Development perspectives in the European Banking sector

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The International Financial Crisis has had a lasting impact on the Global Economy, as well as on the European Banking Sector. In order for the deficiencies to be fixed and for the European Banking Sector to return to growth, a series of steps must be taken by the decisional bodies, supervisory authorities and those responsible of implementing reforms across the European Union and across the European Banking Sector. This paper presents the various suggestions of combinations of measures possible. The matter analyzed being very complex, and trying to simplify it, the paper presents a series of approaches possible in solving the problems that are afflicting the banking system and the EU countries.
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Introduction

The European Union and in particular the Euro Zone Countries have been dragged in a deep economic crisis since the International Financial Crisis started in the U.S and spread to Europe.

The set of rules and regulations applicable to member states for the financial sector have been proven inadequate to prevent such major financial crash from happening. Even as it happened, the provisions initially established have not been able to stop the Sovereign Debt Crisis from taking place and from spreading to member countries.

In regards to the future of the European Banking Sector there are quite a few things to be taken into consideration. We must consider Europe from an institutional, economic, political and regulatory point of view in order to have a clear picture of how the banking system will recover from the financial crisis and from here on, and how it will develop.

The current institutional measures and reforms have not done enough to solve the difficult situation the banks are in. I don't mean to say that they are on the brink of collapse, but they are not in such a healthy condition as to start financing the private sector and the real economy.

As a matter of fact, this situation seems similar to the one the Asian Banks were in the previous Asian Crisis of 1997 - 1999[2]: the banks were too weak to lend money but not as weak as to

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[2] Lybeck, Johan A.: "A Global History of the Financial Crash of 2007 – 2010", Cambridge University Press 2011, New York, p. 285

fail.[3] The Japanese Banks were financially weak and it took a long time for the Government to draw up a $ 500 million rescue plan.

This situation went on for years with the banks in a suspended state. Obviously, this cannot be good for the economy, which desperately needs financing from the financial sector, especially in Europe where other means of financing are not as readily and easily available as in the United States.

The European Union does not have a single government nor does it have a common fiscal policy. In fact, it is rather heterogeneous if we look at the countries that use the Euro currency. This has become obvious with the financial crisis since it has exacerbated all these differences.

We cannot say that the financial crisis is over, but we do hope that the worst has passed. It is certainly a moment of reflection on those things that need to be changed. For the moment, the European banks have undergone stress tests, which determined which of them have capital shortfalls, and have taken measures to correct those issues. From now on, they need to concentrate on growing business. Unfortunately, the European perspectives in terms of economic growth are not so optimistic since there is always the risk of deflation and lack of growth in the short to medium term.

On the other hand, Europe should try to become more homogeneous in terms of approach towards the banking sector, meaning better supervision[4], better regulation and improved reaction speed. Europe needs to become more flexible towards the banking and economic sector and learn the good parts from the U.S. such as in the area of entrepreneurship. It must avoid at all costs over Eurocracy[5] since there is the risk of over regulating too many sectors instead of creating a dynamic European market and growth throughout the EU countries.

In order to try to figure out the perspectives of the banking sector, we need to also look at other factors. There are opportunities to be sought if the Euro currency continues to lose value since this will stimulate exports. On the other hand, decreasing oil prices and the uncertainties of economic growth around the world and in China, are putting pressure of the financial markets and swaying investors from putting their money in Europe.

The main goals of the European Union should be to create economic growth, improve employment, especially among the younger generations, and become more united and efficient.[6] We do not need further reminders besides the financial crisis that things need to change, also in the banking sector. The reform in the banking and financial sector has to continue in order to make these activities safer and more trustworthy.

The implementation of the Basel III Accord

The banking sector has established means of establishing how the banking sector should be run and supervised. This is achieved through the renowned Basel Accords. These refer to the

[3] Krugman, Paul: „The return of Depression Economics and the crisis of 2008”, W.W. Norton & Company, 2009, New York , NY, p. 73
[4] „Financial supervision in the EU – Incremental progress, success not ensured”, from Deutsche Bank Research, August 4th, 2011
[5] Craig, David-Elliott, Matthew: „The Great European Rip-off”, Random House books 2009, London, p. 118
[6] Teece, David J.: „Dynamic Capabilities & strategic management”, Oxford University Press, 2009, New York, p. 198

banking supervision Accords (recommendations on banking laws and regulations), Basel I and Basel II issued (and Basel III under implementation) by the Basel Committee on Banking Supervision (BCSB).

