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THE IMPACT OF FINANCIAL CRISIS ON FINANCIAL SUPERVISION IN THE EU, THE USA AND THE CZECH REPUBLIC

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Abstract: *Globalization and financial integration allows a more efficient allocation of capital in economies. However, integrated financial markets contribute to the dissemination of financial contagion among the financially integrated states. The world financial crisis has uncovered the lack of an efficient system of financial supervision. The paper is focused on the analysis of the impact of the world financial crisis on the systems of financial supervision in the EU, the USA and the Czech Republic. We initially describe the contemporary financial crisis. Then we focus on the system of financial supervision in the EU, the USA and the Czech Republic. We conclude that the system of financial supervision in the EU must be reformed in order to coordinate the different national systems of all EU member states. The same holds for the financial supervision in the USA that is quite complicated because of the dual federal-state banking system. The Czech system of financial supervision does not have to be reformed, because it was modified in 2006 (before the crisis) and now it is very simple, definite and well-functioning.*

Key words: *Financial Supervision, Financial Integration, Financial Crisis, Originate-to-distribute Model, Securitization.*

1. Introduction

Since July 2007 the world financial system has been experiencing substantial turbulences that were triggered by shortcomings in the U.S. subprime mortgage market and lack of financial supervision. This has led to problems in many segments of the money and credit markets all over the world.

The Federal Reserve System (Fed), European Central Bank (ECB) and European nations' central banks have not successfully managed the area of macro-prudential supervision and regulation during the past decade. Like the Fed, they failed to foresee the financial crisis and consequently they failed to prevent it. Hence, the Fed, the ECB and most other EU central banks contributed to the unsustainable credit and asset market boom that turned to the world financial crisis which started in August 2007. They kept interest rates too low for too long, failed to control the excessive growth of credit and the broad monetary aggregates, and were not able to diagnose the excessive leverage, and also the maturity and liquidity mismatch that originated in the US and European banking sector and especially shadow banking sector balance sheets.

Therefore, public authorities at the

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international level have been trying to identify the main weaknesses in the financial system in order to develop better policy responses to strengthen the financial stability in the world.

The paper is focused on the analysis of the impact of the world financial crisis on the systems of financial supervision in the EU, the USA and the Czech Republic. The structure of the article is as follows. The first chapter is an introduction. In the second chapter, we describe the originate-to-distribute model and the contemporary financial crisis. Then we focus on the system of financial supervision in the EU, the USA and the Czech Republic in the third chapter. The last chapter is the conclusion reached.

2. Financial Crisis

2.1. The Originate-to-Distribute Model

In the ***originate-to-distribute model*** (the OTD model) banks do not hold the loans they originate until the maturity but they repackage and distribute them to different types of investors through the issuance of structured financial products (the securitisation process).

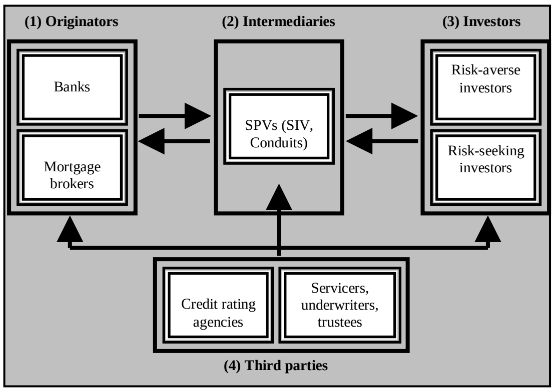

Fig. 1. *Main Players in the originate-to-distribute model*
Source: European Central Bank (2008, p. 15)

The banks thus have the option to bear or to transfer the risk associated with these loans. A very simple structure of the OTD model is demonstrated in Figure 1.

There are four major groups of players in the OTD model: originators, intermediaries, investors, and third parties. Originators cooperate directly with borrowers and produce assets that are sold to the intermediaries. The intermediaries set up the special purpose vehicles (SPVs), which purchase the originated assets and issue securities backed by these assets (asset-backed securities). Investors buy these securities issued by the SPVs. There are a lot of third-party service providers, Credit Rating Agencies (CRAs), trustees, underwriters etc. These subjects do not buy or sell the assets; they perform specific tasks for the various model participants.

