

NEW REGULATORY MEASURES AND THEIR INFLUENCE ON THE EU CAPITAL MARKET – SOURCES OF BUSINESS FINANCING

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—Abstract —

Financial sector has been coming through the significantly turbulent period due to the financial crisis in 2008 to 2010 and following debt crisis in the European Monetary Union. These periods might be generally called as financial crises which may have many causes. Crises may be caused by a failure of investments, deposits and credits, etc. The above mentioned situations have definite influence on business financing. Generally speaking we can state that the enterprises have worsened access to external finance at the time of these crises. That is why macro and micro prudential regulatory measures attempt to eliminate especially information asymmetries and moral hazard among investors and issuers (borrowers) and thus contribute to the overall stability of the financial system.

The article focuses on the institutions established in response to the financial crisis of 2008-2010 in the European Union (e.g. European Systemic Risk Board – ESRB, European System of Financial Supervisors – ESFS). And it aims to assess contribution of these institutions to stabilizing the financial sector.

Key Words: *financial crisis, market regulation, European Union, business financing, capital market.*

JEL Classification: G01, G15, G28, G38.

1. INTRODUCTION

Europe is in this period dealing with an uneasy and prolonged task of how to deal with a climax of a years long process of debt growing of its sovereign states. Debt crisis, as it is often called, was started by at least two major triggers. The first was the financial crisis occurring in the United States of America and the second one was the project of common European currency – Euro.

American financial crisis caused that investors are now trying to be more careful because it was proven that the regulation and supervision systems of the capital market (and this also applies to the banking systems) are not enough for some kinds of financial innovations with structure often known only to a few people and with consequences that will be tried only by means of a bigger systemic financial crisis.

European debt crisis is, as mentioned, connected to the common European currency Euro. Euro is often due this accordance named the main trigger of the European financial crisis (e.g. Klaus, 2012). Euro without question shares a part of the guilt but it is mainly because of the European Monetary Union (EMU) government bonds investors who incorrectly evaluated the project and who were, under the impression of common rules (Maastricht criteria) and mainly because of the loss of interest risk (Lin, Treichel, 2012: 7), willing to offer cheap lends to states that were risky even back then. And on the other hand there are the politicians who made wrong decisions about the approach of some member states of newly created Eurozone and who also possess unique powers to influence debt of their own state. Thus there are two important economic theories suppressed politically. The first one is the optimum currency area developed by Mundell (1961) and the second one is peculiar grasping of Keynesian theory with the aim to stimulate economy with the state funds. Practically unchanging attitude in fiscal policy and for example in the field of labor regulations proved to be critical with the loss of the sovereign stand in the monetary policy.

Nevertheless, European Union and EMU has a big challenge ahead that can help to get rid of the system flaws or at least it can help in the future to identify the potential problems. Than can be achieved for example by stance taken towards the capital market by the new institutions of which position in the system this article focuses and which were created recently as an answer on the situation created by American financial crisis. Their flawless functioning should also, next to other things, work against influences of microeconomics phenomena of asymmetric information and moral hazard. If the philosophy of the whole system will be grasped correctly, it can, in a way, help to lower the occurrence of problem called

“too big to fail” that is connected to banks. This idea will be evaluated later on but it is not the primary focus of the article.

2. METHODOLOGY

To evaluate the approach on the regulation in EU or more precisely EMU, the analysis of theoretical models mainly of capital failures and risk reduction, including literary research, followed by synthesis of literary sources and delivering of recommendations and conclusions about European model of regulation and supervision over capital market was used.

With the aim of understanding wider context of regulation and control over individual member states, local central banks were contacted via email. Out of 26 contacted, 18 answered the question – which government institution deals with regulation and supervision in their state.

3. THEORETICAL BACKGROUND

Research made in this article is supported by the following microeconomic findings that are subjects of studies on economical faculties. It is mainly **market failure** on one hand and **risk reduction** on the other.

3.1 Market Failure

System of regulation and supervision (microeconomical/microprudential and macroprudential policy of the state) has to deal with situations that are described in economical literature as **information asymmetry** which is divided into two fragments – the **moral hazard** and the **adverse selection**. These situations are defined as situations where one side knows more than the other and it leads to market failures.

