor the European Commission or supervisors / regulators in Cyprus manage to rescue the major commercialbanks from failureand thereby, the household savings from being lost. Being an offshore center, Cyprus has faced additional problems similar to those of countries outside the Eurozone and recent joining the EU, but these proved too big for such a small country. However, the necessary measures needed to get out of the crisis and the costs that they have required prompted the European authorities to substantially change the economic model for financial stability.

3. Changes after the financial crisis

The global financial crisis of 2008 caused major changes to financial systems worldwide, not just those in Europe. Basel Agreements are a set of recommendations on how the activity of commercial banks should be regulated. Although not legally binding, most banking regulators use them as a guide for setting their own regulations. Since the first version of 1988, these agreements have been revised twice. First in 2004 and again in 2010-2011, in response to the financial crisis. They focus in particular on capital adequacy requirement on assets held by banks in their own portfolios and the risks that they depreciate over time. In addition to these requirements on accounting, Basel II agreements are also proposing a set of tools for supervisors to use them to assess a bank's financial stability and to outline the recovery measures when they are needed. The novelty in Basel II agreements is a significant change in the way supervisors act, from the pursuit that certain simple indicators are within certain limits, to a more complete evaluation based mainly on value judgments. Even if these recommendations were established in 2004, in many states of the Basel II agreements were implemented on the whole only shortly before the financial crisis, many experts considering that theseagreementshave not had time to make their effects felt.

However, the financial crisis that erupted in 2007-2008 led to substantial revision thereof. Implementation of Basel III will be done gradually and is expected to finish 2019 in most countries. [Press release - Basel Committee on Banking Supervision (2010). Group of Governors and Heads of Supervision announces higher global minimum capital standards.]

Among the novelties introduced by Basel III, are included the introduction of more stringent thresholds for minimum capital requirements, the introduction of liquidity requirements in the area of portfolio assets (being a novelty and a response to the difficulties that central banks faced in ensuring liquidity in the system), as well as some recommendations to increase the quality of banks' portfolios. In addition, Basel III agreements recommends a closer surveillance to major banks from a systemic risk perspective (the so-called "too big to fail"). In Europe these agreements were transposed by EU Directive no. 36/2013 of the European Parliament and of the Council of 26 June 2013 concerning access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and Regulation no. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, and their implementation will be carried out gradually until 1 January 2018.

Basel III agreements represent only a tightening of the Basel II recommendations, with no major modification. The focus is still on the monitoring synthetic indicators (even if now they have introduced some variables on liquidity) and leaves the regulatory and supervisory authorities to choose the best solutions to ensure and maintain the stability of financial systems.

A major problem highlighted by the financial crisis and that the Basel agreements doesn'ttackle is related to corporate governance of commercial banks. [Huidumac C., Popa A. C. (2013). Corporate governance role in transmitting the subprime crisis in the European countries, *European Journal of Science and Theology, June 2013, Vol.9, Supplement 2*, pp-pp. 175-183.]

Bank managers worldwide have acted almost indiscriminately in taking risks and pursuing only profits and bonuses. It is obvious that with the fragmentation of the shareholders, their involvement in establishing the guidelines on long-term banks management is becoming less and less important. Thus the role of the executive management of commercial banks greatly increases. [Greenspan A. (2008), *Era turbulențelor. Aventuri într-o lume nou* [The Age of Turbulence: Adventures in a New World]. Bucure ti: Editura Public .]

Internationally, the issue of corporate governance has been addressed by the OECD, an organization which in 2004 published a series of recommendations in this area in the paper entitled "Corporate Governance Principles",which were reviewed in 2014.

In Europe, the issue of corporate governance has been addressed since the beginnings of the European Banking Authority (EBA) and were included in the above regulations.[European Banking Authority (2011). Guidelines on Internal Governance, London: Retrieved from https://www.eba.europa.eu/documents/10180/103861/EBA-BS-2011-116-final-EBA-Guidelines-on-Internal-Governance-%282%29_1.pdf.]The main novelty is that for the first time regulating authorities include regulations on how bank managers are played. For example, a bonus for a credit is not immediately granted in some cases, but only after a certain period of time and only if for repayments were made according to the timetable.

According to the authors, these measures are welcomed because they limit bank managersappetite to risk, particularly in the departments of sales, and to grant as many loans as they can, including in some degree loans to doubtful debtors by using different accounting tricks or other waysof assessing collateral.

The changes outlined above are not necessarily related to the European Union but they are adopted and implemented worldwide in various forms and timetables. However, the most important change in

financial stability in the EU policy makers is the decision to unify the policies of regulation and supervision of the financial sector as a direct and long-term response to the economic crisis. It is undoubtedly a historic decision that had important consequences for long-term stability of the financial sector. There are two important pillars in this field, the European Banking Authority and the Single Supervisory Mechanism.

The European Banking Authority is an independent European institution, created in 2011 on the foundations of former CEBS, which mainly aims to create a common regulatory framework (Single rulebook) in all Member States on financial intermediation carried out by credit institutions. EBA is part of a European System of Financial Supervisors (ESFS) system comprises the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). Without a common regulatory framework at European level, European financial systems have proved to be highly vulnerable to financial crises often caused by external factors. Another good thing is that European policymakers have understood that supervision and regulation of financial systems must be seen unitary to all types of financial intermediaries, whereas their activities overlap very often (e.g. the US subprime crisis was fueled also by companies in insurance guaranteeing such loans and then packing up these guarantees in the form of financial products and selling themon financial markets to anyone willing to buy - banks and investment companies alike). European System of Financial Supervisors is an attempt to remedy this shortcoming.

