Stanisław Kluza*

THREE PILLARS OF EFFECTIVE CROSS-BORDER FINANCIAL STABILITY FRAMEWORK

I see the global financial stability framework as based on three complementary pillars: one referring to supervision, another to regulation and yet another to responsibility.

PILLAR ONE: COMPETENT FINANCIAL SUPERVISION AT THE COUNTRY LEVEL

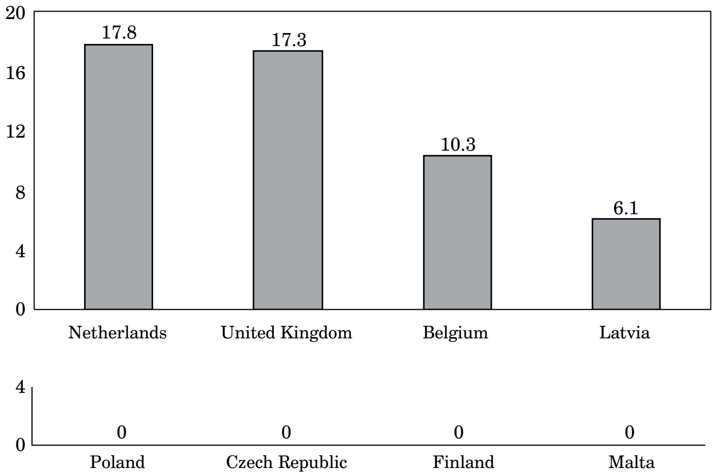
During the financial crisis the developed world has learned that market turbulences spread across borders before anyone can react. This shows just how much we need international cooperation before and when something happens. But another lesson we got is that the very origin of crises is local. Problems of large transnational financial groups resulted mainly from inadequate risk management at the parent companies and from lax home supervision.

The greatest attention, then, must be paid to making national supervisors as competent as they can be. European or global bodies will not solve structural ailments of countries that neglected their domestic regulatory systems. In short,

* Stanisław Kluza is the Chairman of the Polish Financial Supervision Authority (KNF).

national supervisory authorities must be proactive, independent from any internal or external influences and helped by a prudential regime adjusted specifically for the particular market. If this is the case, the country is able to avoid situations in which taxpayers pay banks in order to make their deposits safe.

Public aid for financial institutions as a percentage of GDP (2008–2009, excl. guarantees on interbank loans)



Source: European Commission

We, as the Polish Financial Supervision Authority (KNF), have learned one more lesson. What made our supervisory policy effective was the ability to independently guard financial institutions' capital and liquidity positions. Any international attempt to transfer this competence from the host country to the domestic or European level should be reconsidered very carefully.

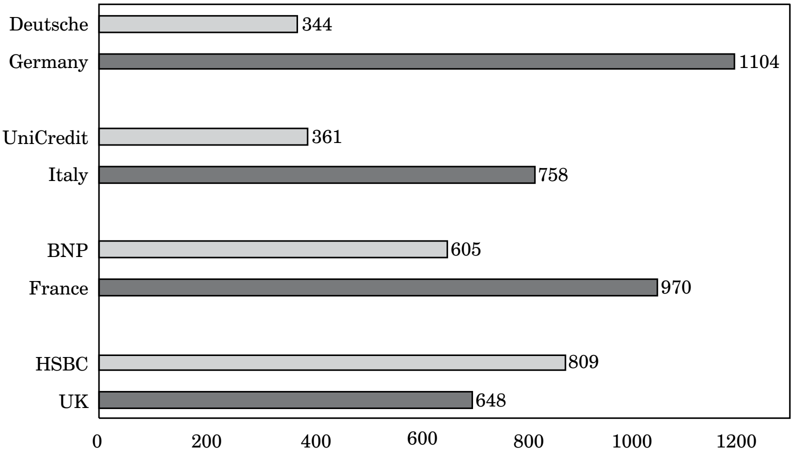
What we lack, of course, is the ability to decisively influence the parent companies of financial institutions based in Poland. Colleges of supervisors have been created in the EU to facilitate control over what is happening in the whole group. We think that one of the main roles of the envisaged European Supervisory Authorities could be to lead these colleges[1].

