Dr Daria Kostecka - Jurczyk
University of Wroclaw

The EU financial sector regulatory reform as an instrument of crisis prevention

Introduction

The financial crisis that has hit global economy in the summer 2007 is without precedent in post-war economic history. The background of the crisis lies in the vast expansion of banks' and other financial institutions' balance sheets (assets and liabilities) concerning their own capital, which took place over the past decade. The expansion resulted from huge global imbalances – Asian savings and Western borrowing to spend – combined to trigger steady growth, low inflation, low (real and nominal) interest rates and a relatively laissez faire stance of financial regulations on the financial market.

The article concentrates on financial regulations in the European Union (EU) being a crucial instrument of hindering crisis in the EU, as well as on financial supervision system in the EU, which is an indispensable means of avoiding financial destabilization in the future. The aim of this article is also to present the situation in Poland and the responsibilities of Polish authorities of financial supervision. Our financial regulations helped domestic institutions to avoid the collapse of our financial market but, of course, they did not protect us from the worsening economic situation.

1. Crisis background

Originating primarily in the United States, the crisis is now global, deep, and even worsening. It is highly complex and it ripples through different market segments and countries. Many parts of the financial system remain under severe strain. Some markets and institutions have stopped functioning. This, in turn, has affected negatively the real economy. Financial markets depend on mutual trust. But much of this trust has faded out. The signals about the difficulties in the US financial system appeared in the years 2005 and 2006 (some say it was in the year 2000 when the internet bubble burst). For example, in the US personal savings fell from 7% (meaning percentage of disposable income) in 1990, to below zero in 2005 and 2006. Consumer credit and mortgages expanded rapidly. In particular, subprime mortgage lending in the US rose from $ 180 billion in 2001 to $ 625 in 2005.

In the recent years global saving-investment imbalances led the US and other industrial nations to import savings from fast growing, low - consuming emerging markets as well as from oil-exporting countries. Large price bubbles in the housing markets partly followed, due to the fact that financial institutions reacted to the surplus of capital by competing for borrowers. To satisfy the surging demand for investments, as well as the need for new risk spreading instruments, the financial sector began designing complex and unclear securities that combined individual loans. These new innovations concealed risk and were partly responsible for the size of the collapse that followed. Moreover, much of the new lending activity and securitization occurred in the so-called "shadow banking system", which was outside the regulations that constrained the activities of such institutions as savings banks.

In its early stages, the crisis manifested itself as an acute liquidity shortage among financial institutions, as they experienced ever stiffer market conditions for rolling over their (typically short term) debt. In this phase, concerns over the solvency of financial institutions were increasing, but a systemic collapse was deemed unlikely. In early 2007 credit boom started to unravel in the US, as problems with subprime loans surfaced and house prices began to fall. Crisis in trust commenced, as investors started to withdraw from a range of credit markets and financial institutions in the US. Stock prices declined with the built up of both distrust of the financial system and gloomy economic prospects. The result was a quick and deep contraction of the real economy that still persists.

In the real economy these problems flooded rapidly with credit restraint and sagging confidence hitting business investment and household demand, notably for consumer durables and housing. It was a cross-border transmission due to tight connections within the financial system and the strongly integrated supply chains in global product markets. EU (27) real GDP shrank by 4,2 % in 2009[1]. There are signs of incipient recovery, yet this process is expected to be rather sluggish[2] as demand will remain low. Risk aversion will weigh on capital formation and R&D.

The causes of the current crisis can be divided into[3]:

- macroeconomic causes
- risk management
- failures of credit ratings agencies
- corporate governance failures

[1] http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020
[2] GDP growth in EU-27 in 2010 is project to increase by 1%.
[3] See: High Level Group on Financial Supervision in the UE, Report, Brussels, 25 February 2009, ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

- regulatory, supervisory and crisis management failures

There have been two serious consequences of these events for markets and a third one may be round the corner. The first was the situation where many of the world's most renowned banks have been pushed close to bankruptcy. For some, this was the direct result of their own recklessness. Governments across the world have stepped in to bail them out by guaranteeing loans, injecting capital, insuring toxic assets and acquiring their shares. The crisis impacted the real economy. The banks have cut lending in every way they should to rebuilt their reserves. This has led to creating severe financial constraints for their business and private customers, resulting in investment cuts, reduced demand and a powerful negative multiplier across the global economy. Governments and monetary authorities have been trying to reverse this situation by slashing interest rates, buying securities, increasing public spending, and temporarily reducing taxes.

