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REGULATIONS OF THE BANK SECTOR IN THE EU IN RESPONSE TO THE FINANCIAL CRISIS

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Анотація. Банківський сектор відіграє провідну роль у фінансуванні економічного розвитку в країнах Європейського Союзу. Остання криза показала, наскільки недостатню стабільність банків. У результаті процесу концентрації в банківському секторі виникла сильна залежність економіки країни від фінансового стану великих банків. Деякі з них отримали фінансову підтримку з боку уряду, який водночас посилив контроль за їх діяльністю. Створення банківського Союзу, який наглядає за діяльністю банків, принципами регулювання і контролювання банкрутства (План відновлення банківської системи), а також забезпечує гарантування вкладів, вже розпочалось. Однак, через суперечливі інтереси різних країн ЄС, ці рішення будуть впроваджуватися поетапно.

Аннотация. Банковский сектор играет ведущую роль в финансировании экономического развития в странах Европейского Союза. Последний кризис показал, насколько недостаточно стабильность банков. В результате процессу концентрации в банковском секторе возникла сильная зависимость экономики страны от финансового состояния крупных банков. Некоторые из них получили финансовую поддержку со стороны правительства, которое в то же время усилило контроль за их деятельностью. Создание банковского Союза, наблюдающий за деятельностью банков, принципами регулирования и контроля банкротства (План восстановления банковской системы), а также обеспечивает гарантирования вкладов, уже началось. Тем не менее, через противоречивые интересы различных стран ЕС, эти решения будут внедряться поэтапно.

Summary. The banking sector plays a leading role in financing economic development in the countries of the European Union. The recent crisis revealed how insufficient the banks stability is. As a result of the process of concentration in the banking sector there came to strong reliance of economies on the financial standing of big banks. A number of them were supported financially by governments which at the same time are tightening the control over their operations. The creation of the banking union taking supervision of banks, the regulation principles and controlled bankruptcy (Banking Recovery and Resolution Plan) as well as the deposit guarantee scheme has already started. However, conflicting interests of different EU countries make these solutions to be introduced in stages and not comprising all the countries.

Ключові слова: *Європейський Банківський Союз, банківського нагляду, системно важливих банків.*
Ключевые слова: *Европейский Банковский Союз, банковского надзора, системно важных банков.*
Key words: *European Banking Union, banking supervision, systemically important banks.*

Statement of the problem. The positive aspects of downturns in the market economy is that they lead to the selection and elimination of inefficient entities and solutions, and therefore, lead to progress and economic development. However, economic and social costs of economic slumps are higher and higher and rise fears about the consequences of the lack of intervention of state authorities in stress situations. This statement is unequivocally proved by the course of events of the recent crisis. Despite noticeable mistakes made by the financial institutions, the governments undertook rescue plans which aimed to protect them from bankruptcy. The costs of these moves, as well as the awareness of the threat to the stability of the economies, made the state authorities prepare and implement other regulations on banks activities. Banks are still viewed to be fundamental financial institutions able to help economy get out of crisis.

This paper aims to analyze the changes undergoing over the last decade in the banking sector and to evaluate the implementation of supervision regulations.

The assumptions and consequences of the financial crisis for banks. The deregulation strategy performed over the last decades proved to be wrong and put the market economy system at risk. This deregulation led to some easing of the relationship between freedom and autonomy of the entities existing on the market on the one hand, and responsibility and consequences born, on the other. With regard to banks two unfavorable phenomena were allowed: the excessive concentration of the sector and bearing no liability for the losses made. Banks continued to develop their activities connected with risk at a much larger scale than it would be justified by the equity capital they held, which guaranteed their security. While facing the threat of bankruptcy large banks resorted to the aid of the state which, in turn, was afraid of the consequences of bank bankruptcies. This means that bank managements and stockholders shifted the risk of their operations on taxpayers while still receiving their high bonuses and dividends.

The deregulation policy was particularly exercised by the EU. In 2005 the EU Commission lifted the barriers carrying out bank mergers and takeovers so that they could develop as quickly as their counterparts in America and Asia. To some extend the development of large banks does not result from free financial flows but rather from the aspirations of some politicians to create «national champions». Currently European banks hold the biggest own funds, assets and the ratio of assets to GDP. (see tab. 1).

