

FINANCIAL STABILITY AS THE GOAL OF POST-CRISIS REGULATORY REFORMS

Algis DOBRAVOLSKAS

Mykolas Romeris University
Ateities g. 20, LT-08303 Vilnius
E-mail: dalgis@mruni.eu

Jusif SEIRANOV

Mykolas Romeris University
Ateities g. 20, LT-08303 Vilnius
E-mail: j.seiranov@mruni.eu

Abstract. The article analyses the reasons of financial instability, which outburst in 2007-2008 crisis and studies the ways of rebuilding financial stability in the process of post-crisis regulatory reforms. The authors consider mostly institutional aspects of the problem. Violation of stability is viewed on the one hand as the result of deregulation processes in major financial markets since 1980s, on the other hand as result of inadequacy of national micro-prudential regulators to match the cross-sector and cross-border activities of so called “too big to fail” financial institutions. The article studies how these targets are met in post-crisis regulatory reforms, analysing institutional frameworks introduced in USA with the pass of Dodd-Frank Act and in the European Union after adopting the new architecture of financial markets supervision and regulation. The impact of these reforms on regulation of financial markets in Lithuania is assessed.

Key words: financial stability, financial crisis, systemic risk, regulatory reform, macro-prudential and micro-prudential supervision

Introduction

The reasons of financial crisis of 2007-2008, followed by global Great Recession and ongoing endangered development in advanced economies, were analysed in detail in reports of various official institutions and scholar research. It is commonly accepted that one of the major reasons behind the crisis, though not the only one, was the breach of financial stability, or outburst of instability in financial system. Since 1990s the

economists were stressing the importance of financial stability and questioning if the processes of deregulation of financial markets combined with accelerating globalisation may undermine the stability of the financial system. These fears strengthened after 1997 East Asian crisis and 1998 Russian crisis. But relatively easy escape of American economy from 2000 IT bubble crisis, European successes in introduction of Euro, brave march of the Eurozone since 1999, robust growth of emerging economies created illusion of Great Moderation. The crisis of 2007-2008 and various cross-border shocks, which followed from banking, insurance, securities sectors as well as from national financial systems, proved that the problem of financial stability was under-estimated by economic policy bodies and regulators. Since 2009 goal of stability becomes the dominating idea of financial reforms launched in national economies and internationally.

The objective of this paper is to analyse whether the vector of regulation development has changed, what major institutional reforms were undertaken as reaction to crisis and how the reforms can serve to creation of financially stable environment for economic growth. For this purpose in the second section of the paper the authors review the concept of financial stability and study its connection with regulation of financial market. The third section explores the evolution from strict regulation of financial markets since 1930s to deregulation period after 1980s, analyses what are inherited problems to be dealt with. In the fourth section institutional reforms of financial markets regulation in the United States and the European Union are studied, the changing role of central banking is discussed, as well as impact on development of Lithuanian regulatory system. Methods applied in the article are based on theoretical concept of financial stability, critical study of latest scholarly research and discussions of the problem, analysis of official documents and reports of regulatory bodies.

Financial stability and need for regulation

Defining financial stability

There is no consensus among researchers about the definition of financial stability. Same set of problems may be addressed as instability of financial system, or ability of financial system to resolve systemic risks. Widely accepted definition is suggested by Garry Schinasi, the author of fundamental study "Safeguarding financial stability: theory and practice"¹. In Lithuanian research Schinasi's approach was applied in the study of central banking role in support of financial stability². According to Schinasi financial system is stable if the system is capable to perform three key functions: 1) the inter-temporal allocation of resources from savers to investors and the allocation of economic resources generally; 2) the assessment, pricing, and allocation of forward-looking financial risks; 3) and the absorption of financial and real economic shocks³.

¹ Schinasi, Garry J. (2006). *Safeguarding financial stability: theory and practice*. Washington, D.C.: International Monetary Fund.

² Leika, Mindaugas. (2009). Financial system stability as a goal of central bank's policy. *Pinigų studijos*, No 1, 2008, pp. 68-83.

³ Schinasi, Garry J. (2007). *Understanding Financial Stability: Towards a Practical Framework*. [accessed on 30-09-2011]. Available from: <http://www.imf.org/external/np/seminars/eng/2006/mfl/gjs.pdf>

Financial stability is closely interconnected with monetary stability. Traditionally, clear distinction is made between these two kinds of stability⁴. Financial stability characterises smooth flow of funds between lenders and borrowers and returns on investments with time and risk considerations. Monetary stability characterises ability to preserve stable level of prices for goods and services and to keep acceptable levels of currency fluctuations versus other national currencies. There is sense in such distinction, grounded by different basic motives (transaction and speculative) driving money and financial markets.

