POZNAŃ UNIVERSITY OF ECONOMICS REVIEW
Volume 11 Number 1 2011

Stanisław KLUZA
Polish Financial Supervision Authority (KNF)

The financial crisis of 2008–2009: the financial supervision perspective

Abstract: The paper presents remarks regarding the recent financial crisis from the supervision authorities' perspective. It mentions remedies taken in the lieu of the crisis as well as underlines the need of preventive actions. The paper focuses on three main lessons that can be learnt from the recent crisis: First, regardless of its scope every crisis has local origins, hence local financial supervisors, who have the best knowledge and understanding of all sectors of their domestic market, should have sufficient tools and powers. Second, financial stability is a public good and it should be dealt with by relevant public institutions co-operating together. Third, there is a need to address the 'too big to fail' problem and to learn how risk increases with the increase in a financial institution's size. In the final part, the paper focuses on various models of financial markets supervision and explains how supervisory system functions in Poland.

The paper is based on the speech by Stanisław Kluza in the expert panel following the lecture by the Nobel Prize Laureate, Robert Mundell, during the 17th Global Finance Conference held in Poznan, Poland in June 2010.
Keywords: financial market stability, supervision of financial markets, financial crisis.
JEL codes: G18, G28.

Introduction

As a financial market supervisor, the Polish Financial Supervision Authority (KNF) devotes a great deal of work to research, supports conferences and employs a great amount of Ph.D. holders proficient in quantitative analysis. Therefore, it is a pleasure for us to cooperate in organizing this event that gathered so many specialists in finance and to contribute to making the speech of Professor Mundell take place. Thank you very much, Professor Mundell, for the inspiring speech you delivered.

In my short comment, I will focus on the supervisory recognition of the recent crisis, which already went through a number of stages. The current stage, which is most evident in Greece, could be called a fiscal crisis, but it was preceded, respectively, by the solvency crisis, liquidity crisis and the crisis in the real sphere of the economy. We may find numerous causes of this course of events, or development of the crisis, but from the supervisory point of view the lack of confidence is of particular significance.

1. Importance of confidence in the financial market

Mutual confidence in the financial market lowers transaction costs and increases efficiency of the market. Thus we can ask ourselves what measures and actions should be taken, what variables should be affected to raise confidence of the market participants. The fundamental factor building confidence is equity capital. If the owners of financial companies put more capital into their business, they build confidence, because their contractors know they would lose more if their business was too risky. Thus we apply appropriate supervisory tools to convince the financial institutions that maintaining capital levels, sufficient with respect to the risks they are exposed to, brings notable benefits. Activities of the Polish Financial Supervision Authority (KNF) in this field contributed to retention of 90% of profits of the domestic banking sector and 2/3 of profits of the domestic insurance sector last year.

2. Lessons to learn

There are at least two reasons why people get involved in analysis of the financial crisis. The first one can be called cognitive and is motivated by a strive to describe evolution of a particular crisis and to explain its origins. The second reason I would call "preventive" as it is aimed at constructing a better model of the market, which would be immune to some of today's problems. The latter is, of course, more appealing for the financial supervision authorities.

2.1. Importance of local supervisory authorities

The basic observation is quite obvious: every crisis, regardless of its scope, has local origins. Prescription resulting from this observation says that local financial supervisors, who have the best knowledge and understanding of all sectors of their domestic market, should have sufficient tools and powers to react to developments in this market. Of course, there is a theoretical possibility of establishing international authorities or agencies, which would be responsible for monitoring specific kinds of risks and supervise financial institutions from the global perspective. However, the local supervisors have informational advantage and the most important competences concerning capital and liquidity should be maintained in their hands, just to minimize the risk of the crisis outbreak at the outset. The proper balance between local versus transnational information and competence should be one of the key issues concerned during a debate on amendments to the Directive on reorganization and winding up of credit institutions (2001/24/EC).

2.2. Financial stability is a public good

Another important lesson from the current crisis is that financial stability constitutes a public good. Being a public good, financial stability should be dealt with by relevant public institutions. In case of Poland, the Ministry of Finance, the National Bank of Poland and the Polish Financial Supervision Authority have regular meetings in the framework of the Financial Stability Committee that serve the purpose of exchanging information on current developments in the financial sector and coordinating actions of participating public institutions. There is, however, one more important element of the financial stability network in Poland – the Bank Guarantee Fund, which also contributes to building up confidence in the financial market by raising deposit guarantee ceiling.

