REFORMING THE BANKING SECTOR IN EUROPE

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Abstract
The global financial crisis that began in 2008 and the ongoing European Sovereign debt crises have brought many changes to the economic structures of EU member countries. As a result, the banking system was affected by the increase in bad loans and exposure to sovereign debt. Other practices in the banking sector which led them to a very precarious situation had to be changed. In this context European Institutions are taking measures to reform the banking sector. The banking sector has taken measures to reorganize its activities, to restructure their portfolios and to cut costs. In this article we will see what these measures are, what the alternatives are and how they are being implemented.

Keywords: reforming, banking, crisis, financial, Europe

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THE CURRENT SITUATION

The global financial crisis that is still showing its effects on the global financial and economic sectors began in 2007 – 2008 with under the form of the “credit crunch” or the “sub-prime mortgage crisis” in the United States and then spread around the world.

In Europe, it took the form of the Sovereign debt crisis, which still represents a great challenge for regulators, financial institutions, banking managers, governments and even to small businesses.

Many have looked into the reasons that triggered these crises in an attempt to understand, solve and prevent future repeats of such situations.

The Financial Crisis Inquiry Commission established in May 2009, after extensive research, presented to the President of the United States and to the U.S. Congress their findings on the then “current financial and economic crisis in the United States”. Their findings are very eloquent and clear and I think they are useful for understanding the measures that followed as well as the lessons to be learnt.

THE PROBLEMS OF THE BANKING SYSTEM IN EUROPE

The problems that are affecting the European Banking System can be summed up in the following paragraphs.

Many European Banks have taken on high amounts of government debt in their portfolios and this has made them very exposed to the Sovereign Debt crisis. In 2012 the Sovereign Debt crisis manifested itself also in the stock markets and the banks with the highest amount of sovereign debt in their portfolio have seen their stocks devalue when the yield of government bonds went up due to the increase in perceived risk of default of that particular country.

The next problem banks face is the worsening of the financial situation of the clients towards which they have exposures due to loans. In the worst possible cases, the clients default on their payments and their loans are not backed up by sufficient collaterals to cover their exposures, or not at all. This kind of problem has been encountered in a more pronounced manner due to the financial crisis. It is common practice for banks to request collaterals as guarantees to back their exposures. However, taking up a guarantee such as a real estate property in times of boom of the real estate market such as it was in 2007, implied accepting a higher value of that specific collateral, than today, when real estate prices have fallen to their lowest levels. Moreover, the fact that more banks try to execute such collaterals in bad market conditions makes it hard for them to sell them at a price level to cover their exposures. In normal market conditions, executing a guarantee enables the banks to cover their exposures towards defaulting clients. As a result of the wave of defaults on loans, banks have to constitute provisions/impairments.

Provisions are liabilities that show up in the balance sheet and eat up operating profits, basically showing up as negative results. These provisions are required according to the International Financial Reporting Standards when clients have overdue amounts of certain maturities and are constituted according to the time the client has not paid as well as to the guarantees available to cover the exposures. Even if European banks are starting to register positive results and operating profits, the difficulties of their clients drag down their overall financial results.

Because of the exposure to sovereign debt, banks have seen their costs of funding go up due to the fact that the cost of funding of the countries of which they hold government bonds went up. As a result, the risk of default of the countries' bonds in their portfolios increased the riskiness of those banks. In consequence, their cost of funding increased and banks became reluctant to finance each other.

The tighter capital requirements imposed on banks at central level, forced some of them to find ways to raise capital, either through increases in share capital as well as by other financial means, meant to strengthen their ratios. The Basel Committee and EBA (European Banking Authority) imposed such limits to banks in order to make them safer and stronger to be able to survive harsh financial and market conditions and crises.

Other than the external factors that drove the financial system to its knees, there are also issues to be solved in the way banks are run. Let's look now at how the European Banking System is to be reformed.

REFORMING THE EUROPEAN BANKING SYSTEM

There are more ways than one to bring change to the European Banking System as well as to the whole Banking System. However, the changes must be made towards the right direction and they must be made from two levels: at the level of the whole banking system and at the level of individual banks.

As far as the general approach is concerned the most acclaimed measure is the establishment of a European Banking Union.

The European Banking Union

Given the economic troubles of the European Financial System it has become obvious that the European Banking Sector is fragmented and therefore it is hard to implement global policies and measures in the whole system. As a result, one solution might be the constitution of a European Banking Union. The implementation of such measure implies that there should be a centralized banking supervision for the banks of all member states, rather than having national supervision.

