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IMPLICATIONS OF BANKING SUPERVISION ACROSS THE EUROPEAN MONETARY UNION, A SOVEREIGN DEBT CRISIS UPDATE

Simona Elena IAGAR*

Abstract: *The current paper analyses the latest measures taken by the main European governing bodies with regard to the banking supervision across the European Monetary Union (EMU) following the 'sovereign debt crisis' phenomenon and its continuing effects throughout the Euro zone for the last five years. Officially preaching financial integration in order to ensure stability of the European banking system, most often the European governing bodies amplify the exact phenomena they expect to reduce doing more harm to both creditors and depositors and ultimately leading to a more fragile business banking environment. The importance of banks is acknowledged at European institutional level as main channel through which the monetary policy is triggered across EMU, therefore active measures have been taken in this regard. Questioning the extent to which these measures are legitimate and meet the purposes that they claim, constitutes the aim of the present paper. Another close linked purpose is a better understanding of what stability means, why it is important and what makes stability occur in a banking system. Having understood and set the theoretical grounds, it therefore follows easily to analyse through this glance the latest actions pursued by the European financial governing bodies focusing on the ones addressing supervision of the banking sector within EMU. The paper concludes and provides a set of recommendations by reminding the nature and role of banks for the real economy, the same objective the European financial governing bodies' target, but which they consistently fail to meet.*

Keywords: banking supervision; banking stability; European Monetary Union (EMU)

JEL Classification: F33; F36; G21

Introduction

The purpose of the current paper is mainly two-fold: on one fold is to lay the theoretical grounds of what stability means in the banking system and how can it be achieved and on the second fold, to analyze the current banking supervisory framework within EMU through this glance in order to be able to conclude with recommendations in this regard.

Over the past five years, since the burst of the sovereign debt crisis, the struggle for liquidity much needed for covering alarming public deficits across EMU, has set the stage for even more banking regulation and supervision coming from the European governing institutions. The European sovereign debt crisis has seen experts from a wide range of fields cite many different factors that were responsible for the ensuing failures of the financial system. Several explanations revolve around inconsistent regulation and supervision of the financial sector, and particular loopholes that allowed financial intermediaries to exploit regulatory arbitrage opportunities. Less often discussed, is the overarching structure of financial supervision and the role this might play, if any, in promoting or

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exacerbating a financial crisis. Set under the clear purpose of helping build a resilient banking system, able to face financial market instabilities, the European governing bodies aim to construct yet another pillar towards financial integration, namely the banking union. In order to achieve this, an institutional supervisory architecture, described in more details in section 3, is now in place, eager to achieve a greater financial integration than other previous recent institutional undertakings at European level (e.g. obliging banks to meet the Basel III Agreement provisions). Along with shedding light in what truly gives banking stability, the aim of the current paper is also to deconstruct a series of misconceptions built around the banking system currently perceived to be a “wolves arena” (Ferguson *et al.*, 2010), an unjust perception that has not brought any honor to the financial and particularly, to banking system from the burst of the global financial crisis in 2008, continuing with European sovereign debt crisis ever since the present days.

1. Stability of the banking system

This section draws the principles and factors underlying soundness of a bank considering that it is the cumulus of individual banks solvency that gives the overall stability of the banking system. The line of argument follows confidently the principles set by the Austrian School of Economics, through which governmental intervention finds no place in running the business of banking, but rather the sole market auto-adjusting nature and principles.

Amongst these principles, one place is reserved to competition, of importance here and understood in the following sense: banks lend their available resources (usually of deposits provenience) to those creditors that prove high rates of returns among the many that compete for these funds and invest to those projects providing the best risk-return profile by closely and permanently assuring that contractual obligations are being met with the ones that trust that these resources are on good hands (deposit owners), else risking bankruptcy. Contrary to this approach, worth bringing into attention is the recent bail-out trend, named amongst the financial crisis exit measures envisioned by policymakers worldwide, an undertaking that, sadly, comes to undermine the above described process by reducing the banks motive to struggle for finding eligible clients and projects to which to direct liquidity to. A bailout programme is mainly designed to maintain the solvency of certain commercial banks, also known as “too big to fail”. In the words of Prychitko:

Big players create big unintended consequences as they, too, act only under conditions of uncertainty and ignorance. The Greenspan Put (now evolved into the Bernanke Put) serves as a stark example. By announcing in the midst of the housing

bubble that speculative investment banks could retain their extraordinarily high profits and count on the possibility of loss-floor, those firms evolved into Big Players themselves. They placed higher bets as the discipline of profit and loss – especially loss in this case – was systematically weakened. The unintended consequences behind the Put – the moral hazard – became all too clear (Prychitko, 2010, p. 201).