The secretariat of the BCSB is in the city of Basel, Switzerland, the city that gave the accords its name.

The Basel III accord, which will enter in force gradually until 2018, establishes tighter capital requirements for banks.[7] As of now, the situation of the European Banks is not so rosy, due to their high non-performing loans percentage in their portfolios, as well as to the capital they have to raise to meet the tougher capital requirements. Many score well on the current requirements for Tier I and Tier II capital. In addition to capital requirements, there are also liquidity requirements measured by two coefficients: the Liquidity Coverage Ratio and the Net Stable Funding Ratio. The former measures the short-term capacity of the financial institution to face short-term liquidity crises, while the latter creates the premises for a stable long-term structure to guarantee the stability of the liabilities needed to finance longer-term assets, which should determine a reluctance to rely on short-term securities which are volatile in their nature.

The implementation of the Basel III accord in a timely manner is beneficial in my view for the global banking system and the European banking sector in particular. The US banks are already doing better than European Banks. Therefore, there is still a lot of work to be done in Europe in regards to establishing better and safer capital requirements.

However, we must keep in mind that a balance must be maintained between safety and growth. What I mean to say is that, tighter capital requirements are necessary to keep the banking system safe at the expense of business development.

This happens because for each euro granted as loan to the private sector, a sum must be set aside as safety margin, as leverage. In the US, the failed financial institutions had a leverage ratio of 75 to 1, therefore their safety was nonexistent, while other bailed out banks had a ratio of 40 to 1.

The initiatives of the Basel Committee are right in my view, but the implementation of the accords and regulations is an issue in its own. Many important institutions, such as the European Commission, the International Monetary Fund and governments in Europe and America (through the Financial Accounting Standards Board), are all active participants in the process of reforming finance, by implementing new regulations for the financial sector. However, the costs of adopting the new regulations has a substantial impact on the banks' profits.

The Basel III accord will make banks supposedly much safer. However, the implementation of this accord is the key to its success or failure. Over-regulating is a trap that must be avoided. This happens when some negative event takes place and the eagerness to stop the phenomenon and prevent it from happening again leads to drastic measures.

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7 Berges, Angel – Guillén, Mauro F. – Moreno, Juan Pedro – Ontiveros, Emilio: "A New Era in Banking – The Landscape After the Battle", Biblimotion, Inc 2014, USA, p . 23

The roles of central banks have been less scrutinized until the financial crisis, however now all the attention is focused on them. The European Central Bank has a very important role in the recovery process and is doing its best to take measures within its mandate, that are the most effective.

The future role of the ECB as leading Central Bank

The European Central Bank is the institution of the European Union in charge with administering the monetary policy of the 16 European Union (EU) member states taking part in the Eurozone. As a result, it is one of the world's most important central banks. The bank was established by the Treaty of Amsterdam in 1998, and is headquartered in Frankfurt, Germany. The current President of the European Central Bank is Mario Draghi.

It would seem that the European Central Bank is an apolitical organization run by a group of technocratic central bankers, but instead it is a unique supranational entity with the potential for profound transformation in the nature of European politics.

Because of the link between politics and economics, it may also influence the change in politics. Given the fact that some political decisions have to be transferred from the member states to the European level, there is a chance to improve things centrally for everyone. We will see however what is the probability that this possibility materializing.

The European Central Bank's (ECB) role in the recent financial, banking and sovereign debt crises has become front page news. Similarly to the Federal Reserve, the ECB's role in short is to[8]:

- Maintain the stability of prices (by keeping inflation under control), especially in countries that use the euro currency;
- Keep the financial system stable – by making sure financial markets and institutions are properly supervised.

In more detail, the ECB's tasks are[9]:

- To set the key interest rates for the Euro zone and control the money supply;
- To manage the foreign currency of the Euro zone and to buy and sell currencies if necessary in order to maintain the balance of the exchange rates;
- To help ensure the adequacy of the supervision of the financial markets and institutions by their respective national authorities and that the payment systems operate correctly;
- To authorize Euro zone countries' central banks to issue EURO banknotes;
- To monitor the price trends and to assess the risks to price stability.