Factors violating stability of financial system can be divided into two large groups of external (exogenous) and internal (endogenous) factors. The first group of factors unites various macroeconomic disproportions in production and consumption, saving and investment processes, in which global impacts become more and more important. Factors united in the second group arise from imperfect nature of financial markets.

Global imbalances and financial stability

Many economists agree that there is a set of fundamental reasons, which resulted in the violation of financial stability during the financial crisis of 2007-2008. This view is also supported by some Lithuanian researchers, which note global cycle synchronization and emphasise non-cyclical causes of global crisis⁵. The reasons of crisis, which lie beyond financial system cannot be regulated within this system alone, they also cannot be attributed to separate national economies and are usually generalised as *global imbalances*. According to Joseph Stiglitz, some major imbalances, which lead to crisis and will remain in the coming years, if not for decades, are:

- Gaps between advanced and emerging countries growth rates;
- Inequality of global income distribution and miserable level of consumption of 1 billion people in the world; global unemployment of about 240 million people;
- Under-saving in United States and over-saving in emerging countries, especially in China;
- Misuse and waste of environmental resources, the real costs of which are not indicated in prices, thus leading to under-investments in nature caring technologies;
- De-industrialization in advanced countries and inability to create enough jobs in service sectors, over-boosted financial sector in terms of corporate profit share. In the years before crisis 40% of all US corporate profits were concentrated in the financial sector⁶.

Some of these imbalances have direct implications for stability of the financial system. Stephen Cecchetti stresses the role of current account and capital flow imbalances. Global imbalances of current account expressed as an absolute sum of current account

⁴ Issing, Otmar. (2003). Monetary and Financial Stability: Is there a Trade-off? Speech at the Conference on Monetary Stability, Financial Stability and the Business Cycle, March 28-29, 2003, BIS, Basel. [accessed on 30-09-2011]. Available from <http://www.ecb.int/press/key/date/2003/html/sp030329.en.html>

⁵ Rakauskienė, Ona Gražina; Krinickienė, Eglė. (2009). *The Anatomy of Global Financial Crisis*. Intellectual Economics, No 2(6), 2009, pp. 116-128.

⁶ Stiglitz, Joseph E.. (2010). *Freefall: America, Free Markets, and the Sinking of the World Economy*. W.W. Norton & Penguin.

deficits (such countries as USA, UK, Italy, Spain and other) and surpluses (such countries as China, Germany, Japan, oil exporters and others) reached maximum of about 6% in years 2006 and 2007⁷ with further reduction to 4% in post-crisis years 2009-2010. As a result, the emerging countries, which have permanent current account surpluses, finance advanced countries' debts.

Imperfect nature of financial markets and financial stability

The fact that instability is inherent to financial markets is well known to economists. Financial crises are regular and frequent, reminds recent brilliant study of Kenneth Rogoff and Carmen Reinhart⁸.

Cyclical mechanism of modern financial crisis is similar to the historically known and is based on extension of credit and changeover of "bubbles" and "busts". Market participants rely on unlimited growth of prices of various assets (real estate, equity, commodities, indices, derivatives). The real income associated with an asset (profit, income, dividend) is irrelevant, and price increase becomes the leading motive. Growing financial assets serve as collateral for credit and further assets acquisition. At some moment the price increase slows or stops, and pro-cyclical mechanism starts to work in reverse direction.

Cyclical adjustments of financial markets are more complicated when compared to other sectors of economy. According to Dirk Heremans, financial markets are imperfect by nature as they have the following specific features:

- dealing with specific commodity – money, supply of which is restricted by state monopoly;
- dealing with future values, higher risks and uncertainties;
- dealing with credence goods – financial services, and their value is difficult to establish;
- stronger asymmetry of information;
- more expressed agency problem;
- higher interdependence and herd behaviour⁹.

Resolution of financial crises burdens high costs on economy, both direct and indirect. Direct costs are cumulated through government interventions for salvation of financial sector. Based on Hoggarth and Saporta analysis, Franklin Allen and Douglas Gale sum up fiscal costs of 24 banking resolutions in the period from 1977 to 2000 as 16% of GDP of the respective countries. Indirect costs can be estimated as cumulated loss of GDP. The average indirect costs of banking crises in the period from 1977 to 1998 amounted to about 16.9% of GDP¹⁰. Imperfect nature of financial markets and

⁷ Cecchetti, Stephen G. (2010). Global imbalances: current accounts and financial flows. [accessed on: 30-09-2011]. Available from: <http://www.bis.org/speeches/sp110928.pdf>

⁸ Rogoff, Kenneth S.; Reinhart, Carmen M. (2009). *This Time Is Different: Eight Centuries of Financial Folly*. Princeton University Press.