Other sources (De Nicolò et al, 2012) with financial crisis is in focus speak of **negative externalities** where negative behavior of for example only one significant subject or a series of negative news concerning the subject occurs, it can cause major systematic difficulties. It was due to these situations why there are institutions created on national and multinational level that are governed by state or also by private sector.

It can be seen from above mentioned that state should create such structure that in case of externalities can apply **internalization**, **sanctions** for producing an externality and also stating the **limits** for potentially risky transactions for subjects that can assist a failure. With information, it is the task of the state to cooperate with non-state subjects from the field to **define and enforce** abundance of the **publishing of the key information**. These information can then be distributed by

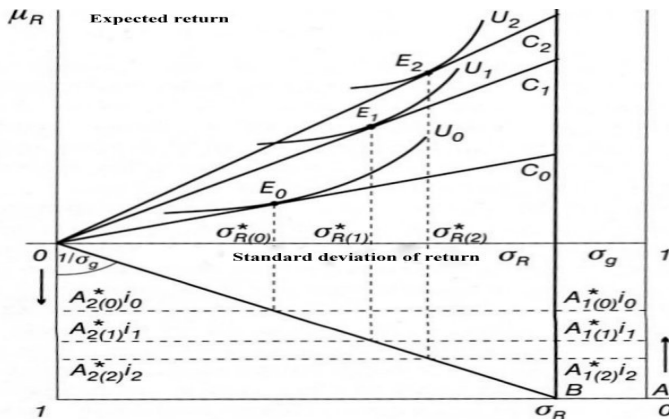
the state, by an institution appointed by the state or even by the institution for which such rules apply. Cooperation with the subjects from the field is advisable mainly because the state can fail in the task. Its decision process can be, despite all the effort, imperfect (mainly because various kinds of delays – informational, political and up to date and delays resulting from implementation). On the other hand with such cooperation there appears a risk of special interest groups known as a phenomena called “**Rent-seeking**”. That is why even the regulation and control system has to answer to someone (for example to some public institution).

3.2 Risk Reduction

Another pillar in economical theory that focuses on regulation and control from the side of the state and also from the private sector subjects is the field of **risk**, mainly its **reduction** when the economical subject is deciding about the structure of its portfolio.

Every investor makes its decision based on three common attributes – risk, liquidity and the rate of profit. Following model (Fig. 1) developed by Tobin (1958) focuses on preferences in liquidity in relation to risk. Tobin thinks of an investor that chooses between the holding of money A_1 and the obligations A_2 with the risk taken (expressed by mean-root-square error σ_R) and with the expected return (μ_R) in relation to the line of alternative possibilities C when trying to get the highest level of benefit U with assumed negative relation towards the risk.

Figure-1: Liquidity preference as behavior towards risk



Source: Mach 2002 based on Tobin 1958.

It can be seen from the model and its conclusions that if the market risk will be lowered (in this case, risk connected to obligations σ_g or to the whole portfolio σ_R) and also the credence of the market increased by means of system precautions, the line of alternative possibilities C will slightly turn around the coordinate origin to the left. This has an effect similar to the effect of increased interest rate i . Investors will then want to hold on to less financial means A_1 and more obligations A_2 . This point of view implies the interest of the investors and also of the companies (debtors) in a functioning market regulation that will in the end mean easier access to money for financing their own activities.

4. RESEARCH

It is possible to empirically prove increased stress and prevailing uncertainty about future development by means of economic indicators that are directly or indirectly connected to the capital market. One such source are without question stock and obligations indexes maintained by stock-exchanges and investment companies all across Europe. In various state or corporate emissions of obligations instruments, the stress can be seen as an increasing risk transmitted to the desired interest revenues. On the other hand this period is in favor for fields and states that are perceived as stable or even progressive and carrying low risk. In such case it is possible to see a phenomena called “flight to quality”. Such economical state where the stress, uncertainty and distrust is dominating makes the whole financial system less effective because under psychical pressure investment and consumer decisions are being postponed (for more on the topic, see Kain, 2012, Hrstková, 2012) or are realized in a very conservative way (Skalková, 2012, Špačková, 2012).

