WEAKNESSES OF THE CURRENT REGULATORY FRAMEWORKS OF THE EU INTEGRATED FINANCIAL MARKET

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Abstract

With regard to the globalization and integration trends within the EU, there have been significant changes in the development of financial markets. A strong and reliably functioning financial market is a prerequisite for healthy development of the economy of each country. Therefore, such a regulatory and supervisory framework should be developed that not only ensures its efficient functioning, transparency and stability, but also provides protection to investors, depositors and policyholders, who should have the option to choose from quality products. It is important to realize that the quality of functioning of financial markets and their stability is largely influenced by the quality of regulation and supervision. The question is whether the current EU regulatory measures are beneficial and what can be seen as weaknesses.

Introduction

Regulation and supervision of financial markets have always been very questionable issues within each state. Due to developments in financial markets and due to global and EU integration trends it is necessary to look at regulation and supervision from a much more complex point of view. It is not possible to only consider the national scale, but it is necessary to also take into account the European and world scale at which changes are taking place in the area of financial regulation and supervision.

The recent financial and economic crisis has exposed weaknesses in the regulation and supervision of financial markets, which led to the creation of the Larosiè re Group, which identified the causes of the financial crisis (low interest rates and excess of liquidity contributed in particular to the crisis in USA, the fault of corporate management as well as wrong authentication of risks by financial institutions). Based on that, we recommended measures that would improve the European system of financial supervision. The paper
focuses on one of the current topics, specifically on regulation of financial markets and identification of weaknesses of the current regulatory frameworks of the EU integrated financial market.

This paper, which was created within the student project titled “EU Approaches to the Regulation of Financial Markets and its Influence on the Czech Financial Sector” No. 38009, aims to assess and evaluate the deficiencies of the current regulation. To correctly evaluate the current state of regulation, it is necessary to structure around the basic theoretical facts regarding the importance of regulation of financial markets as well as around the current institutional arrangements.

1 Importance of Financial Regulation

Today, significant tendencies towards linking the world in various areas – political, economic, socio-cultural and other - can be seen in connection with globalization trends. With respect to that fact, it is essential to ensure stability of the financial system in today’s globalizing world. Financial markets regulation and supervision are often considered the main tools to achieve this goal. In the introductory part of the paper it is therefore necessary to first explain the terms “regulation and supervision of financial markets”.

All over the world, the financial market is one of the most important segments of the economy. It basically constitutes a “blood circulation” in which money flows between economic entities. The global economic and financial crisis that erupted in September 2008 increased efforts put into the regulation of financial services.

Regulation is a set of rules and standards that guide functioning of financial institutions whose main objective is to increase financial stability and client protection. Regulation can take on various forms from information requirements to stringent measures such as capital requirements. On the other hand, supervision is a process designed to control financial institutions to ensure that the rules and standards are used properly. In practice, regulation and supervision are interrelated and therefore it is important to assess them together.

Regulation and supervision mostly take place on two main levels – national (provided by national organizations, in many cases by national central banks) and international. International organizations issuing the standards have only an advisory function. Within the EU, its own regulatory principles are adopted that must be incorporated into the legislation of the Member States of the EU. However, in most cases these recommendations are based on the recommended standards of worldwide regulatory bodies. [3]

International regulation of financial services concerns mainly three areas of the financial market:

- Banking – Basel Committee on Banking Supervision – BCBS;
- Insurance – International Association of Insurance Supervisors – IAIS, International Association of Deposit Insurers – IADI;
- Securities – International Organization of Securities Commissions – IOSCO

The basic objective of regulation and supervision of financial markets is to create long-term stability, maintain the functionality and reliability of the markets and protect investors. The aim is to reduce market risks and the likelihood of destabilization of the financial system, irrecoverability of deposits, investments or insurance benefits due to insolvency, to promote efficiency, safety and reliability of the financial system and also to eliminate the appearance of unfair trading, fraud, immoral behaviour detrimental to market participants and money laundering, and to thereby protect consumers. The regulator must try to find a balance
between ensuring stability and security of the entire financial system on the one hand and competitive, innovative environment on the other. [3]