⁹ Heremans, Dirk. (1999). Regulation of Banking and Financial Markets. *Encyclopaedia of Law and Economics*. [accessed on: 30-09-2011]. Available from: <http://encyclo.findlaw.com/5850book.pdf>

¹⁰ Allen, Franklin; Gale, Douglas. (2004). *Competition and Financial Stability*. *Journal of Money, Credit and Banking*, Vol. 36, No. 3, Part 2, 2004, pp. 453-480.

large losses that financial crises cause to economy on the whole prove the need of government regulation.

The goal of financial stability is limited by considerations of efficiency. Absolutely stable financial system may require excess resources and thus become unattractive for investments, or may transfer extra costs on clients and consequently become too expensive for economy. Absolute stability may mean preservation of market structure and lack of incentives for innovation. Finally, in globalised economy, over-protected stability of national financial system may lead to losing competition to global rivals.

The inter-relation of stability and efficiency also raises the question of optimal market structures. Financial markets should be able to match the needs of other sectors of economy. Concentrated industries request concentration of financial services. What are the limits of concentration in banking, insurance or securities markets? What are acceptable levels of integration of cross-sector and cross-border operations? Could economy of scale be justified if big financial institutions acquire distorting market powers? In the next section we shall track how financial stability choices were changing through evolution of financial markets regulation.

Evolution of regulation and regulation cycle

Regulatory reforms are reaction to market failures. We view evolution of regulation as long regulatory cycle where periods of tightened regulation are changed with lax regulation or deregulation. Regulation-dominated phase covers the period from 1933 to 1979, then deregulation prevails from 1980 to 2008. Following the crisis the new period of Regulation Renaissance starts.

Our suggestion of regulation cycle partly conforms to broader periodisation, proposed by Avgouleas Goodhart, who analyses regulatory dialectics assessing the role of central bank. A. Goodhart detects three epochs: Victorian (1840- 1914); the government control (1930s – 1960s) and the triumph of the markets (1980s –2007). Each epoch is followed by a period of confused inter-regnum. The first and third epochs are characterised by monetary stability and independence of central bank, but both end up with breach of financial stability. In the second epoch government control prevails, role of central bank is subservient, this period finishes with violation of monetary stability and outburst of inflation¹¹.

In our periodisation the beginning of long regulation cycle starts after the Great Depression. Evolution of regulation is defined by USA pattern, developments in Europe generally fit in the same framework.

Rise and decline of government regulation (1933 – 1979)

In USA regulatory response to the Great Depression of 1929 – 1933 was marked by the pass of Glass-Steagall Act and Securities Exchange Act in 1933. In the banking sector protective and preventive structural instruments of control were introduced.

¹¹ Goodhart, Avgouleas E.C. (2010). The changing role of central banks. BIS working papers No 326, November 2010. [accessed on: 30-09-2011]. Available from: <http://www.bis.org/events/conf100624/goodhartpaper.pdf>

Federal Deposit Insurance Corporation (FDIC) was founded. Investment banks were separated from deposit banks. Interest paid on check deposits was prohibited. Interest ceilings were set for terminate deposits. Securities and Exchange Commission was founded to regulate securities market.

Government regulation of financial market dominates till 1970s. Government control over interest rate causes subordinate role of the Federal Reserve in regulation. In Europe, central banks policies were also restrained by governmental regulation of interest rate and cross-border capital movement. Government regulation period is characterised by high level of financial stability. According to Goodhart, in the period from 1945 to 1971 no major banking crises occurred. After the fall of Bretton Woods system and inflation shocks of 1970s oil crises starts the decline of government regulation model, accelerated by strengthening rivalry between the regulated and the regulators. In USA banks use legal loopholes to introduce new products, allowing to broaden deposits base under high inflation (check deposits bringing interest), to expand geographically (inter-state and international), to set new organisational structures (banking holdings, subsidiaries networks). Together with innovations of legal and organisational character technological novelties (use of computers and telecommunications for information processing) are applied. In Europe, dominated by universal banking, these processes were less active, yet visible in international operations (Belgian, Swiss banks).

