The New EU Financial Architecture after the global financial crisis

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Global Financial Crisis

Experience of the global financial crisis (2007-2008) has showed significant weaknesses in supervision of financial markets, both in particular cases of banks and in relation to the financial market as a whole.

Institutional architecture and government provision of a financial safety net for banks and other financial institutions has been a key element of the policy response to the last financial crisis.

The logic inconsistency of the EU financial market framework

- 1 internal market, 28 Member States, 19 Members of Euro Zone

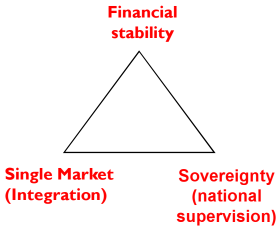
A source of:
- Conflicts
- Co-ordination problems

→ Obstacle to further integration and no optimal model for financial stability

The "Financial trilemma in Europe"

(D. Schoenmaker)

- 3 objectives
  - Financial stability
  - Integration
  - Sovereignty
- Any par of objectives can be achieved, but never all three
- The million dollar question: What's the appropriate trade-off?



New financial architecture

Increasing financial integration

- Cross-border capital flows and payments
- Cross-border establishment of banks & financial institutions – thru group structures

Financial regulation and crisis management have not kept pace with increasing integration of wholesale capital markets and growing cross-border operations of EU financial institutions. How to regulate most efficiently the cross-dimension of systemic risk?

Systemic risk on the financial market

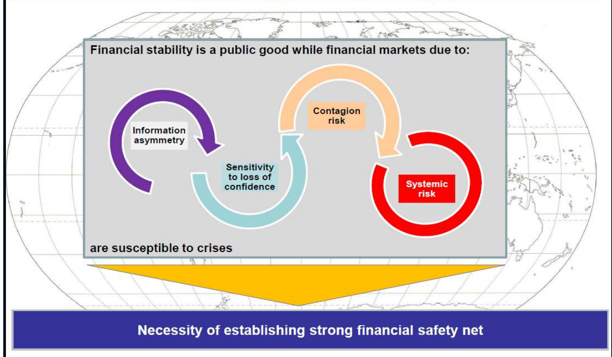
- Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24/11/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (the 'ESRB Regulation').

systemic risk means a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree.

Financial Safety Net issues

- The financial system is not totally failure-free and is not designed to be.
- For one, as a general rule, there is a natural limit to how safe any type of system can be but what makes it difficult to determine the tolerated risk level is the complexity of the financial system and the financial instuments.

Financial stability as a public good



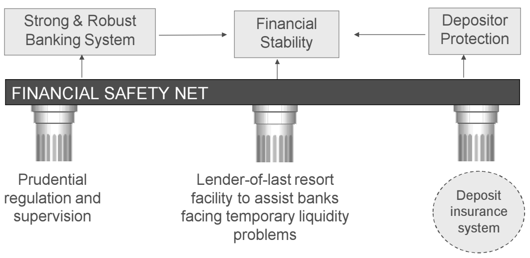
Financial Safety Net issues

- A proper financial safety net is necessary to reduce the risk of severe financial crises.
- Without an appropriate financial safety net, even simple rumours of problems regarding solvency or liquidity of a financial institution have the potential to become self-fulfilling and turn into a full-blown financial crisis.
- With an appropriate financial safety net in place, confidence tends to be greater and the onset of financial crises less likely than otherwise.

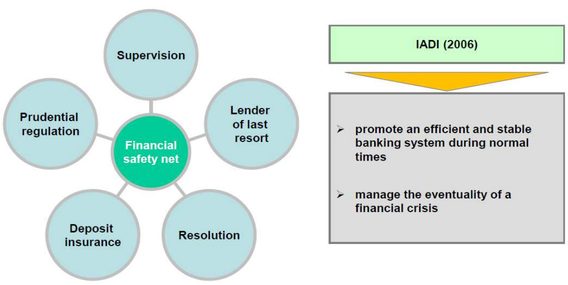
Financial Safety Net Issues

- There is **no generally accepted definition of the key elements of the financial safety net**.
- A narrow definition is limited to deposit insurance and a lender-of-last-resort function, while a more widely accepted one includes (at least) three elements, adding the prudential regulatory and supervisory framework to the previous components

