CHALLENGES FOR FINANCIAL STABILITY IN THE EUROPEAN UNION

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Abstract: In this study we try to underline the main challenges and perspectives for financial stability and financial surveillance. Our investigations regard the European environment issues. We make some consideration about the advantage and disadvantage of financial integrated supervision in relation with sectorial one. Also, we talk about the controversies concerning the central bank involvement in surveillance process and financial crises management. In the end, we highlight the National Bank of Romania preoccupations for financial stability in the European integration perspective.

Key words: financial stability, European integration, central bank, reform, challenges, perspectives, regulation, financial surveillance

Introduction

The transformations in the economic environment lead to a continuous accommodation in what concerns the assurance of financial stability. A series of actual phenomenon constitutes the main challenges for the public authorities. Among the most important ones, without an hierarchisation, are:

- the development and diversification of financial markets, its actors and products offered, connected with the financial innovation;
- the globalisation and the (European) integration process;
- the inflation menace and the fight against it;
- the universalization versus specialisation in the banking activity, connected with the development of giant multinational financial groups.

The financial innovation has as consequence the development and diversification of financial markets, its actors its products and services offered. This trend is doubled by a contradictory process, of universalization and specialization in the financial – banking activity. In a continuously changing market, the financial institutions must restructure themselves in order to remain competitive.

Financial supervision and financial stability

The number of financial conglomerates in World Top 500 of financial institutions increased from 42% to 60% only between 1995-2000[242]. Such a trend called for a specific response also from the surveillance institutions point of view – the increasing number of national consolidated financial supervision agencies.

The first consolidate financial supervision agency was created in Singapore in 1982 and after that in Norway, in 1986, soon other Northern European Countries adopting this system. The same system was adopted also in other countries, including Australia, Japan or Korea, but from the globally 29 such agencies registered in 2004, more than half were in Europe[243].

As a theoretical issue, the institutional model for financial supervision attracted the attention and generated controversies, generated by the rapid transformations in the contemporary financial systems, the new

[242] De Nicoló, Gianni; Bartholomew, Philip F.; Zaman, Jahanara; Zephirin, M. G. – Bank Consolidation, Internationalization and Conglomeration: Trends and Implications for Financial Risk, IMF Working Paper 03/158, 2003

[243] Čihák, Martin; Podpiera, Richard – Is One Watchdog Better Than Three? International Experience with Integrated Financial Sector Supervision, IMF Working Paper No. 06/57, 2006

challenges (such as globalization, financial innovation, the development of multinational financial groups) and the more severe consequences due to financial contagion.

According to Čihák and Podpiera, the general framework for regulation and supervision in the financial sector is structured as follows: macro-prudential supervision, micro-prudential supervision, consumer protection and policies concerning the competition. In most of the countries, the macro-prudential supervision is realized by the central bank and the problems concerning the competition remain to separate supervision agencies. A consolidated/integrated supervision agency is in charge with the micro-prudential supervision of at least three segments of the financial sector: banking, insurance and capital market.

<table>
<tr><th colspan="2">Type of disfunctionality</th><th>Sistemic instability</th><th>Asymmetric information</th><th>Market disfunctionality</th><th>Anticompetition behaviour</th></tr>
<tr><td colspan="2">Area of regulation</td><td>Macro-prudential supervision / financial stability</td><td>Micro-prudential supervision / individual institutions</td><td>Business supervision / consumer protection</td><td>Competition</td></tr>
<tr><td rowspan="4">Subsector</td><td>Banks</td><td rowspan="4">Central bank, monetary authority</td><td>One</td><td>One</td><td rowspan="4">Separate agency, responsible for aspects concerning the general competition</td></tr>
<tr><td>Insurance companies</td><td>or</td><td>or</td></tr>
<tr><td>Intermediaries on the capital market</td><td>more</td><td>more</td></tr>
<tr><td>Other financial institutions</td><td>agencies</td><td>agencies</td></tr>
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Source: Čihák, Martin; Podpiera, Richard – Is One Watchdog Better Than Three? International Experience with Integrated Financial Sector Supervision, IMF Working Paper No. 06/57, 2006, p. 5

Figure no. 1. The general structure of the framework for regulation and supervision in the financial sector

The consolidated supervision has several *advantages*:

- in the context of financial conglomerates, it is more efficient, being able to evaluate the risk of the financial group for the ensemble;
- the coordination and the exchange of information is more efficient in one institution, comparing with the situation of several agencies, forced to cooperate;
- the competitional neutrality between financial-banking products on different financial sectors in a unitary regulation approach, and also the flexibility and the rapidness in response when appears a new product or financial service (especially on emergent markets) and the possibility to evaluate the general impact, not only at sectorial level;
- the cost reduction, the infrastructure, the staff, the administrative and management structure being common, there are substantial savings, comparing with the functioning on independent agencies. Also, the participants in the financial market register some cost savings as consequence of reporting to a sole institution;
- enhanced responsibility, the guilt for an failure could not be shared or transferred to another institution, responsible for a certain financial sector supervision;
- the transparency, due to a better understanding for the public and financial institutions of the supervision activity realized by a sole institution.

Of course, under some circumstances, the financial (integrated) surveillance has some *disadvantages*:

- if the objectives that must be followed by this institution are not very well established and transmitted to the public, could appear deficiencies in the surveillance activity;
- an possible inflexible and bureaucratic organization of the financial surveillance institution, that could make more difficult an efficient supervision activity;
- the risk of political involvement or group interests' involvement in the supervision activity.

Beside the dilemma financial integrated supervision versus sectorial supervision, there is also the controversy about the involvement of the central bank in the surveillance process. If there is an unanimous opinion about the need for the central bank to be involved in the activity supervision at macro-prudential level, about the need to involve also in supervision at micro level, there are different opinions.