Economists are searching for situations that can be identified as trigger mechanisms causing critical periods and that could occur again in time. Field of capital market is due to the globalization very specific because it is the capital that is as one of the means of production, contrary to labor and land, and which is very mobile. The movement of capital is thus the reason why there are national and multinational regulation and supervision organs created. Financial crises were many times induced or at least made worse by this movement of capital, whether it was monetary crisis, for example in Argentina or in southeastern Asia in nineties of the 20th century (Stiglitz, 2002) or the investment crisis, of which the last American crisis connected to derivative transactions is an example.

This article, rather than on justification, focuses on concrete precautions of supervision and regulation and its conceptuality.

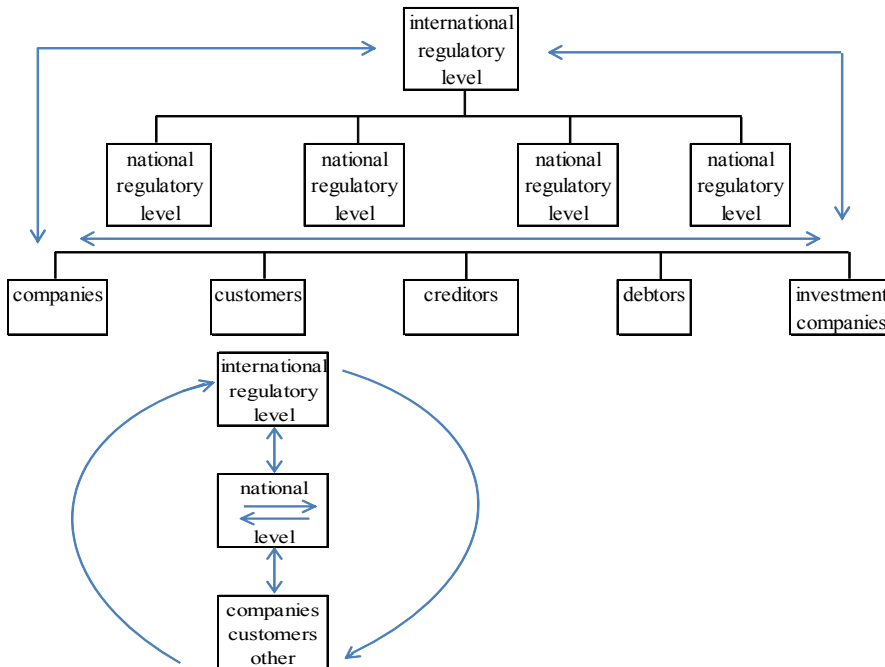
4.1 Tools – Institutions

Rather than legal enactments and regulations administering the business itself and movement on the capital market, the following part of the article focuses on institutions that states or multinational integrating organs are creating and their application into a system.

4.1.1 Structure of systems of regulation organs of economically wide areas

Robustness of the system depends on many factors. If the field that is to be regulated and controlled is very homogenous (economically, culturally, linguistically, juridically, etc.), then it is possible to consider the system to be thinner. But if there is a unit rather heterogeneous, as it often in EU is, despite all the political effort, then it is safe to assume that the system is going to be a robust one. Based on arguments that follow, the propriety of the extent of such system is possible to vindicate. It is even possible to empirically validate such idea based on the example of the USA and EU. Argumentation supported by the following scheme (Fig. 2).

Figure-2: Structure of systems of regulation organs of economically wide areas



Source: own.

Note: blue arrows mark interactions and the information flow

Scheme above illustrates attitude towards the institutionalized setting of regulation and is a better demonstration of advantages and disadvantages of such setting.

Amongst primary advantages of such setting is:

- One regulatory and control organ manages and provides the integrity and is a premise for future desirable homogeneity of the system. It also helps to minimize the risk of uncoordinated and conflicting precautions.
- Preservation of the national level ensures a higher readiness for cooperation on regulatory precautions and their following acceptance. It also helps to reduce the risk resulting from different cultural, economic, legal and many other customs in connected but not exactly homogeneous areas. The cooperation between the national regulator and the regulated subjects is easier too, because there are no communication barriers present (can be due to language, habits, etc.). Therefore only essential information should get to the multinational regulatory subject.
- Advantage of the national regulatory subject is also in the continuity of observed subjects and the parameters that can only help to the regulatory subject to have a better overview over the local market.
- Multilevel system enables to avoid a situation when common policy is claimed equally on all the subjects even when the subjects exist in specific conditions without any possibility of modification (which is, by the way, one of the greatest flaws of European Monetary Union - EMU).

