

LONG FOR A NEW ARCHITECTURE FOR EUROPEAN FINANCIAL STABILITY

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Abstract: The work is part of a complex research theme approached by the authors which follows the knowledge development with favourable implications on the increase of the role and of the importance of the financial stability, having as objective to identify the best methods and institutional structures for the financial stability assurance in an European banking system which slowly surpasses the barriers imposed by the national and economical frontiers. The importance of the financial stability assurance is crucial not only for the general economical evolution, but also for the efficiency of the monetary politics of the central bank. As far as the banks (especially in Romania) represent the key element for the financial system, the state of the economy and the structure of the banking system are closely connected to the financial stability assurance and the macroeconomical evolutions.

I. Introduction

The concept of financial stability finds its application both on the national level and on the international level. The accentuation of the globalisation phenomenon made that, in the last years, the fears concerning the contamination of some financial systems due to the starting of some crises in other systems to become more acute. The answer of the international community was effected in the creation of some consultation instances, reuniting representatives of the actors of the market and of the supervision authorities, who, on the one hand, to create regulations which include the best practices of identification, measurement and administration of risks, and, on the other hand, to assure the transposition and the implementation of these regulations in different jurisdictions.

The financial stability presents a particular importance for every economy. Through the financial institutions are realized vital activities for other economical sectors: payments, money exchanges, companies' acquisitions, financings and so on. Consequently, a crisis of the financial system might lead to real economical blockages, measured both in direct losses and in reductions of the economical increase rhythm or even, in worse cases, at recession. In fact, one of the financial systems crises features is their pro-cyclic character: they tend to start when the economical activity registers a regress and, in their turn, after their production, they tend to grow deeper this regress.

The financial stability has become a more and more important objective of the decisional economical process in the last decades. In the 80s of the last century, the direct regulation of the credit markets and the capital fluxes was eliminated in many countries, that fact facilitating the expansion of the financial system in a more alert rhythm than in other sectors of the economy. The instruments became more complex, the activities more diversified, and the risks more variable. Also, as the result of the

high degree of transindustrial and transfrontalier integration, the interrelationship of the financial systems emphasized both on the national and international level.

There are two types of analysis of risks in the evaluation process of financial stability: the micro prudential and the macro prudential one.

The micro prudential analysis concentrates on the evolutions within the individual institutions and takes into consideration the limitation of their instability, thus protecting the depositors. The macro prudential analysis concerns the financial system as a whole, and its purpose is to limit the instability at the level of the whole system. An important concept is the systemic risk, that is the risk that the liquidity or solvency of a bank to cause liquidity or insolvency problems to other institutions. Thus, the correlation and the usual exposures of the institutions are important in the macro prudential approach. The second approach method refers to the risks that come from outside the financial system. The significant increase of debt and the active prices, beside macro economical problems, as the increase of prices of merchandises or considerable disequilibrium in world's economy can have, in the last, negative impact on the financial stability.

A similar approach is *in the analysis of the potential impact of the macro economical shocks* adverse to the financial stability. The evaluation techniques are regularly used in this purpose. Such techniques analyse the banks' capacity to cope with various types of shocks in various economical conditions and with different reactions from behalf of the monetary politics. The macro economical models proved to be useful for the use of the evaluation techniques. Above all else, there must be made significant progresses in observing the behavior of the economical agents in the case of some extreme macro economical events.

The division of responsibility for the maintenance of financial stability both at national level, and at the level of the authorities in different countries is an actual problem. In most countries, the duty to assure financial stability is divided between the Ministry of Finance, the central bank and the financial supervision authority. To promote an efficient cooperation, the information exchange among these authorities, as the implementation of a formal frame in view of cooperation is essential. The special responsibility of the central bank is in the analysis and the monitoring of the financial system.

The examples of the transfrontalier integration are relevant to the importance of the accent put on the international level on the analysis of the financial stability. Generally, the diversified series of analytical provocations determined the central banks to become more innovative, this aspect being illustrated by the increasing number of financial stability reports published at world level. As a general measure, the authorities use the supervision and the regulation to assure the financial stability. The markets, institutions and infrastructure supervision may contribute to the strict administration of the financial risk.