The issue about the most adequate supervision model must be approached connected to each particular situation. Thus, in an economy with a less developed financial market or oriented more toward the financing through banks (a bank-based economy), the model with the supervision activity concentrated at the central bank is appropriate. For the economies with developed and specialized financial markets, where functioning financial conglomerates, the integrated financial supervision seems to be a better solution, when it is settled an independent agency that collaborates with the central bank, which reserves only the role of macro-prudential stability.

European integration, financial integration and financial stability

The liberalisation of financial services supposes also a huge process of deregulation, which sometimes needs new regulations that concern the financial system of the European Union as a whole. Such regulations, with the view to realise a financial harmonisation in the member states, concretised in a series of Directives, with profound impact on the functioning of the European financial markets and the increasing competition.

Willem Duisenberg, ex-president of the European central Bank, considered that the European banking supervision should face two challenges: the internationalization of the financial activity and the geographical split of the jurisdiction on the monetary policy implementation and the activity of the banking supervision[244].

The success of the European financial integration can be insured only through the cooperation of the member states, that must prove flexibility in adapting to the transformations suffered as result of the integration, both on economical-financial and political level[245]. The national central banks must face the challenge of the potential conflict between the implementation of monetary policy as well as insuring the financial stability.

The financial stability is strictly correlated with the evolution of the assets on the market. It is well known that in the case of the financial crisis the price of securities and real estate assets register significant fluctuations and can be the cause of those crisis. The measures of monetary policy target the fight against inflation, having as indicator the evolution of consumer prices.

The evolution of economies in the last few years lead to the conclusion that between the monetary policy measures and the securities prices on the financial market and the real estate assets prices there is a double determination relationship.

Nowadays, taking into account the recent evolutions on the main world financial markets and the contagion phenomenon, the problem of financial stability became a priority worldwide. The sub-prime mortgage crisis in United States showed us the fragility of the international financial system, the possible failures in financial supervision and the important losses that can occur.

Anna Schwartz, exponent of US monetarism, says that "There never would have been a sub-prime mortgage crisis if the Fed had been alert. This is something Alan Greenspan must answer for" and

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[244] Duisenberg, Willem – The Future of Banking Supervision and The Integration of Financial Markets, Working Paper presented at the conference organised by Euro Group entitled „Improving integration of financial markets in Europe", Turin, 22 May 2000

[245] Stoica, Ovidiu; Căpraru, Bogdan – Impactul integrării europene asupra supravegherii bancare, volumul Conferinței internaționale "Racordarea sistemului financiar la exigentele integrării europene", Editura ASEM Chișinău, 2004, pp. 37–40

highlights that the central bank is itself the chief cause of the credit bubble, and now seems stunned as the consequences of its own actions engulf the financial system.

In the United Kingdom, the Financial Services Authority admitted failures in its supervision of Northern Rock Bank, but said it should continue to have responsibility for regulating the banking system and it would be overhauling its procedures as a result of the weaknesses identified. The FSA recognized "a lack of adequate oversight and review" in the case of Northern Rock, and few regulators were assigned to monitor the bank, which ran into trouble in September 2007.

The International Monetary Fund said at the beginning of April 2008 that the worldwide losses stemming from the US sub-prime mortgage crisis could hit 945 billion dollars as the impact spreads in the global economy, reevaluating it from about 800 billion dollars (500 billions EUR), the estimations in late February. Only in March 2008, the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), the German Federal Financial Supervisory Authority estimated the losses from the sub-prime crises worldwide at about 600 billion euros, among them 10% in Germany.

Apparently, the Romanian banking system was not affected by the sub-prime crisis, at least not directly. However, the increasing refinancing costs on the interbank market and doubts about the real price for real estate assets were the first signs of the crisis we conscience.

In the last period we can observe a real preoccupation for National Bank of Romanian (NBR) regarding the evolution of real estate assets prices. Also, our central bank has implemented some measures against the bank and clients large exposure to the loans in foreign currencies.

In December 2006, NBR has adopted new banking regulations, assuring the transposition into the national legislation of the EU Directives. So, Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy, which, apart from the transposition in principle of provisions of Directives No. 48/2006 and 49/2006, also revises the provisions specific to various categories of credit institutions (banks, credit co-operatives, savings and loan banks for housing, mortgage loan banks and electronic money institutions). Given the applicable unitary prudential regime, according to the Community legislation, credit institutions and investment firms, this Ordinance addresses, in a separate section, issues related to the enforcement of legal provisions on financial investment companies under the supervision of the National Securities Commission. Also, Government Emergency Ordinance No. 98/2006 on supplementary supervision of credit institutions, insurance and/or reinsurance undertakings, financial investment companies and investment management companies in a financial conglomerate ensures the transposition of Directive No. 2002/87/EC and governs the regulation of supplementary supervision of regulated entities that belong to groups carrying out inter-sectoral financial activities (financial conglomerates), with a view to ensuring financial stability and protection of depositors, the insured parties and investors.

Conclusion

The success of the European financial integration can be insured only through the cooperation of the member states, which must prove flexibility in facing the two challenges: the internationalization of the financial activity and the geographical split of the jurisdiction on the monetary policy implementation and the activity of the banking supervision

In the last years, the national central banks must face the challenge of the potential conflict between the implementation of monetary policy as well as insuring the financial stability. Because between the monetary policy measures and the securities prices on the financial market and the real estate assets prices there is a double determination relationship, we consider that the preoccupation of central banks must be focused much more on these prices and interfere whenever it is necessary.

Also, we think that the issue about the most adequate supervision model must be approached connected to each particular situation. For the moment we consider that regarding Romanian financial system the model with the supervision activity concentrated at the central bank is much appropriate.

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