

# Opportunities for a Sustainable European Financial System

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## Abstract

The financial system has traditionally been considered a catalyst for economic growth. Yet the financial crisis of 2008 has shown that the financial system is also capable of triggering a process leading to profound economic instability. This article explores the opportunities for European banks to achieve financial sustainability. SWOT analysis shows that, despite numerous weaknesses and threats, the financial system has a vast number of strengths and opportunities.

**Keywords:** Financial sustainability; Financial system; European union; SWOT

## Introduction

In recent decades, public awareness of business sustainability has grown. Awareness of financial stability has also grown, as reflected by the creation of international indices such as the Dow Jones Sustainability Index (DJSI), the FTSE4Good Index Series, the Domini 400 Social Index, and the Index of Sustainable Economic Welfare (ISEW) [1]. Scholars have even proposed a Banking Sustainability Performance Index that focuses solely on credit institutions [2].

But what is business sustainability? Despite intense interest in this issue, there is no universally accepted definition of what constitutes business sustainability, although numerous definitions are based on what Savitz and Weber (refer to as the triple bottom line (TBL) [3]. The TBL comprises three dimensions environmental, social, and economic that form the pillars of sustainability. Integrating these three dimensions means directing the firm's financial resources toward company policies that positively affect society while yielding returns.

This article focuses on the sustainability of the financial system, whose main function is to stimulate productive investment by channeling savings from economies with surpluses to economies with deficits. Market economies are built on the principle of free movement of human, financial, and property factors of production, so the financial system is a key component of all market economies. The most efficient financial systems are those where savings-generated resources flow toward productive investment and where individual preferences are met [4]. But efficient does not necessarily mean sustainable, even though sustainability is required to ensure the financial system and the market economy that it supports are able to function.

From a social perspective, the sustainability of the financial system is comparable to corporate social responsibility (CSR) or socially responsible and sustainable development [5,6]. For example, many banks, particularly savings banks, engage in projects that give back to society. Savings banks are non-profit organizations, so they do not pay out dividends, and they devote a large amount of their profits to social causes. But savings banks are disappearing. In Spain, for example, savings banks' market share has fallen from approximately 50% to less than 1% in just a few years [7].

Unfortunately, however, banks have been unable to fulfil their pledge of behaving in a socially responsible manner. Examples of banks' improper behavior include investing in subprime mortgages, which has led to housing reposessions, selling high-risk complex products, which has cost small investors large sums of money, colluding in money laundering, taking excessive executive compensation packages, and

irresponsibly managing brokerages, ratings agencies, accountancies, and management consultancies [8]. These actions have contributed to the financial system's central role in the third major financial crisis, which followed the stock market crash of 1929 (due to demand) and the 1973 oil crisis (due to supply) [9]. The financial crisis triggered a series of effects that have shaken the entire global economy, underlining the financial system's fundamental role within the economy.

Interest in studying the sustainability of the financial system owes to the financial sector's fragility and the need to strengthen the system to prevent such a crisis from happening again. This article explores the financial system's strengths, weaknesses, opportunities, and threats (SWOT) to develop a tool that summarizes the scope of the sustainability of a financial system still reeling from the financial crisis of 2008. To develop this tool, we performed SWOT analysis [10]. The use of SWOT analysis represents an original approach. No study has used SWOT analysis to examine the financial system following the financial crisis of 2008. It is hoped that this analysis will reveal the basic conditions that are required for the long-term well-being of today's generations and the generations of tomorrow. As described in the Brundtland report [11], sustainable development consists of this sustained well-being. This article also highlights the necessary steps for banks to encourage systemic sustainability to avoid the risk of financial contagion, which occurs when the failure of one bank causes similar failures in other banks within the local or global financial system [12].

This article contributes to the literature by building on existing research on bank sustainability. Section 2 establishes the theoretical framework and presents a review of literature. Section 3 explains which factors affect the sustainability of the financial system. Section 4 presents the results of the SWOT analysis. Section 5 discusses the findings and offers the principal conclusions of the study.

