Consolidation of Financial Markets Regulation in the European Union

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Abstract. **The objective of the article is to analyse the consolidation process in financial markets regulation in the European Union. The regulation system is viewed as an adjusted balance of preventive and protective framework. The consolidation of regulation is analysed at national and supranational level. The general trend of shifting to more consolidated national regulation models is confirmed. Conclusion is made that creation of Banking Union in Euro Area may lead to two speed consolidation process. The regulation models of the Baltic States are compared, some consequences of joining Euro Area are analysed.**

Index Terms: **financial markets regulation, regulatory reform in the European Union, macro-prudential supervision**

JEL classification: **G18 - Government Policy and Regulation; G28 - Government Policy and Regulation**

I. Theoretical Approach to Financial Markets Regulation

Regulation of financial markets should be able to detect and prevent systemic risks arising across national borders and across traditional business sectors and would have powers and resources to deal with the problems of financial institutions which are "too big to fail". Regulatory reforms have to ensure efficiency and competitiveness of financial markets, otherwise overregulation would become too expensive for economy. Regulation of financial markets can be understood as combination of preventive and protective measures applied by regulatory institutions (Heremans, 1999). According to Dirk Heremans, the preventive or *ex ante* measures, consist of structural and prudential procedures. Structural measures regulate entry into business, scale of operations, define product and geographical restrictions. Prudential measures embrace portfolio restrictions (capital adequacy, liquidity requirements and diversification), disclosure, business conduct rules, inspection and examination.

The protective or *ex post* measures are provided by lender of last resort (government or central bank) and deposit insurance and suggest that certain funds are accumulated or become immediately available to halt contagion. Therefore, effective regulators should not only gain powers to supervise participants of the market and impose regulations, but dispose sufficient funds to restructure and resolve troubled institutions.

The efficiency of regulator depends on how a regulatory model is adjusted to conditions of a certain market. Regulatory functions can be distributed among various agencies or concentrated in a single body. Optimality of the model is determined by relevance to business structure, scale, technologies and practices of given market. Of various approaches to the study of national regulatory models two concepts are broadly accepted. The expert Group of Thirty applies "Four Approaches" in supervision of financial markets: institutional, functional, integrated and "twin peaks" approaches (Group of Thirty, 2008). Four supervision models do not cover all regulatory functions of certain market, so are complimented by the country studies of roles of central bank and deposit insurance. Alternative concept suggested in World Bank studies specifies sectoral, integrated and "twin peak" models (World Bank, 2013). Within sectoral model, which describes traditional by-sector regulation (banking, security, insurance) few modifications are specified. Sectoral and integrated models are complimented by country studies of business conduct regulations. Both reviewed concepts regard integrated and "twin peaks" models as representing higher consolidation in comparison to sectoral (or institutional/functional models. In our paper we shall follow World Bank classification of supervision and regulation models. \

II. Analysis of Changes in Member States' Supervision Models

During last decade the landscape of supervision of financial markets in the European Union was substantially changing. According to Martin Melecky and Anca Podpiera there was a general world trend of shifting from pure sectoral to more consolidated models of supervision of financial markets (Melecky & Podpiera 2012). To summarize developments in the EU countries from 1999 to 2010 we use the data of World bank study (World Bank, 2013) presented in Table 1.

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Since 1999 to 2010 the number of countries applying sectoral model of prudential supervision decreased from 17 to 6. Sectoral model was not newly introduced in any country. In the same period the integrated models were actively introduced. While in 1999 Financial Supervisory Authority (FSA model) independent from central bank was used in just 3 member states, in 2010 it was applied in 12 countries. Consolidation of prudential supervision in central banks (CB model) was not practiced in 1999 at all, while in 2010 there were 4 countries using such model. The FSA model popularity was promoted by creation of Financial Services Authority in the United Kingdom, where it functioned between 2001 and 2013, and establishment of Federal Financial Supervisory Authority (BaFin) in 2002 in Germany. After 2010 the process of introduction of more consolidated models continues. Thus Lithuania transited to integrated CB model in 2012. It is necessary to note that consolidation trend is dominating, but there are important variations. After Financial Crisis of 2007-2008 the UK supervision authority was reformed. In April 2013 functions of Financial Services Authority were transferred to newly created Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), the last one is being part of Bank of England.

