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UOT: 339.727; JEL: F 30

Transformation of the mechanisms a banking investment in the EU in the post-crisis period

Abstract

In the article the basic instruments of the adjusting bank activity are investigational in the countries of EU in the conditions of world financial crisis. The theoretical and practical aspects of formation of Bank Union EU' countries and also inputs of mechanisms, are analyzed Basel III in a post-crisis period. The offered research provides consideration of the main phases of the financial crisis on the EU's market of banking services; analyses of the basic measures of improvement the resilience of European banks in crisis and post-crisis period, determines the main trends in the European banking sector.

Key words: Financial Stability Board, European Commission, Basel Committee on Banking Supervision, Basel-III, Capital Requirements Directive and Regulation (CRD IV), Single Supervisory Mechanism, capital conservation buffer, counter-cyclical capital buffer

Introduction

Systematic transformation of regulation of the European Union banking market in post-crisis period proves the consolidation of all possible legal and economic measures to create a single common market of investment and credit services, which largely forms the favorable conditions for the development of banking and the entire banking system of the EU, facilitates the process of overcoming the effects of the crisis in the financial sector, and aims at restoring consumer trust in banking.

Latest research and publications analysis

Fundamental studies of European scientists clearly show that the process of economic renewal and growth are defined by volume and structure of investment, as well as quality and speed of it. Furthermore, the researchers point out that one of the main problems European countries are facing now is searching for new mechanisms in order to mobilize funds for investment, through which the basis of investment in the national economy of developed countries is provided.

The financing of real investment, including investment banking projects was partially covered in the economic literature. Among Western economists a significant contribution to the development of this subject have been made by H.Aylenberh, Zh.Vihur, G.Nepman, P.Masse, F.Modilyani, M.Miller, K.Reylli, E. Schneider, and others.

Key research findings

The issue regarding specifics of financial markets, international integration of the credit and investment system requires analysis of not only positive improvements in the banking sector, but also potential threats. The sensitivity of national economies to global crises is increasing, while the effectiveness of monetary regulation at the national level is reducing, with the intensity of the international movement of bank capital increasing. In particular, there is not only a bank equity movement, but also the international movement of loan capital, concentrated in banking sector. At the core of international banking investment lies uneven economic development of individual economic entities, industries, countries and regions.

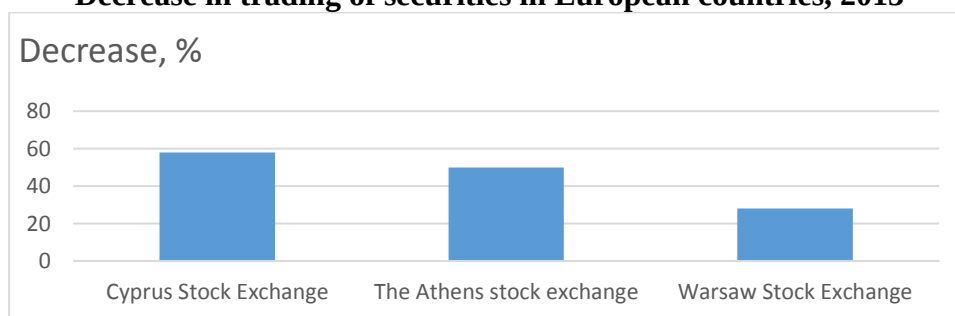


Considering other factors of post-crisis development of the banking market in the EU, including investment processes, the stock market and interest rates on loans, it should be noted that in the pre-crisis years European banks were characterized by relatively low average return on assets (ratio of net income to the average assets) [6].

This factor created favorable conditions for European banks to look for increase in interest margins, both by raising interest rates on active operations, and via their decrease in passive operations. As a result, the share of debt securities and interbank funding in the structure of banks' liabilities of EU countries increased, while the volumes of unsecured consumer lending and long-term mortgage lending significantly grew. After the crisis in 2008, this situation negatively reflected on the asset quality, banks started to reduce lending, which based on the above information, declined more rapidly than the value of deposits, also the volume of trade of securities decreased. The presence of significant government debt in some EU countries has led to the fact that most European markets in 2013 experienced a drop in index and market capitalization (Pic. 1). The largest drop occurred in the Cyprus Stock Exchange (-58%) and the stock exchange in Greece (-50%). If in 2012 the EU faced an increase in trading of securities, in 2013, these stock exchanges had negative results, particularly on the Warsaw Stock Exchange in 2013 the fall of -28% was recorded, while in 2012 the growth constituted 26%. This situation had a negative impact on the banking market as for trading of securities, volume of which was dropping [4].