The ECB had until the financial crisis an easier job to do, since after the adoption of the Euro, it was gradually increasing its area of responsibility. Much of its activity was concerned with

[8] http://europa.eu/about-eu/institutions-bodies/ecb/index_en.htm
[9] http://europa.eu/about-eu/institutions-bodies/ecb/index_en.htm

maintaining financial stability in the Euro area. Since the adoption of the Euro, there had not been serious events to question the stability of the Euro area or even of this currency, therefore the financial crisis that was to come would become the toughest test since its foundation.

The ECB was also managed differently compared to the years after the financial crisis started. This was due in part to the different management and in part to the reaction times needed in today's markets compared to the past. We can agree that the changes that occur right now need much quicker response times than they did before 2008. In this regard, globalization has increased this trend of interconnecting while the financial crisis had the role of catalyst.

The European Central Bank's role has to evolve in order for the European Banking Sector to function properly. This does not mean that right now it doesn't. Instead, what I mean to say is that in certain situations, swift actions must be taken at a central level for the whole banking sector. While in the US measures are taken at central level by the Federal Reserve, and applied throughout the whole banking system, in Europe each country is responsible for their own banking system even if they ultimately report to the ECB.[10]

However, the current system is not enough. For the EU banking system to function properly, the ECB needs to be given more powers from the EU. In this way, it could act in a similar fashion as the Federal Reserve in the United States.

For now, it has taken cautious steps in helping the European economies and banking system. It lowered interest rates, it financed the banking sector at low rates to pop up their liquidity so that the banks can lend money to the economy, and it used non-standard monetary policy measures. The aim of these measures was to maintain the transmission of monetary policy.[11]

However, the success of such measures is limited by the support from the European Governments, regulators and decision bodies, which must play an important role in reforming the banking sector and improving the situation in the economy. I do not believe right not that there is the risk of over regulation. Instead, smarter regulation should be practiced in order to limit bureaucracy while maintaining adequate safety standards.

Another idea is that the ECB has a hard task at hand since it cannot help directly countries due to limitations coming from the Maastricht Treaty. Maybe a good idea would be to expand its role and act as if all the EU countries were one country and intervene in a more prompt manner in case of emergency. It must make the Euro currency become an advantage and not a disadvantage. The reasons for which it was created were to improve the economic activity within the EU.

"If in the past, the creation of a common currency had been seen as catalyst to create political union, which had been regarded as the ultimate guarantor of peace in Europe, it had now turned into an undertaking whose value was measured primarily in the economic advantages it was supposed to afford its members."[12] From this insight of Deutsche Bank we can see that the goals of the Euro went beyond and sought to create a political union. I must add that a political union would be advisable if it would mean that there could be common policies in the EU that can be

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[10] Axilord, Stephen H.:"The Federal Reserve – What Everyone Needs to Know", Oxford University Press 2013, New York, NY, p. 4

[11] European Central Bank: "The ECB's non-standard measures – impact and phasing out", Monthly Bulletin, July 2011

[12] „The political economics of the euro", from Deutsche Bank Research, July 1st, 2011

adapted locally to the member countries. The fact that compared to the US, where there are states under the same umbrella, while in the EU there are different nations with different cultural backgrounds, languages, mentalities, legal and political systems, makes any kind of measure difficult to implement.

Therefore, the ECB, should become the catalyst in gaining consensus in regards to the monetary policies throughout the EU, by implementing the good things done by the Federal Reserve so far.

The future of 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 unitary global policies and measures throughout the entire banking system.

One solution to this problem is the constitution of a European Banking Union which at the current moment in time is on course for being implemented. The implementation of such measure implies that there should be a centralized banking supervision for the banks of all member states, rather than having individual national supervision.[13]

As we were able to see in many occasions in Italy, Spain, Greece and Cyprus 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. It is argued however from an evolutionary perspective that such large institutions should not be saved since occasional creative destruction might be beneficial.[14] This becomes an issue of moral hazard and should be a lesson for institutions taking on too much risk because they know they have to be saved by the state.

Likewise, if the government is in trouble, and in need of financing, the banks could intervene acquiring treasury bills. In any case, both the banking sector and the government become destabilized.

If the European Union is to become fully integrated, economically and financially it must take measures to eliminate the fragmentation that still exists between member states.[15] At the moment, almost everyone is convinced that there should be a Banking Union. However, not all of those are willing to do what it takes to achieve it.

Who should pay the bill for the losses incurred by European Banks?

