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Institutional Change of the Supervisory System of the EU Financial Market

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Abstract

The global financial crisis caused public discussions on the efficiency of the supervisory institutions of the EU financial sector. This paper identified the changes of the EU financial supervisory system and evaluated the directions for improvement of the reform. The logical method is used for making a substantiated generalization of the collected facts and formulating transitional as well as final conclusions of the research. Seeking to evaluate the existing banking regulation in Lithuania and the EU, the method of systematic analysis is applied. The results of the study show that the recent integrated supervision models failed to quickly and efficiently respond to the financial crisis. Ordinary European System of Financial Supervision (ESFA) is insufficient to prevent splitting of the European financial market.

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Introduction

The intervention of the European Union states in the rescue of the banking sector started in 2008/2009 alongside with the worldwide financial crisis on a dramatic scale. The support for the states was rendered in a variety of forms. Consequently, that made a negative effect on the public finances of the states which resulted in a moral hazard. The actions of that kind caused public discussions on the efficiency of the supervisory institutions of the financial sector on the macro and micro levels and disclosed the problems of that sector. Supervision is so far carried out based on

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different national rules without regard of the fact that the single market was established 23 years ago. It became clear that the existing supervisory measures were insufficient to avoid, to manage and to overcome crisis. The national supervisory models lag behind the modern reality, i.e. the integrated and interrelated European financial markets, where numerous financial enterprises operate on a cross-border scale. Unsuccessful regulation and supervision of financial markets should be regarded as one of the main causes of the worldwide financial crisis of 2008 (The Turner review, 2009; McCarty, Keith, Pole... 2010; Levine, 2010).

The studies performed show that the EU institutions and Member States started an unprecedented reform of the performance of supervisory institutions. The presented landmarks of the reform of the banking system and integration of the European supervisory system aim at ensuring stability of global financial systems and returning trust in the markets (Larosiére, 2009; Liikanen, 2012; Masciandro, Pansini, Quityn, 2011; Miklaszewska, Mikolajczyk, Pawlowska, 2012). With regard to that, the aim of this paper is to assess the reform of the EU institutional system of financial supervision and the trends of its improvement. The authors identify institutional changes within the EU financial supervisory system after the financial crisis. A special attention is devoted to the establishment of the Banking Union characterized by a more integrated viewpoint and which can supplement the space of a single currency and internal market.

The research problem is formulated on the basis of the research questions: how the supervision and reorganization of the banking system should be carried out locally and globally?; what new supervisory mechanisms of financial market must be created and how do they have to function?; To what degree are interference and control of the supervisory institutions appropriate, so that freedom of action is not violated and negative effect is avoided?

Practical implications of the paper confirmed that the recent integrated supervision models failed to quickly and efficiently respond to the financial crisis. Ordinary European System of Financial Supervision (ESFA) is insufficient to prevent splitting of the European financial market. Some mechanisms fail to fulfill their functions due to the intricacy of their internal structure and the size of the EU banking sector. The European Banking Union should make sufficient changes in this area.

The logical method is used for making a substantiated generalization of the collected facts and formulating transitional as well as final conclusions of the research. Seeking to evaluate the existing banking regulation in Lithuania and the EU, the method of systematic analysis is applied. Together with the logical method, the generalization method is used which helped to identify general and major features and characteristics of mechanisms analyzed in this paper.

1. The Institutional Model of European Financial Supervision

The EU Founding Treaty fails to contain a special chapter on the regulation of financial services. The greatest attention is devoted to harmonization of supervisory rules and requirements with the view of tightening and unifying the supervisory terms in the EU and internationally. For a long time, adoption of supervisory measures for financial markets was based on the so-called Lamfalussy process (2001). A new structure of committees was established aimed at simplification of the decision making process and promoting efficiency of financial markets supervision (Hix, 2006). Later, however, the reform of the process became inevitable. Regarding that fact, the European Commission authorized a group of experts headed by J.Larosiére, to analyze the situation and put forward possible schemes of financial supervision and regulation. In 2009 the report was publicized where 31 practical recommendations on how to improve the whole supervisory mechanism were put forward (Larosiére, 2009). That was how a new European system of financial supervision (ESFA) was established which started in 2011 (Regulations (EU) No 1092/2010, 1093/2010, 1094/2010, 1095/2010 of the European Parliament and of the Council, 2010). That was an important achievement in a further integration of a single market of financial services. ESFA is responsible for ensuring the EU system of financial supervision on two levels.

The supervision of macro-level risk restriction on the European level is carried out by the European Systemic Risk Board (Regulation (EU) No 1092/2010 of the European Parliament and of the Council, 2010). The Board's aim is to prevent systemic risk threatening the EU financial stability and to minimize its effect with regard to macro-economic changes. When the ESFA thinks that a critical situation might occur, it provides confidential warning to the Council as well as the evaluation of the system. The European system of financial supervision on a micro-level consists of the multilayer system of the appointed institutions. Different layers can be distinguished according to the

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