

REFORMING THE EUROPEAN FINANCIAL AND BANKING ARCHITECTURE IN THE CRISIS CONTEXT. THE BANKING UNION CONCEPT

Magdalena, Rădulescu¹

Abstract:

Deep financial crisis which started in 2007 proved to be extremely contagious affecting the financial and banking EU system. Achieving an integrated banking market is the main component of the European policy in the financial-banking services area. The latest developments underlined that the difficulties faced by the banks can negatively impact on the entire financial stability of the member states. That's why, the European Central Bank will be entitled to supervise any bank of the euro area, especially the ones that benefit of public support. Reforming the financial and banking system must be shaped in the frame of insuring some durable national finances, of an urgent recapitalizing of the banks that need that and of elaborating some common fiscal and financial and banking regulations effective in the eurozone.

Keywords: *banking regulations, supervision, banking systems, Banking Union, crisis.*

JEL Classifications: E42, E63, F33

1. Introduction

It is widely recognized that the strong financial crisis that began in 2007 in the USA, as a crisis in the mortgage market, has proven highly contagious and has globally spread and corrupted the financial and banking system of the EU. The risk of contagion depends on the pattern of interbank linkages (Ionescu, 2012).

The international financial markets were located in the epicentre of this financial earthquake, which has led to the uncovering of some weaknesses of the regulatory system, of the profit-hungry corporate governance, as well as to the promotion of some vulnerable financial products, that could even be considered "toxic by some experts".

According to the European Commission, the crisis that initially started in the banking sector has expanded over the public finances, which made necessary the introduction of some austerity programs, which had a heavy impact on the public finances. This critical situation has required the concentration of the EU efforts to stabilize the financial-banking system, in order to remove all irregularities and abuses which existed, in order to prevent the emergence of other crises and not least to promote the sustainable economic growth (European Commission, 2010).

Achieving an integrated market for banks and financial conglomerates is a key component of the European policy on banking and financial services. The policies promoted by the European Commission in regulating the banks and financial conglomerates contributed to the implementation of the Financial Services Action Plan (European Commission, 2012). It is noteworthy that the secure banking financial institutions are crucial for the financial stability in the EU and need to establish a common framework to ensure a prudential supervision and consumer protection across the European internal market.

In order to strengthen the supervision of the financial systems, new European supervisory authorities (ESA) have been established, operational since January 2011: The European Banking Authority (EBA), the European Insurance and Operational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

On 19 January 2011 the European Commission adopted the "Omnibus proposal," which among others amended the Directive 2009/138 / EC to take into account the new insurance supervisory architecture.

¹ Associate Professor, University of Pitesti, Romania, E-mail: magdalena.radulescu@upit.ro

The European Commission considered essential the improvement of the regulations both for banks and investment firms, as well as for the insurance companies.

These regulations include both the increased stability by strengthening the prudential requirements, as well as the improvement of the internal risk management through better corporate governance.

The role of these new financial institutions is to closely cooperate with the financial institutions in the Member States to harmonize the regulations and to ensure their strict and consistent implementation. The European Supervisory Authorities have increased powers in case of critical situations. Thus, if the Council decides that there is a dangerous situation in the financial markets, these supervisors can coordinate the supervision of the financial institutions in the Member States and may require necessary actions for their harmonization across the EU. Thus, the European Systemic Risk Board (ESRB) was established to monitor the threats which endangered the financial system. The ESRB monitors the occurrence of any risks in the financial market and makes recommendations to prevent them.

2. The Developments of the Financial and Banking Regulations

In November 2008, the European Commission mandated a high level group the mission to propose recommendations regarding the ways to strengthen the European supervisory arrangements with the purpose to better protect its citizens and to restore the confidence in the financial system. As one of the two largest financial markets in the world, the EU has a clear responsibility to promote the financial stability and global security, a role that can be performed only with a solid framework for regulation and supervision. The final report submitted by the group in February 2009 proposed a more pragmatic and balanced view on a new European financial supervisory system. This vision is based on proposals to strengthen the cooperation and coordination between the national supervisors.

Later in April 2009, in the European Commission's Communication entitled the "European Financial Supervision", it was emphasized that the current supervisory arrangements proved unable to prevent, manage and resolve the crisis. The National supervisory structures have failed to keep pace with the reality of the current European financial markets based on integration and interconnection, in which many financial firms operate across borders (European Commission, 2009). The crisis exposed serious problems at the forefront of cooperation, coordination, consistency and trust between the national supervisors.

