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THE DEVELOPMENT OF MACRO-PRUDENTIAL SUPERVISION AFTER THE GLOBAL FINANCIAL CRISIS

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SUMMARY

The preceding wave of financial market deregulation and the lack of macro-prudential supervision were central reasons for the 2008 Global Financial Crisis (GFC). The regulatory authorities had completely underestimated the systemic risks arising from over-complex, highly leveraged, and internationally traded securities. After the GFC, the Financial Stability Oversight Board was established in the US to identify systemic risks at an early stage. At the G20 level, the Financial Stability Board was established for a similar purpose. In the EU, the implementation of the European Systemic Risk Board and the European System of Financial Supervision established a new macro-prudential supervisory regime.

Key words: Global Financial Crisis, macro-prudential supervision, systemic risk, financial regulation, Financial Stability Board, Dodd-Frank Act.

РОЗВИТОК МАКРОПРУДЕНЦІЙНОГО НАГЛЯДУ ПІСЛЯ ГЛОБАЛЬНОЇ ФІНАНСОВОЇ КРИЗИ

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АНОТАЦІЯ

Попередня хвиля дерегулювання фінансового ринку і відсутність макропруденційного нагляду були основними причинами глобальної фінансової кризи 2008 року (GFC). Регулюючі органи повністю недооцінили системні ризики, пов'язані з надмірно складною, високовитратною міжнародною торгівлею цінними паперами. Після глобальної фінансової кризи в США була створена Рада з нагляду за фінансовою стабільністю для визначення системних ризиків на ранній стадії. На рівні G20 була створена для аналогічної мети Рада з фінансової стабільності. В ЄС імплементація Європейської ради із системних ризиків та Європейської системи фінансового нагляду встановила новий режим макропруденційного нагляду.

Ключові слова: Глобальна фінансова криза, макропруденційний нагляд, системний ризик, фінансове регулювання, Рада з фінансової стабільності, Закон про реформування Уолл-стріт і захисту споживачів Додда.

REZUMAT

Valul anterior al dereglementării pieței financiare și absența supravegherii macroprudențiale au fost principalele motive ale crizei financiare globale din 2008 (CFC). Autoritățile de reglementare au subestimat complet riscurile sistemice asociate cu titluri de valoare extrem de complexe, cu costuri ridicate și tranzacționate pe plan internațional. După criza financiară globală din Statele Unite, Consiliul de Supraveghere a Stabilității Financiare a fost creat pentru a identifica riscurile sistemice într-un stadiu incipient. La nivelul G20, Consiliul pentru Stabilitate Financiară a fost creat pentru un scop similar. În UE, punerea în aplicare a Consiliului European pentru riscuri sistemice și a sistemului european de supraveghere financiară a instituit un nou regim de supraveghere macroprudențială.

Cuvinte cheie: Criza financiară globală, supravegherea macroprudențială, riscul sistemic, reglementarea financiară, Consiliul pentru Stabilitate Financiară, Legea privind reforma pe Wall Street și Protecția Consumatorului Dodd.

Introduction. In 2007, a financial crisis erupted in the US that originated in the subprime mortgage market. Within the EU, the first signs of the impending crisis were evident in Germany after the subprime lender New Century Financial Corp. filed for insolvency on 14 March 2007 [1]. Nevertheless, European governments and regulators persistently underestimated the degree of interdependence of international financial markets and the systemic risks associated with highly leveraged and overly complex, internationally traded securities. At the beginning of 2007, the Deutsche Industriekreditbank (IKB), Sachsen LB, West LB AG and the Bavarian Landesbank reported the substantial need for value adjustments due to the value decline of securities backed with US real estate. The survival of these banks could only be ensured through takeovers by other banks in Germany and emergency loans worth billions. In Europe, however, the crisis was initially thought to be predominantly an US-American crisis [2, p. 1]. By the autumn of 2007, an increasing number of banks were reporting write-offs in the US and Europe due to subprime paper. In December 2007, the European Central Bank (ECB) and the Bank