Deregulation and central banks' golden age (1980 – 2008)

Inflation acceleration of 1970s resulted in opting for monetary stability priority, minimization of government intervention in financial markets regulation and unprecedented rise of central banks' role. In USA the beginning of deregulation phase is marked by the pass of Depository Institutions Deregulation and Monetary Control Act in 1980 and Garn-St.Germain Depository Institutions Act in 1982. Interest rate ceilings on saving accounts were cancelled, market conditions unified for market participants, borders between specialized financial institutions blurred. Access to the Federal Reserve and inter-state operations were liberalized, deposit banks started working with risky assets. The old regulation framework was finally demolished with the pass of Gramm-Leach-Bliley Act in 1999. The provision of the Glass-Steagall Act prohibiting a banking holding from owning another financial company was cancelled. From now on deposits may be forwarded into securities operations. In Europe this period is marked by elimination of borders for capital mobility and integration of financial market within the European Union. EU accepts Bundesbank concept of a powerful, independent central bank, ensuring macroeconomic and financial stability by giving priority to monetary (price) stability.

The decade before 2007 is commonly known as the Great Moderation – long period of predictable output and stable low inflation. Claudio Borio summarized the beliefs of that period as follows:

- Price stability is sufficient for macroeconomic stability;
- Financial stability shall be provided mostly by micro-prudential supervision and regulation;

- Short-term interest rate is sufficient for transmission of monetary policy;
- Global stability shall be provided if each central bank provides stability in the borders of its responsibility¹².

As further developments showed, the Great Moderation was a myth¹³ ignoring systemic risks accumulation. Central banks concentrated on short-term consumer price indicators and did not react to asset prices boosting in mortgage markets; banking sector and securities market regulators overlooked threatening build-ups in shadow banking activities of hedge funds; insurance market regulators ignored huge liabilities arising from credit default insurance. Additionally, it is believed that motivation of regulatory bodies was compromised by “regulator capture”. Researchers were trying to analyse growing systemic risks by applying concentration-stability and concentration-fragility approach. Yet, the results of these studies were providing conflicting evidence on the connection between growing concentration and endangered stability. Thorsten Beck, Asli Demirgüç-Kunt and Ross Levine analysed data of 70 countries from 1980 to 1997 and found that crises are less likely in economies with more concentrated banking systems; regulatory policies that thwarted competition were associated with greater banking system fragility¹⁴. Notably the Lithuanian researcher analysing an extended 20 years’ period up to 2007 came to similar conclusions¹⁵.

By the time of crisis national regulation systems became no match to globally interconnected financial institutions, operating with cross-border and cross-sector financial flows. So called financial innovations, such as securitisation created illusion of risk management disguised by multiple refinancing supplied by traditionally regulated financial institutions to sectors escaping regulators’ supervision.

Post-crisis regulatory reforms

Crisis development showed that in a financial system dominated by globally interconnected institutions contagion passes from private finances to banking sector and further to public finances. Traditional means of central banks to increase liquidity and governments’ actions to restructure separate problematic institutions do not work. Besides, central banks have limited options in a situation where interest rates are reduced and levels of public and private indebtedness are high, as any substantial increase of interest rate causes tensions in debt servicing. At the same time, bankruptcy or radical restructuring of inefficient financial institutions is connected with the risk of collapse of the whole system. This problem, addressed as “too big to fail” (TBTF) or “too important to fail” (TITF), leaves little choices to regulators other than to continue

¹² Borio, Claudio. Central banking post-crisis: What compass for uncharted waters? BIS working papers No 353, September 2011. [accessed on: 30-09-2011]. Available from: <http://www.bis.org/publ/work353.pdf>

¹³ Acemoglu, Daron. (2011). *Inequality, Finance and Economic Stability*. Speech at the Conference ICEF-2011, Istanbul, May 20.

¹⁴ Beck, Thorsten; Demirgüç-Kunt, Asli; Levine, Ross (2006). *Bank Concentration and Crises: First results*. Journal of Banking and Finance, 2006, v 30 (5,May), 1581-1603. [accessed on 30-09-2011]. Available from: <http://www.nber.org/papers/w9921>

¹⁵ Deltuvaitė, Vilma. (2010). The Concentration-stability Relationship in the banking system: An Empirical Research. Economics and Management 2010.15, pp. 900-909.

salvation actions and preserve the *status quo*. Rebuilding of financial stability requires creating integrated regulatory bodies at national and supra-national level, able to detect and solve TBTF problem. We call these new regulating institutions *mega-regulators* to stress their engagement in cross-sector and cross-border regulation.

USA regulatory reforms

The United States made a first step in creating integrated regulation framework of financial markets with the pass of Dodd–Frank Wall Street Reform and Consumer Protection Act¹⁶ in July 2010. The Act, which is rightfully called the most comprehensive regulatory effort for financial markets since the 1930s¹⁷, marks concentration of regulating powers within the government. Dodd-Frank Act creates facilities to support financial stability, to evaluate and fight systemic risks coming mostly but not exclusively from financial markets. Financial Stability Oversight Council is created, presided by the Secretary of Treasury, with members including Chairman of the Federal Reserve and all heads of financial market regulating agencies. Another important institution created under the Act is the Office of Financial Research, the head of which is appointed by the President. Some new institutions, such as Bureau of Consumer Financial Protection for supervision of problems overlooked by old regulators are established. Dodd-Frank Act makes provision for managing failure of TBTF institutions covering all range of actions, starting from assessing to restructuring and liquidation. The Act partly restores Glass-Steagall Act provisions on separation of deposit banks from investment banks and sets limits for speculative operations of deposit banks. According to Volcker rule, proprietary trading by depositary banks is limited to 3% of Tier 1 Capital.