TABLE 1
CHANGES IN NATIONAL PRUDENTIAL SUPERVISION MODELS, EU-28, 1999-2010

Type of supervision model	Countries, applying the model in 1999, number of countries in brackets	Countries, applying the model in 2010, (number of countries)
Sectoral [1]	Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, France, Germany, Greece, Hungary, Latvia, Lithuania, Netherlands, Poland, Romania, Slovak Republic, Slovenia, Spain (17)	Cyprus, Greece, Lithuania, Romania, Slovenia, Spain (6)
Sectoral, partly integrated, banking outside CB [2]	Austria, Belgium, Luxembourg (3)	Luxembourg (1)
Sectoral, partly integrated, banking within CB [3]	Finland, Ireland, Italy, Portugal, Malta (5)	Bulgaria, Croatia, France, Italy, Portugal (5)
FSA [4]	Denmark, Sweden, United Kingdom (3)	Austria, Belgium, Denmark, Estonia, Finland, Germany, Hungary, Latvia, Malta, Poland, Sweden, United Kingdom (12)
CB [5]	none	Czech Republic, Ireland, Netherlands, Slovak Republic (4)

Notes to Table 1. [1] Sectoral supervision by three sectors. [2] Partial integration, where two financial sectors are supervised by the same institution, banking is supervised by an agency outside of the central bank. [3] Partial integration, where two financial sectors are supervised by the same institution, banking is supervised within the central bank. [4] Integration of the main financial subsectors' supervisions in an "FSA" (Financial Services Authority type), a supervisory agency separate from the central bank. [5.] Integration of the main financial subsectors' supervisions into the central bank.

Source: Composed by author from the data from World Bank Global Financial Development Report 2013.

In this paper we analyse the changes in supervision models only and do not cover business conduct analysis. It should be noted that twin peaks model is applied in Netherlands since 2003 and in Finland since 2009. Restructuring of FSA in the UK in 2013 also introduces twin peaks model. We may conclude that generally EU countries were following the trend found by Melecky and Podpiera. These results also conform to supervisory structure analysis of ECB (ECB, 2010). The shifts in national models application is illustrated in Figure 1. From prevailing use of less integrated sectoral and partly integrated sectoral models in 1999 there is a definite move to more integrated FSA and CB models by 2010.

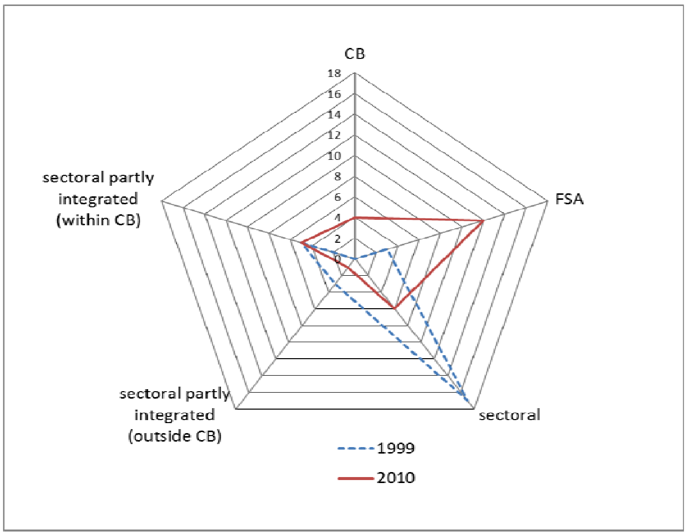

Figure 1. Shifts in supervision models application in EU-28 (1999-2010)

III. Developments in preventive and protective branches in the regulatory system in the European Union

Foundations of pan-European preventive framework were laid soon after creation of common European currency. Process known as the four level Lamfalussy supervision process was launched in 2000 to promote Financial Services Action Plan and united four levels of decision making. Third Level expert committees were organized for micro-prudential supervision of relevant financial market sectors. Together with certain successes in integration of financial markets supervision in the EU remained divided by sectors and national borders. The process of creation of supra-national regulation system in the European Union accelerated after 2007-2008 financial crises. Based on Report of de Larosiere Group of 2009 (Report, 2009) new framework of macro- and micro-prudential supervision and regulation was introduced since January 2011. The micro-prudential arms are represented by European Supervisory Authorities (ESA), consisting of refurnished and strengthened sector regulators, replacing former expert committees: 1) European Banking Authority; 2) European Securities and Markets Authority; 3) European Insurance and Occupational Pensions Authority. The macro-prudential arm of supervision and regulation, represented by the European Systemic Risk Board , is responsible for safeguarding financial stability in the EU. Thanks to its structure, the Board creates a new mechanism of interaction between the European Commission and the European Central Bank.