As we were able to see in many situations in Italy, Spain and Greece the problems affecting the banks also affect the governments and vice versa. If the banks are in trouble or there is the risk of collapsing, then the government might intervene (especially for systemic financial institutions – too big to fail) with bailouts. Likewise, if the government is in trouble, and in need of financing, the banks can intervene acquiring government bonds (and not necessarily to help, but because the increase in interest rates due to higher risk makes them attractive). In any case, both the banking sector and the government become destabilized.

The European Banking Union has as objectives the improvement of supervision activities, smoother coordination of banking measures and better coordination in case of difficult market conditions. The European Banking Union has started to be implemented in January 2013 and will continue until 2018.

The idea of a Banking Union seems practical at the concept level, considering its ambitious objectives. However, the way in which it will be implemented will count very much.

Currently, the banking regulator for the 27 EU member states is EBA (European Banking Authority). From January 2013, this role is to be moved according to The Economist to the European Central Bank through the SSM (Single Supervisory Mechanism). For the banks outside the euro zone, they will continue to be supervised by their national supervisors.

As of now, it is hard to say to what extent the Banking Union will be successful, considering the fact that the European Union is so fragmented. Perhaps there should also be a Political Union and a Fiscal Union in addition to the Banking Union. The Monetary Union and Banking Union just aren't enough. According to CESifo Forum, "The Eurozone is atypical as an economic union because monetary policy is decided at the central (European) level while fiscal policy is mostly carried out at the sub-central (member state) level (Bordo et al. 2011). Therefore the view is widespread that there are just two options for the future of the eurozone – either it is complemented by a fiscal union, or it will fall apart." This raises many questions of how much power member states are willing to give up for a common objective.

The success of the Banking Union depends a lot on reaching common grounds on who holds the power and makes the decisions and who follows their implementation. Will the National States and Central Banks be willing to give up control, and to what extent? Also, the big players might have a different view of how things should be run. According to the Economist, the "commission's proposals are also meeting resistance within the euro zone, particularly in Germany, which would prefer the ECB to concentrate on fewer, bigger banks. Aspirations to move towards harmonized deposit-guarantee schemes and bank-resolution mechanisms cause even more alarm. German savings banks and mutual banks are used to the idea of mutualized guarantees: they have formed joint-liability groupings, which vouch for the solvency of each bank in their group. They are far less keen on having to vouch for banks outside Germany." As a result, this kind of resistance from Germany or any other state could stall the implementation process. It is logic that states with stronger banking systems will be reluctant to take the burden for states with weaker banking systems. As long as this nationalistic view persists, it will be very hard to reach common grounds.

The Basel 3 Accord

As mentioned earlier, the Basel 3 Accord has started to be implemented in January 2013 and the implementation process will go on until 2018. The third version of the Basel accord comes after the implementation of Basel I and II but with tighter capital requirements, more stress tests on banks, and more on market liquidity risk.

These measures are meant to guarantee the stability of banks in case the market conditions turn bad or some fail. The fact that the implementation of tighter capital requirements on European Banks was postponed until 2015, gave the banks a moment to breathe and the markets space to applaud this measure with a wave of acquisitions that drove the value of the shares of financial institutions up.

However, the implementation of this accord will continue to have strong impact on the whole financial system worldwide in the following years. We have to keep in mind though that the tighter capital requirements will change banking from now on. This means that in order to lend money, banks must put aside a considerably higher amount of money than before. Therefore, they will be able to lend less money than they previously did but they will supposedly be safer.

Other measures to reform European Banks

Besides the measures on a global scale to reform the European Banking Sector, I believe there are other steps that should be taken from within the system.

First of all, rules and regulations are useless if the people that are responsible for implementing and following them are not suitable for those roles or are corrupt. Personal interests often predominate over the right decisions. As long as there is greed on the part of managers, employees, financial institutions and no long term commitments for transparency

are made, there is always the risk that all measures fail. When I say personal interests I don't necessarily mean direct benefit on the part of the person or entity taking a certain action. I also refer to top managers using various shenanigans through financial means to do window dressing on their financial results. Such is the case of the most ancient bank Monte dei Paschi di Siena. It turns out that in 2009 the bank executed a swap operation with derivatives with the Japanese Nomura Bank in order to avoid showing more losses and make its financial statements look better.

Another measure worth mentioning regards the reward schemes for top banking executives. Until now, their compensation package included a fixed part, the salary, and a variable part, the bonuses. As a result, if at year end top executives obtained positive results, they received instantly huge bonuses. However, in the financial sector but not exclusively, this has determined CEOs and other top executives to test the limits of financial correctness and their financial creativity when drawing up their financial results. For this they have been rewarded with multimillion bonuses. Now it turns out that the financial results weren't as good as they presented them and the institutions where they worked are in a worse condition than expected. Closing this parenthesis, the solution to this is to avoid rewarding the top management for their short term activity but rather on the long term activity, as well as setting up an appropriate risk monitoring system and better supervision at the central level.

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