2.The approach of the financial stability in Romania

For *the Romanian banking sector*, in an ample process of structural transformation, of financial freedom and European integration, the problem of financial stability has a particular importance.

The concept of financial stability has not yet enjoyed a consecrated definition and nor a model or analytical framed of evaluation. On the one hand, it may be considered that financial stability is noticeable in the situations in which is not manifested any

systemic crisis. On the other hand, taking into consideration the functions of the financial system, it can be appreciated that it is stable when it is capable to efficiently allocate the economical resources (both in space, and especially in time), to administrate the financial risks through an adequate measurement and to auto-correct itself when it is affected by external shocks.

Romania's National Bank defines financial stability, in a large sense, that the characteristic of the financial system to not cope with systemic shocks on a durable basis and without major perturbations, to efficiently allocate financial resources in economy and to identify and efficiently administrate the risks.

The indicators of financial stability in Romania certify the existence of a robust and healthy system, although still small and unequilibrated in the development of its components. From this point of view it is felt the need of an attention towards the developments on medium term, because the keeping of structural disequilibrium but at values substantially high can lead to the increase of the vulnerability degree of the whole system.

Romania still presents the characteristics of an emergent financial market. In the ensemble of this market, the banking sector occupies by far the weight of a majority. Thus, at the end of the year 2006, the actives of the banking system represented approximately 53% from the volume of the intern raw product. 1) At the same date, the total volume of the liberty of the capital market 2) was at 25% from IRP, but in the conditions in which the "free float", that is the shares/stocks offered to be traded, represented less than a tenth from the capital volume.

In a similar way, the insurances market and that of the non-banking financial institutions represent reduced weights comparatively to the banking one. Because of this, in our country, the impact of some dysfunctions in the banking system on the stability of the entire financial system would be much bigger if the problems took place within another component of the financial sector.

As a consequence, although the supervision quality is important for each component of the financial system, the banking supervision has the predominant role in the assurance of the financial stability, and that is why it is necessary the fast raise of it to the level of the best international standards. In these conditions, is not surprising the fact that RNB assumed, in the last years, besides the role of supervisor of the banking market, accorded by the law, also the role of monitoring the financial stability.

The first steps in this direction were made beginning with the year 2003, when the Central Bank took the initiative to close cooperation agreements with the entities involved in the supervision of the other segments of the financial market. Starting with the year 2006, RNB also assumed the monitoring of the financial stability and began publishing, on an annual basis, reports in this sense.

The reports propose to achieve a diagnosis on the way in which the recent evolutions in the area of financial institutions, the macro economical frame and the sector of the companies and the population can affect the financial stability. The risks associated to these evolutions are analyzed through the angle of a set of indicators, and where this thing is possible, it is also done a *stress test* to directly commensurate the impact of eventual shocks on the solvency of the banking system.

Accordingly to the actual stage of development of the banking system, the main analyzed risks in this sector are *the credit risk*, using as indicators as the ones concerning the quality of the credits portfolio, the coverage degree with provisions, the

general risk rate, etc., *the liquidation risk*, and the *market risk*, mainly under the aspect of the interest risk and of the one of rate of exchange.

The way of valuing of the reports' conclusions on the financial stability was not explained by RNB. It can be supposed that the elements with conclusions characters within these are taken into consideration by the Central Bank in the establishing of its own prudential politics, when it is about the credit institutions and the non banking financial institutions (UFI), the supervision of which is directly assured, or within the regular dialogue with the other entities with supervision attributes of the financial sector.

In the year 2006, The ECOFIN Council recommended the states members of the European Union the strengthening of the national capacity to administrate the potential financial crisis situations, through the creation, by July 2007, of a permanent national committee for financial stability (*Domestic Standing Group – DSG*), in which to be represented at least the central banks, the supervision authorities and the Ministries of Finance. The central objective of this committee must be in the exchange of information between authorities, as in the prevention, the evaluation and the administration of the potential problems with systemic impact.

