FINANCIAL CRISIS – IS THERE A DIFFERENT APPROACH IN THE U.S.A. AND EUROPE? [1]

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Abstract

The recent financial crisis started a detailed discussion to find its basic causes as well as how to predict future crises and how to minimize their negative impacts. The United States has reacted to this crisis differently than Europe. Policy of deregulation, moral hazard of managers in large financial holding companies and too-big-to-fail problem are among the most often mentioned reasons for the financial crisis in the U.S.A. In this connection, the structure of the financial sector is discussed. In EU countries, the institutional organization of regulation and supervision is a center of recommended reforms and international coordination of measures taken by national regulators and governments is underlined.

Key words: *financial crises, moral hazard, too-big-to-fail problem, institutional organization, different reaction*

JEL Codes: *G18, G28, L51*

1. Introduction

We can find many reasons mentioned as basic sources of financial crises as well as many different recommendations how to prevent future financial crises. Various studies, which have different philosophical and methodological approaches, take care and mention quite different features of financial crises. But above all recommendations about how to analyze long-term systemic risk are very different.

The basic question about regulation and supervision is whether a long-term broadening, deepening and strengthening of regulation and supervision is the right way that reduces systemic risk and negative impacts of possible financial crisis. The fact is that it is quite difficult to refuse the view that in today's economies banks and other financial institutions are very important and that their collapse and possible collapse of the whole

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financial system could have negative social impacts and could bring many negative externalities (systemic risk – negative impacts proliferate through capital markets, collapse of liquidity, clearance of assets, financial losses, break in financial flows). On the other side the economic theory and practice gave a principal answer on what and how to regulate a long time ago. More and deeper regulation means less flexibility and to an excessive degree regulated economies are less effective. That is the basic reason why preference is generally given to the market economy. But in such a case the cyclicity is an integral part of any economic development. No regulation is able to stop crises or financial crises. Regulation and all interventions are not omnipotent and the last crisis just confirms this fact.

2. System and Structure of Supervision

Governments (central banks) do not look at too penetrative steps with favor because of above mentioned negative externalities and potential social-economic impacts brought about by large financial conglomerates collapses and because of moral hazard. The intention to eliminate all these risky situations could finally mean that governments are saving banks and other large financial institutions without considering related costs. In connection with financial crises the too-big-to-fail problem seems to be the key element. And without any doubt moral hazard of management of large financial conglomerates is one of the most important reasons of recent financial crisis. Moral hazard is firmly connected with too-big-to-fail problem.

Despite of these facts above all coordination of used measures in member countries and changes in regulation and supervision are discussed in the EU. The true is that quite non-transparent structure of regulation and supervision appeared due to 10 new countries joining the EU in 2004. The national model of regulation and a single European pass mean to rely on more than 75 independent national supervisors, to expect the same quality of their supervision, the same general view and attitude to regulation and supervision and the same consistency in used measures. Nevertheless the institutional arrangement of supervision itself is very miscellaneous in EU member countries (table). Changes in the EU that can influence institutional arrangements in many countries are not the only reason why to follow carefully development in this area. As data in table confirm integrated supervision in central bank is not the only possible arrangement and for sure it is not the perfect solution. Majority of EU countries having an integrated supervision located it outside the central bank – 14 countries used such arrangements in the end of 2009. The number of these countries is continuously growing[2] while the integrated supervision is located only in 3 countries (Ireland, Slovak Republic and Czech Republic) in central bank.

This is one of reasons why national and global regulation is discussed in EU countries. Further steps in regulation of financial industry are closely related to the Lisbon Treaty ratification. While opponents of the Lisbon Treaty were gradually loosing their strength and influence it seems that opponents of global regulation of financial sector are more and more powerful. The backfire *On Financial Supervision in the EU Report* (Larosiere Group Report) presented by a group of experts nominated by European Commission in February 2009 confirms this. Despite of many objections the impacts of recent financial crisis and the Lisbon treaty ratification could be rudiment of real global regulation that is necessary at least on the EU level. It is evident that any coordination among particular groups of countries (including EU member countries) was absolutely missing during the recent crisis.