of England provided EUR 20 billions of liquidity to prevent the financial markets from collapsing. In Europe, the generally shared assessment still prevailed that the financial markets were stable at this stage. At the beginning of 2008, the investment bank Bear Stearns had to be sold to JP Morgan Chase for rescue and in September 2008, the real estate financiers in the US Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) were de facto nationalised to avoid bankruptcy [3, p. 1-2]. Eventually, interbank lending came to a halt worldwide directly after the insolvency of Lehman Brothers, the US government's nationalisation of one of the world's largest insurance companies, the American International Group (AIG), and a USD 85 billions credit guarantee to AIG in September 2008. The collapse of AIG clearly showcased that also the failure of non-bank financial institutions can cause significant systemic risks that jeopardise the entire financial market and the economy as a whole. Accordingly, the mutual trust among banks and faith in the stability of the financial markets had collapsed. In his article 'Rational Irrationality', John Cassidy notes that economically rational behaviour by individual actors can lead to irrational, and, thus, even disastrous outcomes for the economic system at large [4, p. 314]. He stresses that 'in a market environment the individual pursuit of self-interest, however rational, can give way to collective disaster. The invisible hand becomes a fist' [5]. During the GFC, capital withdrawals by creditors had reached unprecedented global proportions, although it was characteristic in past financial crises such as in Mexico 1994–95, Argentina 1995 and in East Asia 1997 that they were local and limited [6, p. 2–3].

During the Asian crisis, the International Monetary Fund (IMF) promoted fiscal measures in order to ensure currency stability and significantly increase interest rates in the countries affected. This served to reduce credit volumes, resulting in the closing of non-profitable financial institutions and the implementation of corporate governance, and was aimed at restoring confidence in the markets [7, p. 50–51]. In the first phase of the crisis in 1997, the IMF procured considerable financial resources for emergency lending to countries in crisis, including Thailand, Indonesia and Korea. Funds from the US, Japan, Singapore and other European countries were added during the second phase. Overall, the measures taken during the Asian crisis involved loan packages, macro-economic measures to stabilise the exchange rate, considerable restructuring of the financial sector through an increase in good governance and transparency, and an improvement of competitiveness through privatisation and the break up of monopolies. Based on the lessons learned from the 1997 South East Asian Financial Crisis, the Financial Stability Forum (FSF) was established in 1999 with the objective of developing international standards that help nations prevent future crises. Prompted by this significant event, the Standards and Codes Initiative were adopted, which was primarily focussed on implementing systems to stabilise the exchange rate in the individual countries [8, p. 142]. This approach was corresponding to the different macro-economic initiatives of the IMF taken during the Asian crisis. The financial sector assessment programs the IMF created in 1998 were mainly based on the implementation of best practice, governance mechanisms and regulatory guidelines at the domestic level [9, p. 142–143]. These measures were fundamentally micro-prudential with the exception of the stabilisation of exchange rates.

The purpose of this article is to assess the relevant EU as well as national legislation and international regulations in the context of macro-prudential supervision to examine whether this new regulatory regime offers a sufficiently robust system to manage future crises. In order to achieve this aim, this article examines the measures introduced to ensure financial stability in the wake of the Global Financial Crisis (GFC) involving the supervision of banks, financial service providers, and other capital market participants at the micro- and macro-prudential levels in the European Union (EU) and internationally. The article argues that regulatory harmonisation is the only approach to create a robust global financial system that is resilient to systemic risks.

The Development of Macro-prudential Supervision after the Global Financial Crisis. For governments and international organisations, the GFC has dramatised the need for macro-economic oversight, as systemic risks are not contained by national borders, but pose a threat to the global financial system due to the international interdependence of banks and other international institutions. In the EU and G20, this realisation resulted in the establishment of new multilateral macro-prudential coordination and regulation that lead to the creation of Financial Stability Boards in the majority of G20 countries [10, p. 21]. In contrast to the Asian crisis that was primarily the result of enormous growth rates and a consequential balance of payments crisis, and, therefore, much more predictable than the GFC, the GFC revealed systemic risks only manageable through international regulatory measures at the macro-prudential level. Accordingly, the GFC confirms that the self-regulation of the market cannot overcome such a crisis because of systemic risks that can lead to a loss of confidence in the ability of financial markets to function at all [11, p. 572–573].