In this context, the European Commission estimated that the new European financial supervisory framework must fully respond to the political authorities of the EU and it is necessary to create a common supervisory culture. Moreover, communitarian experts have stressed the fact that the community interests of all Member States and the need for a balanced and consolidated relationship, which could strengthen the trust between the authorities from both home and host country. The European Commission has revealed the promotion of a system based on high standards of supervision, equally applied correctly and consistently to all market players, while respecting the independence of the supervisors in fulfilling their respective duties.

Another important step was made on June 2, 2010, through the Commission's Communication to the European Parliament, the Committee, the European Economic and the Social Committee and the European Central Bank, entitled "Regulating the financial services for the sustainable growth." This paper aims to improve the safety and responsibility of the financial sector in order to encourage the development of the sustainable economic growth. In this sense, all the reforms undertaken by the European Union (EU) in the financial sector are designed to improve the safety and responsibility of the financial sector in order to encourage the development of the sustainable economic growth (European Commission, 2010).

The proposals presented in the Communication are an addition to the reforms already initiated following the 2008 financial crisis and G20 summits and focus on four key goals:

1. Increasing the transparency of the financial markets;
2. Establishing a monitoring and effective enforcement of the controls in the financial sector;
3. Increasing the strength and stability of the financial sector;
4. Increasing the accountability of the financial players and improving consumer protection.

One of the main concerns of the European Commission is to regulate in a more efficient way the capital requirements of the banks. The capital requirements represent the banks' capitals and guarantee their solvency in case of difficulties. The European Commission reiterates that it is essential to encourage banks to accumulate capital in good economic times, in order to cope with any potential crisis.

As a result of the intensive work of the Financial Stability Board, of the G20 and the Basel Committee, the European Commission proposed amendments to the Capital Requirements Directive (European Union, 2010b) in order to improve the quality and quantity of the capital held by banks, to introduce capital stocks and to guarantee the capital accumulation in flourishing times so that it could be used in case of deteriorating economic conditions. The specialists of the European Commission considers that the recent global financial crisis has highlighted the need for the crisis prevention to start even at the internal level of the banks, for the shareholders and managers to participate actively and responsibly in the prevention activity and that the prevention activity must be based on the robust internal control systems.

Consequently, by introducing the new Basel III regulation it is intended that the European banking system to become more secure by repairing many of the errors that have become visible during the crisis. Improving the quality and size of the capital and liquidity management renewal should encourage banks to improve their capacity to manage systemic risk. The implementation of this new agreement is gradually achieved from 2011 to full implementation at the end of 2018.

The goal is that eventually the banks should achieve the restructuring of risks - which can be considered a new paradigm of risk - which should be good for business, consumers, investors and governments. In response to the new Basel III rules, banks will have to work in the following directions: ensuring an efficient management of the capital and liquidity, balance sheet restructuring, adjustment of the business model and offered financial services (Harle & Lüders, 2010).

Banks provide a number of measures in order to mitigate the impact that the implementation of Basel III would have. Therefore, banks:

- can optimize the scope of consolidated capital through the purchase of minority shareholdings or by restricting the excess of the capital of bank branches;
- can optimize their holdings in the financial institutions by placing unconsolidated investments below the thresholds defined by the regulatory authority for the capital deductions;
- can reassess the pension contracts and requires an accurate value of assets that can be withdrawn from the fund and thus becoming eligible for validation in the regulatory capital.

Besides the effort to align the balance to the new capital requirements, banks must continually invest in their management capacity. Banks face a number of significant challenges: a clearly defined timeline, important results after implementing a major complexity of the measures and interdependence. The challenge comes from three areas: design, data quality and complexity of the reporting activity.

International Monetary Fund, in the "Global Financial Stability Report," October 2012, states that the "major banking groups may be, to a greater extent, capable of absorbing the spending regulations; as a result, they may become even more important players in certain markets, making these markets more concentrated."

3. Banking Union

In September 2012, in order to implement the conclusions of the European Council and the Eurozone Summit, which took place in late June 2012, a set of proposals for legislative measures were adopted which were intended to establish a single supervisory mechanism for banks, being coordinated by the European Central Bank. These measures were presented in the Commission Communication to the European Parliament and to the European Council, "a map to the banking union" (European Commission, 2012b).

