# The New EU Financial Architecture after the global financial crisis (2007-2008):

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## Introduction

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- ***Chinese word** for "**crisis**" is composed of two signs **meaning** "danger" and "opportunity"*



## Global Financial Crisis

**In the fall 2008, following the bankruptcy of Lehman Brothers Bank, confidence among banks fell further.**


**At the same time, it became increasingly clear that the policy interventions to date were not successful in restoring confidence in markets and among the wider public.**


**There was a growing sense that the financial turbulence could develop into the worst financial crisis since the Great Depression.**

## 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

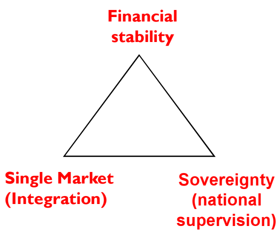
→ Obstacle to further integration and no optimal model for financial stability



## 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?*



## 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 Safety Net issues

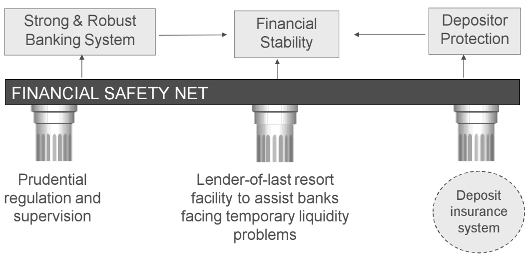
- A proper financial safety net is necessary to reduce the risk of severe financial crises.
- Without an appropriate financial safety net, even simple rumours of problems regarding solvency or liquidity of a financial institution have the potential to become self-fulfilling and turn into a full-blown 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






## Banks; systemically important financial institutions

- Traditionally, financial safety net elements such as the deposit insurance and lender-of-last-resort functions have evolved with a focus on deposit-taking institutions such as (commercial) banks.
- Banks are an inherently unstable part of the financial system and have the potential to cause significant economic disruption in the case of failure.
- Failures of these entities generate negative externalities on their depositors, and on financial system stability, as a banking crisis can develop rapidly into a full-blown financial crisis.
- Banks can be systemically important as their balance sheets are highly leveraged and strongly interconnected.

## Interrelations between elements of financial safety nets

- A wide set of different institutions are involved in the provision of the various elements of the financial safety net.
- Besides the prudential authorities – regulators and supervisors – monetary and fiscal authorities play an important role and there are often specialized agencies providing deposit insurance which may have additional special responsibilities in a crisis situation, including in relation to bank failure resolution.



## 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



## 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.

## LoLR; classical definition

- The classical interpretation of the concept of LOLR was defined by the 19th century British economist Walter Bagehot.
- According to the interpretation, the LOLR should prevent temporarily illiquid but solvent banks from failing, lending as much as necessary, but at a penalty rate (so that banks cannot use the loans to fund their current lending operations) and against acceptable collateral (valued at pre-crisis prices).
- The support should be vis-à-vis the entire market and not to specific institutions and it must be credible.



## 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.



## EU financial supervision

- Financial crisis in 2008 and 2009 prompted a review of European supervisory model
- The existing Supervisory architecture of the EU Single Financial Market proved itself in crisis conditions incapable of preventing, managing and resolving the financial crisis.

## EU financial supervision. Background & Timeline

- In November 2008, the Commission mandated a High-Level Group chaired by Jacques de Larosière to make recommendations on how to strengthen European supervisory arrangements with a view to better protecting the citizen and rebuilding trust in the financial system.
- In its final report presented on 25 February 2009 (the 'de Larosière Report'), the High-Level Group Recommended, inter alia, the establishment of European System of Financial Supervisors and a Union level body charged with overseeing risk in the financial system as a whole.



## EU financial supervision. Background & Timeline

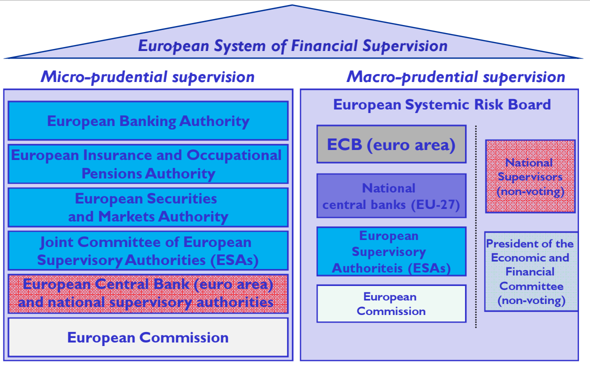
- In its Communication of 27 May 2009 entitled 'European Financial Supervision' the Commission suggested a series of reforms to the current arrangements for safeguarding financial stability at the Union level, in particular including the creation of a European System of Financial Supervisors (ESFS) with Systemic Risk Board (ESRB) responsible for macro-prudential oversight.
- *22 September 2010:* European Parliament approved legislation allowing establishment of European Supervisory Authorities (ESAs)



## 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").

## The new EU supervisory architecture (ESFS)






## European Supervisory Authorities

- Ensuring that a single set of harmonised rules (single rule book) and consistent supervisory practices is applied by national supervisors;
- Ensuring a common supervisory culture and consistent supervisory practices;
- Collecting micro-prudential information;
- Ensuring consistent application of EU rules, and resolving disputes in cases such as the manifest breach of EU law or ESA standards and disagreement between national supervisors (home and host).



## ESAs; Legal bases

- Article 114 (TFEU) as the legal basis for the establishment of European supervisory bodies that are vested with responsibilities for contributing to the harmonisation process and facilitating uniform implementation by EU Member States.
- Actually and objectively apparent from the legal act creating the body in question that its purpose is to improve the conditions for the establishment and functioning of the internal market.
- Legal status: Legal personality as well as administrative and financial autonomy. Accountable to the European Parliament and the Council of the European Union

## The European Systemic Risk Board

- The European Systemic Risk Board is an independent EU body responsible for the macro-prudential oversight of the financial system within the EU. Its seat is in Frankfurt am Main. Its secretariat is ensured by the ECB. Follow up warnings and recommendations

- "The ESRB shall be responsible for the macro-prudential oversight of the financial system within the Community in order to prevent or mitigate systemic risks within the financial system, so as to avoid episodes of widespread financial distress, contribute to a smooth functioning of the Internal Market and ensure a sustainable contribution of the financial sector to economic growth"



## *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.



## 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.

## Crisis management and safety net evolution

- Evolving financial risks and increasing integration in EU financial markets along with globalisation of financial risk. So, given the integration of international financial markets and the contagion risk of financial crises, there is a need for a strong commitment on the part of the Union at the global level.
- Financial institutions may be systemically important for local, national or international financial systems and economies.
- EU legislation has evolved from liberalisation, to harmonisation of law, to uniform rulebooks and supervisory practices and EU bodies, to federalisation of financial market law.

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## 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.

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