Simply put, if the banking sector does not have the same constraints as any other business has, it would be difficult to achieve the economic development the public authorities preach for. Competition within the banking system would also means leaving banks compete on all levels, European and non-European and also the access to liquidity to be possible for all types of stakeholders, be them private or public entities, inside or outside EMU, European or non-European for that matter. Quite often the counterargument for free market banking competition is that it would result in the abandonment of prudential behaviour by the banks although the author of the current paper finds no risk for such behaviour if borrowed resources are 100% backed up. There is, indeed, the possibility to abandon prudence and incur losses but all these are due to the inability to align to market signals or bad management decisions as happens within any other business. The author envisions no possibility for banking stability outside competition among banks, a competition that is currently impeded by existing supervising framework on which the ECB operates, one which is closely analysed in section 3 of the current paper.

The argument highlighted so far does not praise a concept of absolute stability as even banking activity is subject to change but rather introducing the most imperative objective of the well-functioning of the banking system, and not, as Tsionas mentioned, “any metaphysical or empiricist notion of never changing or policy-induced-changing” (Tsionas, *The Euro and the International Financial Stability*, p. 171) within European banking system. It is therefore the subject of the next section to conclude whether supervision is necessary in such context and to also deconstruct a series of other reasons calling for banking supervision.

2. Theorising around banking supervision

Banking supervision, generally defined, implies state regulation and control of the banking system to allegedly secure its soundness. The main reasons calling for banking supervision from public authorities have always been officially communicated as protection of depositors from unsecure banks or asymmetric information on one side and protection of banks in engaging in unsafe and dangerous credits, on the other side. Additional reasons are to ensure that banks retain enough incentives to lend in order for the business environment and real economy not be affected by lack of

liquidity, much needed for investments and for the overall economic development as such. Strictly speaking, the tool to achieve all these is by consistently monitoring bank's balance sheets for items like non-performing loans (NPL). It is the task of the current section to argue against the above mentioned motives around banking supervision.

In a financial playing field lacking the activities of supervision and its corollary, regulation, if banks engage in giving loans to clients proving weak capacity of returning the borrowed resources, this further translates into the classic risk of doing the business of any kind. The over-expansion of bank credit will not occur in a market that adjusts itself in a natural way, comprising all actions of involved stakeholders: customers and providers, altogether. As mentioned, there is a series of motives brought by public authorities that allegedly call for banking supervision and close control and those are, amongst other, the asymmetry of information and the moral hazard that, in fact, characterize any financial transaction. To start with the first, the literature mentions that:

Asymmetric information is a situation in which one party to a financial contract has much less accurate information than the other party. For example, borrowers who take out loans usually have much better information about the potential returns and risks associated with the investment projects they plan to undertake than do lenders (Mishkin, 2001, p. 2).

Asymmetric information therefore would lead to two loopholes in the financial system: adverse selection and moral hazard. Prior to conclude on why these do not hold relevancy in a free of supervision banking system, these concepts will be subject to a more in depth analysis.

Adverse selection is indeed an asymmetric information phenomenon, one created with each financial transaction when borrowers that most need financial resources but prove a low credit return profile, are willing to pay the highest interest rate; thus, according to mainstream interpretation of the adverse selection concept, credit is granted to "adversely selected" borrowers producing an undesirable outcome for banks, financial system and ultimately to economic development. In order to minimize adverse selection problem, the lenders shall be closely supervised and required to better analyze credit risk profiles.

The second aspect relates to the creation of moral hazard which occurs after a transaction takes place, when the creditor is exposed to a hazard imposed on him by the borrower who uses the granted resources in ways that defy the creditor's requirement for returning the loan. The phenomenon happens due to an increased borrowers' appetite to engage in riskier projects – if the investment proves successful, the borrower claims the gain while if it proves unsuccessful, it is the creditor who will bear the loss.

Both asymmetric information and moral hazard defined as above allegedly result into suboptimal levels of lending and investment therefore calling for close banking supervision and intervention when identified. A counter argumentative point is worth noted, specifically that:

At the gross market rate which prevailed on the eve of this disturbance, all those who were ready to borrow money at this rate, due allowance being made for the entrepreneurial component in each case, could borrow as much as they wanted. Additional loans can be placed only at a lower gross market rate. It does not matter whether this drop in the gross market rate expresses itself in an arithmetical drop in the percentage stipulated in the loan contracts. It could happen that the nominal interest rates remain unchanged and that the expansion manifests itself in the fact that at these rates loans are negotiated which could not have been made before on account of the height of the entrepreneurial component to be included. Such an outcome too amounts to a drop in gross market rates and brings about the same consequences (Mises 1998, pp. 549-50).