Assessing the new EU supervision system we may note that ESA authorities have got more powers to implement prudential control, prepare rescue plans, arrange refinancing, while ESRB has mostly advisory powers. The significance of the EU supervision bodies is shadowed by creation of more integrated system of supervision and regulation within Euro Area. Formation of Banking Union is accelerating and after the legislative confirmation of Single Supervisory Mechanism in October 2013 (Council of the EU, 2013) the lag in consolidation speed between Eurozone members and non-members deepens. With ECB to monitor directly around 130 Eurozone banks the functions of European Banking Authority certainly diminish and asymmetry at least in banking supervision grows.

EU sovereign debt crisis of 2010-2011 and efforts to stabilize Eurozone proved that that preventive branch of regulation should be developed alongside with protective branch. In order to meet cross-sector and cross-border financial risks and effectively deal with problems arising from sovereign debts, regulators should have access to funds larger than resources of separate national governments or national central banks. Due to strong national egoism direct fiscal transfers between the member states are impossible. Hence rescue mechanisms in the EU work on lending basis. Salvation of problem economies requested various schemes engaging European stabilization funds, European Commission funds, International Monetary Fund (IMF) as well as bilateral agreements between creditors and borrowers. The first temporary mechanism of fund transfers within the Eurozone was created in June 2010 by establishing of the European Financial Stability Facility (EFSF). EFSF held active operations till June 2013. The programs facilitated rescue of national finance systems of Ireland, Portugal and Greece. Notably, in Ireland and Portugal cases the funds were mostly provided to refinance government support to national banking sectors. In September 2012 was launched permanent European Stability Mechanism (ESM) scheduled to replace the temporary EFSF. After EFSF stopped active operations in July 1, 2013, new mechanism ESM is the single facility providing new rescue programs for Eurozone member states. ESM, which can be labelled as “IMF of the Eurozone” has a subscribed capital of €700 billion with effective lending facility of € 500 billion. ESM has already been engaged in support of Spain finances and in Cyprus crisis resolution, in fact to refinance relevant governments’ support to national banks.

The use of ESM funds as for rescue of financial sector is limited by condition that only the government of the member state can be a borrower from ESM. ESM is tailored to substitute fiscal transfers and can be used for recapitalization of financial institution only as an emergency instrument until adequate mechanism is created. So the role of ESM in protective branch of regulation is limited and temporary.

While at first stages of financial crisis the function of the lender of last resort in Eurozone was carried by national governments, at later stages ECB started to play increasingly important role. Since the end of 2011 ECB launched long-term refinancing operations with total volume over €1 trillion, also provided unconventional Securities Markets Program and Covered Bond Purchase

Program. The full scale protective branch of regulation in banking sector may be created within the Banking Union of Eurozone member states (MEMO/13/679, 2013). It is worth to note, that of four projected pillars of Banking Union, preventive Single Supervisory Mechanism and single rule-book, and protective Single Resolution Mechanism and Deposit Guarantee Scheme, only SSM is introduced. Given the significance of banking sector in the EU, the priority of creation preventive mechanisms in this sector is reasonable, however two speed consolidation process in Eurozone and beyond Eurozone should be noted.

IV. CONCLUSION

The changes of financial markets urge rebuilding of regulation systems, restructuring both preventive and protective branches of regulation. In the European Union regulatory reforms imply changes at national and supranational levels.

The restructuring of supervisory institutions of member states at national level started more than decade ago and seeks to meet the systemic risks coming from cross-border and cross-sector operations of financial institutions. The decade long trend is the transition from sectoral models of supervision to more consolidated models with rising role of central banks.

At supranational level the European Union finalized many of supervision regulatory reforms started by Lamfaloussy process. The driving factor of the changes is the quest for adequate protective facilities, as ESM funds cannot be used for financial sector rescue at constant basis. There forms a trend of two speed consolidation process (Euro Area and beyond) in the process of Banking Union creation.

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