Governments and central banks across the world have taken many measures to try to improve the economic situation and reduce the systemic dangers: economic stimulus packages of various forms, huge injections of central bank liquidity, recapitalizing financial institutions, providing guarantees for certain types of financial activity and, in particular, inter-bank lending. These actions were also taken in the EU.

2. EU stability actions

The EU has taken unprecedented measure to restore stability on financial markets and to get credit flowing again. These must be matched by robust reform to prevent a return of the crisis and to rebuild trust in the banking industry.

The EU has already taken steps to increase protection of bank depositors, make credit ratings more reliable, improve risk management in financial firms and reinforce the solidity and supervision of banks and insurance companies. The European Union is also moving to tighten the rules concerning hedge funds and to curb banking pay practices that encourage recklessness.

Looking ahead, the EU has set out detailed plan for improving the regulation and supervision of its financial markets and institutions. The plan calls for measures to promote integrity an transparency and to prevent excessive risk. It forces European institutions to supervise financial firms active in several member states, and the European body to oversee the stability of the financial system as a whole.

On 26 November 2008 the European Commission published the European Economic Recovery Plan[4]. The strategic aims of the plan were to:

- swiftly stimulate demand and boost consumer confidence,
- lessen the human costs of economic downturn and its impact on the most vulnerable, especially to help stem the loss of jobs and then to help people return quickly to the labour market, rather than face long-term unemployment,
- help Europe to prepare to take advantage when growth returns – meaning, that the European economy should be prepared to improve competitiveness and fulfill the needs of the future as outlined in the Lisbon Strategy for Growth and Jobs. Therefore, that EU needs to take structural reform, supporting innovation and build a knowledge economy,
- limit carbon energy, limit climate change and promote energy security.

This plan has to two key pillars: the first one is a major injection of purchasing power into economy to boost demand and stimulate confidence. The Commission proposed that, as a matter of urgency, Member States and the EU agree to an immediate budgetary impulse amounting to € 200 billion (1.5% GDP) to boost demand in full respect of the stability and Growth Pact. The second pillar rests on the need to direct short term action to reinforce Europe’s competitiveness in the long term. The Plan sets out a comprehensive programme to invest in certain areas which could stimulate future growth and generate clean technologies to boost sectors such as construction and automotive, in the low-carbon markets of the future and investing in infrastructure and inter-connection to promote efficiency and innovation.

In response to the crisis, since the summer of 2008 EU has put forward four legislative proposals on financial regulations:

1. Directive on Deposit Guarantee[5] - The Deposit Guarantee Scheme was adopted on 11 March 2009. It includes such solutions as: a) minimum deposit guarantee level of € 50.000 to be increased to to € 100.000 by December 2011; b) the payout delay reduced to 20 days, with further 10 days in exceptional circumstances – by December 2010; c) the compensation to cover 100% of eligible deposits; d) the Commission to be tasked with reporting on effective payout procedures, cooperation arrangements and the impact of increasing the upper limit – by December 2009.

[4] Communication from the Commission to the European Council, *A European Economic Recovery Plan*, Brussels 26.11.2008, COM (2008) 800 final.

[5] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009, amending Directive 94/19/EC on deposit guarantee schemes as regards the coverage level and the payout delay, OJ 2009 L 68, p. 3.

