EU FINANCIAL STABILITY NETWORK REFORM AND RISK EXPOSURE OF THE SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

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Abstract

With the introduction of strict capital and liquidity requirements, it would seem that Europe has reinforced its control over its financial sector. The European Commission has properly spotted and grabbed the opportunity to strengthen integration between the Member States through the introduction of a banking union. But the question is whether the safety of the financial sector really increased. The capitalization of the largest banks has undoubtedly increased and so has their liquidity, but this came at a price. Compliance with the new regulations is expensive, yet the expectations towards the banks' profitability remains high, pushing them to seek risky but profitable investments. This article will attempt to analyse the net impact on security.

The article consists of three parts. First of them is presenting the definition and significance of the financial safety net. Second quantifies and discusses the impact of the new requirements and thresholds. The last part concludes the study, pointing out the weak spots of the regulations and suggesting further steps towards strengthening the resilience of the largest banks in Europe.

Keywords supervision, safety net, capital buffer.

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INTRODUCTION

The massive gap between debt and equity of the financial institutions has long been discussed and seen as a threat to the stability of the financial systems around the World. Once the risk has partially materialized, resulting in bailouts of different banks with public funds, European Commission has decided to narrow this gap. New capital requirements are forcing financial institutions to increase their equity and strengthen their liquidity, yet this does not necessarily

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mean that the risks of insolvency have dropped. With the growing costs of doing business, banks may be tempted to greater risk taking in order to maintain their profitability. The aim of this article is to analyse the net impact of introducing the new financial safety net over the European financial sector.

The article consists of three parts. First presents the definition and significance of the financial safety net. Second, quantifies and discusses the impact of the new requirements and thresholds. Final part concludes the study, pointing out the weak spots of the regulations and suggesting further steps towards strengthening the resilience of the largest banks in Europe.

1. BUILDING THE FINANCIAL SAFETY NET

It is hard to present a universal definition of a financial safety net. In general, the purpose of a safety net is to facilitate safe functioning of the financial system and that all the institutions effectively cooperate. Thus from a broad perspective, the financial safety net is a network of institutions and the underlying regulatory framework. This was designed to protect the economy and society from any consequence of loss of liquidity and insolvency of the financial institutions [Cheng 2016, pp. 1]. The European Central Bank defines the financial safety net as a set of institutions and mechanisms which provide financial support to countries hit in a financial crisis [Scheubel and Stracca 2016, pp. 4]. In a more focused approach, a safety net is established through the functioning of the central bank as a lender of last resort, deposit guarantee fund, prudential regulatory and supervisory institutions, as well as a resolution mechanism [Schich 2008, p. 76]. The aim of the existing financial safety net is to create conditions, in which the financial system will be both efficient and secure, invulnerable to minor shocks and will not create shocks itself [Alinska 2011, pp. 92–94].

2. REFORM OF THE EUROPEAN FINANCIAL SAFETY NET AFTER THE CRISIS

After the last financial crisis in 2008, the European Union (EU) had to face multiple problems in the European financial sector. Different proposals on how to tackle the crisis and avoid systemic risks in the future have been submitted. Yet this article will focus on the ones that managed to pass through the European Parliament and commenced the reconstruction of Europe's financial safety net.

The foundations of the new financial safety net in the European Union have been established by the High Level Group on the Financial Supervision. The Group was established by the European Commission in 2008 to advise on the future of financial supervision and regulations in Europe. Chaired by Jacques de Larosiere, President of the National Bank of France, the group prepared a report, published in 2009 and had a significant impact on the reform in the European financial safety net [De Larosiere 2009].

The High Level Group proposed a vast range of changes in both micro and macro categories. These two levels of supervision were both created to constitute the new financial safety net in the form of the European System of Financial Supervision (ESFS) [*Regulation (EU) No 1092/2010…*, article 1]. Macroprudential supervision concerns the evaluation of stability of Europe's financial system as a whole. Microprudential supervision relates to supervising individual financial institutions in a way that would ensure its effectiveness. The High Level Group underlined that effectiveness of the existing macroprudential supervision cannot be achieved unless supplemented with well-targeted microprudential supervision and vice versa [De Larosiere 2009, pp. 45].

The reform of macroprudential supervision suggested in the de Larosiere Report came to life in December 2010 through the adoption of Regulation no. 1092/2010 establishing the European Systematic Risk Board (ESRB). The task of the European Systematic Risk Board was to monitor and assess the systemic risk during times of the financial stabilisation in order to detect and counter potential threats to the system stability [*Regulation (EU) No 1092/2010…*, article 1]. The ESRB is chaired by the President of the European Central Bank and coordinates the cooperation between the European Central Bank and national central banks for effective, comprehensive supervision.