Picture 1.

Decrease in trading of securities in European countries, 2013



Taking into account innovations in banking institutions of the EU and the development of new financial instruments, including derivatives, these trends create new risks for the banking system. An important achievement of financial markets in the post-crisis period in the banking system of the EU countries was the development of the secularisation of financial instruments, which resulted in emergence of new approaches to risk management, providing risk-sharing and increase of the turnover of financial resources for long-term bank lending. The negative aspect of such financial innovations includes the spread of credit risk and accordingly the risk of incurring financial losses for a large number of entities, whereas previously this risk had only one participant in the financial market. Along with increasing concentration and universalization of banking systems in the EU due to the conversion of debt into securities the risks were transferred not only to lenders of the issuing bank, but also to its depositors and correspondents. As a result, the distribution of risks between banks economic agents takes place, which include non-financial companies, individuals, investors, bondholders, and mortgagees. Based on these steps in the EU banking sector a new source of funds emerged, aimed at improvement of the quality of assets and liabilities, also individual funds which had not been used because of the need to ensure the capital adequacy of banks were released [1, 30].



In post-crisis period the number of mergers and acquisitions and refinancing volume increased in the EU banking sector. This was connected with a reduction in the number of banks in the participating countries due to the debt, as despite the new EU countries accessing, the number of banks for the period 2003 – 2015 decreased from 9,465 to 8,838 entities. Because of the difficult financial situation banks have been subject to acquisitions, with large banks in particular, including British HBOS, German Dresdner Bank, and Belgian-Dutch Fortis. Another consequence of the increase in the concentration of banking systems in the EU in the post-crisis period was their universalization, which reflected in the development of functions of financial institutions purchased, as well as the development of new segments of the banking market.

Quite an important role in post-crisis recovery period for investment banking market in the EU was paid to recapitalization of banks. Currently, losses due to impairment and write-off of assets, losses from current activities cause negative impact on the value of banks' capital, leading in some cases to the fact that total equity of the banking sector in some countries, particularly in Greece, is negative. At the same time, central banks conducted their recapitalization, which was completed nationalization of certain credit institutions in an effort to restore the proper level of functioning banking systems,. Thus, programs of recapitalization of banks in post-crisis period was carried out in Austria (the value of the transaction amounted to 15 bln. Euros, with Bank Medici AG nationalized), the UK held the nationalization of 8 large banks of total amount \$ 500 billion pounds, including such giants as Royal Bank Scotland, Germany conducted the nationalization of Hypo Real Estate, in Italy recapitalization cost 12 billion Euros, in Portugal 4 bln Euros were spent, with Banco Portugues de Negocios nationalized. The French recapitalization amounted to 40 bln Euros, and the Switzerland 5.2 bln USD to recapitalize the bank UBS [11].

The programs for the recapitalization of banks in the EU together with other support measures, as well as some positive changes in the macroeconomic conjuncture allowed many countries to not only fill the loss of bank capital, but also to ensure its growth. As a result, of some stabilization in the banking market many EU credit institutions have improved their financial performance, allowing for recapitalization using profits. However, in countries like Romania, Greece, Italy, and Spain the negative financial performance of the banking sector in general is observed, which adversely affects the volume of banks' equity.

Positive changes achieved as a result of the capitalization of the euro area banks did not eliminate all potential threats to credit institutions own funds, such as the cost of additional reserves on loans and other assets, falling of market price of joint-stock capital and losses from current activity. In the short run during 2017 one foresees certain capital growth of the banking sector in most EU countries, although rates will be much lower compared to the period of active support of the banking systems by the countries.

In order to ensure banking institutions access to financial resources central banks of developed countries have reduced current refinancing rate and plan to keep it in the short run. Central banks provide direct support to the banking sector by issuing loans of various types and urgency. State guarantees on loans have become quite widespread recently. In particular, in Germany the federal government has provided up to 400 billion euros in interbank loan guarantees. In Italy state guarantees were provided on short and medium debts of banks. In Portugal mechanism of state guarantees was introduced on almost all financial operations of credit institutions. Central bank of France has provided up to 320 billion euros of state guarantees for transactions in the interbank market [10].