2. Capital Requirements Directive[6] – adopted in 2006, transposes the Basel II rules into EU law. The Basel II accord consists of three pillars: a) sets minimum capital requirements for credit, market and operational risk, b) firms and supervisors must take a view on whether additional capital should be held against risks not covered in the first pillar, c) firms are required to publish details of capital, risks and risk management. In the year 2009 the Commission submitted key amendments to the Directive which were: a) limit banks' exposure to any one party, b) colleges of supervisors established for all cross-border banking groups, c) clear definition of quality of capital and whether certain capital can count towards a bank's minimum requirement level, d) rules on securitised debt, including transparency and retention of risk requirements.

3. Regulation of Credit Rating Agencies (CRA)[7] – the key elements of the Regulation are: a) CRA must disclose key models, methodologies and assumptions on which their ratings are based, b) removal of conflicts of interest from the ratings system through disclosure requirement, c) introduction of a registration regime for CRAs, d) EU financial institutions may only trade in instruments rated by an EU-registered rating agency.

4. Regulation of alternative investment funds[8] – the Commission's solutions in this area concentrate on four issues: a) authorization – all fund managers within the scope of proposal (those managing a portfolio of over € 100 m) will require authorization and will be subject to harmonized standards, b) enhance transparency of funds and fund managers, c) ensure all funds have robust systems in place for management of risks, liquidity and conflicts of interest, d) granting access to the European market to third country funds after a transitional period of three years.

The EU Commission pointed out, that the crisis revealed significant shortcomings in the financial supervision, which had failed to prevent the accumulation of excessive risks in the financial sector, and has, in particular, highlighted the weaknesses of the existing macro-prudential oversight. This facts induced the Commission to entrust de Laroisière Group with the preparation of recommendations on how to strengthen European financial supervision. The aim was to improve the protection of citizens while rebuilding trust in the financial system. The Group recommended the establishment of an EU-level body to oversee risk in the

---

[6] Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investments firms and credit institutions (recast), OJ L177/201 (Commission has put forward further revision of EU rules on capital requirements for banks, see: Proposal to change the capital requirement directive on the page http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/citizens_summary_en.pdf.

[7] Regulation (EC) No 1060/2009 of the European Parliament and the Council of 16 September 2009, on credit rating agencies, OJ L 302, p.1.

[8] Alternative investment funds include: hedge funds, private equity funds, real estate funds; http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm

financial system as a whole. During the meeting on 19-20 March 2009, the European Council agreed on the need to improve the regulation and supervision of financial institutions within the EU and to use the report of the de Laroisière Group[9]. In a response, the Commission set out series of reforms to the current arrangements for safeguarding financial stability within the EU, including the creation of the European Systemic Risk Board (ESRB), responsible for macro-prudential oversight.

The Commission decided that the European financial supervision should be composed of two pillars:

1. European Systemic Risk Council (ESRC)
2. European System of Financial Supervisions (ESFS)[10]

The first institution should monitor and assess potential threats to financial stability that arise form macro-economic developments and developments within the financial system as a whole. The ESRC would provide an early warning of system wide risks, that may be building up and issue recommendation (if necessary) for action to deal with these risk. The creations of the ESRC will address one of the fundamental weaknesses highlighted by the crisis, which is vulnerability of the financial system to interrelated, complex, sectoral and cross-sectoral systemic risks.

The main tasks of ESRC are:

- to identify risks
- to inform about risks warnings
- to give recommendation (if necessary) on the measures to be taken in reaction to the risks identified
- to monitor the required follow-up to warnings
- to collect and analyze all information relevant for monitoring and assessing potential threats to financial stability that arise from macro-economic developments and developments within the financial system as a whole,
- to liaise effectively with the IMF, the FSB and third country counterparts.