Though under Dodd-Frank Act, the Federal Reserve acquires some new and strengthens existing powers (expansion of companies falling under Fed's regulation, control of banking holdings' subsidiaries, etc.), Fed is requested to share its previously sole responsibilities with some other agencies (FDIC), also Fed's powers to facilitate extraordinary lending is limited and may be vetoed by Secretary of Treasury¹⁸. Generally we could state that relative powers of America's central bank in the new regulatory system are more modest than before the crisis.

European Union new regulatory architecture

Though legal steps implementing new regulatory system in Europe followed after USA reforms, priority in creation of first supra-national regulation belongs to the European Union. Before the 2007-2008 crisis integration of financial markets supervision was implemented within the four level 'Lamfalussy' supervision process, named after the author of the project Alexandre Lamfalussy. The process, launched in 2000

¹⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act. (2010). Public Law 111–203, H.R. 4173. 21 July 2010.[accessed on 30-09-2011]. Available from: <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>

¹⁷ Acharya, Viral et al. (2011). Dodd-Frank: One Year On. Centre for Economic Policy Research. [accessed on: 30-09-2011]. Available from: <http://www.voxeu.org/sites/default/files/file/proofs.pdf>

¹⁸ Parkinson, Patrick. (2011). *A Stronger or a Weaker Fed?* Published in: Dodd-Frank: One Year On. Centre for Economic Policy Research. [accessed on 30-09-2011]. Available from: <http://www.voxeu.org/sites/default/files/file/proofs.pdf>

to promote Financial Services Action Plan, united four levels of decision making: the European Parliament and the European Commission (EC) (Level 1), EC specialised committees (Level 2), expert committees busy with transposition of EC directives into national legislation (Level 3), and follow-up control and supervision (Level 4). Third Level expert committees were organised for micro-prudential supervision of relevant financial market sectors: Committee of European Banking Supervisors (CEBS), European Securities Regulators (CESR), and Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Together with certain successes in integration of financial markets (SEPA project in payments, SOLVENCY II project in insurance) supervision in the EU remained divided by sectors and national borders.

The pace of reforms was fastened after the crisis. In February 2009 de Larosiere Group, chaired by Jacques de Larosiere, presented a report with the new agenda of regulation and supervision reform, aiming to create a new framework of financial stability in the European Union¹⁹. Based on these proposals, new framework of macro- and micro-prudential supervision and regulation was introduced since January 2011. The micro-prudential arms are represented by European Supervisory Authorities, consisting of refurbished and strengthened sector regulators, replacing former expert committees:

- 1) European Banking Authority (EBA) replacing Committee of European Banking Supervisors (CEBS);
- 2) European Securities and Markets Authority (ESMA) replacing Committee of European Securities Regulators (CESR);
- 3) European Insurance and Occupational Pensions Authority (EIOPA) replacing Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

The macro-prudential arm of supervision and regulation, represented by the European Systemic Risk Board (ESRB), is responsible for safeguarding financial stability in the EU. Thanks to its structure, the *Board* creates a new mechanism of interaction between the European Commission and the European Central Bank. Notably, among Board members ECB representatives and EU national central bank governors outnumber representatives of the EC, the secretariat is also provided by the ECB.

It is probably too early to assess the efficiency of the created institutions, yet some moments need to be noted. While ESA authorities have got more powers to implement prudential control, prepare rescue plans, arrange refinancing, ESRB has mostly advisory powers. Compared to the US regulatory scheme, the decision-making and responsibilities are blurred. ESRB and EBA are dominated by representatives of central banks whose independence is guaranteed by the EU Constitution and national legislation. Ability of new regulatory bodies to meet systemic threats are yet to be proved.