Until now we have looked at ways to improve the health, efficiency and stability of the European Banking Sector. However, one important question has not yet been discussed. The question is who should pay the bill for the losses incurred by European Banks. Answering it

[13] The euro crisis: "Bankers of the euro area, unite! - Why a banking union is more problematic than many seem to assume", from the Economist print edition, June 30th 2012

[14] Ferguson, Niall: "The Ascent of Money – A Financial History of the World", Penguin Books 2009, London, UK, p. 357

[15] Berges, Angel – Guillén, Mauro F. – Moreno, Juan Pedro – Ontiveros, Emilio: "A New Era in Banking – The Landscape After the Battle", Biblimotion, Inc 2014, USA, p. 53

will help improve in the future the way things are run in the banking system and how new crises affect the shareholders of the banks, the depositors, the governments and the taxpayers.

However simple the question may seem, answering it is quite complex for the reasons I am about to mention. First of all, we must establish case by case who the culprits are for the bad situation that banks are in. As we saw in the US, there were multiple guilty parties at all levels of the banking process. They each had a part of the blame and their combined behaviors led to the crisis.

For now bailouts have been associated to losses transferred from the banks to the taxpayers for the sake. In the US, the Government and the Federal Reserve have bailed out the financial institutions that were on the brink of collapse but after they regained their strength, they received fines for their reckless behavior that led to the financial crisis. The bailout process involved acquiring risky securities that others would not buy.[16] Effectively, if the underlying collaterals of these securities would effectively go bad, the losses would be transferred by the Fed to the federal governments. In the next step, there would be higher taxes for the individuals.

In Europe, other methods have been experimented, such as bail-ins, by getting money from the depositors of failing banks (as was done in Cyprus) or from the shareholders of those banks (as was done in Italy). While I agree that the taxpayers should not bear the losses of the banks, I do not agree with penalizing the small investors that are shareholders in banks with problems, since they do not have voting rights and cannot influence the management of those banks. Instead of being rewarded for enduring the losses in their invested capital and by subscribing highly dilutive share capital increases, they are being seen as rogues and penalized further. In my view, those that should bear part of the burden are those responsible for the losses, namely, the majority shareholders that named the top management of the financial institutions. The small shareholders that don't have a say and are not speculators, should not be punished. The same applies to the taxpayers: if a financial institution is bailed out with public funds, those funds should be repaid in full and with interest by the financial institutions that were saved once they recover. Such was the case of Banca Monte dei Paschi di Siena that has repaid in full its debt towards the Italian State in advance after the second increase in share capital in the last 2 years, as well as the added interest.

The prospect of a European Fiscal Union

The times we are living are of extreme novelty in the current state of development of the financial sector. It's true that we have seen years of financial crisis and economic downturns in the past, but the evolution of technology today makes the effects of such phenomena to be felt much faster. The European Union is struggling to find a way to function efficiently also from a financial point of view.

[16] Shiller, Robert J.: "The Subprime Solution" , Princeton University Press 2008, New Jersey, p. 91

Considering the conditions under which the bailout funds were given to Cyprus (by imposing high losses on depositors with large deposits), just because the EU thought of Cyprus as a fiscal haven and thought to put that burden also on depositors regardless of the sources of their funds, we must think that there should also be a centralized European Fiscal Union. This Fiscal Union could be the natural evolution to the Monetary Union established more than a decade ago. It is foreseeable that such union will take place under one form or another, or its role be attributed to a separate European Institution.

The prospect of a European Political Union

According to Deutsche Bank Research "With political union in our view very unlikely, the best option for a stable future of EMU would be a return to the basic principles of the Maastricht Treaty. Without political leadership from the top, this outcome must be driven by grass-root events (e.g., a rebellion of the backbenchers in the Greek or Berlin parliament against their leaders or a bank run in Greece). Given the recent momentum in the political debate, we would give such an outcome over the coming 6-12 months the highest probability. Alternatively, if the political elites remain in control and enforce the continuing execution of unviable adjustment programs, we see a significant risk of an eventual break-up of EMU."[17]

I agree with Deutsche Bank's view but I would like to add a few elements. Considering the nature of politics and the cultural and political differences between EU countries, it would be very hard for each member country to give up also this part of its own sovereignty.