The second institution – ESFS – is aimed at micro-prudential supervision. It consists of a robust network of national supervisors working in tandem with the new European Supervisory Authorities to safeguard financial sector and to protect consumers of financial services. The new European network is based on mutually reinforcing responsibilities, combining

[9] High Level Group on Financial Supervision in the UE, Report, Brussels, 25 February 2009, ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

[10] Communication from the Commission, *European financial supervision*, Brussels, 25.05.2009, COM(2009), 252 final.

nationally based supervision of firms with centralization of specific tasks at the European level. This is aimed at fostering harmonized rules, as well as coherent supervisory practice and enforcement. It would also enhance trust between national supervisors, ensuring that host supervisors have an appropriate say in setting policies relating to financial stability and consumer protection, thereby allowing cross-border risks to be addressed more effectively.
ESFS's task is, inter alia, to deal with the following issues:

- ensure single set of harmonized rules,
- ensure consistent application of EU rules,
- ensure a common supervisory culture and consistent supervisory practices
- collect micro prudential information

Both pillars are crucial for effective supervisory system to reinforce financial services regulation. The project of building new architecture of the financial sector is in accordance with G-20 framework for international plan to built a stronger regulatory and supervisory system for the financial sector.

On 29 October 2009, the EU Commission published "An EU Framework for Cross-Border Crisis Management in the Banking Sector"[11]. It is an instrument of building resolution regime that would ensure that all competent authorities effectively coordinate their actions and have the appropriate tools for intervening quickly to manage the failure of a bank, with the objective of minimizing the need for states to resort to the kind of exceptional measures that have been necessary in this crisis. The Commission proposed to improve supervision in three key areas:

1. Early intervention, covering actions by supervisors aimed at restoring the stability and financial credibility of an institution when problems are developing, together with intra-group asset transfer between solvent entities for the purpose of financial support. These actions would be taken before the thresholds conditions for resolution are met, and before the institution is likely to become insolvent. The new European Banking Authority could play a role in coordinating supervisory early intervention in a cross-border group.
2. Resolution, covering measures taken by national resolution authorities to manage a crisis in a banking institution, to contain its impact on financial stability and, where appropriate, to facilitate an orderly winding up of the whole or parts of the institution. These measures take place outside the framework of banking supervision and may be taken by

[11] COM(2009) 561 final.

authorities other than supervisors, although it is by no means precluded that supervisors might be involved.

3. Insolvency, covering reorganization and winding up that takes the applicable insolvency regime.

Since the start of the crisis, EU regulators have already submitted two sets of amendments to the Basel framework[12]. One was agreed on in April 2009, the second one is still on the table. It mandates banks to hold at least 5% of the securitization issuance in credit risk transfer products, in order to provide the incentive to monitor in 'originate and distribute' activities[13].

OECD, like the EU and the USA, confirms its engagement in the creation of new financial regulations and points out, that the crisis is not an effect of market failure but also policy failure and reconstruction of the financial sector. It also states that the economy needs good regulation on deposit insurance, tax provisions, corporate governance, competition policy, accounting rules and executive compensation. Because of this issue, OECD has pointed at some aspects of economic policy and regulation which should be taken into account in repair action:

- determining desirable size of volatile investment bank segment, updating and strengthening the governance and regulation of these institutions, including possible stronger capital requirements;

- rising safety of pension funds and diversification strategy between public and private provision of retirement income;

- improving international cooperation and implementation of agreed international corporate governance standards in such areas as: board oversight of risk management, board practices, governance of the remuneration process, exercise of shareholder rights;

- considering taxation impact on financial markets developments and examining how taxes may have influenced the current crisis and what changes in the regulations are required to avoid re-occurrence of the recent events[14];

---

[12] The Basel capital adequacy rules were implemented in the EU with Capital Requirements Directive. Initially proposed in 1988, the rules were substantially amended in 2005, generalizing the use of credit ratings for risk weightings in the external ratings-based approach and the use of internal models for more advanced financial institutions (Basel II). Basel sets a minimum capital requirement of 8% for the banking book but the differentiation of risk weightings prevented supervisors from noticing the growing degree of leverage in the financial system.

[13] Consultative proposals to strengthen the resilience of the banking sector announced by the Basel Committee on 17 December 2009 http://www.bis.org/press/p091217.htm

[14] *OECD Strategic Response to the Financial and Economic Crisis: Contributions to the Global Effort*, C(2008) 191/Final, p. 5-7.