Institutional changes in regulation can be an important, but insufficient part of regulation reform. In order to meet cross-sector and cross-border financial risks and effectively deal with problems arising from sovereign debts, regulators should have access to funds larger than resources of separate national governments or national central banks. Mechanism of fund transfers within the Eurozone was created in June 2010 by establish-

¹⁹ Report of The High Level Group on Financial Supervision in the EU. (2009). [accessed on 30-09-2011]. Available from: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

ing of the European Financial Stability Facility (EFSF). EFSF funds are guaranteed by 17 members of the Eurozone up to € 440 billion, up to € 250 billion are guaranteed by the International Monetary Fund, up to € 60 billion are raised by the EC and guaranteed by the EU budget. At the moment of writing the member states of EFSF ratify upgrade of their guarantees to facility up to € 780 billion. Notably, EFSF acts within the ECOFIN Council, and the Board consists of representatives of national ministries of finance. The EFSF is a temporary institution active till June 2013. After expiration of the EFSF, according to the decision of the European Council it should be replaced with a permanent institution - European Stability Mechanism, which can be named an "IMF of the Eurozone".

In our opinion, extension of the EFSF and further transition to permanent European Stability Mechanism may change the roles of the EU executive powers and the ECB in formation of the monetary base of the Eurozone. European Stability Mechanism may serve as substitution to otherwise necessary direct fiscal transfers among the Eurozone members. It would allow the ECB to concentrate on providing monetary stability based on short-term debt instruments, while responsibility for anti-crisis actions based on medium and long-term instruments would be shared with the EC and national governments.

Globalised financial markets and institutions request cooperation of national and supra-national regulatory authorities in creating regional and global financial supervision and regulation frameworks. Researchers of Asian markets see opportunities of building regional supra-national authorities in Asia on the basis of the 'Lamfalussy' process analogue²⁰. The G-20 Financial Stability Board, International Monetary Fund participation in the EFSF, Basel III Accord implementation are the elements of the new global financial architecture. The restricted scope of this article does not allow us covering these issues, which are prospective for further study.

Projects of merging financial markets regulation in Lithuania

Changes in the architecture of financial markets regulation in the European Union, effective since January 2011 raised questions about reforming Lithuanian regulating bodies. The concept of reform was presented by the Ministry of Finance²¹, and the package of draft laws was forwarded for parliamentary discussion in the beginning of September 2011. The basic idea of the concept is to centralise supervision and regulation of banking, insurance and securities markets within the institution of highest competency, which is the Bank of Lithuania, the central bank of the country. The package consists of more than 20 draft laws²², of which is the Financial Markets

²⁰ Hsu, Chen-Min; Liao, Chih-Feng. (2010). *Financial Turmoil in the Banking Sector and the Asian Lamfalussy Process: The Case of Four Economies* Asian Development Bank Institute.

ADBI Working Paper Series. No. 221, June 2010. [accessed on 16-10-2011] Available from: <http://www.adbi.org/working-paper/2010/06/28/3920.financial.turmoil.prc.banking.lamfalussy.process/>

²¹ Ministry of Finance of the Republic of Lithuania. (2011). Press release [accessed on 16-10-2011] Available from: http://www.finmin.lt/web/finmin/naujienos?erp_item=naujiena_001664

²² Selection of the draft laws may be viewed through the Seimas of the Republic of Lithuania legal acts search engine [accessed on 16-10-2011] Available from: lrs.lt/pls/inter3/dokpaieska.rezult_l?p_nr=&p_nuo=2011%2008%2031&p_iki=2011%2009%2005&p_org=&p_drus=2&p_kalb_id=1&p_title=&p_text=lietuvos%20bankas&p_pub=&p_met=&p_lnr=&p_denr=&p_es=0&p_rus=1&p_tid=&p_tkid=&p_t=0&p_tr1=2&p_tr2=2&p_gal=

Supervision System Reorganisation Law, amendments of the The Bank of Lithuania Law, draft laws amending the Financial Institutions Law should be mentioned as the most important. According to the project, the functions of supervising and regulating the banking sector remain with the central bank. Insurance and securities markets supervision presently effected accordingly by the Insurance Supervisory Commission and the Securities Commission falls under the responsibility of the central bank; separate industry regulators shall expire with commencement of the reforms. The central bank gets new spheres of regulation, such as consumer credit, and acquires more powers, such as administrative power to settle disputes among market participants, to protect interests of non-professional consumers of financial services and other. Financing of integrated supervision services should be based on fees paid by professional market participants.

There are certain positive moments in the planned reform, such as fee-based financing, extension of regulation to areas previously not encompassed by qualified regulation (consumer credit, financial services to non-professional participants are presently regulated by the State Consumer Rights Protection Authority). Yet the reform misses strategic focus on financial stability, substituting the issue by administrative optimisation of existing institutions and involving the central bank into meticulous day-to-day activities.