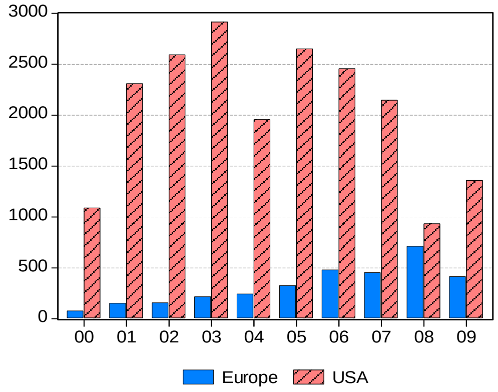

Fig. 2. *Securitisation in Europe and the USA from 2000 to 2009 (€ Billion)*
Includes data concerning ABS, CDO, MBS (RMBS+CMBS).
Source: Association for Financial Markets in Europe/European Securitisation Forum

The prevalence of the OTD model over the past twenty years has led to a growth of the structured financing to a great extent in the USA and partly in Europe; the European structured financial market thus remains smaller than the U.S. market. Figure 2 illustrates this fact.

The issuance of structured products was much higher in the USA than in Europe until the end of 2007. However, the volumes were almost the same in 2008 (€711,3 billion in Europe, €933,6 billion in the USA), because Europe experienced an improvement in the markets of structured products, while the U.S. issuance was less than one half of the issuance in the previous year. In 2009, the situation is opposite, i.e. higher issuance in the USA in comparison with Europe. According to the Association for Financial Markets in Europe (the former European Securitisation Forum), some fundamental issues are still preventing a recovery of the European securitisation market (a reduced investor base, the fact that originators utilise more competitive sources of funding etc).

2.2 The Present Financial Crisis

According to De Larosière J. et al (2009), financial innovations (including the OTD model), rapid credit expansion, high liquidity, low interest rates, and insufficient financial supervision have been the major factors behind the present financial crisis. Though the credit volume grew rapidly and excess liquidity showed up in unduly rising asset prices, central banks felt no need to tighten their monetary policies. Because of low interest rates, investors sought higher yield opportunities. Therefore, financial institutions developed more innovative (but also more risky) products, thus generating a sizeable expansion of leverage within the world financial system.

Moreover, both financial institutions and central banks failed in the assessment of risk (partly due to extreme complexity of structured financial products), hence financial institutions overestimated their ability to manage the risks and underestimated the volume of capital they should hold and no bank expected a total freezing of the interbank money market. CRAs influenced the risk perception by giving high ratings to structured financial products, the same excellent rating they gave to almost riskless government or corporate bonds.

The OTD model can bring a lot of benefits. However, a poor risk assessment by CRAs, an insufficient valuation by investors, and opacity of information on complex structured finance products resulted in substantial rating downgrades in July 2007 and subsequently in the fall of the value of underlying assets and a loss of investors' confidence. The OTD model broke down the relationship between lenders and borrowers, diverted attention away from the borrower's ability to repay a debt towards lending against collateral thus leading to lower lending standards. It also created conflicts of interest that market discipline failed to correct. Originators of bank loans failed to require a sufficient documentation of income and ability to pay. Intermediaries encouraged the underwriting standards to decline by not setting high standards for the loans they were willing to buy from originators. Investors trusted the CRAs. This huge lack of transparency prevented market participants from understanding the full nature of the risks they accepted.

This process was accompanied by insufficiently supervised mortgage lending, extremely low interest rates, and unprecedented financing based on securitisation techniques in the USA. Moreover, the U.S. government promoted the government sponsored entities (GSEs) Fannie Mae and Freddie Mac to provide mortgages to low income households. Within Europe, mortgage lending was more responsible.

This has led to great global financial market imbalance and uncovered serious limitations in the existing supervisory framework globally, both in a national and cross-border context. Strong competition among world financial centres also contributed to hesitation or reluctance of national regulators and supervisors. The surveillance of the International Monetary Fund (IMF) did not function properly either. Insufficient regulatory and supervisory abilities combined with different national systems of supervision led to an increased interest of international authorities to improve the system of financial regulation and supervision.