The institutional structure of financial services regulation at the European level is now undergoing a significant evolutionary, maybe even revolutionary process. And not only with regard to the efforts to respond to the financial crisis, but also thanks to the Lisbon Treaty, whose aim is to reform the institutions of the EU and its functioning. Lisbon Treaty provides to the EU the legal framework and tools necessary to meet future challenges and fulfil people’s expectations. (it strengthens the European Parliament and national parliaments, gives citizens more opportunities to express their opinion and better defines the division of powers between the EU and Member States). It also simplifies decision-making procedures and voting rules and increases the EU capacity for action in priority areas. The Lamfalussy process – a system of institutions and processes through which regulatory rules for financial markets in the EU arise, which was valid until recently – will thus undergo fundamental changes soon. The aim of this process was to simplify and speed up the legislative process of the EU within the area of financial services. On the basis of this four-level process of the EU institutions created political framework legislation. The basic idea of the Lamfalussy process should, however, remain unchanged and it is the achievement of such a regulatory mechanism that would be sufficiently fast, flexible, democratic and transparent with regard to the dynamics of financial markets. Emphasis is also placed on the mutual cooperation of all stakeholders - creators, executors of regulation as well as regulated entities. [11]

2 Institutional Structure of Regulation and Supervision of Financial Markets

A number of national, European and also international organizations deal with the question of regulation. Given the high number of organizations collaborating in the creation of regulatory measures, it is important to ask the question whether regulation of financial markets is sufficiently effective. It is also necessary to think about who is responsible for the regulation as a whole or who is responsible for the creation of regulatory measures.

In the context of the interconnection of the world, we would like to mention the process of integration in the supervision of financial institutions and financial markets. The level of integration can be assessed according to several criteria:

- Rate of concentration of the volume of financial operations in individual regulation and supervision institutions;

- Total number of institutions responsible for the regulation and supervision.

We can mention two basic models of institutional arrangements for financial regulation and supervision:

- Sectoral model, which is organized by the main sector of financial intermediation:
  - Section of banking regulation and supervision;
  - Section of regulation and supervision of the capital market;
  - Section of regulation and supervision of insurance companies.

- Functional model which also has three versions:
  - Separate regulation;
  - Partial integration;
  - Full integration.
Given the fact that financial regulation at the European level affects financial markets of individual Member States, it should be borne in mind that there are significant differences between Member States. These differences can be seen partly in specific economic conditions of the financial markets, i.e. the economic level of the country and the historically specific institutional arrangements, but also in the legal system of the country. For these reasons, it is important to ensure adequate harmonization of European legal acts with the acts of the member countries. [4]

With the growing internationalization and globalization, cooperation in the regulation and supervision at the international and global level is gaining significance. The importance of international organizations can be seen especially in that they allow the creation of a common platform to solve common issues and in order to meet common objectives and ensure the effectiveness of financial supervision in the EU. Starting point of this effort can be seen in that four-level process (first level deals with the key principles of primary legislation, the second level receives detailed technical implementing measures, the third level deals with the cooperation of supervisors and fourth level deals with monitoring and enforcing legislation). [5], [13]

At the global level, the following institutions are particularly important in terms of financial regulation and supervision - Organization for Economic Co-operation and Development (OECD), World Trade Organization (WTO), International Monetary Fund (IMF) and other. At the international level, we can mention - Financial Stability Forum (FSF), Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS), International Organization of Pension Supervisors (IOPS), International Association of Insurance Supervisors (IAIS) and other. Within the European Union, the following institutions are important in terms of regulation - European Commission, European Parliament, European Insurance Committee (CEA), European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), European Securities and Market Authority (ESMA) etc. Given the above list of institutions, we can talk about the disproportionately large number of regulatory entities, indicating the complexity of the decision-making process itself and the complexity of the implementation of these decisions. [13]