The underlying argument here is that adverse selection and moral hazard assume a counterbalance between different types of contractual arrangements between creditors and borrowers weighing both costs and benefits by the parties involved. The misleading argument on asymmetric information described above is that it targets the data related to the object of the contract and not focusing on the context framed by the regulations. The information provided by the markets, the sole at hand, is the only suitable one when analyzing a contractual deal by both parties` prior to engaging in it. Making use of the profit and loss statement, banks can find the most appropriate available means to deal with these informational problems.

3. EMU banking supervisory architecture and its implications

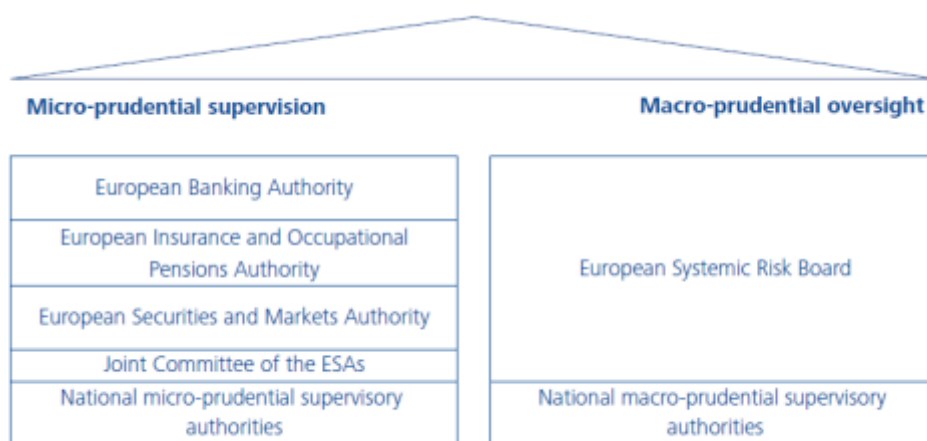
European policymakers themselves recognize that the effectiveness of monetary policy across EMU depends on a well-functioning banking sector as operating through the bank lending channel. In recent years, efforts have been made to control this channel and policymakers agreed to establish a banking union with the European Central Bank (ECB) assuming supervisory responsibilities within it. By financial supervisory structure the reference is made here to the number of regulators that European Union (EU) employs to monitor the three most important components of its financial system, the banking, securities and insurance sectors. Officially named the European System of Financial Supervision, ESFS is a framework comprehending supervision all across areas of the EMU financial system with the implementation of active institutions set to closely monitor each of these streams. The aim is to go further and much closer towards financial integration and harmonization

across the EMU, rather than encouraging the competition of decentralized supervision of different countries models.

Envisioned as an answer to financial and sovereign debt crisis, the European Union (EU) has chosen to dramatically shift its banking policy of the EMU area by transforming its supervisory set-up – more specific, EU took action to redirect the banking supervisory authority from banks to supranational level. Entrusting ECB with exclusive banking supervision powers did not only diluted the nature of the central bank as previously understood, namely governing the EMU, but opened the door for building an extensive banking union with a single resolution authority and fund. In order to understand the significance of such a step, this in the literature banking union is often called one of the most significant developments in European integration since the Maastricht Treaty (Howarth and Quaglia, 2014). It was in June 2012 that the finance ministers across EMU countries agreed to the creation of the European Stability Mechanism (ESM) as well, thought to directly recapitalize fragile banks without further liability for the sovereign countries that further shaped the banking union along with its common supervision, single rulebook, harmonized national deposit insurance and a resolution mechanism, set to be the source of common funding between 2014 and 2022 (Rynck, 2014).

Starting in November 2014, ECB has been granted additional authority being now the institution exclusively entrusted to issuing and withdrawing banking licenses and allowing acquisitions or release of shareholders. Moreover, the ECB replaces national authorities for the direct supervision and dispute settlement of approximately 130 institutions representing 85% of bank assets.

Figure 1 – The European System of Financial Supervision (ESFS)



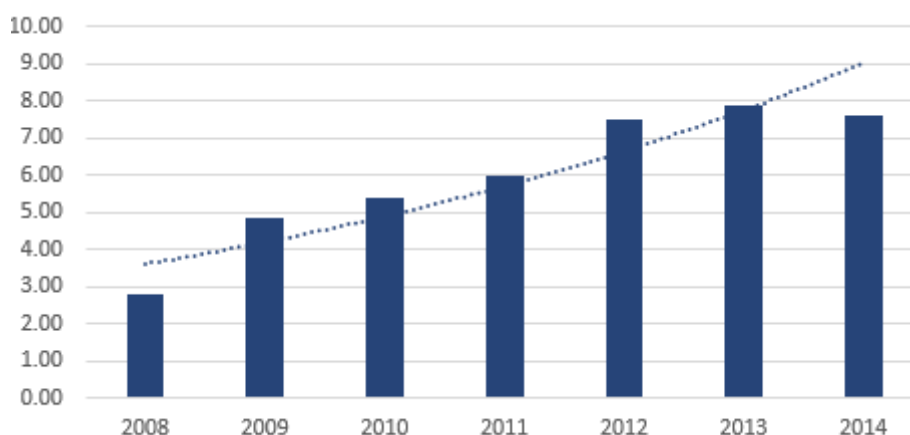
Source: ECB Annual Report on supervisory activities 2014 (ECB, 2014a)