Regarding microprudential supervision, the High Level Group suggested creating a European net of institutions. There are three institutions on the European level responsible for different parts of the financial sector: The European Banking Authority (EBA) which governs the banks, the European Insurance and Occupational Pension Authority (EIOPA) looking after the insurance and public sector and The European Securities and Markets Authority (ESMA) created for overseeing the market sector [Demarigny et al. 2013, pp. 10–11]. While the EBA, EIOPA and ESMA coordinate the financial sector`s functioning at the European level, the domestic markets remain under the supervision of the local authority.

In the middle of 2013 a new package of regulations was published. It was called the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR). Its creation was a response to the new financial supervision standards proposed by the Basel Committee for Banking Supervision. The package of regulations focuses on activity of the financial institutions in the European Union. CRD IV and CRR relates also to the managerial and supervisory aspects of their functioning by introducing a set of prudential requirements aiming to improve their resilience.

The package of regulations established capital buffers to steer the level of credit institution's capitalization, especially in terms of their core capital, i.e. the so-called Common Equity Tier 1 (CET 1) calculated as the institution's equity and retained earnings [*Regulation (EU) No 575/2013…*, article 25]. The new solutions also introduced a new financial tool: a leverage ratio. The aim of the leverage ratio was to restrict banks from taking on excessive debts in the financial markets [*Regulation (EU) No 575/2013…*, article 429].

Four capital buffers were established by the new regulations. First of them was the countercyclical capital buffer which adjusts the capital requirements towards banks to the current stage of the economic cycle. It aims to mitigate the potential excessive credit risk exposures. The countercyclical capital buffer rate is set between 0–2,5% of the total risk exposure amount and is managed within its limits by the home country supervisory authorities [*Directives 2013/36/EU…*, article 136].

Two of the created buffers relate to the „Global Systemically important Institutions" (G-SIIs), and the „Other Systemically Important Institutions" (O-SIIs). These institutions are the largest and most important to the global economy. Their failure could cause a collapse of the entire financial system [*Directives 2013/36/EU…*, article 131]. The lists of the G-SIIs and the O-SIIs are announced and monitored annually by the EBA. Every member state is responsible for identification the G-SIIs [*Directives 2013/36/EU…*, article 137]. The systematically important institutions are divided into five buckets, with a different buffer value respective to their risk exposure value. According to the article 137 of the Directive, the buffer value is 2% for the O-SIIs and 3,5% for the G-SIIs.

The last buffer created by the CRD IV/CRR package was the systemic risk buffer. It relates to the long term financial sector condition of each member state or minimum one segment of the sector [*Directives 2013/36/EU…*, article 133]. The systemic risk buffer was created to prevent and at the same time mitigate long-term systemic risks. Each member state is responsible for a definition of the applicable value of this buffer. The minimum value is 1%, but the directive grants a right to increase this buffer by up to 5% [*Directives 2013/36/EU…*]. It should be noted that although the national authorities have a right to adjust the systemic risk buffer, its values may affect competition on the internal market. Any value exceeding 3% needs to be notified to the ESRB [*Directives 2013/36/EU…*].

The next step in reforming the financial safety net in the European Union was to create a banking union. The idea of creating the banking union was presented in the end of the 2012 and intended to complement the monetary and economic integration in the EU [read more in: Van Rompuy 2012, retrieved: 29.10.2016]. The banking union consists of:

– The Single Supervisory Mechanism, focussing on the prudential supervision over the biggest banking groups.

– The Single Resolution Mechanism, responsible for effective resolution of the failing credit institutions.

– The European Deposit Insurance Scheme. This pillar has been established through harmonising the protected deposit threshold along with the pay-out procedures in each Member State.

3. NET IMPACT ON FINANCIAL STABILITY

Speculations over a potential impact of the new regulations have dominated the discussions in Brussels for a long time. Different sides of the discussion were arguing whether the new liquidity and capital thresholds could actually increase stability of the financial sector. Some stakeholders argued that the capital`s necessity to increase the equity of some institutions was too much of a burden, considering the marginality of their liquidity at the time. It became apparent that the introduction of new thresholds would be gradual and that the actual impacts needed to be properly quantified, so as not to worsen the economic condition of the financial sector.