![European supervisory structure](image)

*Source: Self elaboration [7]*

**Fig. 1: European supervisory structure**

Given that the financial crisis has helped reveal systemic weaknesses of the European supervisory framework, it was necessary to create a new organizational and conceptual structure of European institutions (see Fig. 1). Two completely new supervisory authorities were established – ESFS – European System of Financial Supervisors and ESRB – European
Systemic Risk Board. ESRB deals with macroprudential supervision and ESFS deals with microprudential supervision. The aim of ESRB is mainly to identify and monitor systemic risk and make recommendations for its reduction. ESFS is made up of a number of financial supervisory authorities of Member States cooperating with new European supervisory authorities. [9], [15]

3 Weaknesses of the Current Regulatory Framework

The current form of regulation that was created in response to the global financial crisis is the subject of many discussions, which lead to contradictory opinions regarding the tightening or easing of financial market regulation. Tightening refers to a change in the provisions relating to the regulation and supervision leading to the removal of identified deficiencies. It should be noted that more information about the regulation could be learnt primarily through the study of the causes of previous financial crises. [13]

In the current financial system, new regulatory measures are adopted that would strengthen the resilience and reliability of individual financial institutions. The banking sector is currently establishing the Basel III regulation which is a proposal of BCBS focused mainly on strengthening the capital adequacy of banks, i.e. the ability to absorb risk. On the other hand, the European Commission is leading the Solvency II project to develop harmonized standards for insurance supervision in the EU. [1]

3.1 From Solvency I to Solvency II

The existing solvency margin requirements were established in 1973 within the first non-life insurance directive (73/239/EEC) and in 1979 within the first life insurance Directive (79/267/EEC). The third generation of the life insurance Directive (92/96/EEC) and non-life insurance directive (92/49/EEC) gave the basis for creation of a single insurance market.

The single passport/license principle was introduced to the field of financial services. Based on this principle, entity can operate in any Member Country under the authorization (license, registration) issued in one country in which the entity has place of business or place of residence. The entity operates on basis of notification obligation to the competent authority of the country which has granted permission. Activity in the single market is carried out depending on the degree of integration into the host Member State economy. It is based on the right to establish branches (so-called right of establishment) and on the freedom to provide services (direct services without establishing branches in the Member States). One of the most competitive insurance markets in the world is EU insurance market. [3]

This system is grounded in mutual recognition of supervision exercised by the various national authorities according to the rules harmonized to the extent necessary at the EU level. Requirement of insurers to generate sufficient solvency margin is one of the most important prudential rules.

The current regulatory framework of solvency adjustment represented a significant progress at its beginning. Solvency I has considerable shortcomings in the present of financial integration and interconnection of financial services. These weaknesses are seen especially in the conception of capital requirements and in the fact that solvency is monitored with regard to the liability side of the balance sheet and doesn’t reflect the asset side of the balance sheet. [4]

Capital requirements under the Solvency I are not based on the risk profile, because they do not take into account the risks of insurance company. This is only a capital requirements calculation based on the size of the portfolio; single legislative framework is not established for measuring of risks, which is not integrated; risk management has very little effect on
capital requirements; mentioned composition of the assets on the balance sheet is not taken into account but composition of the liabilities is taken into account; other significant risks are not taken into account (operational, legal, etc.). [4]

The new Solvency II regime emphasizes in its three-pillar structure:

- quantitative requirements concerning the regulation of technical provisions; Minimal Capital Requirement (MCR) which is a kind of guarantee; Solvency Capital Requirement (SCR) whose calculation is based on the assessment of underwriting risk, credit risk, market risk, operational risk and liquidity risk; rules for investing of insurance companies into various investment instruments;
- qualitative requirements relating to internal control systems adequate to business structure and risk profile of the insurance company; risk management; principles of supervision which are focused on the functionality of the insurer’s management systems;
- obligation to disclosure information of the risks; scenario analysis of assets and technical provisions; transparency and comparability strengthening of insurance products and business of the insurer. [8]

The transition from Solvency I to Solvency II shows Fig. 2 below.