Implementation of Macro-prudential Supervision in the EU after the Global Financial Crisis. In 2008, the central banks tried to avert immense liquidity difficulties caused by the loss of trust among banks through massive injections of liquidity into the financial system. The US Federal Reserve provided USD 150 billion to the credit markets. The ECB and the Bank of England provided renewed liquidity of EUR 70 billion as early as September 2008 in order to prevent the markets in Europe from collapsing. The occurrences surrounding the bank Northern Rock, culminating in a bank run, illustrate that there was also an enormous deficit in recognising systemic risks in the UK. On 17 September 2007, the Chancellor of the Exchequer on Financial Markets expressed in his statement that Northern Rock had only short-term liquidity deficits [12]. It became clear that this was a misjudgement when Northern Rock was nationalised in February 2008 in the UK in order to be rescued. At the end of September, there were further takeovers in England to rescue banks [13]. In the US and Germany, the crisis evolved similarly dramatic as in the UK. The US government passed a USD 700 billion rescue package that came into force at the beginning of October 2008. The UK adopted a rescue package worth GBP 500 billion that entered into force on 10 October 2008. On 13 October 2008, the German Federal Government adopted a national rescue package for Germany worth EUR 480 billion. On 14 October 2008, the US government adopted a USD 250 billion rescue package for the funding of banks. As all major investment banks in the US applied for commercial bank licenses, pure investment banks did not exist anymore. The Eurozone governments adopted emergency financial support measures in the form of national rescue plans on 12 October 2008 and the EU Commission published principles on the application of the state aid rules on 25 October 2008 [14].

The very first crisis management measures were purely supportive and involved immense provision of state guarantees and liquidity as well as takeovers of distressed financial institutions by states. In light of the risks to the economy as a whole, the recognition of serious shortcomings within the global financial market supervision system led the EU Commission to instruct a group of experts in 2008, chaired by Jaques de Larosière, in order to provide recommendations for the future regulation and supervision of financial markets [15, p. 14]. The

resulting 2009 Report stressed the need to create a macro-prudential supervisory authority to address systemic risks at the EU level and strengthen monitoring and supervision of individual financial institutions and capital market participants [16]. As a consequence, the European System of Financial Supervision (ESFS) and the European Systemic Risk Board (ESRB) were founded at the EU level, the latter being responsible for macro-prudential supervision to avert and curb systemic risks [17], [18, p. 7–9]. Article 3 of Regulation 1092/2010 entrusts the mandate to the ESRB to pre-empt and prevent risks that could endanger the entire financial system and pose a threat to the internal market and the economy as a whole [19]. The ESRB is comparable to the Financial Stability Oversight Board (FSOB) in the US [20, p. 9].

The formation of a single supervisory mechanism (SSM) transferring the supremacy of banking supervision to the ECB and the establishment of a single mechanism for the settlement or restructuring of banks in crises (SRM) [21] created a three-pillar system [22, p. 327]. The EU Bank Recovery and Resolution Directive (BRRD) as well as the Single Resolution Fund (SRF) complement the SRM system [23]. The completion of the third pillar through a uniform deposit guarantee system (EDIS) is envisaged. Yet, political reservations exist, especially in Germany, concerning the collectivisation of liability risks [24, p. 588–589]. The ECB has the oversight of the largest system-relevant banks in the Eurozone since 2014. Banks with assets worth EUR 30 billion or banks account for more than 20% of the gross domestic product of the home country in which they are established fall under the supervision of the ECB. In addition, the three largest credit institutions in the individual EU Member State are placed under ECB supervision as a result of Article 6(4) of the Council Regulation (EU) No. 1024/2013 [25, art. 6(4)]. In the course of the completion of the EU-wide supervisory system, the EU founded the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) for micro-prudential supervision [26]. The EBA is responsible for all EU Member States, develops standards for the banking market, issues instructions to the national supervisory authorities in emergencies and concludes final decisions in disputes between supervisory authorities of different Member States [27, p. 33]. The ESMA has been entrusted with the supervision of rating agencies and derivatives trading on the basis of the aforementioned regulation, as both areas have played a central role in the GFC [28].