The EBA began collecting different aggregated data from large financial institutions in Europe in order to monitor a potential impact of implementing the Basel III recommendations. Results of the annual monitoring exercise are published at the end of each year in a form of a report analysing the state-of-the--art compliance of different financial institutions with new standards. The analysis focuses on both the capital ratios (CET 1, Tier 1) and the liquidity ratios (LCR, NSFR). Tier 1 capital includes the CET1 positions, as well as non-controlling stocks and reserves. The Liquidity Coverage Ratio shows a coverage of banks' short-term obligations by its highly liquid assets, whereas the NSFR presents an adequacy of banks' stable (longer-term) funding to a corresponding capital, required over the same term [read more in: Basel Committee of Banking Supervision, 2013, *Basel III: The Liquidity*…; Basel Committee of Banking Supervision, 2014, *Basel III: The net stable*…].

The 2015 Basel III Monitoring Exercise Report proves that most banks have managed to comply with the new capital requirement, with considerably small capital shortfalls for some institutions (see table 1). It would therefore seem that the pace in which the capital thresholds introduced was adequate to the financial capacity of different banks. Considering the LCR ratio, 98% of the analysed banks were compliant with minimum 70% of requirements. It should also be noted that around 79% of these banks are already compliant with the full 100% NSFR requirements.

	CET1	Tier 1	Total	LR	LCR	NSFR
Group 1	**12.4**	**13.1**	**15.9**	**4.7**	**126.8**	**105.5**
Group 2	**13.6**	**13.9**	**15.5**	**5.6**	**169.3**	**112.7**
- Large	13.5	13.8	15.5	5.7	171.4	110.4
- Medium	14.2	14.4	16.1	5.9	183.7	117.4
- Small	13.6	13.8	15.2	5.0	150.6	115.9
Total	**12.7**	**13.3**	**15.8**	**4.9**	**133.7**	**107.0**
- G-SIIs/O-SIIs	12.6	13.3	15.9	4.7	129.9	106.3

Table 1. Capital and liquidity ratios of different European credit institutions (in %)

Source: European Banking Authority [2016, pp. 7].

The most recent EBA monitoring results prove that in fact different thresholds could even be met by most institutions faster than the legislation obliges them to. What the test does not touch upon however, is the impact on revenues generated by the affected sector and the effective increase in financial stability in Europe.

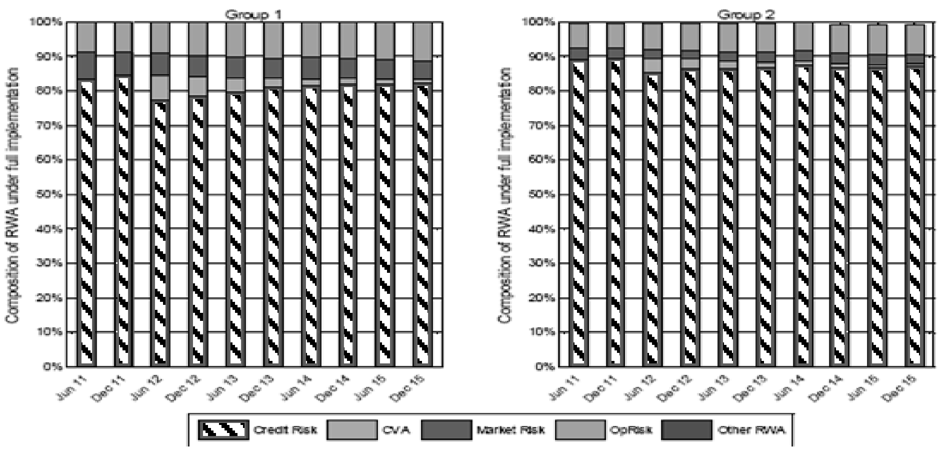

Figure 1. Composition of the risk weighted assets of the credit institutions in Europe (in %)

Source: European Banking Authority [2016, pp. 25].

One would assume that strict regulations towards liquidity and capitalization might not only not reduce the engagement of G-SIIs/O-SIIs in the most risky, but most profitable activities, but in fact enhance it. The greatest investment default risk for banks lies in the credit risk exposure (see figure 1). The way this risk is assessed and managed is a matter of the institutions' internal procedures. Bearing that in mind, it is questionable whether the net impact on stability is positive or negative, and whether a default in a number of risky credits can be absorbed by these institutions without resorting to state aid.

Figure 2 depicts a comparison of the total values of Risk-Weighted Assets (RWA) and corresponding Tier 1 values changing over time for five of the largest credit institutions in Europe (single scale for both values was maintained on purpose). It is visible that except for UniCredit and Nordea, the value of RWA has either closed down to the level from 2009 (ING) or grown (Deutsche Bank, Credit Agricole). While it is clear that not all of these banks' assets are risky and pose a threat, it is debatable whether the Tier 1 ratio of even 15% (fully-loaded basis) would be enough to save these large institutions from trouble in times of crisis.