After the outbreak of the crisis in 2007, a variety of actions were taken to improve banks financial resilience as well as to decrease incentives to take excessive risk by banks. The purpose was to avoid considerable costs of banks bankruptcies, and in particular, those connected with rescuing them with public funds. In the current crisis the need for rescuing banks by means of public funds led to the crisis of public finances. As late as in 2009 it was still not realized that a debt crisis might spread from one small country throughout the whole EU. Meanwhile, despite hundreds billions of dollars pumped into the banking sector, there has been no change either in its organizational culture or the mindset of bank executives. Bank operations are by no means more transparent than before the crisis [4, p. 12]. What is more, financing banks which ran into financial trouble meant transferring funds to those entities which turned out to be ineffective instead of those ones which needed them for the activities financing economic development. Big banks donated by the state compete with smaller financial institutions, and this distorts the conditions of equal position on the market. All this makes one reconsider the need to change the state's attitude towards the banking sector. Instead of direct financial interventions to rescue banks, there is a need for actions improving the structure of the bank system, increasing competitiveness at the banking market and implementing more effective supervision of banks.

Tabl 1

Comparison of bank markets in 2011

Country/region	Core capital in bn $	Assets in bn $	Assets/GDP in %
Euro zone	1.721,6	40.895,0	349
USA	1.051,9	13.341,0	
China	781,5	13.533,2	
Japan	600,9	13.075,5	

Source: Top 1000 World Banks 2012, «The Banker» July, 2012, European Banking Federation 2011.

Within the framework of the European Union various actions are taken to increase supervision of banks.

Currently there are works carried out on new resolutions in four areas:

- Creation of bank union
- Separation of traditional bank operations from investing
- Regulation of bonus system for bank executives
- Imposing tax on financial transactions.

This broad range of actions results from a significant role of banking sector in the European economy as well as the scale of problems which arose following the crisis. There is no doubt that implementing new regulations to some extend expresses the need to curb the expansion of banking sector and to introduce more supervision of its activities. Over the last decades banking sector has been developing faster than real economy. It led to the situation that

banks at a larger and larger scale carry out financial operations irrelevant of the flow of goods and services. These operations quite often bear high risk.

The assumption of the banking union. The idea of creating bank union is relatively a new one and appeared in June 2012 in connection with seeking the ways to overcome the debt crisis in the euro zone. This crisis is firmly related to the bank crisis in a few EU countries. The bank union expresses further integration of the financial system in euro zone countries but it is also to be open for the rest of the EU countries. It will consist of three elements:

- Single Supervisory Mechanism (SSM);
- Banking Recovery and Resolution Plan (BRRP);
- Deposit Guarantee Scheme (DGS).

Out of these three subsystems the work on the implementation of one single bank supervision is the most advanced. The already existing model based on the twenty-seven national systems proved to be ineffective. It could pose a threat of system arbitration, i.e. shifting operations to where the supervision is more relaxed.

A big challenge the banking union faces is the number of banks which totals 6 000 000 and which has to be covered by the European Central Bank (ECB) supervision. This bank not only would be unable to exercise effective supervision on such a big number of banks but a fear arises that there might come the need to rescue falling banks in countries of weaker economies with the money coming from the richest countries. Therefore, direct supervision will only cover at first Systematically Important Financial Institutions, but they run into dozens. Supervision of other banks will continue to be performed by national supervision systems.

The supervision of banks is to be conducted by the European Central Bank since March 2014. It requires a clear separation of the two functions performed within the framework of this institution: running monetary policy and bank supervision. There is a likelihood of conflict of interests here [2, p. 2] as the ECB might lower interest rates to help banks in financial trouble, and this would stand in contradiction to its fundamental role, i.e. keeping an inflation level low.

It may be noted here that a number of world banks including the ECB are guided by the idea of direct inflation objective. This method is questioned more and more often. Referring to the example of the Federal Reserve System (FED), it is emphasized that monetary policy should take into account also other parameters such as the increase in unemployment. A more careful approach points at the need to supplement conventional monetary policy with macroprudential supervision, i.e. to safeguard the stability of the financial system as the whole [3, p. 5]. This approach is gradually applied in the European Union which can be best proved by the creation of the European Systematic Risk Board (ESRB) in 2011, and now conferring tasks referred to the bank supervision to the ECB.

The banking union will cover in full only the countries of the euro zone. Other countries will be able to enter into the single banking supervision on voluntary basis, which will assure them specific rights to [8, Art. 6A] to take decisions through their own institutions of bank supervision. It is the more important for the countries of Central and Eastern Europe that a number of banks operating there are daughter – companies of big banks seated in the countries of the euro zone.