This foundation has created a new banking and financial market regulation regime under the supervision of the ECB, aimed at ensuring financial stability, which takes into account the need for regional oversight beyond the national borders of the individual EU Member States [29, p. 327–328]. The ESRB is designed to ensure robust financial stability in the EU. In order to achieve this aim, the ESRB has formulated five macro-prudential objectives in its recommendations of 4 April 2013:

– Mitigate and prevent excessive credit growth and leverage

– Mitigate and prevent excessive maturity mismatch and market illiquidity

– Limit direct and indirect exposure concentrations

– Limit the systemic impact of misaligned incentives with a view to reducing moral hazard

– Strengthen the resilience of financial infrastructures [30].

During the GFC, advanced industrial nations completely neglected the dangers associated with the globalisation of the financial markets, especially the fact that the US could be so severely affected by the crisis. These dangers particularly arose from the trade in new financial products and the securitisation of mortgage-related securities. Internationally, this led to a vertically integrated regulatory process, consisting of (1) the setting of Agendas by the G20 and FSB, that led to (2) Agendas through the Basel Committee, IOSCO, FATF and others, leading to Basel III and (3) the monitoring by the IMF and World Bank and peer-review publications and (4) the implementation of new surveillance rules in national regulations [31, p. 145-146]. The supervision of banks based on the early detection of systemic risks and effective crisis management by providing recovery and resolution tools replaced a risk-based supervision, which prior to the crisis focused primarily on monitoring single financial institutions to ensure their compliance with legal requirements. The establishment of macro-prudential supervision within the EU after the GFC thereby aimed at making the risk and impact of failures of financial institutions manageable without compromising financial stability or the economy as a whole [32, p. 181].

Establishing Macro-prudential Regulations for Maintaining Financial Stability in the Banking and Capital Market System. The Basel III criteria [33] were incorporated into EU regulations in addition to the creation of a new EU supervisory structure and reflect the lessons learned from the GFC about the weaknesses of Basel II [34] in the area of macro-prudential supervision [35, p. 78]. This has led to increased equity ratio requirements of banks through the guidelines of CRD IV [36] and CRR [37] and the introduction of the MiFID II [38], which regulates the entire product and sales cycle in the financial market [39, p. 7-11]. To increase banks' resistance to crises, equity ratios have been increased from 2% to 4.5% and an additional capital conservation buffer of 2.5% was established [40, p. 353]. The CRD IV requires the implementation of a systemic risk buffer, which serves to prevent long-term non-cyclical systemic or macro-prudential risks that are not included in the CRR for institutions that could pose a threat to the national economy of respective EU Member States. Based on macro- and micro-economic indicators, national supervisory authorities can demand a counter-cyclical capital buffer of up to 2.5% from systemically important financial institutions (SIFIs). At the same time, national supervisory authorities must report to the competent authorities, EBA, ESRB or ESMA, based on the CRD IV [41, p. 347]. In the EU, macro-prudential regulation in the banking sector involves cross-border monitoring of possible systemic risks and associated cross-border risks in the finance sector [42, p. 359-360]. In essence, the implementation of the Basel III criteria increased the capital and liquidity requirements for banks and financial institutions to ensure that a certain proportion of high quality assets are available to cover short-term liabilities. As a result of increased monitoring and reporting of risk exposures, the supervision of systemic risks has considerably improved in the EU. Greater transparency and the commitment of banks and financial institutions to make financial disclosures to the supervisory authorities in line with the capital and liquidity requirements has ultimately resulted in the clear improvement in financial stability.

The International Implementation of Macro-prudential Supervision. The GFC led to the creation of macro-prudential governing authorities in many countries around the world, such as the US, Chile, Mexico, in order to identify systemic risks and to ensure financial stability in the financial sector at an early stage. The US was the first to implement measures that allowed the US government to buy distressed assets from financial institutions by passing the Emergency Economic Stabilization Act [43] and establishing the Treasury Department's Troubled Asset Relief Program [44] in 2008 [45, p. 13]. These short-term measures were followed by the enactment of the Dodd-Frank Act [46] and the creation of the Financial Stability Oversight Board as a macro-prudential authority responsible for the prevention of systemic risks [47, p. 425].