3. Financial Supervision in the EU, the USA and the Czech Republic – Response to the Financial Crisis

3.1 Financial Supervision in the EU

The system of financial regulation and supervision in the EU has been based on separate systems of member states so far. Now we are facing the financial crisis, the EU representatives are convinced that this nation-based system has to be changed. Therefore, their effort is focused on the revision (or creation) of relevant legislation in order to move from the present separate nation-based systems to the common European-based system of financial supervision.

The European Commission adopted an important package of legislation to significantly strengthen the supervision of the financial sector in Europe in September and October 2009. [6] [7] This package represents a reaction of the Commission to the current financial crisis in order to remove shortcomings in the European financial supervision. The main weakness in the EU's supervisory framework is the fragmentation along national lines despite the existence of a European single market. In other words, interconnected complex market risks were not properly analysed, nor were the consequences drawn for the regulatory and supervisory policy. Therefore, these tendencies are an integral part of the Commission's strategy for preventing future crises.

This new European supervisory system is based on the "*de Larosière Report*". [2] In November 2008, the Commission mandated a High Level Group chaired by Jacques de Larosière to prepare recommendations on how to improve European supervisory system to better protect its citizens and renew trust in the European financial system. The final report which was presented on 25 February 2009 introduced a new vision for a new system of European financial supervision. The aim of this vision is to strengthen cooperation and coordination among national supervisors through the creation of a European authority responsible for overseeing risk in the financial system and new European Supervisory Authorities.

In the past, the interest of financial supervision has been elaborated only at the micro-level, focused on assessing the balance sheets of individual financial institutions without omitting interactions among institutions and the broader financial system. Therefore, the new legislation creates a ***European Systemic Risk Board*** (ESRB) to monitor and detect threats and risks that arise from macro-economic developments and from the financial system of the EU as a whole (the so called "macro-prudential supervision"). It has a critical function to issue early risk warnings to be rapidly acted on. The ESRB has the power to issue recommendations to EU Member States and their national supervisors and to the three European Supervisory Authorities. The ESRC is also responsible for monitoring compliance with its recommendations; subjects have to comply or explain why they have not done so. The creation of the ESRB addresses one of the weaknesses revealed by the financial crisis, i.e. the vulnerability of the European financial system to interconnected, complex, sectoral and cross-sectoral systemic risks. The ESRB is fully accountable to the Council and the European Parliament in the form of reporting to these institutions regularly, (the so called formal accountability). However, the ESRB has no direct responsibilities in the area of managing the crisis. The ESRB consists of the central bank governors of the 27 EU Member States, the President of the ECB, the chairpersons of the three European Supervisory Authorities of the ESFS, senior representatives of the national supervisory authorities, a member of the Commission, and the Economic and Financial Committee chairperson as an observer in ESRB meetings. This composition of the ESRB makes the national central banks the dominant players in this system of the macro-prudential financial stability framework. The ERSB should cooperate with the IMF, the Financial Stability Board and third country counterparts in order to give a worldwide system of early warnings.

The second institution created by the new legislation is a ***European System of Financial Supervisors*** (ESFS) for the supervision of individual financial institutions and firms and protecting consumers of financial services (the "micro-prudential supervision"). It is composed of a network of national financial supervisors and three new European Supervisory Authorities for the banking, securities and insurance and occupational pensions sectors: a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA). This large network should be based on the principles of partnership, flexibility and subsidiarity. It tries to enhance trust among national supervisors by ensuring, that host supervisors have a possibility to participate in setting the policies relating to financial stability and consumer protection. Thereby, the cross-border risk could be addressed more effectively. The focal point for day-to-day supervision rests at the national level. Thus, the national supervisors remain responsible for the supervision of individual entities (they will still monitor the capital adequacy etc.). This network approach to micro-prudential supervision, where new European Supervisory Authorities cooperate with national financial supervisors, is proposed in line with the de Larosière Report. The solution of the full centralisation of supervision at the EU level has no support of the Commission.