- examining the financial institutions' tendency to focus on the short, rather then the medium or long-term and their moving to less transparent jurisdictions offshore to evade tax and regulatory provisions;

- removing tax barriers which hamper the effective functioning of financial markets, particularly at the international level;

- developing financial education and awareness campaigns which will help individuals understand financial risks and products, and thus take good decisions.

3. Recommendations of the Polish Committee on Banking Supervision

In Poland, the results of the financial crisis are, so far, less noticeable than in other countries. In 2009 real GDP growth rate amounted to 1.7%[15]. The situation in Poland was influenced by various complex factors, among which the crucial ones included a relatively weak development of the financial system and restrictive regulations of the financial supervision institutions. The Polish financial system had experienced a dynamic growth after joining the EU, but the market of many high risk financial instruments and subprime loans was not yet developed. The ratio of the assets of the financial system to GDP rose from 85% in 2005 to 110.5% in 2008[16], while the value of the assets of the financial institutions in Poland amounted jointly to PLN 836 billion in 2008, and PLN 1407 billion in 2009[17].

The development of the financial institutions resulted mainly in an easier access to loans and credits, and lowered the costs of credits. As a result, the demand for loans and credits rose which situation, in turn, increased the vigilance of the institutions of banking supervision which began issuing (even before the financial crisis in the USA started) prudence regulations vital for the safety of the financial system, as well as its clients.

In March 2006, the Committee on Banking Supervision (KNB) issued an "S-Recommendation" on good practices in the field of credit exposures secured by mortgages. It includes, in particular, the following guidelines:

- banks should offer mortgage loans primarily denominated in PLN,
- if a customer chooses foreign currency loans, they must have the credit capacity amounting to 120% of the credit denominated in PLN (it was a response to expanse loans

[15] http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020
[16] *Rozwój systemu finansowego w Polsce*, NBP, Warsaw, 1.12.2009, p. 3.
[17] Ibidem, p. 5.

denominated in foreign currencies triggered by high divergences in the interest rate in Poland and, for example, in Switzerland or Euro Zone),

- banks must inform clients interested in a loan in a foreign currency of the risks associated with foreign exchange and interest rates risk, if the loan is based on variable rate,
- once a year the bank should analyze the impact of exchange risk, interest rate risk and changes in the property market on the quality of the portfolio of credit exposures secured by mortgages,
- the bank is obliged to provide prospective borrowers with simulations, showing how the instalments may be affected by changes in exchange rates as well as changes in interest rates (for loans based on variable rate).

On 17.12.2008 the Financial Supervision Commission (FSC)[18] adopted a "Recommendation S II" which increased the protection of bank consumers with loans contracted in foreign currencies[19]. It has come to life on 1 July 2009. In 2008 FSC's survey revealed weaknesses in credit risk management process in banks. In particular, it disclosed an accepted general practice of an excessive debt burden compared to the income of the borrower. The recommendation indicates the need for banks to inform customers about the existence of the spread rate, the burden, and the risk associated with it, prior to singing a contract.

On 23 February 2010, the FSC has adopted a "Recommendation T", which is a set of best practices in retail lending, based on the principle of a fair examination of creditworthiness of the customer. The main objective is to improve the quality of risk management in banks, including preventing the phenomenon of excessive indebtedness of borrowers. The recommendation envisages a requirement to have an own contribution amounting up to 20%. It relates to:

1. credit risk management and control,
2. identification, measurement and risk acceptance, according to which the bank should:

- assess credit worthiness of the household and credit worthiness of persons responsible for repayment of obligations on the basis of complete, reliable and consistent with the facts and legal information,

[18] An institution which, on January 01, 2008, replaced the Committee on Banking Supervision, taking over and expanding the scope of its competence.

[19] According to the FSC At the end of November 2009, the value of foreign currency housing loans to people in the Polish banking sector reached PLN 139.3 billion, which is 63 percent of total housing loan portfolio. As a comparison, at the end of 2008 this share was 70 percent.