As an example deposit insurance can serve. Since 1995 the EU's limits of deposit insurance were minimally 90 % of deposits and the minimum amount of 20 000 EUR. Because of moral hazard in most countries limit of 90 % insured deposits was settled. Limits are considered the key element reducing systemic risk in most countries as well as in many international institutions. Practical arrangements and steps of particular countries were not coordinated in this area and even brought further destabilization. The proclaimed important advantage of EU proceedings that allows member countries to set more strict rules and limits then those set by EU Directives also seems to be very disputable.

The financial crisis caused that many countries has changed the limits in an attempt to avoid bank runs and started to guaranty 100 % of deposit for any amount of deposit and in some countries the guaranty started to cover companies, too. Already in October 2008 all deposits started to be guaranteed after Ireland also in Greece, Germany, Austria and Denmark. Higher limits of deposit insurance were settled also in Great Britain, the U.S.A. and Sweden. Since December 2008 both limits were changed in the Czech Republic as well (100 % of deposit, minimum of 50 000 EUR). Steps done by Great Britain were triggered by huge flow of money from British banks into "safe" (secured) banks in Ireland and changes in Austria and Denmark triggered by worries of the same if limits are not changed as in Germany. It is evident that competitive environment was violated and that coordination was absolutely missing. The same disordered proceeding of regulation concerns the U.S.A. and its attitude to

[2] In Poland, the sectoral system of supervision was replaced by a supervison intergrated out of the central bank in 2008.

Lehman Brothers and AIG. The collapse of Lehman Brothers was maybe less costly for the U.S.A. government but for many developed countries to rebuild trust and stability of their own economies was quite difficult and costly problem.

The above mentioned examples confirm that international cooperation of anti crises steps is really a serious and very specific topic. There was a lot of arguing about it during the recent financial crisis and discussions still go ahead but the implementation is far behind needs. Global regulation and supervision is one solution.

This does not mean that national and international institutions should not care about these issues. For sure they should try to predict crises and to look for steps that could mitigate their negative impacts. In the case of failing institutions authorities have basically an option to help or not to help, they have an option to save or not to save the institution using public money. At the foundation they should choose the lesser evil or the higher contribution between costs covered by public sources and reducing systemic risk. There is an immense problem and despite assurances that government (central bank) is helping to solvent but only illiquid institution we can always argue if the proceeding was correct. Even more we can see that costs of saving or collapse are in many cases nearly the same. And it is possible to argue if the collapse of large financial conglomerates hits an average household more and worse than huge payments of government budgets paid finally by tax payers and anyway accompanied by economic crises with unemployment and other negative impacts.

3. Systemic risk and too-big-to-fail problem

Despite of many attitudes to the financial crisis and many different recommendations it is generally agreed that the reform process cannot be judged and cannot succeed unless it substantially reduces systemic risk generally and, in particular, the too-big-to-fail problem. As to me the most important is to look for a structure of financial system in which without negative systemic impacts the bankruptcy of any financial institution will be possible. It is understandable that such a structure of financial system is absolutely different than the existing one. Such a financial system could not be based on several very large financial conglomerates having a key and unshaken position in economies of particular countries or regions. Financial holding companies are usually formed by a large commercial bank and another set of very large financial institutions not subject to prudential regulation.

It would be wonderful to have financial institutions that would not jeopardize the whole economy in the case of their bankruptcy contrary to the existing large financial conglomerates. This means to have institutions that could be allowed to collapse. No doubt smaller (and therefore also more transparent) financial institutions are principally solving the too-big-to-fail problem. Some regulators (for instance FRS's Governor Daniel K. Tarullo) even consider the too-big-to-fail problem front and center as the regulatory reform effort moves forward.[3] What is interesting that American government (despite of its intention to increase financial sector regulation) is starting to prepare financial system reform promising that no bank would be so big that it could not collapse. The U.S.A. Minister of Finance T. Geithner intends to make the FRS (Federal Reserve System) more powerful and to enhance its competence on all financial institutions. The new legislation discussed in November 2009 in Congress is increasing power of FRS and Federal Deposit Insurance Corporation (FDIC). According to this new legislation banks, hedge funds and other financial institutions with capital over 10 mld. USD should participate in the process when institutions in troubles are saved. The 10 mld. USD limit should protect small local banks against purposeless costs. FRS should have power to split large financial institutions in the case they are risky for the whole system and to order to financial institutions the necessary value of their capital or level of liquidity.