A. Böhm a K. Mužáková consider “adopting the concept of Solvency II as binding regulation for crossing of the invisible boundary between the creation of the single market in insurance on the basis of harmonization of national standards and the creation of dirigiste EU institutions regulated system of the subjects behavior of this market.” [5]

The introduction of Solvency II currently seems problematic. At first, it was assumed that the system Solvency II will replace the existing Solvency I regime in November 2012. The second term for the application of this methodology was the beginning of 2013. The fact that in this period a regime of capital adequacy (solvency) and reporting to the insurance sector wasn’t adopted, raises among European insurers considerable concern. Based on the Directive of the European Parliament and of the Council 2012/23/EU of 12 September 2012 amending Directive 2009/138/EC (Solvency II) as regards the day of her execution, the date of application and the date of repealing certain Directives. Recently, there has been a strong
pressure to Solvency II Directive to come into force on 1 January 2014. Postponement is due to differences of opinion between Member States concerning the final form of the project. However, it is also considered other postponing implementation Solvency II to 2016 or 2017. EIOPA, however, disagrees with reflections on the postponement of the original term and insists on the implementation of Solvency II in 2014 as planned. [4], [8]

3.2 From Basel II to Basel III

According to the Czech National Bank, weaknesses of Basel II banking regulation can be seen chiefly in low quality requirements (the ability to absorb losses) and quantity requirements (relative to risk-weighted assets) of bank capital; in the lack of liquidity risk regulation due to the dependence of many big banks on finance through the financial market (as opposed to funding via deposits); in the complexity of Basel II rules; in underestimation of credit risk by relying on statistical models of risks measurements and the trustworthiness of external ratings of many financial instruments; in the procyclicality of Basel II (the tendency to strengthen the credit cycle) or in regulatory capital requirements that insufficiently limited the incentive to raise earnings from capital through increasing of ratio of liabilities to equity (leverage). [7] The regulatory framework Basel III will be progressively implemented within the banking reform process between years 2013 and 2014. Basel III should make significant changes in the regulation of capital requirements: The new definition of regulatory capital means strengthening of global capital framework with raising the quality, consistency and transparency of the capital base, strengthen the risk coverage with a capital conservation buffer, supplementing the risk-based capital requirement with a leverage ratio, reducing procyclicality and promoting countercyclical buffers, addressing systemic risk and interconnectedness, a new liquidity requirement and other elements (“SIFIs” – Systemically Important Financial Institutions). [2] [14]

The aim of regulators is to regulate complex financial markets by increasingly complex regulatory frameworks. It should be noted that such complexity in the financial market may not only be beneficial, but it can cause market failure and lead to over-regulation both various segments of the financial market and the financial system.

Although Basel III and Solvency II aim to ensure sufficient regulatory capital, which is held by banks and insurance companies, it is necessary to point out certain differences. Basel III aims to improve the quality and level of capital. Solvency II aims to improve the protection of policyholders by ensuring that the quality and quantity of capital required is determined by the risks to which insurers are exposed. At the same time Basel III and Solvency II were characterized by different developmental processes as Basel III was created in response to the recent financial crisis, but Solvency II creates standard, which is fully based on the risk for the entire European insurance sector. Given that the banking and insurance sectors are characterized by a completely different business models and represent different role in society, the regulation should be adapted to this facts. [1], [12]