It should be kept in mind that under the provisions of currency board the opportunities of the Bank of Lithuania to impact financial stability by means of monetary policy are limited. Most of systemic risks originating in Lithuania result from macroeconomic imbalances manifested in the form the public finance problems (national budget, social insurance funds, public debt) and depend on the fiscal policy of the government. Fiscal and monetary authorities need much greater mutual coordination than the present system allows. The provision of the plan to create the Consultative Financial Markets Policy Commission, chaired by the Minister of Finance, may be viewed as first, but insufficient step in this direction.

CONCLUSIONS

Violation of financial stability is caused by factors, which can be divided into two large groups. In the first group of external factors global imbalances are the most important. They should be taken into consideration, however, they cannot be directly affected by changes in the financial system. Factors comprising the second group arise from imperfect nature of financial markets. Market failures should be corrected by regulation. Specific condition of financial markets requests specific regulation forms seeking to find optimal balance among regulation, competition, efficiency, innovation and stability.

Regulatory reforms are a reaction to market failures. We view evolution of regulation as long regulatory cycle where periods of tightened regulation are changed by lax regulation or deregulation. Regulation-dominated phase covers the period from 1933 to 1979, deregulation processes dominate from 1980 to 2008. Following the 2007-2008 crisis the new period of Regulation Renaissance begins.

On one hand, the financial crisis of 2007-2008 was a result of deregulation process and confidence in central banks' ability to reach financial stability by means of short-term monetary instruments; on the other hand, it was a result of unprecedented complexity and interconnectedness of financial institutions and markets. Regulatory frameworks became no match to cross-sector and cross border operations within concentrated market structure.

The principal goal of regulatory reforms undertaken in the United States and the European Union is to create facilities to evaluate and diminish risks arising from "too big to fail" financial institutions. The new regulatory frameworks unite macro- and micro-prudential regulators, and central banks are integrated in regulation activities. We call new regulating bodies *mega-regulators* to stress their occupation with cross-sector and cross-border regulation.

While preserving the leading role in safeguarding monetary and financial stability, central banks need to share responsibilities with other regulatory bodies. The Golden Age of central banking is over. This trend is more expressed in the US government-dominated regulation reform and is less obvious in the European Union.

In Lithuania reforms of financial markets supervision and regulation are presented by plans to merge regulating authorities under the brand of the Bank of Lithuania. Though certain targets like better non-professional clients' protection might be achieved in the course of such reorganisation, we generally view the draft reform as formal, detracting from the strategic goal of building financial stability. More profound mechanism of coordination of government and central bank policies is needed, especially for evaluation and prevention of risks arising from public finances.

References

- Acemoglu, Daron. (2011). *Inequality, Finance and Economic Stability*. Speech at the Conference ICEF-2011, Istanbul, May 20.
- Acharya, Viral et al. (2011). Dodd-Frank: One Year On. Centre for Economic Policy Research. [accessed on: 30-09-2011]. Available from: <http://www.voxeu.org/sites/default/files/file/proofs.pdf>
- Allen, Franklin; Gale, Douglas. (2004). *Competition and Financial Stability*. Journal of Money, Credit and Banking, Vol. 36, No. 3, Part 2, 2004, pp. 453-480.
- Beck, Thorsten; Demirgüç-Kunt, Asli; Levine, Ross (2006). *Bank Concentration and Crises: First results*. Journal of Banking and Finance, 2006, v 30 (5,May), 1581-1603. [accessed on 30-09-2011]. Available from: <http://www.nber.org/papers/w9921>
- Borio, Claudio. Central banking post-crisis: What compass for uncharted waters? BIS working papers No 353, September 2011. [accessed on 30-09-2011]. Available from: <http://www.bis.org/publ/work353.pdf>
- Cecchetti, Stephen G. (2010). Global imbalances: current accounts and financial flows. [accessed on 30-09-2011]. Available from: <http://www.bis.org/speeches/sp110928.pdf>
- Deltuvaite, Vilma. (2010). The Concentration-stability Relationship in the banking system: An Empirical Research. Economics and Management 2010.15, pp. 900-909. ISSN 1822-6515
- Dodd-Frank Wall Street Reform and Consumer Protection Act. (2010). Public Law 111-203,