At the same time the intention of T. Geithner is to remove the protection of consumers from FRS on a newly established institution and to take away from FRS free and final decision to help to any failing financial institution. FRS should keep the position of lender-of-last-resort but any credit to illiquid but solvent institution should be approved by Ministry of Finance. The approval could be given only in the case of "complicated" situation on financial markets and only to solvent companies. Unfortunately T. Geithner does not say how to identify solvent companies and how to learn there is a complicated situation on financial markets. Anyway a regulatory change is strongly demanded in the U.S.A. so that any firm whose failure could have serious systemic consequences ought to be subject of regulatory requirements.[4] The result should be that tax payers will not be finally paying loses of private companies.

One of possible ways how to response to the too-big-to-fail problem are certainly regulatory changes. It is clear that some regulatory requirements are not sufficient, but to find an appropriate metrics for such requirements is evidently very difficult. Above all

[3] TARULLO, D. K. Confronting Too Big to Fail, p. 1. Speech of the Governor, October 21, 2009 (http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm).
[4] TARULLO, D. K. Confronting Too Big to Fail, p. 2. Speech of the Governor, October 21, 2009 (http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm).

requirements of Basel Committee (as capital adequacy) seem to be very complicated and not very flexible[5]. Because of very rapid development of financial sector and variety of financial institutions as to me this is not the way how generally protect financial sector and economies against crisis. On the other hand regulation focused on creation and preservation a more transparent structure of financial sector could be a corresponding answer. But to establish such a regulation seems to be more complicated in comparison to other types or arrangements of regulation.

In financial industry the concentration is one of the highest among all industries. It is understandable that big companies need big banks and today's financial system cannot exist without big banks. But most ordinary clients do not use and do not need most sophisticated products of large financial conglomerates and other financial institutions. Dozen of those products are very risky and stand partly behind the financial crisis. But products demanded by most ordinary clients could be offered by smaller, more secured and safe and much more transparent banks and other financial institutions than the large financial conglomerates are. Safety of deposits standing behind most too-big-to-fail activities of central banks and governments could be solved by these institutions. Also credit unions could play much more important role in financial intermediation. In the Czech Republic the existence of such a kind of institutions is partly in doubt because of negative experience from the beginning of transformation process.[6] In postwar period credit unions expanded in some countries - despite this their role is everywhere limited. The structure of financial industry with relatively small competitive banks, credit unions and other financial institutions is evidently missing in many EU countries. And exactly this financial sector's structure formation should be supported by regulation and supervision creating conditions for its long-term existence on national level, the EU level and worldwide. Such a structure of financial industry means to deprive existing large financial conglomerates a lot of power, to restrict their privileged position. Practical examples of failing large financial conglomerates (nowadays considered too-big-to-fail) would probably be necessary. This means to stand strongly against moral hazard and too-big-to-fail problems.

[5] É. TYMOIGNE (2009) argues that any meaningful systemic and prudential regulatory changes should focus on the analysis of expected and actual cash flows (sources and stability) rather than capital equity. He also argues that pyramid Ponzi processes (generally it means that servicing of a given amount of outstanding debts requires a growing amount of refinancing operations and/or asset liquidation at rising prices) always collapse and therefore should not be allowed to proceed.

[6] In Slovakia allegedly first credit union around the world was established (HORVÁTOVÁ, E. *Bankovníctvo*. Žilina: GEORG, 2009, s. 11-12). But after 1990 the legislation even does not allow existence of credit unions.