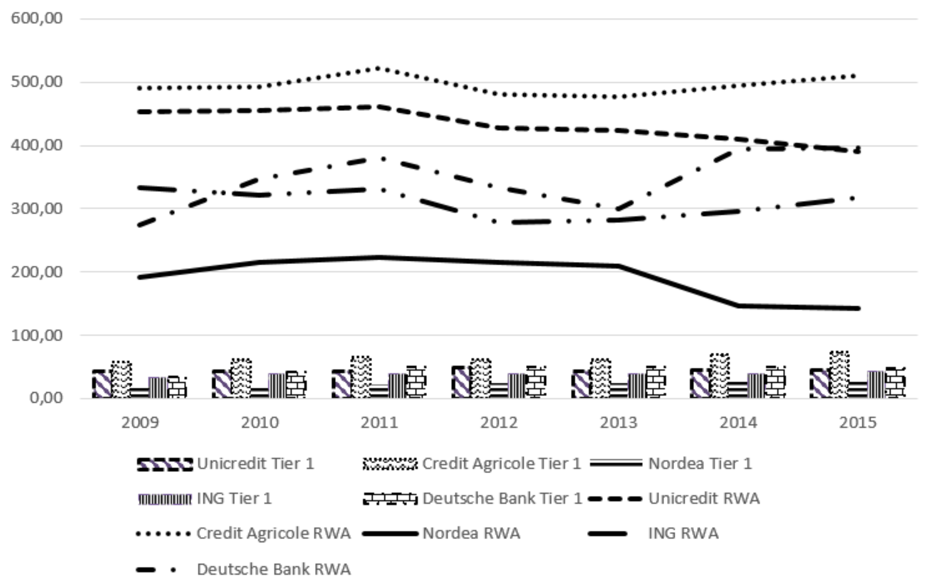

Figure 2. Risk-Weighted Assets and Tier 1 value comparison (in bln EUR)

Source: own elaboration based on *The Annual Reports of UniCredit Group*…, *Credit Agricole Group*…, *Nordea Bank*…, *ING Group*…, *Deutsche Bank for the years 2009–2015* [retrieved: 20.10.2016].

It could be argued that the internal risk-exposure assessment procedures analyse the risk of default from a „business as usual" perspective, whereas a global economic shock would affect these values significantly. Until now, the debt instruments issued by the governments of the Euro-area are treated as zero-risk, and constitute a significant part of these banks' capital [European Political Strategy Centre, 2015, pp. 1]. Such approach is highly controversial, given the continued solvency difficulties of different countries in the Eurozone.

The value-at-risk parameter for the interesting case of Deutsche Bank (DB) has been presented on figure 3. At a glance, it would seem that the graph presents a true success-story of Deutsche Bank's adjustment to the risk exposure [*Regulation (EU) No 575/2013…*, article 26]. Then why is the story different, and at the time of preparing this article Deutsche Bank is facing serious solvency issues?

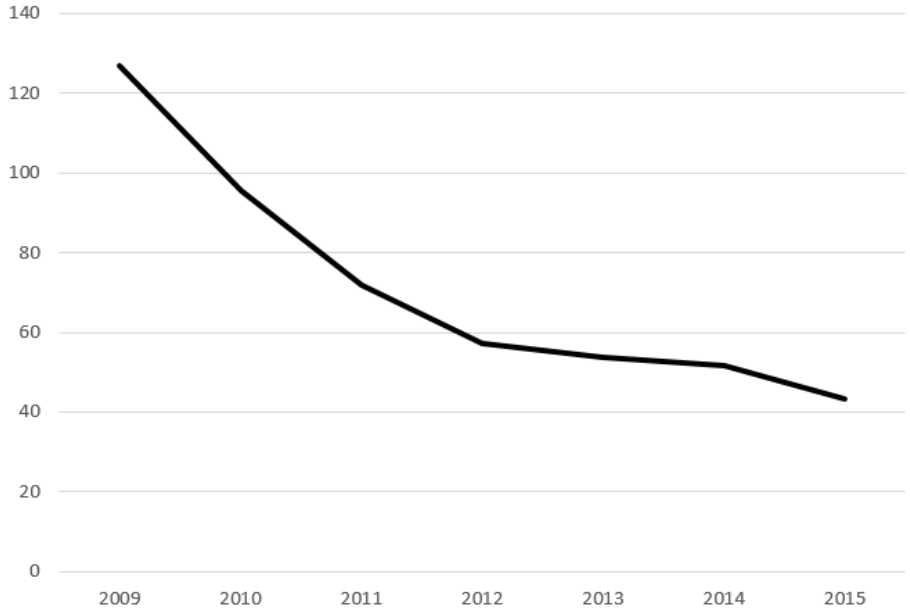

Figure 3. Deutsche Bank's average one-day Value at Risk (in EUR mn)

Source: own elaboration based on *The Annual Reports of Deutsche Bank for the years 2009–2015* [retrieved: 20.10.2016].