Of the many views on current regulatory measures may be mentioned prof. C. Goodhart and prof. Wagner’s opinion expressing the idea that even if the regulatory framework Basel III progressively closer to a safer financial system, we can see some flaws. One of the possible deficiencies perceive a lack of diversification of financial institutions caused by the passage of time, financial institutions are becoming more and more similar to each other and interconnected, resulting in the exposure of financial institutions funding the same risks [10]
Conclusion
Firstly, changes in the Solvency I and Solvency II regulations and secondly changes in the Basel II and Basel III regulatory frameworks were assessed in this paper. Given that increasingly complex regulatory frameworks are arising from the regulation, weaknesses can be seen in the current regulation, which of course have an effect on the stability of financial markets. As the main weaknesses of the current treatment Solvency I have been found mainly in the concept of capital requirements, in the failure to disregard the assets and risk profile of the insurance companies. Weaknesses of the regulatory framework of Basel II can be seen in the lack of quality requirements but also of quantity requirements of bank capital, in the complexity of the project or in the underestimation of credit risk. At present, there is only waiting for the introduction of new regulatory projects Solvency II and Basel III, while Solvency II faces the problem of the continuous postponement of the implementation date. Of course, only the act of implementation in practice shows other possible challenges to move in the desired direction. Finally, it is necessary to add basic rules for regulation to be effective - take into account the different approaches to banking and insurance market, fast, efficient and inexpensive implementation of regulatory projects.

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Literature


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S ohledem na globalizační a integrační trendy v rámci EU dochází k výrazným změnám ve vývoji finančních trhů. Silný a spolehlivě fungující finanční trh je předpokladem pro zdravý vývoj ekonomiky každé země. Měl by tedy být vytvořen takový rámec regulace a dohledu, který nejen zajistí jeho efektivní fungování, transparentnost a stabilitu, ale také poskytne ochranu investorům, vkladatelům a pojišťencům, kteří by měli mít možnost volby z nabídky kvalitních produktů. Je třeba si uvědomit, že kvalita fungování finančních trhů a jejich stabilita je ve velké míře ovlivněna kvalitou regulace a dohledu. Otázkou je, zda jsou současná regulatorní opatření EU prospěšná a jaké lze spatřovat slabé stránky.

SCHWÄCHEN DER BESTEHENDEN RECHTLICHEN RAHMENBEDINGUNGEN DES INTEGRIERTEN EU-FINANZMARKTES

Angesichts der Globalisierungs- und Integrationstrends innerhalb der EU kommt es zu erheblichen Veränderungen in der Entwicklung der Finanzmärkte. Ein starker und zuverlässig funktionierender Finanzmarkt ist eine Voraussetzung für eine gesunde Entwicklung der Wirtschaft des jeweiligen Landes. Es sollten daher solche regulatorische und aufsichtsrechtliche Rahmenbedingungen entwickelt werden, die nicht nur für ihre effiziente Funktionsweise, Transparenz und Stabilität sorgen, sondern auch einen Schutz der Anleger, Sparer und Versicherungsnehmer gewährleisten, denen die Möglichkeit der feinen Produkte gegeben werden sollte. Es sollte angemerkt werden, dass die Qualität der Funktionsweise der Finanzmärkte und deren Stabilität in hohem Maße von der Qualität der Regulierung und Aufsicht beeinflusst werden. Die Frage ist, ob die aktuellen EU-Vorschriften vorteilhaft sind und was als Schwäche betrachtet werden kann.

SŁABE STRONY OBECNYCH RAM REGULACYJNYCH ZINTEGROWANEGO RYNKU FINANSOWEGO UE

Ze względu na tendencje globalizacyjne i integracyjne w ramach UE rozwój rynków finansowych ulega istotnym zmianom. Silny i stabilnie funkcjonujący rynek finansowy stanowi przesłankę dla zdrowego rozwoju gospodarki każdego kraju. Powinny być zatem stworzone takie ramy regulacyjne i nadzorcze, które nie tylko zapewnią jego efektywne funkcjonowanie, przejrzystość i stabilność, ale również ochronę inwestorów, deponentów i ubezpieczonych, którzy powinni mieć możliwość wyboru z oferty wysokiej jakości produktów. Należy mieć świadomość, że jakość funkcjonowania rynków finansowych i ich stabilność w dużej mierze zależna jest od jakości regulacji i nadzoru. Pytaniem pozostaje, czy obecne działania regulacyjne Unii są korzystne i jakie można dostrzegać ich słabe strony.