At the G20 meeting in Seoul in November 2010, the Member States declared the need for promoting regulatory change

in terms of the establishment of macro-prudential networks and supervision authorities at the national and regional level as an essential aim. The FSB, the BIS, and the IMF specified this macro-prudential policy objective in their Progress Report to the G20 in 2011 as follows:

(i) Its objective is to limit systemic risk – the risk of widespread disruptions to the provision of financial services that have serious negative consequences for the economy at large. (ii) Its scope covers the financial system as a whole (including the interactions between the financial and real sectors) as opposed to individual components (that take the rest of the system as given). (iii) The financial instruments and associated governance are focused primarily on prudential tools calibrated to target the sources of systemic risk. Any non-prudential tools that are part of the framework need to clearly target systemic risk [48, p. 4].

This newly agreed supervisory policy required the global exchange of information on financial stability and possible risks in the financial sector. The IMF Report [49] of 2013 on key aspects of macro-prudential policy assesses the implementation of macro-prudential supervision after the GFC as the key tool for avoiding systemic risks, both in emerging and in highly developed economies. Today, many countries have followed the IMF's recommendations in order to realise the main macro-prudential policy objective of creating robust financial markets capable of withstanding another financial crisis. This includes that counter-cyclical capital buffers were implemented to reduce vulnerabilities where systemic risks exist.

A key objective of the FSB and the G20 is to end the "too-big-to-fail" (TBTF) policy and substitute a system capable to absorbing losses in resolution situations of SIFIs. That is why the 2013 FSB Report [50] on steps to end the TBTF has developed principles to avoid systemic risks and moral hazard risks posed by G-SIFIs through a series of measures designed to secure financial stability [51, p. 162-164]. In 2013, the FSB also published Guidelines [52] to implement an effective resolution strategy for the planning of recovery and resolution for SIFIs. This has contributed to the development of a system, which, in addition to a single point of entry through which the home authority is responsible for the resolution approach, has created a multiple point of entry that allows different national and regional authorities to work together and enables the cooperation of authorities affected by the distressed financial institution. To ensure this cooperation between the different authorities, the FSB adopted a guideline for the resolution of cross-border banks aimed at the mutual recognition of jurisdiction in 2014, which was revised in 2015 [53].

Conclusions. The overall objective of financial regulations is to ensure the functioning of capital markets, protect depositors and secure the stability of financial markets. After the 2007/2008 GFC, it became evident that banks and financial markets that were previously considered as safe could not be saved without international cooperation and significant rescue measures of the US, the EU, IMF and World Bank. Accordingly, the worldwide shock was immense. Before the GFC, the protection of the stability of the financial system was not an explicit goal, but it was rather implicitly assumed to be sufficient when micro-prudential-oriented supervisors regulate and oversee individual financial institutions. Leading economists, such as Joseph E. Stiglitz [54], have notably argued that deregulation was the primary cause of the 2007/2008 GFC. This thesis is supported by the findings of the US Financial Crisis Inquiry Commission, stating that it 'conclude[s] dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis' [55, p. xvii]. One can certainly concede that regulatory measures can lead to over-regulation that brings about other problems, but the key question is not whether regulation is perfect but whether it is necessary. The GFC has definitely clarified that the globalisation of financial markets requires close cooperation and coordination within an institutional framework to detect and to avoid systemic risks that do not stop at jurisdictions or geographical borders [56, p. 329]. Systemic risks may only be controlled by means of effective global rules and regulations. The Trump Administration's intentions in the US to deregulate the financial industry and abolish the Dodd-Frank Act strongly contradict the measures necessary to ensure system stability, capital market functioning, and investor protection. Nonetheless, the operation among regulators and establishment of international cooperation through the FSB combined with the implementation of a recover and resolution strategy for G-SIFIs has led to a robust framework that is much better equipped to deal at an early stage with future financial crises than the measures in place prior to the GFC.

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