There would be no benefit actually in my view from amassing such heterogeneous bunch. What can be done instead is for each country to designate representatives from the most important political parties to present their views on important matters in the EU, on appointment from their governments, coalitions they represent. This way, the EU countries would not lose control of what measures are to be implemented at the level of the EU.

In addition, considering that European countries each have their own contribution to the EU, they carry different weight in the decisions. In my view, this shouldn't be the only factor since developing countries need much more attention than developed ones and they should be able to make decisions that affect them.

The European Crisis

According to Paul Krugman, if we looked at Europe, and in particular to the Euro area, as an aggregate, by adding up the numbers from the euro-zone countries, it should not have been in such a bad shape considering that private and public debt were lower than in the US while inflation levels were similar.[18]

Unfortunately, Europe is not an aggregate as is the US. This means that we cannot just add up the parts to get a good picture of the situation. Each of its comprising nations has its own budgets (with low fiscal integration) and their own labor markets but they do not have their own currency.

[17] „The political economics of the euro", from Deutsche Bank Research, July 1st, 2011
[18] Krugman, Paul: "End this Depression Now", W.W. Norton & Company Inc. 2012, New York, NY, p. 179

As a result, my opinion is that there should be better fiscal integration with the establishment of a fiscal union. This would solve at least an important part of the fragmentation problem afflicting the EU.

The wrong assumption regarding the European financial crisis

Mr. Paul Krugman states in regards to the causes of the European crisis that there is the wrong assumption that it was caused by fiscal irresponsibility. As a result, countries ran excessive budget deficits getting themselves too deep into debt, and the important thing now is to impose rules that will keep this from ever happening again.

While in part this may be what happened to Greece, it is not the whole pictures. He argues that this problem is viewed more in moral terms: the nations are in trouble because they have sinned and they must redeem themselves through suffering.[19] This view clearly goes against what international financial institutions such as the IMF, or even countries such as Germany believe. However, one must make sure that those that have the power to influence policies do so keeping into account that not all situations are equal and all players involved should be treated fairly and benefit from an unbiased assessment.

The financial crisis has also had an impact on the taxpayers since some of the burden of bailing out the financial sector has fallen on their shoulders regardless of who was responsible of creating the problems in the first place.

Who should bear the burden of bail-outs?

According to an article of the Economist[20] bondholders should suffer losses when the banks whose bonds they hold need rescuing. For now, the only case where depositors of the banks were forced to bear the burden of rescuing those banks, were in Cyprus.

However, the EU and the Troika unofficially maybe believed that a large part of the money of depositors were from illicit sources and it was money that evaded taxes in their countries of origin. Cyprus was seen as a safe haven for money laundering.

The Economist believed that the short term creditors of Spanish banks could be forced to incur losses due to a planned euro-zone rescue of their financial system. It is however difficult to achieve this. It would be called “bailing in” instead of “bailing out” when converting debt to equity for the bondholders. In Cyprus, some depositors were supposed to receive bonds issued by the banks in exchange for the money that was taken from their deposits.

In my view, imposing such harsh measures on the bondholders of financial institutions will be detrimental for the health of the financial system, because the shareholders would just sell their shares to escape this penalty, thus creating instability in the financial system. Investors that invest in shares are not willing to bear the burden of bailouts because they do not necessarily

[19] Krugman, Paul: “End this Depression Now”, W.W. Norton & Company Inc. 2012, New York, NY, p. 177
[20] Europe’s banks: “Slouching towards a banking union - The prospects of big bank bail-outs are intensifying calls for a central fund”, from the Economist print edition, June 9th 2012

make a profit from being shareholders of banking institutions. For the purpose of being clear and correct we must make a distinction between large shareholders that have decision powers through representation in the Board of Directors and the petty investors that acquire shares on the stock market.[21] If the large shareholders through their representatives have adopted positions that put the financial institution at risk and generated losses, then they should be held accountable for that in case of a bailout from the government.

I agree that taxpayers should be protected from having their money used to bailout banks. We are considering here the case in which the taxpayer loses money from the bailout. However, the system could be improved to guarantee that in the future, those institutions that are bailed out repay the taxpayer the money they received plus interest. In this way, the taxpayer would benefit from this process, and the financial system would too. This would be a win-win situation. Therefore, this is the approach that is a healthy one in my view.

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[21] Tricker, Bob: „Corporate Governance – Principles, Policies and Practices", Oxford University Press, 2009, New York, p. 282