It is essential to complete the regulatory reform of the financial and banking system in order to better cope with the threats to the financial stability in the Economic and Financial Union. In this respect, the European Commission proposes both to intensify the efforts to counter the risks of contagion across the whole Eurozone in the case of a new financial crisis and to increase the responsibility of a common monetary policy to boost the economic and financial integration process in the EU, and to break the link between sovereign debt and banking crisis.

The switch of the bank supervision at the EU level will be complemented by other measures such as the: harmonization and simplification of the deposit-protection systems and an integrated management in the case of crises in the European banking system. According to this unique mechanism of supervision proposed by the European Commission, the ECB will oversee all banks in the EU, which apply the specific common rules of the single market.

Thus, if the banks will get in trouble in the future, the citizens must have confidence that the troubled banks will be restructured or closed to minimize the costs for taxpayers. This system will help strengthen the necessary trust between Member States, which is a precondition for the introduction of the common financial arrangements to protect depositors and to resolve failing banks in an orderly manner.

The single market of the financial services is based on common standards which ensure that banks and other financial institutions, that enjoy rights under the Treaty of freedom of establishment and freedom to provide services, are subject to equivalent rules and adequate supervision throughout the EU. Creating the banking union must not compromise the unity and integrity of the Single Market, which remains one of the greatest achievements of European integration. The single market and banking union reinforce each other.

The EU Commission Communication regarding the banking union accompanies two legislative proposals, namely one for the establishment of a single supervisory mechanism by entrusting the ECB with specific features on the policies related to the prudential supervision of the credit institutions and another one on the improvement of the Regulation establishing a European Banking Authority (EBA). According to these regulations, the ECB is given the key and specific supervisory tasks that are essential to ensure the detection of risks that threaten the sustainability of banks. The ECB will be, among other things, the competent authority for authorization of credit institutions, assessment of the qualifying holdings, ensuring the compliance with the minimum capital requirements, ensuring the internal capital adequacy in relation to the risk profile of the credit institution, the supervision on a consolidated basis and supervision of the financial conglomerates. The ECB will ensure compliance with the provisions on the relationship between funds raised and those borrowed (leverage) and liquidity, the application of the capital reserves will be performed in coordination with the relevant authorities and the

early intervention measures when a bank violates the provisions on the capital requirements. The ECB will be invested with the necessary powers of investigation and oversight to perform its duties. It includes the active involvement of the national supervisors in the single supervisory mechanism to achieve the effective training without supervision problems and implementation of the decisions and the necessary coordination and flow of information regarding both local and European issues, with the purpose to ensure financial stability throughout the EU and its Member States.

All the tasks which are not explicitly attributed to the ECB shall be borne by the national supervisory authorities. For example, the national supervisory authorities will remain responsible for consumer protection and fighting money laundering, as well as for the supervision of the credit institutions from third countries which established branches or provide cross-border services within a Member State. The ECB must be able to achieve all supervision functions in full independence and is fully responsible for its actions.

The Commission's proposal contains a number of organizational principles to ensure a clear separation between the monetary policy and banking supervision, which will mitigate the potential conflicts between the different political objectives. All preparation and execution activities will therefore be carried out by separate organisations and administrative divisions separated of the monetary policy functions through a Board of Supervisors established within the ECB for this purpose.

Creating the European Banking Authority (EBA) through the Regulation (EU) nr.1093 / 2010 of the European Parliament and of the Council of 24 November 2010 of establishing a European Supervisory Authority (EBA) and the European System of Financial Supervision has already contributed to the cooperation between the national supervisors. But, the European Commission alleges that in many cases the financial and banking supervision continues to be carried out at a national level in order to cope with integrated markets. In this respect, the new proposed changes will ensure that the EBA can continue to effectively achieve its mission concerning all Member States. In particular, the EBA shall exercise its powers and duties also regarding the ECB.

The works on the operational implementation took place during the year 2013. It is necessary to ensure a clear separation between the ECB monetary policy and its supervisory functions, as well as ensuring a fair treatment and representation of the euro area Member States and those beyond which participate in the SSM (single supervisory mechanism). The single supervisory mechanism was to be based on the highest standards of banking supervision and the ECB was able, in different ways, to exercise direct supervision. Also, the ECB is able to use its powers conferred by legislation effective immediately upon its entry into force. In addition, it is extremely important to establish a single regulatory framework which would be the core of the centralized supervision.