Architecture of the Financial Safety Net



Components of the safety net



Interrelations between elements of financial safety nets

- **The monetary authority**, whatever its involvement in prudential responsibilities (and there is an ongoing discussion about the extent of that involvement), plays a crucial role within the financial safety net because of its role as "lender of last resort".
- **The fiscal authority** is involved in the financial safety net either directly or indirectly because of its role as "solvency provider of last resort" but also because of its political responsibility for the use of taxpayer money

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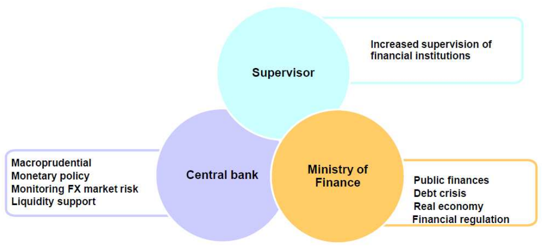
Increased involvement of other safety net players

During the crisis the Central Bank, Supervisor and Ministry of Finance become more engrossed



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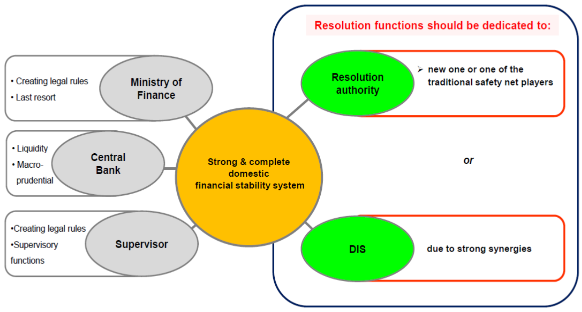
Robust domestic financial stability network



Lender of Last Resort (LoLR) function

- Liquidity risks are endemic to banks given that these entities undertake maturity transformation, taking short-term deposits and investing them in assets that typically have longer terms to maturity.
- This nature of the banking business implies that banks may at times be subject to „bank runs" resulting in their illiquidity, even if they are solvent.
- Through the close credit risk linkages among banks, the problems at one institution may then spill over to its peers, perhaps leading to a banking crisis.

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Central Banks in the role LoLR

- The recent financial turbulence has highlighted anew the importance of liquidity in modern financial markets and how rapidly it can dry up even in core segments of the market.
- By providing temporary lending (emergency liquidity facility) to the market in a time of financial distress, the central bank can relieve tensions and limit the potential fears that might prompt bank runs.
- The existence alone of the capacity of the central bank to act as a LOLR may stabilize expectations without necessitating any particular course of action.

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The new EU supervisory architecture

- a *European Supervisory Authorities* (ESAs) for the supervision of individual financial institutions ("micro-prudential supervision"),
- a *European Systemic Risk Council* (ESRC) which should monitor and assess risks to the stability of the financial system as a whole ("macro-prudential supervision").

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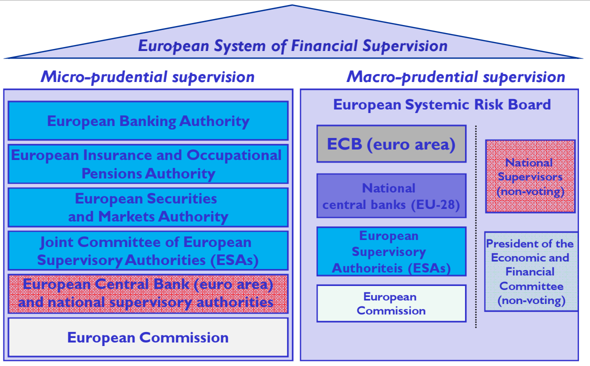
The new EU supervisory architecture (ESFS)



Bank Deposit Guarantee Scheme

- Whenever a crisis hits, interest in guarantee arrangements rises.
- A guarantee reduces the threat of bank failures by raising the likelihood that depositors, which provide a large part of funding for banks, continue to provide a stable source of such funds.
- The expansion of guarantees or the introduction of new ones thus buys time, as it increases the chances that existing deposits will not be withdrawn. Thus deposit insurance enhances depositor confidence.

Federalization of the EU financial market law

The new regulatory and supervisory changes transfer more powers to the EU and enhance the process towards the federalization of financial market law.

The new model of EU financial market law is based on four components:

- the introduction of supervisory bodies at EU level;
- a higher degree of harmonization through the introduction of a pan-European rulebook;
- greater consistency in the application of EU regulations;
- the transfer of direct supervisory powers over market actors to EU regulatory agencies.