Sometimes relevance of financial stability is being questioned as it supposedly restricts free competition in the financial market. I have to emphasize that a free-market economy does not mean a situation in which profits are private and losses are public. If a state is expected to take over responsibility for financial institutions in bad shape, then the state should be able to set and execute rules for the financial sector. We have recently seen many cases of states which financed assistance programs for troubled financial institutions with taxpayers' money. Last month the European Commission released data on the value of the public support measures for the financial sector used by EU Member States in the wake of the crisis. It amounted to more than 1.2 trillion euros, i.e. almost 10% of GDP of the whole EU (27 Member States), contributing to deterioration of the fiscal situation in the most heavily indebted Member States. If financial institutions expect the state to be "investor" of last resort, then they should accept the fact that the state sets more stringent rules that have to be followed by everyone.

2.3. 'Too big to fail' issue

The third lesson I would like to address relates to the phrase 'too big to fail'. This phrase means that the institution in question does not internalize all the consequences of its activity, because if business goes wrong, the state will be obliged to help that institution just to avoid the social costs of its bankruptcy. Sometimes, the state has to intervene, but the question is whether the state could avoid the moral hazard of this kind. That is a wrong equilibrium, but it is also important for quantitative research to create models to learn the function of risk, how risk rises with the increase in a financial institution's size. There is lots of literature claiming that when the size of a financial institution increases, the risk diminishes as correlations cancel or limit these risks. Correlations did not work out in the recent crisis, but expansion of financial institutions dramatically increased potential consequences of their failure. This is another area, which is very interesting for theoretical research.

3. Organization of the financial market supervision

In the final part, I would like to mention the ways supervisory frameworks are organized in some countries. If we take a picture of how financial supervision works in various countries, it would be impossible to find two countries with exactly the same models of supervision. There are diversified models and the question appears which model is optimal, or what criteria should be applied to compare different models of financial supervision. In Poland we had such a debate 4–5 years ago. The conclusion of that debate was that supervision should be:

1) integrated,
2) not situated within the central bank as the conflict of interests between monetary policy and supervision policy is possible; especially, in time of crisis, when the former would be eased and the latter – more stringent.

What are the benefits and risks of a situation, when those two aspects of control would be held by one institution? One point of view is that both are concerned with the creation of money, so a single institution could optimize controlling this phenomenon. However, there are many cases in which the approach from a monetary policy point of view would be opposite to that of financial supervision. Therefore, the two aspects of control over the financial sector should meet and cooperate, but if they were held by a single institution, one policy would be primary while the other would be seen as secondary or supplementary. That is not a perfect situation for fulfilling the tasks of financial supervision. Because of this, it is beneficial for big countries with strong and independent monetary policy to separate those two institutions, the financial supervision authority and the central bank, with their policies and sets of instruments.

There is one area which is not often discussed in public debate. KNF has a specific scope of tasks that differ from other countries. In all countries in the world, supervision is of prudential nature - the definition can be wider or more narrow, but that is the general situation. In Poland we also have two additional tasks, that only some of the world's supervisory institutions have in their scope. We take into consideration the development of the financial market. It is possible to be so prudential, have such high capital requirements that the development would be very slow. In our actions we look at long-run soundness of the financial sector, that requires sustainable development of financial institutions.

Another aspect of financial supervision, in which Poland is an innovator, is consumer protection. In some countries, it is not relevant for the supervisors to oversee whether financial institutions are fair to their clients, because if the sector makes extra profits at the expense of the clients, it accumulates more capital and becomes safer. This description may seem a bit exaggerated, but we observed similar situations in some countries.

In Poland the financial supervision authority is involved in consumer matters taking into consideration a specific asymmetry between financial market participants. On the supply side, there are financial institutions, who are usually not very numerous and are quite potent in terms of legal support, quantitative analyses and any other expertise that is costly, but available on the market. On the other side, there are millions of retail clients, not professional financial players, who have no access to superior financial recommendations and legal advice. That creates an asymmetry, which has to be dealt with. Otherwise, specific disequilibria and bubbles may arise, that can initiate serious problems or crises.

Conclusions

Concluding, I hope that some of the questions raised in this speech will inspire you as economists and policy analysts into research in factors of financial markets equilibrium and proper scopes of financial supervision, monetary policy and fiscal policy. Many interesting research problems can also be identified within the area of financial supervision theory, especially when financial risk is perceived as a negative externality imposed on other market participants, and financial stability – not just as a market equilibrium, but a public good.