The problem of the Systemically Important Financial Institutions. The contemporary crisis once more animated a debate on acceptable size and significance of financial institutions including banks. Not only is essential the size of a particular institution expressed, for example, by the amount of its equity capital or the value of its assets, but the significance in a given country measured by the ratio of its assets to the Gross Domestic Product (GDP). Today the biggest financial institutions in Europe (SIFI) hold higher assets than GDP of the countries, in which they are seated (see table 1). These are the banks whose assets exceed € 30 bn or account for at least 20 % of GDP of the parent country, or have branches in at least three countries of the Union. The operations carried by entities which fall into this category, was one of the reasons of the present crisis and the expenditures on rescuing many of them led to a crisis of public funds in a number of countries. So far in relation to these entities the principle «too big to fail» was applied. The alternative solution to rescue these institutions from bankruptcy is not to allow them to grow in size and importance by manner of administrative solutions. As it should be taken into consideration that neither financial aid nor administrative actions are market solutions. They bring about certain costs which should be related to the effects of undertaken actions (Fig. 1).

The efficiency of single banking supervision requires the implementation of restructurising mechanism as well as an orderly manner in bank liquidation. On the onset of the financial crisis in Europe,

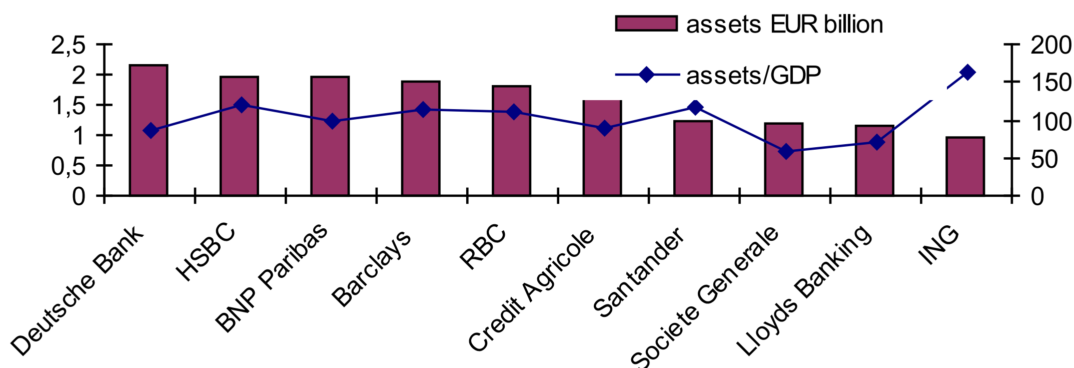

Fig. 1. Top 10 banks in the European Union

Source: Banking data from SNL Financial, GDP data from Eurostat

i. e. 2008, the European Commission took decisions on rescuing 59 banks by the member states. The total amount of €1,7bn was allocated in the form of direct re-capitalization, guarantee and liquidity support. To ensure protection for SIFI, Single Resolution Mechanism (SRM) will be created, which is to protect weaker countries from the consequences of the fall of a bank in this category. At the first stage the funds for this purpose are to be assigned by banks, but the final guarantee would come from public funds raised by the member states on the similar basis to those involved while creating the CBE capital.

For over two decades the European Union has been systematically developing the regulations on banks supervision. However, only recently in response to the recent financial crisis and the role of big banks which brought it about, there have been actions undertaken to regulate the very operations of banks. So far there have been no solutions which would put some order into the issues of handling with the banks which are sources of risk for the whole financial system. Up to now such banks have been either subject to nationalization or they were allowed to go bankrupt. By order of the European Commission the group chaired by Erkki Liikanen prepared draft legislation on the reform on the European banking system [5, p. 68–87]. These are the actions aimed to create safer architecture of the European banking system. This team recommends separation of banks operations and their location in two separate companies. Traditional banking providing services for individual and business clients would be run in one, while the others would run investing operations as those run to the banks' account and derivatives trading. These companies will be allowed, however, to run their activities within holding, wherein they will hold separate capital. The separation of bank operations is to be referred only to those banks in which 15 up to 25 % assets are exposed to high risk or the nominal value of such assets risk exceeds €100bn. Introducing the separation in bank operations into these two areas will be connected with the increase in costs but in the long run it will increase the stability of banks and make them develop lending operations for the sake of economical boom. The European Commission is facing now the task of transferring the experts' recommendations into legislation which undoubtedly is going to be met up with the opposition from the strong banking lobby.