The analysis of the story should start at the time of the financial crisis. Although not bailed out directly, Deutsche Bank, being a counterparty to the American Insurance Group (AIG), was rescued through a 11,8 billion USD pay-off by AIG using money from its own bail-out in 2008 [Prins 2013, pp. 62]. The situation already highlighted by DB's risk exposure despite claims of being solvent and priding itself of not resorting to state aid to endure the crisis.

The bank continued to limit its risk exposure to levels below 40% of its value from 2009, yet there are a number of issues that need to be taken into account here. Firstly, the very structure of Deutsche Bank's capital during these years did not reflect the risk associated with the bank's huge exposure to the toxic debt of different Euro-area countries. Secondly, the value at risk parameter does not reflect, among others, the fines that may be imposed on the bank. These could be a serious blow to its liquidity (e.g. the 2,5 billion fine on Deutsche Bank for market manipulations in 2015). Finally, the value-at-risk parameter presented on the graph is the average value calculated by the bank itself, whereas the maximum values of this parameter calculated for these years were higher by as much as 20 million euro/day. With countries like Greece still struggling with the debt crisis, and much higher fines being imposed on the bank in September 2016 by the US Department of Justice, Deutsche Bank is facing a serious crisis, threatening the World's financial stability once again.

CONCLUSIONS

The safety net in Europe has severely restricted the capital and liquidity requirements for domestic financial institutions. This was an important decision, to attempt to make the so-called too-big-to-fail more responsible for their own operations again. At the heart of this net, the establishment of the Banking Union was an important step forward in terms of integration. Perhaps, it would not be possible without the consequences that had to be faced by many EU countries during the crisis.

That being said, the net impact of strict regulations to strengthen the financial stability is yet to be tested. Even after the capital requirements are fully implemented, there is no guarantee, that the higher equity level of the most important financial institutions will allow them to cover the losses on risky investments, especially considering the share of credit risk exposures in their portfolios. In other words, a severe breakdown of the economic situation in some capital-intensive branches of the industry (e.g. construction) may result in a domino effect despite covering part of the default from the additional capital.

The principles of the new safety net in Europe are a step in the right direction, although certain deviations from the strict regulations undermine the effectiveness of the new arrangements. Perhaps one of the most risky moves on the account of the EU Member States was agreeing to treat all the bonds of the Eurozone as Tier 1 capital. Insolvency of any of the euro-area countries under the existing arrangements would undoubtedly result in an uncontrolled panic on the financial markets and presumably in a run from the banking system. In order to maintain credibility of the financial sector, all of the risks associated with credit institutions' operations need to be properly taken into account.

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REFORMA EUROPEJSKIEJ SIECI BEZPIECZEŃSTWA FINANSOWEGO A EKSPOZYCJA NA RYZYKO SYSTEMOWO WAŻNYCH INSTYTUCJI FINANSOWYCH

Abstrakt

Wraz z przedstawieniem surowych wymogów kapitałowych i płynnościowych wydawałoby się, że Europa wzmocniła kontrolę nad własnym sektorem finansowym. Komisja Europejska prawidłowo dostrzegła okazję do wzmocnienia integracji pomiędzy państwami członkowskimi poprzez utworzenie unii bankowej. Jednak pytanie, czy bezpieczeństwo sektora finansowego faktycznie wzrosło, pozostaje otwarte. Kapitalizacja i płynność największych banków niewątpliwie wzrosła, jednak może to mieć swoje konsekwencje. Spełnienie nowych wymogów jest kosztowne, jednak oczekiwania odnośnie dochodowości banków pozostają wysokie, zachęcając do poszukiwania ryzykownych, lecz wysoko rentownych inwestycji. Ten artykuł przedstawia propozycję oceny wypadkowego wpływu na bezpieczeństwo.

Słowa kluczowe nadzór, sieć bezpieczeństwa, bufor kapitałowy.