## Theoretical Framework

Business sustainability has garnered considerable attention from academics. The financial system acts as a catalyst for economic growth

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**Received** October 23, 2018; **Accepted** November 15, 2018; **Published** November 25, 2018

**Citation:** Climent-Serrano S, Bustos-Contell E, Labatut-Serer G (2018) Opportunities for a Sustainable European Financial System. J Bus Fin Aff 7: 357. doi: 10.4172/2167-0234.1000357

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is thus an indispensable part of the economy [13,14]. Despite the importance of business stability and the financial system, few studies have focused on the sustainability of banks, and even fewer have examined banks' financial sustainability. According to the Banking on Sustainability report by the International Finance Corporation, the sustainability of financial institutions covers four areas, which appear in Table 1 [15].

The literature on social sustainability is abundant. Lo and Sheu found that banks that appear in sustainability indices are sustainability leaders within the sector and benefit from the growing demand for sustainable financial products [16]. Scholtens proposed a framework to assess CSR with international banks [17]. Chih et al. studied the determinants of CSR in the banking sector [18]. Soana analyzed the associations between the corporate social performance and corporate financial performance of banks [19]. Carnevale and Mazzuca found that the disclosure provided by sustainability reports positively affects stock prices [20]. Sobhani et al. documented sustainability disclosure practices in the annual reports of banks in Bangladesh and designed a model to predict trends in these practices [21]. Piñeros et al. analyzed the organization and structure of the sustainability department of a Colombian bank that embraces sustainability culture as part of its business strategy [22].

In terms of environmental sustainability, Yadav and Pathak studied different approaches to green banking among Indian banks and discovered that public banks are more ecologically aware than private banks [23]. Medeiros et al. reported the need for banks to inform their employees about environmental management policies so that employees can share this culture with customers [24]. Sulaiman and Razman proposed measures to protect the environment by adopting a costs and benefits approach, thereby combining the environmental and economic pillars of sustainability [25]. Tornjanski et al. explored economic sustainability from a quality management perspective [26].

This article focuses on the financial sustainability of banks. Here, financial sustainability refers to the bank's ability to achieve good financial performance without the need for external support and without compromising resources or returns. This is the area of sustainability for which the literature is scarcest. Accordingly, this study represents a particularly valuable contribution to the literature. Among the studies that have explored this issue, Piot-Lepetit and Nzongang studied a combination of financial and social sustainability among microcredit institutions devoted to reducing poverty in Cameroon [27]. The authors proposed a tool to strike a balance between financial self-sufficiency and poverty reduction. Raut et al. also combined several areas to evaluate banks' financial sustainability, focusing on the perspectives of customer relationship management, internal business processes, and environmentally friendly management systems [28].

Few studies have focused on financial sustainability. In one such example, Marbella investigated financially sustainable growth rates of three types of credit institutions, although this study was conducted before the financial crisis of 2008 [29]. Finally, Zveryakov studied banking sustainability from different approaches to determine the

Dimension	Goal
Social	Improving living standards and reducing poverty
Environmental	Preserving natural resources and analyzing the environmental impact of the bank's investments
Economic	Promoting economically sustainable projects
Financial	Ensuring the bank's financial sustainability

Table 1: Dimensions of sustainability of financial institutions.

factors that affect banking sustainability and the components of banking sustainability management [30].

## Factors of Financial System Sustainability

### Negative factors

Recent changes have profoundly affected credit institutions' earnings and equity, which are fundamental for any firm to generate returns. Greater earnings and less equity mean greater returns. Conversely, lower earnings and greater equity mean lower returns. This rule holds for any sector because investment naturally flows toward sectors with higher returns and away from less profitable sectors. This section discusses the effects of perceptions within society and the way legal risk affects the financial sustainability of the banking sector.

**Structural changes affecting revenue:** The main source of revenue for a financial institution is the net interest margin, which is calculated as the difference between the interest earned from lending activities and the cost of financing these loans. The net interest margin has been shrinking for decades. Figure 1 shows how the net interest margin with respect to the total assets and gross income has varied over time in Spanish banks. This trend can be extrapolated throughout Europe.

In the mid-1980s, the net interest margin equated to approximately 1% of total assets and 90% of gross income of Spanish credit institutions. In 2015, however, the net interest margin equated to approximately 0.2% of assets and 50% of gross income. This fall in the net interest margin has led to a drop in revenues. To compensate, credit institutions have diversified their revenue streams by charging commissions for their services [31]. Doing so has further worsened the image of banks, causing customer churn and creating a barrier to financial sustainability.

**Regulatory changes affecting equity:** In recent decades, banks' equity-to-assets ratio has increased considerably, with negative consequences for investors. Data from Spanish banks reflect this trend (Figure 2). This trend can be extrapolated throughout Europe.