Deposit guarantee schemes. Since 1994 the member states in the European Union have been obliged to have the deposit guarantee schemes**.** Yet, these schemes vary so much that it only brings about the creation of specific «deposit heavens», which can be best illustrated by Ireland, Cyprus or Luxemburg. The banks in some countries attracted deposits, which banks in other countries were in short of. Since different countries have got different ability to guarantee deposits, it makes the reliability of guarantee doubtful and may lead to undermining the bank system stability. The schemes are rather weak and in the crisis circumstances they are not able to cover clients losses without having to resort to public funds.

The leverage factor, specifying what part of deposits are covered by funds being at disposal of institutions which guarantee them, are, e.g. 0,15 % in Germany, 0,21 % in France, 0,37 % in Spain [1, p. 3]. The proposals to obligatorily maintain this ratio at the level of no lower than 2,5 % were rejected by the biggest EU countries due to the costs of creat-

ing such a guarantee. At the same time a number of EU countries (Italy, Great Britain,, Holland, Austria) have got deposit guarantee systems functioning on ex-post basis, i.e. raising funds to cover damages for the loss of clients deposits only at the moment the bank announces bankruptcy.

The works on creating one uniform deposit guarantee system are the least advanced element of the banking union. It has not been decided yet whether it will cover all the banks or merely SIFI. Neither is it clear when the common deposit guarantee system will come into force.

New prudential regulations in the European Union. The current financial crisis is of global nature and affected countries all over the world. At the same time it clearly showed how strongly are linked the segments of the financial market and how radically the loss of confidence in entities from one segment may affect the rest of the elements of the financial market. Guided by this experience the representatives of the highest developed financial markets and international organizations gathered in Basel Committee on Banking Supervision (BCBS) made amendments to the Capital Accord of 2004 (Basel II) introducing its another version (Basel III), and by the end of the last year they introduces changed into Basel Core Principles [7, p. 26]. These principles provide a set of best practice in respect of the performance of the supervisory boards, the supervision process and the performance of banks themselves. Their transition into legislation of particular countries ensures regular extension of supervision standards on a global scale.

Basing on arrangements undertaken within the framework of BCBS (Basel III) the European Union worked out regulations introducing new prudential requirements – Directive CRD IV and Directive on Capital Requirements Regulation (CRR).They refer to three areas: providing banks with their own funds, liquidity and the amount of the bonuses. These requirements are to take effect on 1 December 2014, thus with a year delay in the initial plans. The delay was the consequence of controversies following the restrictions imposed on bank managers' bonuses and negotiations which extended the process of drafting the union directive.

Quite essential are the regulations relating to equity capital of banks which amend and extend existing regulations. The capital ratio will stay unchanged calculated as the ratio of core capital to risk weighed capital. It will remain at the level of 8 %. It is to be viewed as a uniform standard for banks in all the EU countries, although Great Britain insisted on determining it as a minimal standard which may be raised by supervision authorities of particular countries.

To reach a compromise it was agreed that raising the capital ratio will only be possible in stress situations at the approval of the European Commission. The adoption of such an approach to determine the ratio is justifiable in terms of preserving the unity of the market, where all the banks should be provided with the same conditions to run fair competition.

With the unchanged amount of the core ratio, the structure of capital used for its calculation changes and additional capital requirements appear. The most stable part of core capital, i.e. common equity, is to increase its share in own funds from the current 2 up to 4,5 % in 2019. At the same time the least stable funds from tier 3 introduced in 2004 by Basel II will not be likely considered as a capital requirement. What is more, banks will have to create a conservation buffer up to 2,5 % of assets as well as a countercyclical buffer. The amount of the latter should be within 0 – 2,5 % of core capital depending on the state of the economic situation (fig. 2). Banks