Following these recommendations, it was created in July 2007 The *National Committee for Financial Stability* the main attributions of which aim at the promotion of a permanent and effective exchange of information between authorities responsible with the regulation and the supervision of different sectors of the financial system and of the Ministry of Economy and Finance, as the evaluation, the prevention and, in case, the administration of the situations of financial crisis at the level of the individual financial institutions, the financial groups or the financial market on the whole.

3. The european banking integration and the financial stability

The importance of the research of the financial stability for the European banking economy in a process of integration is also put into evidence by the interest manifested by the European regulation authorities which organized a simulation of a financial crisis with continental extent, on the background of the insufficient preparation to be able to stop the transfrontalier propagation of a problem.

The exercise comprised the simulation of the entrance in payment incapacity of a big bank, which has operations in a number of big countries, to verify if BCE, the central national banks and the Ministries of Finance can cooperate in solving the crisis. The simulation exercise took place at the central office of BCE in April 2006. The finality of the simulation was the verification of the capacity of national regulation authorities to exchange information with other national authorities in the case of a crisis and to surpass “the cultural differences” and other practical difficulties.

The regulation authorities are concerned especially in the risks for the financial stability generated by the increase of the volume of transactions with units of the hedge funds and with credit derived instruments.

There were registered very few progresses in the elaboration of structures on international level for the administration of the crises and that is why there was insistently recommended that the national regulation authorities to make their own simulations.

The report elaborated after the simulation identified as possible risk sources the collapse of the immobile market, a pandemic with aviary flu and high prices of petrol, but stating that the banking sector is solid. The report also sustains that while the hedge

funds for protection against risks can contribute to the market's efficiency, they can also be a source of systemic risks.

The stability of the financial system makes necessary that its main components, respectively the markets, the correspondent infrastructures and the financial institutions to be capable of, together, absorbing the perturbations. The stability also demands that the financial system facilitate a supple and efficient reallocation of the financial resources of those who save money to the investors, that the financial risk to be analyzed and valued precisely and to be efficiently administrated. The market of a given ensemble of instruments or financial services is totally integrated when the potential operators of this market: (i) are under a unique ensemble of rules in the situation in which they decide to exploit these instruments or financial services, (ii) dispose of an access equality of this ensemble of instruments or financial services and (iii) make the object of a treatment equality when they intervene on this market.

In the theoretical and practical works realized at international level, it is recognized the accentuation of the complexity of the monitoring of the banking system, in Europe, for example, it was already put the problem referring to the implementation of the macro prudential supervision in the context of banking supervision at national level. Thus appear new methods of approach of the evaluation of risks in the banking system either at national level, or at transfrontalier level. One of these methods is based on new techniques resulted from the theory of extreme multivariate value, a statistic method of evaluation of the simultaneous appearance of rare events, as the grave problems in the banking field. More precisely, using the semi parametric method is estimated, as measure of the systemic risk, the possibility of decreases of the quotations of the shares issued by banks according to the decline of the banking shares issued by other banks or to another factor of the market.

The banking sector has a particular importance for the stability of financial systems. In the main economies, as those of the United States and the Euro zone, the banking sector was subjected to some significant structural changes. For example, the consolidation of the banking system in the United States and in Europe produced since the 90s of the past century, still in the same period were created complex institutions of big dimensions. The setting up of the conditions for the unique market of the financial services in the European Union, at the same time with the European Monetary Union, marked the progress to the banking integration. These structural changes had as effect the accentuation of the complexity in which concerns the monitoring of the banking system. In Europe, for example, it was put the problem referring to the implementation of the macro prudential supervision in the context of the banking supervision at national level.

Relevant for the research are also the implications on which the concentration and the competition in the banking system can have on the stability of the banking system. Even if there is not an obvious correlation from a theoretical point of view, the practical studies indicate the fact that a bigger concentration and a more reduced level of competition have a stabilizing influence. With all this, in the case in which the competition seems to be intensified – contrary to the process of banking consolidation, such a correlation cannot be necessarily applied to the European banking systems.