Increase of the banking systems capital of most EU countries contributed to the growth of its sufficiency. Some countries however show reverse trend associated with large



losses of the banking system due to the existence of significant debt (e.g. in Greece), asset quality deterioration and rapid growth of risky active operations. In general, during the post-crisis years most EU countries have a significant capital adequacy ratio of the banking sector: UK – 15.7%, Germany – 17%, Italy – 12.7% (Pic. 2). In the short run one expects a slight decrease in the capital adequacy of banks in most EU countries due to limited opportunities for further capitalization of banks and increase of the volume of risky assets. Troubled European countries (such as Greece, Spain, Italy and others.) are at high risk of reduction of bank capital adequacy. One should highlight that economic crisis of the EU countries in 2008-2010 negatively influenced the quality of bank assets and resulted in a variety of monetary and financial tools applied to improve the quality of the loan portfolio, increase the value of trade and investments in securities, and fight the decrease in the value of different types of collateral for loans [4].

Central banks and governments of the EU countries have done a lot to reduce the share of troubled assets on the balance sheet: redeemed or transferred such assets to the specially created institutions. In particular, in Austria packages of mortgage-backed securities for the amount of 6 billion euros have been redeemed. In Germany, Special Financial Market Stabilization Fund (SoFFin) reserved 80 billion euros to redeem troubled assets. In Italy one has implemented measures for temporary exchange of banking assets for government securities. The Swiss National Bank has redeemed troubled assets of UBS Bank for the amount of 46 billion US dollars [7].

Picture 2.

Capital adequacy ratio of the banking sector, EU in post-crisis period



Given the recession, which resumed in the EU, we can predict that in the banks in these countries high levels of bad credit debt will continue in the short term, and in some developed countries it may slightly increase. In the post-crisis period is rather risky to investment in securities due to the high volatility of exchange rates, indicating unattractive securities trading banks in the EU and the unresolved problems of this important banking market. In general, banking assets in the EU in the post-crisis period have a high exposure to credit, market and currency risk under the circumstances of continuing macroeconomic uncertainty [3].

As noted, one of the monetary factors of post-crisis development of the EU banking was reducing the interest rates on loans by the central banks, which lowered the cost of their maintenance in commercial banks. In the crisis period, central banks of the EU countries reduced interest rates by 0,75-1,5%, while their typical changes constituted 0,2-0,25%. In particular, the Bank of England has reduced the discount rate by 1.5% in November 2008 and by 1% in December 2008, the European Central Bank - by 0.75% in December 2008. However, this practice of reducing interest rates by central banks of the EU countries was atypical and was used together with other anti-crisis measures and in exceptional cases. To



facilitate access to finance there was secured sufficient liquidity and solvency of the banking system of the EU as in times of crisis and after the crisis allowing to reduce the number of problem banks and the deterioration of their activities [2].

It should be noted that the central banks of certain EU countries conducted monetary policy so as to ensure the maintenance of nominal interest rates on positive levels against inflation i.e. to prevent the growth of inflation the official interest rates remained higher than the level of inflation. Thus, during the 2008-2015 the rule kept was kept in the central banks of the EU countries like Hungary, Romania, Latvia, and Poland.

In certain periods of 2008-2015 this rate was not maintained by the European Central Bank and the central banks of Sweden, Great Britain, Czech Republic, Bulgaria, of Denmark, due to the need for loose monetary policy or even a policy of "zero interest rate" (the European Central Bank, Switzerland, UK) to stimulate the growth of national economies. Commercial banks received access to low-cost funds that could lead to the development of the various entities. In the post-crisis period, central banks of the European Union drew efforts to create conditions for long-term economic progress using tools of weighted interest rate policy and its quantitative loosening [8].

Certain changes in the banking sector in the EU post-crisis period were incurred by the bank management because of the need to implement Basel 3 standards, primarily capital requirements. The European Union introduced rules on capital, with the EU countries being limited in setting additional capital requirements i.e. the level cannot exceed the minimum listed in the Basel 3. In many EU countries in the post-crisis period there were introduced requirements for banks in the area of liquidity, in particular, the quality of liquidity, liquidity risk management, liquidity management and monitoring of foreign exchange transactions. Thus, in the EU in 2011 there were issued appropriate recommendations by the European Systemic Risk Office (European Systemic Risk Board). The requirements of Basel 3 bank influenced such instruments as derivatives in terms of trading standard products. In the EU, these requirements were adopted in 2012. Among the highlights of Basel 3, which had a significant impact on the market of banking services in the US, we can note the special requirements for the structure and size of bank assets and rules of the assignment of credit ratings [6].