Banking supervision in particular is the subject of the exact above mentioned SSM, which has three main objectives, namely to: ensure the safety and soundness of the European banking system, increase financial integration and stability, and ensure consistent supervision (ECB, 2014b).

But does this supervisory structure corresponds to an improvement of the banking sector? According to certain opinions in the economic literature, it should be the target of the governing bodies to call for an even more integrated supervising structure, as it has happened: if not a single one, then a closer collaboration and a standardized set of objectives bringing together the existing ones (Ubide, 2013). Following the same line of argumentation, others categorize the general framework of financial supervision as concerning (micro) prudential supervision and business conduct, each of which addresses a type of market failure, asymmetric information and market misconduct, respectively (Cihak and Podpiera, 2008).

The implications of previously mentioned supervisory actions are analysed by having a close look at the banks performance over the last five years, since the burst of the sovereign debt crisis, in order to assess the improvements or, in the contrary, the damages resulted following these actions. One banking sector performance indicator is the nonperforming loans ratio (NPL).

Figure 2 – EMU Bank nonperforming loans to total gross loans (%)



Source: Author's perspective, based on data taken from IMF Global Financial Stability Report, 2014 (IMF, 2014)

Defined as an unsafe asset in banks' balance sheet, the evolution of bank nonperforming loans to total gross loans (%) (the trend is shown in figure 2) is relevant in this context as it reveals the failure of all above institutional undertakings to diminish it as source of "systemic risk". "Systemic risk" is often considered to weaken the resilience of the banking system, although a difference is worth noted among one side, the bankruptcy of a bank due to losses for which it disappears from the market incurring no social costs, and on the other, the collapse of it due to restrictions on balance

sheet items, like is the context described above. Banking policies within EMU are left to the ECB that creates a misleading perception of banking stability by artificially maintaining the solvency of banks by close supervision, monitor and control with regard to their private decisions on the relationship between risk and return. It should be of any interest or matter whether these decisions are appropriate or not – as this information is soon verified by the market. What matters most is that the competition in the banking system is not compatible with the concept of “financial stability” as draw by the ECB.

Conclusions

The banking system is important to the wealth of the financial and economic state, as it plays the vital role in an economy of channelling funds from savings to investment needs. If the banking system does not perform this function well, then the economy cannot operate efficiently, and economic growth could be severely hampered.

A bank is considered to be “sound” when enjoying the public confidence which plays a decisive and overwhelmingly important role in a competitive banking system, specifically as a result of the resources that depositors and borrowers altogether entrust to that bank. Nevertheless, what is considered sound and solvent for the European financial institutions governing over the banking system within EMU differs; aiming to impede “systemic risk”, asymmetry of information, moral hazard in order to increase banks resilience on the financial markets, the European institutions, with the ECB as main policy driver, has put in place a framework of supervisory, monitor and resolution of banks across EMU. It was the aim of the current paper to analyse whether this undertaking had proved to meet its objective and it did so by mainly pointing out that the focus is wrongfully directed. Heading towards a baking union, unison with fiscal and monetary policy may not the way out from the European sovereign debt crisis and will be the challenge of the author for future research to further recommend specific backward steps rather than steps forward a European banking union. The intervention of European authorities in the banking system within EMU remains profoundly intrusive and leads to further distortions as all the objectives behind it find their natural answers in a competitive banking system. Theorizing around stability and the importance of stability very often preached on public European agendas, findings point out that stability does not imply a static playground where things do not change but rather requires extensive restructuring of the banking sector in order to revert to a sound banking environment where risk prevails when financing investments.

Although the above mentioned points may appear utopian and very distant from the practical problems the banking system has to deal with, they at least indicate a proper direction that a reform should take and threats that must be avoided. Unless fully acknowledged that the sovereign debt crisis and its economic consequences are continuously fuelled by the ongoing interventions in the financial markets, is highly improbable to maintain stability of the real economy. There is no possibility to maintain financial stability without competition in the banking system that is currently hampered by the supervisory context in which European institutional governing bodies operate. To conclude, in a competitive banking sector there are only the sound and solvent banking institutions that will prevail thus enforcing financial stability. Any other central management authority set to supervise the banking system will induce more instability.

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