Guido Tabellini (2011) points out that the new European institutions are the only solution, and if the markets cannot perform this activity, the European Commission should act as an intransigent guardian of the public finances and budgetary discipline. The first step is to drastically strengthen the control mechanisms over the national decisions on economic policy. However, the control of the public finances is not enough. The EU institutions should also have tools to prevent the accumulation of excessive debt in national banking systems. All this requires a substantial transfer of economic sovereignty from the EU countries to the EU authorities (the European Commission or the regulatory agencies). Some economists emphasize that the stress tests for European banks may be an opportunity to assess the readiness to act in this direction, but it will be necessary to go beyond the stress tests, and strengthen the powers of the new European Banking Authority. Clearly, the transfer of sovereignty must involve all Member States, including France and Germany, not only the so-called "European periphery" (Tabellini, 2011).

The creation of the "banking union" through a single supervisory mechanism will exert a direct control on banks to ensure the compliance with prudential rules and to conduct effective monitoring of cross-border interbank markets. But in terms of "good governance", the tasks related to the monetary policy will be strictly separated from the supervisory tasks, to eliminate the potential conflicts of interest between the monetary policy and prudential supervision.

The global financial integration and the EU single market has allowed the banking sector in some Member States to exceed several times the GDP recorded by them, resulting in institutions that are "too big to fail" and "too big to be saved". Moreover, history shows that the failure of banks, although relatively small, can cause cross-border systemic damage. Moreover, banks that operate across national borders may critically weaken the national banking systems. The enhanced surveillance in the banking union will improve the robustness of banks. If, however, there is a crisis, it is necessary to ensure that the institutions can be protected in an orderly manner and that depositors have their savings safely secured. A banking union should include a more centralized management of banking crises involving major European institutions.

The obstacles to achieving a banking union are large and numerous. A single supervisory authority, be it the ECB must have the support of all 27 member states. Countries such as Sweden, Hungary, Poland, the Czech Republic are dissatisfied that the Commission's proposal which does not provide favourable conditions for those who choose not to take part and only weak guarantees concerning the authority of the supervisor. The Czech Prime Minister Petr Necas said he would veto a European Union plan of banking union, unless changes are made to the proposed regulations. He stated that the Czech Republic is not a member of the Eurozone and the Czechs are not willing to expose their banking financial sector highly capitalized and protected against the risks arising from pooling risks with other EU Member States. The EU leaders discussed the proposals on banking union during the summit of 19 October 2012, but a number of countries, including other non-euro member states like the UK and Sweden - have raised objections to the plan that would give large regulation power to the European Central Bank.

The challenges and risks of the banking union cannot be neglected. Member States act as guardians of the "sovereignty", even when at stake is the increased financial integration in the EU. Some economists emphasizes that financial markets consist of a dense network of credit and financial flows, in which some sections of markets and intermediaries play a critically important role. This network acts as a rick multiplier: when the financial operator does not have cash or becomes financially insolvent, its problems are disseminated in the financial system and its creditors will also suffer losses of liquidity and solvency. Therefore, the size of the risk of a banking system as a whole is much larger and complex to be calculated by simply summing the individual risks of financial operators in the system. In other words, there is a macro-dimension of financial risk, which differs greatly from the micro-size which characterizes each portfolio and each intermediate of the banking sector (Bruni, 2011).

Outside Britain, countries that have not adopted the euro do not object in principle against the banking union, but want more power of influence. The deepening of the financial integration (economic) by achieving banking union is obvious, but there is a danger of a division of the EU. The making decisions process and tasks of the ECB can be questioned, although its role as a supervisor cannot be disputed. The British, who have a strong financial centre-City of London, might find themselves in the minority, but there is still a risk of a strong division of the EU, in terms of the vision regarding the financial sector (Wallace, 2012).

The issue of the democratic accountability of a single supervisor was raised by the representatives of Poland. For states that do not use euro, but where the banking systems are controlled almost entirely by euro area banks, it is raised the question about the degree

of involvement of the ECB and its national impact, as well as the expansion of the liquidity requirements and guarantee schemes, if they adhere to them. The non-euro states entering the banking union did not provide voting rights similar to those in the euro area and the ECB jurisdiction over them remains a sensitive issue, as well as the confidence in the effectiveness of new mechanisms.