The aim of this reform is to ensure a smoother interaction of supervision at the macro-prudential and micro-prudential levels. The ESRB would need a timely flow of micro-level data in fulfilling its role as a macro-prudential supervisor, while the ESFS (including national supervisors) would benefit from the ESRB's macro-prudential data. Building these two pillars of the new system of European financial supervision is essential to ensure a fully connected macro-micro supervisory framework. However, there are differences in the national transposition of Community law stemming from exceptions, derogations, additions or ambiguities in current directives that must be identified and removed in order to define and apply one harmonised set of standards within the EU.

This new European financial supervisory framework must be fully responsible to political authorities in the EU. This system must be based on high supervisory standards, applied equivalently, fairly and consistently to all markets actors. It must also respect the independence of national financial supervisors.

The G20 Group has decided to reinforce the global arrangements for protecting the world financial stability and established the Financial Stability Board (FSB), the successor to the Financial Stability Forum (FSF), expected to cooperate with the International Monetary Fund (MMF) to provide early warnings of risks at the global level. [6] [7]

3.2 Financial Supervision in the USA

Fed and its supervisory functions in the USA have evolved to create a U.S. banking and financial structure which is quite unique. The ***Glass Steagall Act*** was largely responsible for this unique structure. This Act separated commercial and investment banking from 1933 in order to prevent another financial crisis arising from the large number of bank failures during the Great Depression. The securities functions of commercial banks were limited to underwriting and dealing in municipal government debt. On the contrary, investment banks could engage in securities and underwriting, but were prohibited from taking deposits. The act was repealed in 1999 when the ***Gramm Leach Bliley Financial Modernisation Act*** was signed into law. The reason is that modern technologies have started to erase the borders between commercial and investment banking. Under this Act, U.S. bank holding companies can transform into financial holding companies which can consist of commercial banks, investment banks and insurance subsidiaries.

The U.S. legislation limited the extent to which banks could set up branches. It was quite obvious in the other banking systems in developed countries. The regulation of establishing the branches was a matter for individual states. As a result, each state had different types and degrees of restrictions. In 1994, the part of the ***Riegle Neal Interstate Banking and Branching Efficiency Act*** removed these restrictions and allowed all U.S. banks to acquire banks in other states and to convert subsidiaries into branches. [8]

These financial reforms have started a change in the structure of the U.S. banking system: universal banks have originated together with nation-wide branching. It created new opportunities for financial institutions. At the same time, it accentuated the functions of the U.S. financial regulation and supervision.

As the U.S. central bank, Fed has a supervisory and regulatory power over a wide range of financial institutions and activities. It cooperates with other federal and state supervisory authorities in the USA to ensure the safety and soundness of financial institution, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions. In case of domestic banking institutions, the Fed shares its responsibilities with the ***Office of the Comptroller of the Currency*** (OCC), the ***Federal Deposit Insurance Corporation*** (FDIC), and the ***Office of Thrift Supervision*** (OTS) at the federal level, and with the banking departments of the various states. [11]

Table 1 summarizes the supervisory responsibilities of the Fed and other federal banking agencies.

Federal supervisor and regulator of corporate components of banking organizations in the United States Table 1

Component	**Supervisor and regulator**
Bank holding companies	Fed
Nonbank subsidiaries of bank holding companies	Fed/Functional regulator
National banks	OCC
State member banks	Fed
State non-member banks	FDIC
Thrift holding companies	OTS
Savings banks	OTS/FDIC/Fed
Savings and loan associations	OTS
Edge and agreement corporations	Fed
Foreign banks[1)]	
Branches and agencies (state-licensed)[3)]	Fed/FDIC
Branches and agencies (Federally licensed) [3)]	OCC/Fed/FDIC
Foreign banks – representative offices	Fed

[1)] Applies to direct operations in the United States. Foreign banks may also have indirect operations in the United States through their ownership of U.S. banking organizations.

[2)] The FDIC has responsibility for branches that are insured.