[1] One of the European Parliament's proposals for regulations establishing the European Supervisory Authorities, dated June 2010, included this point, but at the moment of writing of this article it was not clear whether it would be finally accepted.

PILLAR TWO:
REGULATORY REGIME THAT DISCOURAGES CONSOLIDATION

Many financial institutions all over the world have simply grown too large. There are countries in Europe where a single bank has deposits bigger than public budget's expenditures[2]. The same applies to the assets. In 2007, ten European financial institutions had assets larger than GDP of their countries. In 2009 there were already fifteen of them[3].

Deposits held in the largest banks and total state budget expenditures (bln euro, 2009)



Source: Bloomberg

One might say that we have a free market and it is not public authorities' duty to prevent growth of private companies. But the point is that regulations today seem to encourage it. Capital and liquidity requirements applied on the group level, cross-border crisis management, vague regulatory concepts such as "group

[2] HSBC is the most prominent example. At the end of 2009, the bank held deposits worth 809 bln euro. The UK state budget expenditures for the whole 2009 amounted to 648 bln euro. In case of this bank, no public aid was employed nor needed. In case of Belgium, a bank with deposits exceeding state's budget came to the brink of collapse. In Iceland – three such banks did collapse. Source: Bloomberg.

[3] Andrew MacAskill and Jon Menon, European Banks Growing Bigger 'Sowing the Seeds' of Next Crisis, Bloomberg, 2 December 2009, http://noir.bloomberg.com/apps/news?pid=newsarchive&sid=aRDrzOAWRekc

interests" – all those ideas potentially stimulate consolidation[4]. This would create the perverse impact of lowering funding costs of consolidated financial institution giving them incentive to take more risk and simultaneously certainty that they are too big to fail. This is not the goal we should pursue given the amount of risk such large groups generate.

So it is on the level of individual institutions where requirements should be applied – both for the institutions' stability and for the avoidance of consolidation[5].

PILLAR THREE: PROPERLY ADDRESSED RESPONSIBILITY

We, at KNF, propose a simple rule: those who influenced a bank's strategy should be held accountable if it fails. It refers both to supervisory authorities and to parent companies.

Today, all financial institutions in a given country participate in the costs of bankruptcy of one of them, through the deposit guarantee schemes (DGSs), even if they had no influence on the bankrupt's policies. But the guarantee funds are running short of money. In 2008–2009 taxpayers form seventeen European countries had to step in to rescue ailing banks[6].

Against this background, it seems not justified that the parent institutions' financial responsibility for their subsidiaries is limited only to the capital invested. It is the parent who really impacts the subsidiary's strategy, capital allocation, dividends, and composition of the management team. What we propose, then, is to make the parent companies more accountable for the mistakes their daughters commit if these mistakes lead to bankruptcy. In practice, this aim could be achieved by establishing a formal link between home and host deposit guarantee schemes. The former would participate in the costs of bankruptcy borne by the latter. The proposal should be subject to discussion in the context of the new revision of the directive on deposit guarantee schemes.

[4] The level of application of capital and liquidity requirements is currently being discussed once again in the context of the new amendments to the capital requirements directive (CRD 4). The European Commission's approach has been published here: http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf

[5] The stance of the KNF on the level-of-application issue is summarized in a comment for the Basel Committee on Banking Supervision's consultation: http://www.bis.org/publ/bcbs165/pfsal.pdf

[6] Within the EU only ten states did not resort to direct public aid for banks: Bulgaria, Cyprus, Czech Republic, Estonia, Finland, Lithuania, Malta, Poland, Romania, Slovakia.

The “New Europe” has been very hospitable to foreign financial groups. But this made our financial systems vulnerable to external shocks. The network of DGSs would partly eliminate that.

The functioning of deposit guarantee schemes should also be reviewed in the context of foreign banks operating via branches. We agree with those countries that want to ensure that the Icelandic is case never repeated. Branches of foreign credit institutions do not participate in local deposit guarantee schemes and are supervised by the local authorities only to a limited extent. At the same time they are able to lure many clients, thanks to high interest they can pay.

Transformation of the branches of foreign banks into subsidiaries would subject them to local supervision and make them pay a fee to the local DGS. KNF believes that if they are not willing to convert, they should still pay an additional reinsurance fee to the host DGS. This reinsurance would be activated if the home DGS fails to meet its obligations.