The disadvantages are as follows:

- System has to be multilevel and needs a wide multinational level and therefore it needs to be robust and the costs are higher.
- Some information will not be send from the national level to multinational and some will not even be send from one national level to another and that can prove to be dangerous from the viewpoint of evaluation of system risks of an economically united area.

Pradhan (2012) from the IMF in connection with the Eurozone crisis and the crisis of its banking system recommends creation of a single supervisor to provide a unified supervisory framework, and deter the financial market fragmentation. Authors of this article believe that this recommendation can also be applied to capital market (not only on the banking system) but the power of the regulatory organ should not be overestimated in such diverse area of EU. It should be more about the connection of the national systems with the one that is common to the

whole union as it is illustrated in the scheme above and in the arguments underneath.

4.1.2 System structure of regulatory authorities in EU

European Union is due to its economical and political aims a kind of laboratory of hastened and sometimes even forced process of globalization with all its pros and cons. It is an area that is considered culturally united but there can be found differences mainly in the mentality of the nations. This goes hand in hand with the specific approach to economics in individual states. Nevertheless the movement of capital is in a way ahead of the integrations processes in Europe for which the European Union is prepared and enlightened by the financial crisis in America and also by the Spanish and Irish real estate bubble and to which it responds by means of regulatory precautions and supervision over markets with newly created authorities on macro and micro level.

The European Union has taken the approach where there is on all-European level, aside to **European Central Bank (ECB)**, working in parallel in terms of **European System of Financial Supervision (ESFS)** **European Systemic Risk Board (ESRB)** and from 1st January 2011 the system of control and regulation named **European Supervisory Authorities (ESA)**. This ESA system is then focusing on the bank institutions – **European Bank Authority (EBA)**, insurance companies and pension funds – **European Insurance and Occupational Pensions Authority (EIOPA)** and finally the institutions focused on capital market in a narrow sense – **European Securities and Market Authority (ESMA)**. Under the supervisions of these institutions there are authorities working on national levels. From electronic poll it was found out that on majority of the area there is one national regulator functioning as a part of local central bank or more often working as an autonomous institution. Maximum number of regulatory and supervisory offices is two.

5. ESMA

Now follows a brief analysis of EMSA because of the primary focus of the article. EMSA is an independent authority within the EU and such state is crucial. Aims of the union are atop the national aims. *ESMA (2011) contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection.* Important is the cooperation and convergence with other regulatory subjects, such as EBA, EIOPA and also ESRB. With the aim of common rules applied all across the EU and with the care for investors hand in

hand with the equal conditions of competition for the financial service providers, ESMA works on a development of a single rule book containing securities legislation with powers that the former Committee of European Securities Regulators (CESR) did not possess. For example the ability to draft technical standards that are legally binding in EU Member States; the ability to launch a fast track procedure to ensure the consistent application of EU law and so on (see ESMA, 2011). Everyday regulatory activities remain in the hands of national regulators. Though in some cases the ESMA can be appointed to oversee directly – mainly in case of pan-European entities (i.e. Credit Rating Agencies – **CRAs**).

6. CONCLUSION

Recent financial crisis and the following debt crisis speeds up some processes in Eurozone that would probably take longer under normal conditions. But in times of crisis there is a demand for quick and concrete decisions that would regain markets and individual economies its trust.

The system of the union is in terms of the capital market basically in consensus with the conclusions made by the authors of the article. Next to the macro-control (ESRB), there was an authority established for the whole union ESMA with aims and functions in concord with the national regulators. Systematically significant subjects, such as CRAs are regulated and controlled directly by ESMA whilst the common regulatory activities remain in the hands of national regulators. Because the system of union is still fairly heterogeneous with numbers of various nations with their languages and habits not only in economics, it is not advisable to undergo any significant changes or reduction of the structure in foreseeable future.

It seems as an important element that ESMA along with other regulatory authorities should in the long term continually assess the risks and the potential system failures. Stable capital market with correctly defined risks can also ease the access of subjects to the other means of financing their activities than bank loans (for example shares and bonds). That can also due to diversification of corporate sources in total amount help to reduce the significance of the bank sector which, if in trouble, does not supply loans (called Credit Squeeze).

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