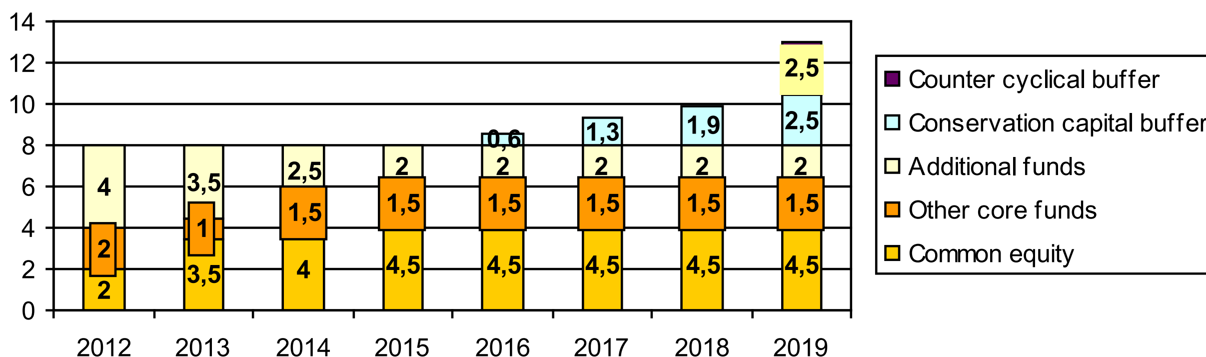

Fig. 2. Basel III – capital requirements

Source: Basel Committee on Banking Supervision

will raise means within a countercyclical buffer in the periods of economical boom and reach for them at the time of recession. The amount of the a countercyclical buffer is to be determined by national supervision authorities basing on the ESRB guidelines. These solutions are made in response to the situation of the recent crisis, when it became clear that banks hold too low core capital to be secured in case financial markets collapse.

A serious problem which arose at the beginning of the recent crisis was the loss of mutual confidence of European banks to each other, and difficulty in maintaining liquidity in the banking industry. In response to these events within the frame of the new prudential regulations there are introduced standards referring to liquidity which are to enable to survive 30 days of stress period. additionally there is introduced a requirement to balance long-term assets with long-term liabilities.

Regulations on banker's bonuses and bank tax. The financial crisis fuelled a lot of criticism of remuneration systems for bank executives. It referred to both the amount of salaries as well as bonuses and incentives paid to supervisory boards and part of the staff. The example of salary structure in Germany is presented by table 2.

Especially appalling was the payout of bonuses while the bank was making losses. This practice, at the time when banks were granted significant aid to rescue themselves from bankruptcy, made the representatives of the biggest world economies undertake actions aimed at limiting the ability to pay various forms of bonuses irrespective of financial results of the institution which were doing so. It seems, however, the pressure to restrict the excessive bonuses, or appealing to social responsibility are ineffective as such conduct is conditioned by the system.

For the first time regulations relating to salaries of executives managing banks appear within European standards. They provide caps on bank executives' bonuses at a year's base salary. Only in extreme circumstances, at the approval of the majority of bank shareholders will it be possible to raise bonuses up to two year's pay. The efficiency of the regulations on remuneration may be limited in practice as it is easy to circumvent them through raising basic part of the salary. It may also be feared that remuneration curbs will result in the flee of some bank executives outside the European Union to the countries with developed financial markets. Therefore, the regulations provide for the review of their effects in a few years' time.

Tabl 2

Top Management Salaries in Top-30-Banks in Germany in 2012 (€ ooo,s)

position	Base salary			Total remuneration		
	1.Quartil	Median	3.Quartil	1.Quartil	Median	3.Quartil
Branch Manager	217	247	310	404	512	605
Departament Manager	145	162	192	202	259	329
Team Manager	99	108	117	124	144	177

Source: [6, p. 80]

The last of the above mentioned areas of changes in the banking system of the European Union is a tax on financial transactions. It will come into force in 2014.For the time being eleven EU countries agreed on this.

Markets tend to get degenerated unless they are regulated in the proper manner. In modern economies the state should create conditions to run fair competition which boost economic development, but at the same time it should be consistent in applying the principle of bearing responsibility for its own actions. Only based on such rules market economy can be an effective regulatory mechanism.

The banking union is to contribute to strengthening the currency union and reaching another stage of economic integration within the European Union. Considering the rate of works on preparing and implementing subsequent elements of the banking union this undertaking may be executed within a few next years. Yet, one may express doubts as to whether the banking union will be efficient enough without the fiscal union whose lack makes economic integration still incomplete.

It should also be noted that the activities aiming at putting the Union banking sector in order are only fragmentary ones without working out harmonized assumptions relating to the whole architecture of this market segment. They are carried out under the pressure of the current situation in which only conflicting interests of particular countries are revealed. They comprise both adjustments to existing regulations as well as new resolutions, which by no

means makes up a consistent system. Implementing every now and then new regulations for banks rise fears of overregulation of the whole system with the unintended consequences difficult to be foreseen. The entities covered by these regulations are able relatively fast to find ways how to circumvent them.

Conclusions. Thus it may be concluded that the process of regulating the banking sector in the European Union does not ensure its currently much desired consistency. It poses the threat of overlapping resolutions and arising conflicts. The Single Supervisory Mechanism covers directly only seventeen countries belonging to the euro zone. The rest will be covered by supervision conducted on already existing basis. The current actions should therefore be viewed rather as seeking for solutions which would allow to overcome present difficulties than creating the target model of the banking sector.

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