Post-crisis banking transformation in the EU, in terms of monetary regulation was associated with changes in organizational structures. Currently, banks are changing organizational structures, management, and financial incentives for workers. This is due to the need to review the organizational structure of the Bank prevailing before the crisis and providing the rule of financial investment units, focus on short-term profits, a close relationship with third party organizations that were involved in financial speculation, and reducing the role of traditional banking activities. A large number of banks reduced the investment and financial business and number of staff. At the same time more attention in the post-crisis period was directed to building effective risk management systems, improving the efficiency of the internal control services that would allow banks to perform the functions of credit institutions in the future. This approach is justified in the recession of the EU economy and the need to focus resources on real projects of development, not to create additional risks and threats to the emergence of the crisis by investing in projects without sufficient material resources. Some changes have taken place in the system of material incentives for employees, providing the repeal of ultra-high bonuses, strengthening the connection between communication material incentives with long-term results of the bank operation. This approach can be justified because it involves workers in the results of banking operations and



is designed to obtain long-term stable income and is not focused on multiple bonus payments [9].

Furthermore, the effectiveness of monetary and financial instruments regulating banking services market in post-crisis period in the context of liquidity changes and the EU banking system profitability is too low. Banking sector liquidity of the EU countries, in particular, in crisis period has experienced negative impacts due to deterioration in the asset quality, increasing distrust of credit institutions from both private and corporate creditors.

In post-crisis period, liquidity situation in banking sector has stabilized in most EU countries, which is a sign of positive effects of monetary measures taken. At the same time, according to IMF, banking systems of some countries had very low liquid ratio (liquid assets to total assets). Thus, in Denmark – 13,8%, Finland – 8,6%, Italy – 4,4%, Norway – 10,5%, Portugal – 12,6%, Slovenia – 14,6%. There also is a low level of covering short-term obligations with liquid assets in the banking sector of some EU countries. In Bulgaria, in particular, it constitutes 26,6%, in Cyprus – 30,9%, in Estonia – 26,4%, in Italy – 2,7%. There is no doubt that commercial banks can count liquidity support from central banks, but insufficient assets liquidity level creates potential risks for banking systems [5].

Conclusions

Therefore, world financial crisis on banking services market resulted in decreasing activity of foreign banks in the EU countries in Eastern Europe, increasing state support of financial institutions in covering debt liabilities, lower level of financing high-risk projects, strengthening bank supervision by central banks, including European Central Bank.

If in pre-crisis period was characterized by intensified globalization processes and internationalization of banking services in the EU accompanied by advancement of new banking technologies and creation of prerequisites for functioning of banking sector in countries of Eastern Europe on the basis of open economy, then typical organizational and economic measures of intensification of integration processes became the following: 1) unification of legal framework for banking institutions with EU standards; 2) growing influence of competitive environment in banking sector in the EU countries; 3) privatization of banking systems and their unification with the participation of foreign capital; 4) increasing share of foreign investors in banking institutions.

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Aİ ölkələrində böhrandan sonrakı dövrdə bank investisiya mexanizmlərinin transformasiyası

Xülasə

Məqalədə Aİ ölkələrində beynəlxalq maliyyə böhranı şəraitində əsas tənzimləyici alətlər tədqiq edilir. Bankların formalaşmasının nəzəri və praktiki aspektləri, həmçinin Aİ ölkələrində böhrandan sonrakı dövrdə Bazel standartlarının III mexanizmlərinin tətbiqi araşdırılır. Avropa İttifaqının bank xidmətləri bazarında maliyyə böhranının əsas mərhələləri müəyyənləşdirir, əsas tədbirlərin davamlılığının artırılması və Avropa böhran şəraitində bankların böhrandan sonrakı dövrü təhlil edilir, bank sektorundakı müasir meyillərə baxılır.

Açar sözlər: *Maliyyə sabitliyi şurası, Avropa Komissiyası, Bank nəzarəti üzrə Bazel komitəsi, Bazel-III, kapitalın qorunması üzrə bufer, antisiklik dövrü kapital, kapital və tənzimləmə üzrə tələblər və təlimatlar (IV CRD), vahid nəzarət mexanizmi*



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**Трансформация механизмов банковского инвестирования в странах ЕС в
посткризисный период**

Аннотация

В статье рассматриваются основные инструменты регуляторной политики в странах ЕС в условиях мирового финансового кризиса. Исследованы теоретические и практические аспекты формирования банковского союза стран ЕС, а также внедрение механизмов Базель III в посткризисный период. Предлагаемое исследование определяет основные этапы финансового кризиса на рынке банковских услуг ЕС, анализируются основные меры повышения устойчивости европейских банков в условиях кризиса и посткризисный период, рассмотрены современные тенденции в европейском банковском секторе.

Ключевые слова: Совет по финансовой стабильности, Европейская комиссия, Базельский комитет по банковскому надзору, Базель-III, Директива требования к капиталу и регулированию (CRD IV), Единый контрольный механизм, буфер сохранения капитала, антициклический буфер капитала