The researches made at international level come over difficulties because, on the one hand, the stability degree cannot be clearly presented by the individual indicators, and, on the other hand, the determination of the competition's degree of intensity raise

up significant problems. The International analysis demonstrates that the concentration processes were many times the results of financial crises.

With all this, the simple comparisons of the indicators concerning the competition and the stability, as also the econometric profound studies indicate the existence of a positive correlation between the stability and the concentration or the market power in the banking sector. At the same time, it appears that, although the concentration has a stabilizing effect, the institutional restrictions on the competition have a destabilizing effect.

The international financial connexions, the new financial products and the more ample distribution of the risk also increased the interconnection degree on an international level of the financial markets. Thus, the financial systems are more exposed to risks, because of the possible contagion. Due to this, the skeptics expressed their concern related to the stability of financial integration on world level, considered as potential destabilizing of the world economy. There is also the contrary opinion according to which the financial integration would reduce the risks with which confront the global economy.

The Report of Financial Stability of the Bank of England, published on the 23rd of October 2007, sustains that the actual financial crisis could not be solved rapidly and without costs. The loans to the sub prime debtors of USA generated big losses, and the lack of information concerning the bank exposure to global risks determined the effective closing of the market for guaranteed titles with actives and loans with guarantees. In report, it is recognized that both banks and the regulation and supervision institutions need plans to cope with the problems that such banking systems present. The supervisors must assure themselves that banks have adequate liquidity for the type of developed activity. More, the Basel II regulations concerning the banking capital, which demand a bigger exposure of the banks, could contribute to the increase of transparency, thus reducing the tendency to keep the very extreme risk actives outside the bookkeeping balances of the banks. The banking system is well capitalised and profitable and it should be capable of adapting to a new regime, in which it is taken into consideration the risk in establishing the actives prices. Still, the conditions of financial fragility should persist for a while, and the system will be vulnerable in front of new shocks. The Bank of England furnished an equilibrated evaluation of the implications and of the remedies, but the success was limited in the approach of the situations in which the Bank's behavior was the subject of critics.

4. The financial stability – a european priority

A financial system which functions well allows an economy to exploit at maximum its increase potential, because it assures the necessary financing of the investment opportunities, at minimum costs. From this reason, the European Union considered the financial stability a priority on the order of the day of the Lisbon Assembly.

One of the first two directions on which based the Informal Council from Lisbon, developed in the period 18-19 October 2007, was the financial markets, the European leaders stating that the Union has macro economical solid bases which allow a durable economical increase. Still, in the context of the crisis in USA, the leaders of the 27 states of EU demanded from the Ministries of Finance, from the European Commission and from the European Central Bank to continue the close *monitoring of the evolutions on the financial markets and of the world economy on the whole*. Moreover, Great Britain, France and Germany, the three big powers in the European Union, announced

that they want to offer *the legal frame for a bigger transparency of the financial markets*, as eventual regulations in a field which prevents the production of crisis as the one through which are going now the international financial markets. In the common declaration published at the end of the informal summit, the British Prime Minister Gordon Brown, the French President Nicholas Sarkozy and the German Chancellor Angela Merkel declared that thrust and transparency are two essential elements for the proper functioning of markets. “We suggest that at the European Council in the spring of 2008 to take a decision referring to the way in which to answer the need of more transparency of financial markets and a better administration of risks”, is in the declaration of the three state chiefs.

More, the British Prime Minister Gordon Brown recently proposed the transformation of the International Monetary Fund (IMF) in an independent institution for monitoring the financial market, which will represent the first line of defence against global economical crises, considering that the rapid extension of the crisis of credits in USA demonstrates a weakness of the global financial systems. “*IMF should concentrate on the supervision of the global economical and financial system. Its role would be to prevent the crises and not just administrate or solve them as in the past*”. “*The International Monetary Fund, working with the Forum of Financial Stability, should function as an alarm system, involving economical institutions of monitoring and regulations from all countries*”, added The Prime Minister. The Forum of Financial Stability is formed by representatives of central banks, of organisms of market regulation and of international economical institutions. Gordon Brown declared that IMF should develop a financial instrument, which assures the economical stability in the case of the sudden reduction of the capital influxes.

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