Source: The Federal Reserve System

The Congress created the ***Federal Financial Institutions Examination Council*** (FFEIC) in 1979 in order to promote consistency in the examination and supervision of banking organizations. The Council is a formal interagency body and its purposes are to create uniform federal principles and standards for the examination of depository institutions, to promote coordination of financial supervision among the federal agencies that regulate financial institutions, and to encourage better coordination of state and federal regulatory activities. The Council has additional statutory responsibilities to facilitate public access to data that depository institutions must disclose.

Over the years, the legislation has resulted in a complex bank supervision in the USA, with a great deal of overleap between supervisory authorities. Banking regulators at the state and federal level had a potentially conflicting mission to promote safe and sound banking practices, while other agencies had a clear mission but limited tools and jurisdiction. Therefore, it is necessary to build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects financial consumers and investors, that ends loopholes allowing big Wall Street firms to escape supervision, that makes it clear that no firm is "too big to fail", that is able to adapt and evolve with changes in the U.S. financial market. In June 2009, the U.S. Department of the Treasury published an important document named ***Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*** in order to fight the contemporary financial crisis. This document proposes reforms to meet five key objectives:

1. Promote robust supervision and regulation of financial firms.
2. Establish comprehensive supervision of financial markets.

3.Protect consumers and investors from financial abuse.
4.Provide the government with the tools it needs to manage financial crises.
5.Raise international regulatory standards and improve international cooperation.

It is proposed to create a new institution named ***Financial Service Oversight Council*** (FSOC) of financial regulators (chaired by Treasury and including the heads of the principal federal financial regulators as members) to help fill the gaps in supervision, identify emerging systemic risks in the financial sector, identify firms whose failure could pose a threat to financial stability (due to their combination of size, leverage, and interconnectedness), improve cooperation among the principal federal financial regulatory agencies, coordinate policy and resolution of disputes. The FSOC should replace the President's Working Group on Financial Markets.

This document also proposes the creation of two new agencies: the ***Consumer Financial Protection Agency*** (CFPA) and the ***National Bank Supervisor*** (NBS). The CFPA is an independent agency protecting consumers across the financial sector from unfair, deceptive, and abusive practices. In other words, the CFPA is an agency with the power and accountability to make sure that consumer protection regulations are written fairly and enforced strongly. The CFPA is designed to reduce gaps in federal supervision and enforcement, improve coordination with the states, set higher standards for financial intermediaries, and promote consistent regulation of similar products. The NBS is an agency responsible for supervising federally chartered banks, and all federal branches and agencies of foreign banks. The NBS is going to take over the prudential responsibilities of the OCC, which supervises nationally chartered banks and federal branches and agencies of foreign banks, and also the responsibility for the institutions supervised by the OTS, which supervises federally chartered thrifts and thrift holding companies.

Moreover, the Fed will be given new authorities to supervise all large and interconnected firms that could pose a threat to financial stability (and large banks with assets exceeding the amount of $50 billion), to oversee payment, clearing, and settlement systems, etc. These firms should not be able to escape a consolidated supervision of their risky activities by manipulating their legal structure ever again. Therefore, the largest, most interconnected, and highly leveraged financial institutions would face more severe prudential regulation, including higher capital requirements and stronger consolidated supervision. These firms must be forced to internalize the costs they could transfer on a society in the event of failure.

The proposals outlined in this report do not represent the complete set of potential reforms in financial regulation. More should be done in the future. It is also necessary to support these efforts abroad and to improve oversight of global financial markets.

These reforms should have been approved by the Congress by the end of 2009 in order to come into force in 2010. President Obama is trying to press the Congress to enact these changes in financial markets oversight in 75 years, arguing that excessive risk-taking by banks and lax enforcement by regulators helped cause the credit crisis and brought the financial system to the edge of collapse. However, it has not been approved yet. It is expected, that the Senate will discuss this proposal in April 2010.