The Single Supervisory Mechanism (SSM) is the second important pillar proposedby the European authorities in response to the financial crisis. It is coordinated at the European Central Bank and requires close cooperation with national supervisors. This mechanism includes all Eurozone countries, and some countries outside the EU who opted to join the mechanism (including Romania). This ECB is directly responsible for the stability of banking systems in countries that joined SSM, dealing directly with major European banks (about 123 banks, holding 82% of total assets across the Eurozone), while for the rest ECB will work closely with national supervisory authorities. The system will became active in November of 2014.

Along with SSM, in the EU Banking Unionit is important to note the unique mechanism of Resolution (SRM) whose main objective is to ensure the efficient resolution of banks in the process of entering into difficulties with minimal costs for taxpayers and taxes. Due its new supervisory powers, the ECB is the main institution that will decide whether a bank is in the process of entering the difficulty or may fall into difficulty.

Banking union and a single rulebook in financial intermediation is an obvious solution to the problems brought on by the financial crisis and to the long-term political objective of the EU Member States to act in an economic union within which markets are open 100%. The decision is consistent with that of the 1993 concerning the creation of Monetary Union by the Treaty of Maastricht. What is unfortunate, however, is that it took a financial crisis to justify it.

4. Conclusions

Financial stability is a key aspect of any economic model, which is determined by the particular importance that the financial intermediation in the economy represents. It has a role in supporting the real sector, but when financial systems lose touch with the real economy, this will only produce a temporary and expensive illusion of wealth. The financial crisis comes to restore this connection, finally having a beneficial effect on the economic balance. This despite the fact that it is an undesirable phenomenon for the whole world because of the costs involved.

Every crisis should prompt a thorough investigation of those responsible in determining the coordinates economic model to follow, political and economic science specialists alike. Solutions must be found to correct the shortcomings in order not to repeat this phenomenon.

As regards to financial stability, measures taken at European level are of two types: referring to implementing solutions and recommendations by competent international institutions, respectively Basel III agreements and OECD recommendations on corporate governance, and referring to unification of regulatory and supervisory policies similar to those in the field of monetary policy.

No crisis is like another and it is difficult to assess at this point how effective will these measures be to prevent a new economic and financial crisis, but we should recognize the efforts made in this regard. But these efforts were driven primarily by European funds used to counter the effects of the crisis and not by a correct and consistent vision of the decision makers mentioned above. Perhaps this is the merit of the crisis if we want to look at the bright side.

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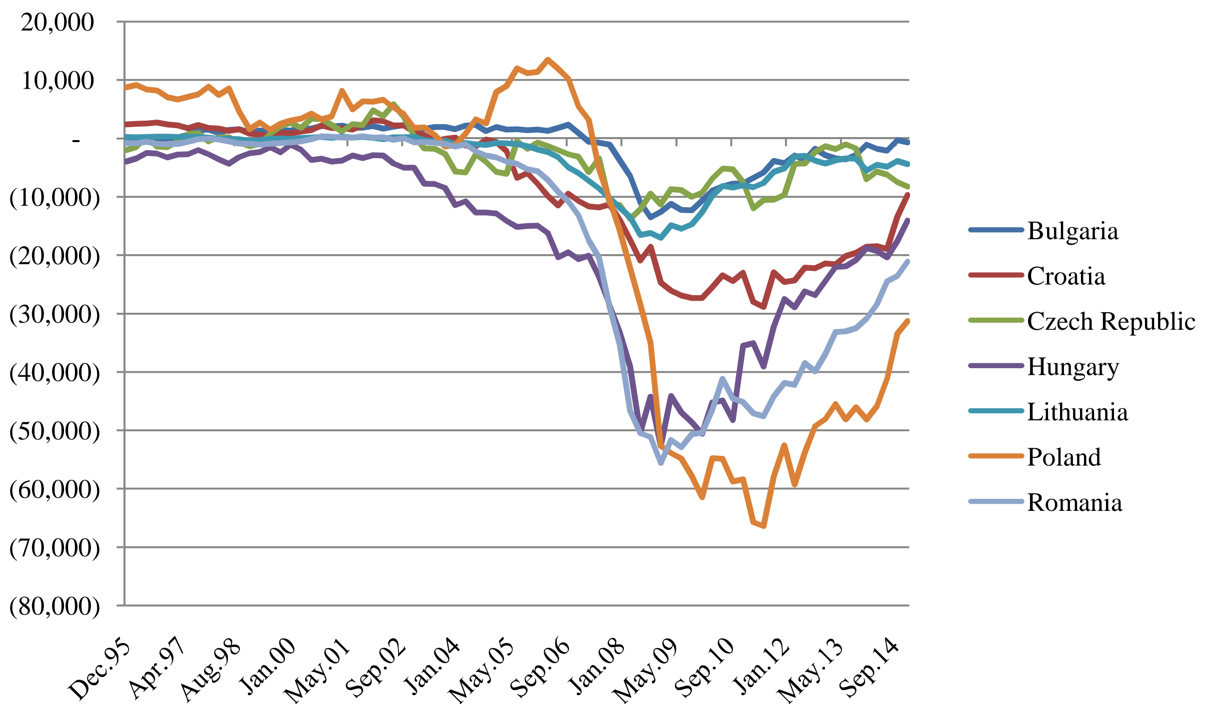
Figures



Source: BIS Locational Statistics - http://www.bis.org/statistics/bankstats.htm, author's calculations

Figure 1. Evolution of the gap between the volume of deposits in banks of BIS member states and loans granted by them in relation to EU countries outside the Eurozone - million USD -