- include all elements which may have significant impact on the creditworthiness of the household supporting the obligations (including revenue at the actual disposal of the household after deduction of any taxes, fees, premiums and other charges of similar nature, expenditures and macroeconomic conditions),
- while assessing the creditworthiness, take into account all of the expenses of the household and persons liable for repayment of the loan, including their level of income, number of persons comprising the household, their social status, housing residence, maintenance of existing and projected commitments,
- for foreign currencies loans – to analyze the creditworthiness of the customer, assuming that the interest rate for the loan rate is at least equal to the interest rate for the PLN loan, credit and capital is greater than 20 percent and if household income is obtained in currency other than the currency in which the loan is offered,
- assume, that the maximum level of expenses related to the operation of credit and financial obligations to the household income should not be higher than 50 percent,
- pay attention to the relevance of documents necessary for the analysis of creditworthiness,
- monitor the creditworthiness of the borrower,

3. Security for credit exposure, according to which the bank should, among others:

- adopt a buffer to cover the effects of changes in the size of the LTV (Loan to Value[20]) ratio, arising from changes in currency exchange rate or the misalignment of currency exposure and the currency in which the collateral is expressed, at the level of minimum 10 percent for loans up to 5 years and minimum 20 percent for loans over 5 years.

4. Reporting of risk management policies of credit exposures to households and the level of risk for these exposures.
5. Internal control in the risk management of credit exposures to households.

Conclusions

The EU's likewise the US's response to the current economic downturn is concentrating on different kinds of intervention tools. The US administration firstly prepared stability package and is now working on financial regulations. The EU Commission and Council prepared a highly significant set of regulations aimed to safeguard the European society from the irresponsibility of the financial institutions. The EU concentrates on improving or building

[20] The indicator used in banking to determine the amount of the granted credit or loan to the size (value) of the security for the repayment of the loan.

mechanisms which failed before the crisis and, vicariously, caused the current crisis. Some indicate, that such a regulations policy is affecting the foundation of the free market economy, capital allocations and investment processes. It is still too early to discuss on the effects of the regulation expansion, but it is worth to ask if it is indeed a different way?

The history of economical crisis in the 20th century proves that deregulation is not a panacea for putting economy back on a path of growth. It can be helpful, but deregulation itself, without prudential regulations implemented at the same time, can create conditions for a next crisis. This is the main reason for breaking out the crisis we are in. Therefore, now the most important task for the European Union and the United States is to develop a new mechanism of control of financial markets. Certainly, the new system will rely on tighter regulations, not on the lack of them.

The course of crisis in Poland is relatively mild due to the conservative and restrictive policy of the Polish financial supervision, and because polish financial market is very shallow, comparing to its counterparts in the Western Europe and the United States.

Bibliography:

1. *An EU Framework for Cross-Border Crisis Management in the Banking Sector*, 29 October 2009, EU Commission, COM (2009) 561 final.
2. Communication from the Commission to the European Council, *A European Economic Recovery Plan*, Brussels 26.11.2008, COM (2008) 800 final.
3. Communication from the Commission, *European financial supervision*, Brussels, 25.05.2009, COM(2009), 252 final.
4. Consultative proposals to strengthen the resilience of the banking sector announced by the Basel Committee on 17 December 2009 http://www.bis.org/press/p091217.htm
5. High Level Group on Financial Supervision in the UE, Report, Brussels, 25 February 2009, ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf
6. *OECD Strategic Response to the Financial and Economic Crisis: Contributions to the Global Effort*, C(2008) 191/Final.
7. *Rozwój systemu finansowego w Polsce*, NBP, Warsaw, 1.12.2009.
8. Regulation (EC) No 1060/2009 of the European Parliament and the Council of 16 September 2009, on credit rating agencies, OJ L 302/1.
9. Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009, amending Directive 94/19/EC on deposit guarantee schemes as regards the coverage level and the payout delay, OJ 2009 L 68/3.
10. Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investments firms and credit institutions (recast), OJ L177/201.
11. http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/citizens_summary_en.pdf.
12. http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb020

13. ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf
14. http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm