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A safe and stable banking and financial system as the basis for the development of the economy and society

Introduction

The safety and stability of the banking and financial system are two crucial economic issues that have been the subject of numerous research works, reports, and analyses [see, for example, Tyler 2013]. In the aftermath of the economic crisis of 2008, the importance of the safety and stability of financial institutions has increased as a consequence of the numerous bailouts that many states across the globe have encountered.

Since 2008, banks have been at the heart of discussions about efficient regulations and ways of mitigating insolvency and bankruptcy risk. The European Union (EU) is still suffering from the consequences of insufficient supervision under the old financial system and its institutions. In response to the financial crisis, many new institutional measures, mechanisms, and instruments have been adopted [Czarnecki 2011].

There are four main branches in the literature review. The first one is focused on the reasons behind, and factors responsible for, the crisis of 2008. The second branch is devoted to discussion about the most sufficient way to deal with the issue of financial stability in the future. Some authors have pointed out that the previous approach to monetary policy in the Eurozone was inadequate because it prioritized price stability over all other monetary policy goals, especially those addressing financial stability and the maintenance of the integrated Eurozone financial market (*The economic crisis*, 2008). The IMF (International Monetary Fund), based on the opinions of authors such as Reinhart and Rogoff 2009; Calomiris 2009; Claessens and Kose 2014; Eichengreen 2002 and 2010; and Claessens et al. 2010, formulated a list of common causes for the crisis. It includes items such as the credit boom, financial expansion, rapid asset price appreciation, the creation of new financial instruments, financial liberalization and deregulation, and the widespread and sharp rise of households' leverage along with their subsequent defaults on (housing) loans [Claessens and Kodres 2014, p. 6]. On the other hand, many banking "sins" are listed and have been provided as an example of bad practices that were key drivers in speeding up the crisis.

One of the reports considered the "seven deadly sins" of banks in a very comprehensive way by taking into account: megalomania, addiction, distortion, exploitation, greed, trickery, and recklessness [The Seven Deadly Sins of Banks 2014]. What is especially true is the presence of megalomania and the problem of the *Bigger is Better* mentality, which may be considered in different ways: too big to fail, too important to fail, too sensitive to fail, too big to manage, and too big to save. Banks became bigger and bigger because they were interested in reducing competition and increasing their profits. There are some cases where banking assets were over 500% of a country's GDP (Gross Domestic Product), for example, in the UK (United Kingdom); that means the bank in question was too big for the economy as well.

The next problem is addiction to risk taking and so-called toxic assets. The roots of the last crisis were in the subprime market and its derivatives. Increasing public and private debt was also an important factor, because debt in general was the basis for creating speculative financial instruments that caused the speculative bubbles and overdoses [The Seven Deadly Sins of Banks 2014, p. 8].

After the financial crisis of 2008, the main questions have been: what is the role of the banks in today's economy? and is the banking profession distorted? Many banks preferred to speculate rather than finance households and companies, which is obvious after an analysis of the crisis' main indicators, as seen in the loans and financial assets as a proportion of total assets[1] [The Seven Deadly Sins of Banks 2014, p. 8].

Taking into consideration the bailouts and the way banks have been managed so far, the vital part of the discussion is concentrated on the problem of state aid (subsidies and financial aid for banks and other institutions from the state budget), wage divergence in the banking and financial sector (greed), and the activity of banks in so-called tax heavens.

All of the previously mentioned factors are critical dysfunctions of the banking and financial system and are responsible for its malfunction. In addition,

[1] For example, in 2011, Barclays only set aside 28% of its balance sheet for lending to the real economy [Denis 2014, p. 12].

there are reasons to take new steps and to adopt reforms that improve the system and enhance the efficiency of risk management, supervision, and control of financial institutions across Europe. Many improvements and regulations have already been implemented while some of them are still in progress (the European Banking Union among them).

The goal of the study is to discuss key factors responsible for the financial crisis of 2008, to point out the main changes and challenges in the banking and financial sector before and after the crisis, and finally to present and consider the new regulations and solutions proposed in response to the crisis of 2008.

Methods

In order to verify the research goal, the authors formulated the main hypothesis of the study while assuming that in order to mitigate the risks and consequences created by the last crisis, comprehensive, complex, integrated, and systemic regulations and tools are needed. This means that centralized supervision and control among European Union countries is a requirement. However, support and involvement at the local (country) level is also crucial for the success of the concept.

The methods the authors have chosen in order to verify the hypothesis and reach the paper's goal involve the comprehensive analysis of opinions and arguments presented in the literature as well as a literature review. The authors considered the literature within the finance and banking scope, but also reviewed reports and recommendations of the European Union, which are important on a practical level.

Financial System Stability: In Search of a Definition

Financial stability is a vital condition for economic growth. The importance of financial stability is perhaps most visible in situations of financial instability. In extreme cases, financial instability may even lead to bank runs, hyperinflation, or a stock market crash. A broad overview of various definitions and descriptions of financial stability (or financial instability) by a select group of officials, central banks, and academics was provided by G. J. Schinasi [Schinasi 2004, pp. 13–16]. According to Schinasi's broad view, a viable definition is as follows: a financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events. The definition of financial stability involves several complexities that have practical significance in terms of assessing risks to the healthy functioning of the financial system. In addition, the following contributions to public policy can ensure financial stability: (a) developments in financial stability cannot be summarized in a single quantitative indicator, (b) developments in financial stability are inherently difficult to forecast, (c) developments in financial stability are only partly controllable, (d) policies aimed at financial stability often involve a trade-off between resiliency and efficiency, and (e) policy requirements for financial stability may be inconsistent with regard to time.

Jurek points out that concentration on the financial sector accompanied by the web of cross-ownership linkages is also dangerous for the old EU member states, as it may intensify systemic risks related to the "too big to fail" and "too many to fail" misconceptions. This threat stems from the fact that decision-making centers of large financial institutions are located within the old member states. Therefore, the authorities of these countries are the ones who have to interfere in the functioning of large financial institutions when there are disturbances in the financial markets, thus taking it upon themselves to provide these institutions with public financial help at the expense of taxpayers if necessary. The former governor of the Bank of England, Mervyn King, aptly said, "Global banks are global in life, but national in death" [Jurek 2014, p. 137].

Perhaps the most debated area of financial services that people associate with the global financial crisis is regulatory failure. Public opinion, politicians, and some policymakers have converged on the need to overhaul the financial regulatory system because of its failure to prevent the deepest and widest banking crisis since the 1930s. Regulation lies at the heart of the banking business, because it has a large impact on the levels of risk, growth, and profitability present. Moreover, regulation defines the social contract between the banking system and society. Banks enjoy privileges not available to any other sector, mainly in the form of explicit or implicit guarantees from the state that seeks to maintain the stability of the financial system in terms of both liquidity and solvency [Berges et al. 2014, pp. 21–22]. There are six main areas of regulation with the potential to significantly alter the landscape of the financial services industry: (a) new capital requirements in banking, (b) new risk-management approaches, (c) separation in activities, (d) incentives, (e) consumer protection, and (f) new taxes on banking and other financial activities [Berges et al. 2014, pp. 23–24].

Safety and Stability as a Challenge for the Banking and Financial System after the Financial Crisis of 2008

Safety and stability became a challenge and key requirement for the banking and financial sector after the crisis of 2008. There are many steps that have been taken to overcome the consequences of the last crisis and to reduce their impact on the Eurozone economies and societies.

Regulatory responses to the financial crisis after 2011 have focused on the new concept of the European System of Financial Supervision (ESFS), which has been operating for three years so far. There are also other mechanisms and solutions, such as Basel III (CRD/CRR package), the European Banking Union, and the European Stability Mechanism (ESM) and safety net.

Moreover, there are concepts worth mentioning that are not strictly connected to banking and financial sector regulations but are important for the stability of the public finance system of every European Union member state (especially those belonging to the Eurozone). These include, for example, the Stability and Growth Pact, the Six Pack, the Two Pack, and the European Semester.

The key document for the considerations concerning the new regulations and their potential impact on the safety and stability of the banking and financial sector is the de Larosičre Group Report [The High Level 2009], and it makes the following points:

- faced with the increasing size and meaning of the banking and financial sector, there is a prominent need for additional regulations and the creation of more convergence between EU member states;
- the creation of international institutions and collegial supervision is in high demand;
- many legal regulations are not sufficient when considering the changing environment and conditions of financialization.

According to the de Larosičre Group's recommendations, the EU established the following bodies and made them responsible for increasing the safety of financial markets:

- the European Systemic Risk Board, ESRB;
- the European Supervisory Authorities, ESAs (includes the European Banking Authority, EBA; the European Insurance and Occupational Pensions Authority, EIOPA; and the European Securities and Markets Authority, ESMA);
- the Joint Committee.

The ESAs have a much wider range of tasks, rights, and responsibilities than previous operating committees, which had been focused on the issue of non-binding guidelines and recommendations in order to advise the European Commission.

This complex approach to risk management and supervision is reflected by microprudential and macroprudential regulations and policies. According to Angelini, Neri, and Paletta (2012), the primary purpose of macroprudential policies must be to limit the accumulation of financial risks in order to reduce the probability, and mitigate the impact, of a financial crash [Angelini, Neri, Paletta 2012, p. 6]. The macroprudential assumptions are made by:

- efficient financial market supervision;
- identifying and categorizing systemic risk;
- diagnosing threats that might influence financial stability.

In general, microprudential policies examine the responses of an individual bank to exogenous risks and do not incorporate endogenous risk or considerations of interconnectedness with the rest of the system [Osiński, Seal, and Hoogduin 2013, p. 3]. The microprudential concept is implemented by:

- creating common standards, practices, and regulations;
- creating a common culture of good supervision;
- monitoring and evaluating markets.

Micro- and macroprudential policies and regulations are complementary concepts and should ensure the complex approach to the maintenance of financial market stability works well.

One concept that is still being discussed is the European Banking Union. This concept consists of three pillars [Goyal et al. 2013]:

- banking supervision;
- banking settlement;
- a resolution fund.

Goyal et al. [2013] expressed the following opinion: “a banking union – a single supervisory-regulatory framework, resolution mechanism, and safety net – for the euro area is the logical conclusion of the idea that integrated banking systems require integrated prudential oversight” [Goyal et al. 2013, p. 4]. The authors are convinced that sharing responsibility for potential financial support and bank supervision can reduce the fragmentation of financial markets, stem deposit flight, and weaken the vicious loop of rising sovereign and bank borrowing cost *oversight* [Goyal et al. 2013, p. 4].

On the other hand, there are negative opinions about the concept; one example comes from Hans Werner Sinn, whose concern is that a banking union might cause any future disaster to be much more serious than today’s current European threats.

Gual highlights the weakness in Sinn's thinking and claims that the current design of the banking union increases its role in bail-in processes, which is appropriate in terms of its objectives and goal of preventing future crises.

However, the banking union may be a serious source of instability at a time when the economic situation is fragile and Europe's financial markets are still fragmented; the system has yet to fully recover its stability [Gual 2013, p. 24]. The conclusion is that the pressures to make the banking union a reality before 2018 could negatively impact its expected results.

Gual's analysis of the pros and cons takes into consideration what Schäuble has called a "«timber-framed» banking union, and the risk is that the resulting structure may simply be made of straw, likely to be easily wiped out by the markets should they believe that systemic risk is not under control" [Gual 2013, p. 24].

As a final appraisal of the banking union concept, we may assume that "a banking union is necessary for the euro area, but accommodating the concerns of non-euro area European Union (EU) countries will augur well for consistency with the EU single market" [Goyal et al. 2013, p. 4].

The important part of the banking union is the bank resolution[2]. The agreement regarding the Bank Recovery and Resolution Directive (BRRD) was reached on December 11, 2013. The BRRD will be implemented in the Eurozone countries through the Single Resolution Mechanism (SRM). The BRRD is going to come into effect in January 2015[3].

Conclusion

The banking and financial system is a unique element in the business landscape. Banks and other financial institutions play a specific role in the economy and society. The growing role and size of the financial sector has generated numerous advantages and disadvantages. The environment of low nominal growth and high unemployment is the major underlying factor driving the challenges to financial stability. The financial crisis has made it clear that the present architecture for financial security and corporate governance is very fragile. The crisis

[2] For the text of the EU Bank Recovery and Resolution Directive, see http://europa.eu/rapid/press-release_MEMO-14-297_en.htm (accessed: 11.30.2014).

[3] http://www.pwc.com/en_GX/gx/banking-capital-markets/assets/pwc-eu-bank-recovery-and-resolution-directive-triumph-or-tragedy.pdf (accessed: 12.05.2014).

exposed the shortcomings in existing risk measurement methods for financial institutions and it has made it necessary to search for new approaches to risk assessment and management in finance, with special attention paid to banking.

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Abstract

The paper focuses on the problem of the banking and financial system's safety and stability in the European Union after the financial crisis of 2008. The concept is divided into three parts: the theoretical background, methods, and findings. The theoretical section presents a literature review, the main thesis, and the goals of the study. Conventional wisdom is discussed and the major assumptions, tools, and legal regulations are presented.

Key words: safety, stability, banking and financial system, European Banking Union

Bezpieczny i stabilny system bankowo-finansowy jako podstawa rozwoju gospodarki i społeczeństwa

Abstrakt

W artykule zaprezentowano problematykę bezpieczeństwa i stabilności systemów bankowego i finansowego w Unii Europejskiej po kryzysie 2008+. Celem opracowania było przedstawienie głównych czynników determinujących ryzyko w sektorze bankowo-finansowym oraz zwrócono uwagę na sposoby jego minimalizowania. W szczególności wskazano na kierunki ewolucji instytucji bankowo-finansowych oraz przybliżono mechanizmy i instrumenty wzmacniające nadzór nad sektorem bankowo-finansowym w UE po kryzysie 2008+.

Słowa kluczowe: bezpieczeństwo, stabilność, system bankowo-finansowy, Europejska Unia Bankowa