4. Conclusions

In conclusion, the financial and banking system reform must be considered in the context of ensuring a good governance of the EU. There are three key steps that the EU should go through:

1. Firstly, the sovereign finances need to be sustainable. Such a strategy means fiscal joint action. If a Member State carefully approaches long-term risks such as increased spending on pensions or healthcare costs increase, they will have more chances in the short term to support the economic growth and jobs.
2. Secondly, banks need urgent recapitalization. They must be strong enough to withstand the risks of sovereign debt and low economic growth rates. If these issues are not solved, we could easily see the further spread of economic recession in the EU, or even a liquidity crisis. The most efficient solution would be first the recapitalization of banks through private resources, but also using the public funds if necessary. One option would be to mobilize the European Financial Stability Facility or other European funds to recapitalize banks directly.
3. The current economic crisis has highlighted some serious flaws in the Eurozone architecture, flaws that threaten the sustainability of the entire project. So Europe must credibly promote a common vision, and it must be built on solid foundations, including fiscal rules (and banking) that actually work.

The crises in modern times did not differ in terms of causes and effects from the crises in the classical period. The only difference is given by their scale and a more rapid pace with which they succeed at the moment. The failure of the state to mitigate their frequency of occurrence and mitigate the negative effects of these crises is obvious. Even if a better regulation of the financial markets and of the actors' behaviour in these markets is enforced, there will always be new financial innovations that will pass the limit of jurisdiction of these measures. The only way out of the current crisis remains reforming the state intervention in the money markets, limiting the monetary expansion, the moral hazard created by the monetary expansion.

The current economic and financial crisis, beyond the problems it generates both at the micro and macro level, must determine the adaptation of the mechanisms, financial/monetary institutions and policies to the real economy.

References:

- [1]. Bruni F. (2011) *The Europe and World Economy Governance: The Monetary and Financial Perspective*, in Sechi, Vilafranca *Global Governance and the Role of EU, Assessing the Future Balance of Power*, USA, Edward Edgar Publishing Limited.
- [2]. European Commission, (2012a), *Restoring the health and stability of the EU financial sector*", Brussels, [online] available at: http://ec.europa.eu/internal_market/smact/docs/20120206_restoring_health_en.pdf [Accessed 17 July 2014]
- [3]. European Commission, (2012b), *Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union*, [online] available at http://ec.europa.eu/internal_market/finances/docs/committees/reform/20120912-com-2012-510_en.pdf [Accessed 17 July 2014]

- [4]. European Commission, (2010a), *Regulating the financial services for a sustainable growth*, Brussels, [online] available at: <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2011:107:0021:0025:RO:PDF> [Accessed 17 July 2014]
- [5]. European Union, (2010b), *Directiva 2006/48/CE of the European Parliament and of Council from June 2006 regarding the initiation and exercising the activity of the credit institutions* [online] available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=DD:06:09:32006L0048:RO:PDF> [Accessed 17 July 2014]
- [6]. European Commission, (2009), *European financial supervision*, Brussels, [online] available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0252:FIN:RO:PDF> [Accessed 17 July 2014]
- [7]. Harle & Luders (2010), *Basel III and the European banking: its impact, how banks might respond and the challenges of implementation*, USA, Mc Kinsey & Company.
- [8]. International Monetary Fund, (2012), *Global Financial Stability Report*, Washington DC, [online] available at: <http://www.imf.org/external/pubs/ft/gfsr/2012/02/pdf/text.pdf> [Accessed 17 July 2014]
- [9]. Ionescu C., (2012) *Incomplete markets and financial instability. The role of information*, Annals of the University of Petroșani, Economics, 12(1), pp. 141-150.
- [10]. Tabellini G. (2011), *The Eurozone crisis: What needs to be done*, London, The Centre for Economic Policy Research, [online] available at: <http://www.voxeu.org/article/eurozone-crisis-what-needs-be-done> [Accessed 17 July 2014]
- [11]. Wallace T. (2012), *UK fears impact of Eurozone's banking union*, City A.M. Journal, [online] available at: <http://www.cityam.com/article/uk-fears-impact-eurozone-s-banking-union> [Accessed 17 July 2014]