One of ways following this approach is as to me split demanded by governments in some institutions and companies. Governments are trying not only to reduce bonuses to be paid in large financial conglomerates (Goldman Sachs Group, Morgan Stanley, JPMorgan Chase), but also increase efficiency in companies and institutions where huge amount of money was pumped to save them. There are examples of this proceeding in Europe as well.[7] The sale of more than 700 branches of British financial institutions The Royal Bank of Scotland, Northern Rock and Lloyds Banking group in several years is called a revolution in British banking. They have to do it to justify government help. The sold property will be secured for new investors in British banking industry. According to the plan there should be 2-3 new banking groups in Britain in 5 years. Agreement between ING group and EU Commission assumes split of ING Group in 2 divisions; the insurance division should be sold in less than 4 years. The ING should stay as a bank focused on European market with smaller divisions in other parts of the world.

4. Conclusion

The recent financial crisis and following regulatory steps of international institutions as well as governments and central banks confirm that to enhance market discipline must be considered as the most important step to secure financial stability. Market discipline is closely connected with transparency and a strict rejection of moral hazard and too-big-to-fail problem. Better coordination of supervision and supervisors and maybe global regulation may have supportive role but the role of market discipline is the central element of any financial system regulation and prevention of systemic risk.

[7] Bankovnictví, 2009, č. 40.

Institutional structure of supervision in the EU countries (November 2009)

	Supervision over			
	banks	insurance industry	financial market and investment services	
Belgium	**Banking, Finance and Insurance Commission**			stand-alone integrated supervisor (2002)
Bulharsko	central bank	integrated institution		sectoral model (2003)
Czech Republic	**Czech National Bank**			integrated supervisor under the central bank (2006)
Denmark	**Danish Financial Supervisory Authority**			stand-alone integrated supervisor (1988)
Estonsko	**Financial Supervision Authority**			stand-alone integrated supervisor (2002)
Finland	**Financial Supervision Authority**			stand-alone integrated supervisor (2003, 2009)
France	unitary agency	unitary agency	unitary agency	modified sectoral model (2003)
Ireland	**Central Bank and Financial Services Autority of Ireland**			integrated supervisor under the central bank (2003)
Italy				specific model of supervision (1993, 1998)
Cyprus	central bank	unitary agency	unitary agency	sectoral model (1997, 2002, 2007)
Litva	**Financial and Capital Market Commission**			stand-alone integrated supervisor (2001, 2006)
Lotyšsko	central bank	unitary agency	unitary agency	sectoral model (1992, 2004, 2006)
Luxembourg	**Commission de Surveillance du Secteur Financier**			stand-alone integrated supervisor (1998)
Hungary	**Hungarian Financial Supervisory Authority**			stand-alone integrated supervisor (2000)
Malta	**Malta Financial Services Authority**			stand-alone integrated supervisor (2002)
Germany	**Federal Financial Supervisory Authority (BaFin)**			stand-alone integrated supervisor * (2002)
Netherlands				specific model of supervision (2007)
Poland	**Polish Financial Supervision Authority**			stand-alone integrated supervisor (2008)
Portugal	central bank	unitary agency	unitary agency	sectoral model (1998, 2008)
Austria	**Financial Market Authority**			stand-alone integrated supervisor (2002)
Rumunsko	central bank	unitary agency	unitary agency	sectoral model (2004)
Greece	central bank	unitary agency	unitary agency	sectoral model (1992, 2008)
Slovakia	**Slovak National Bank**			integrated supervisor under the central bank (2006)
Slovinsko	central bank	unitary agency	unitary agency	sectoral model (1999, 2002, 2007)
Spain	central bank	unitary agency	unitary agency	sectoral model (1994, 1998, 2009)
Sweden	**Swedish Financial Supervisory Authority**			stand-alone integrated supervisor (1990)
Great Britain	**Financial Services Authority**			stand-alone integrated supervisor (1997)

* The Bundesbanka keeps the strong position in banking sector supervision, above all in prudential supervision

Under unitary agency we understand agencies not combined with any other agency(ies). They are specialist, dedicated supervisors for each area of the financial system (banks, insurance and security firms).
Stand-alone integrated supervisor is single supervisor who oversees the entire financial sector (banks, insurance and security firms).
Under sectoral model we understand supervision of unitary agencies.

Source: web sites of central banks and financial supervisors (http://www.bis.org)

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