- H.R. 4173. July 21, 2010.[accessed on: 30-09-2011]. Available from: <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>
- Goodhart, Avgouleas E,C. (2010). The changing role of central banks. BIS working papers No 326, November 2010. [accessed on 30-09-2011]. Available from: <http://www.bis.org/events/conf100624/goodhartpaper.pdf>
- Heremans, Dirk. (1999). Regulation of Banking and Financial Markets. Encyclopaedia of Law and Economics. [accessed on 30-09-2011]. Available from: <http://encyclo.findlaw.com/5850book.pdf>
- Hsu, Chen-Min; Liao, Chih-Feng. (2010). *Financial Turmoil in the Banking Sector and the Asian Lamfalussy Process: The Case of Four Economies* Asian Development Bank Institute. ADBI Working Paper Series. No. 221, June 2010. [accessed on 16-10-2011] Available from: <http://www.adbi.org/working-paper/2010/06/28/3920.financial.turmoil.prc.banking.lamfalussy.process/>
- Issing, Otmar. (2003). Monetary and Financial Stability: Is there a Trade-off? Speech at the Conference on Monetary Stability, Financial Stability and the Business Cycle, March 28-29, 2003, BIS, Basel. [accessed on 30-09-2011]. Available from <http://www.ecb.int/press/key/date/2003/html/sp030329.en.html>
- Leika, Mindaugas. (2009). Financial system stability as a goal of central bank's policy. Pinigu studijos, No 1, 2008, pp. 68-83.
- Ministry of Finance of the Republic of Lithuania. Press release [accessed on 16-10-2011] Available from: http://www.finmin.lt/web/finmin/naujienos?erp_item=naujiena_001664
- Parkinson, Patrick. (2011). *A Stronger or a Weaker Fed?* Published in: Dodd-Frank: One Year On. Centre for Economic Policy Research. [accessed on 30-09-2011]. Available from: <http://www.voxeu.org/sites/default/files/file/proofs.pdf>
- Rakauskienė, Ona Gražina; Krinickienė, Eglė. (2009). The Anatomy of Global Financial Crisis. Intellectual Economics No 2(6), 2009, pp. 116-128. ISSN 1822-8011
- Report of The High Level Group on Financial Supervision in the EU. (2009) [accessed on 30-09-2011]. Available from: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf
- Rogoff, Kenneth S.; Reinhart, Carmen M. (2009). *This Time Is Different: Eight Centuries of Financial Folly*. Princeton University Press. ISBN-9780691152646
- Schinasi, Garry J. (2006). *Safeguarding financial stability : theory and practice*. Washington, D.C.: International Monetary Fund. ISBN 1-58906-440-2
- Schinasi, Garry J. (2007). *Understanding Financial Stability: Towards a Practical Framework*. [accessed on 30-09-2011]. Available from: <http://www.imf.org/external/np/seminars/eng/2006/mfl/gjs.pdf>
- Seimas of the Republic of Lithuania, legal acts search engine [accessed on 16-10-2011] Available from: lrs.lt/pls/inter3/dokpaieska.rezult_l?p_nr=&p_nuo=2011%2008%2031&p_iki=2011%2009%2005&p_org=&p_drus=2&p_kalb_id=1&p_title=&p_text=lietuvos%20bankas&p_pub=&p_met=&p_lnr=&p_denr=&p_es=0&p_rus=1&p_tid=&p_tkid=&p_t=0&p_tr1=2&p_tr2=2&p_gal=
- Stiglitz, Joseph E. (2010). *Freefall: America, Free Markets, and the Sinking of the World Economy*. W.W. Norton & Penguin. ISBN-9780393075960

FINANSINIS STABILUMAS KAIP POKRIZINIŲ REGULIAVIMO REFORMŲ TIKSLAS

Algis DOBRAVOLSKAS, Jusif SEIRANOV
Mykolo Romerio Universitetas

Santrauka. Straipsnyje analizuojami finansinio nestabilumo, kurio protrūkis pasireiškė per 2007–2008 m. krizę, priežastis ir nagrinėjami finansinio stabilumo atstatymo būdai pokrizinių reguliavimo reformų procese. Autoriai daugiau dėmesio skiria instituciniam problemos aspektui. Stabilumo pažeidimas pristatomas iš vienos pusės kaip nuo praeito amžiaus 80-ųjų metų pagrindinėse finansų rinkose vykdomų dereguliavimo procesų rezultatas. Iš kitos pusės – tai nacionalinės mikrolygio (sektorinės) priežiūros netinkamumo kontroliuoti vadinamųjų „per didelių, kad žlugtų“ finansinių institucijų tarpvalstybinę ir tarp-sektorinę veiklą pasekmė. Straipsnis nagrinėja, kaip stabilumo atstatymo tikslai yra realizuojami pokrizinėse reformose, analizuoja institucinius pokyčius, įvykusius JAV priimant Dodd'o-Frank'o įstatymą, ir Europos Sąjungoje įvedant naują finansų rinkų reguliavimo ir priežiūros architektūrą. Straipsnyje taip pat vertinamas šių reformų poveikis finansų rinkų reguliavimui Lietuvoje

Reikšminiai žodžiai: finansinis stabilumas, finansų krizė, sisteminė rizika, reguliavimo reforma, makrolygio ir mikrolygio priežiūra