3.3 Financial Supervision in the Czech Republic

The system of the financial market supervision in the Czech Republic was broadly reorganised in 2006; the new laws entered into force on 1 April 2006. The main change was to reduce the number of financial market regulators from four to one. Before April 2006, there were four supervisory institutions in the Czech Republic: the ***Czech National Bank*** (supervision of banks), the ***Office for the Supervision of Insurance and Pension Funds*** under the Ministry of Finance (supervision of insurance companies and pension funds), the ***Czech Securities Commission*** (capital market supervision), and the ***Office for the Supervision of Cooperative Banks*** (supervision of savings and credit cooperatives, i.e. the cooperatives banks). In April 2006, The Office for the Supervision of Insurance and Pension Funds, the Czech Securities Commission, and the Office for the Supervision of Cooperative Banks ceased to exist. At the same time, ***Financial Market Committee*** was created as a new advisory body to the Bank Board of the Czech National Bank (CNB) for financial market supervision. This integration of financial market supervision into a single authority should prevent inefficient overlapping of competencies (apparent in the USA) and create a basis for more efficient supervision over financial institutions and markets in the Czech Republic.

Thus, the Czech National Bank is the only supervisory authority of the financial market in the Czech Republic. The CNB supervises the banking sector, the capital market, the insurance industry, pension funds, credit unions, bureaux-de-change, and payment system institutions. Simultaneously, the CNB lays down rules safeguarding the stability of the banking sector, the capital market, the insurance industry and the pension scheme industry. It systematically regulates, supervises and, where appropriate, issues penalties for non-compliance with these rules. [13]

Supervision of credit institutions covers banks, credit unions and electronic money institutions. Credit unions differ from banks with respect to their legal form (credit unions can be established only as cooperative societies), the amount of capital they are required to have (CZK 35 million = €1,4 million, as against CZK 500 million = €20 million for banks) and the type of clients for which they are authorised to carry out activities (for members only). Otherwise, credit unions are subject to essentially the same requirements as banks, especially as far as the prudential rules are concerned. [14]

By performing *capital market supervision*, the CNB strengthens the confidence of investors and investment instrument issuers in the capital market above all by contributing to the protection of investors and the development of the capital market and promoting public awareness in this area. It means in particular, supporting the sound development and transparency of the capital market, market discipline and competitiveness of capital market service providers, preventing systemic crises, supporting issuing activity, protecting investors and clients and strengthening public confidence in the capital market.

Banks and branches of foreign banks are required to participate in the deposit insurance scheme; they contribute a fixed annual percentage of their deposits to the ***Deposits Insurance Fund***. The main subject matter of the Fund’s activities is to compensate authorized persons for their receivables from deposits. [15]

The Czech system of financial supervision does not have to be reformed, because it was modified in 2006 (before the world financial crisis). Now, the system of supervision is very simple, transparent, definite and well-functioning. Moreover, the Czech financial system is sound, Czech banks – unlike the European and U.S. banks – generate profits.

4. Conclusion

The world financial crisis is a result of a lot of factors, namely large financial innovations, rapid credit expansion, high liquidity, low interest rates, and insufficient financial supervision etc. National central banks have not successfully managed the area of macro-prudential supervision and regulation during the past decade. They failed to foresee the financial crisis and consequently they failed to prevent it and contributed to the unsustainable credit and asset market boom that turned to the world financial crisis. Therefore, governments and central banks at the international level have been trying to develop better policy responses to strengthen the financial stability in the world.

We conclude that the system of financial supervision in the EU must be reformed in order to coordinate the different national systems of all EU member states. By creating two institutions of the new system of a European financial supervision it is possible to ensure a fully connected macro-micro supervisory framework in the EU. The same holds for the financial supervision in the USA that is quite complicated because of the dual federal-state banking system with a great deal of overleap between supervisory authorities. The Financial Regulatory Reform brings several important innovations to the U.S. supervisory system and raises the supervisory power of the Fed. The Czech system of financial supervision does not have to be reformed, because it was modified in 2006 (before the crisis) and now it is very simple, transparent, definite and well-functioning.

However, the recovery of the world financial system will take a lot of time. And the public authorities should be aware of the fact that a stronger financial regulation and supervision could lay foundations for new, more complicated, less transparent, and therefore more dangerous financial innovations.

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