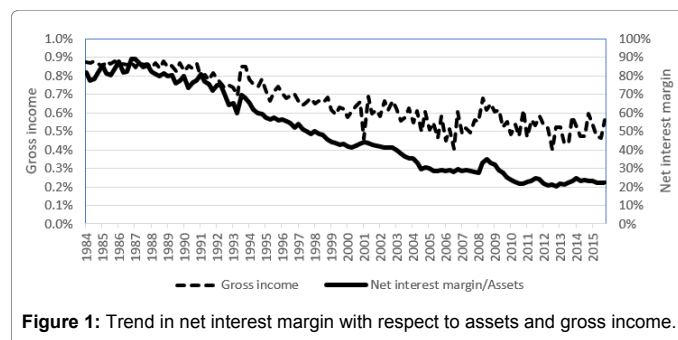


Figure 1: Trend in net interest margin with respect to assets and gross income.

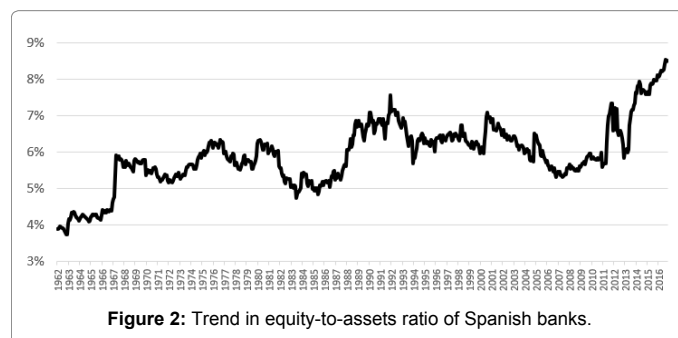


Figure 2: Trend in equity-to-assets ratio of Spanish banks.

From a low of 4% in the 1960s, the equity-to-assets ratio has grown to a high of 9% in 2016. Hence, with the same profits in absolute terms, investors in 2016 would receive half of what they would have received in the 1960s because these profits must be divided among twice as much equity. Having accelerated in recent years because of the Basel Accords, this trend may continue for several years to come, especially following the implementation of the latest Basel Accord (Basel III). Basel III stipulates that credit institutions must steadily increase their equity to ensure they can cope with losses during economic downturns and will not need public bailouts, as they have in recent times.

The current economy, however, is far from ideal for banks to increase their equity. Structural changes to savings banks have enabled the IPOs of these institutions, increasing the number of listed credit institutions. This increase has led to an excess in the supply of banking sector investments and has therefore prevented banks from raising the capital they need and securing their financial sustainability.

**Public perception of banks:** Since Lehman Brothers collapsed in 2008, too many banks have had to be bailed out to ensure economic stability and avoid contagion. These bailouts have accentuated the moral hazard, causing greater social ill will toward banks [32].

In Spain, the public perception of credit institutions is poor. Although the government has only had to bail out savings banks because of poor management, Spanish society has extended its sense of grievance against poorly managed savings banks by repudiating all firms in the banking sector. The financial sector has been forced to fundamentally restructure its labor force. According to the Bank of Spain, between 2007 and 2015, 74,357 bank employees (36.64% of all bank employees) have lost their jobs. Financial sustainability has thus come at a major social cost, which has also harmed the image of banks.

**Legal risk:** Credit institutions are subject to a high degree of legal risk, which refers to the risk of losses derived from legal issues. In recent years, this risk has materialized in the form of sanctions or costs derived from improper behavior by credit institutions. Table 2 presents some examples of the consequences of legal risk due to improper management of banks.

These sanctions and costs reflect the protection of banking customers and the loss of banks' hegemony. The high cost of their unlawful actions has a strong impact on banks' profits, which threatens banks' financial sustainability.

### Positive factors

Recent legislative changes and cost reductions have enabled banks to improve their financial sustainability. Financial innovations and the MIFID II regulations have also helped.

**Changes in legislation:** To fight money laundering within the banking system, most European countries limit the amount that professionals are allowed to pay for trade operations. This measure requires intervention from credit institutions and forces them to act in a socially responsible manner. In Spain, the limit for cash payments is 1,000 Euros or the equivalent in foreign currency. The corresponding amount is 3,000 Euros in France, 1,000 Euros in Italia and Portugal, 5,000 Euros in Slovakia, 10,000 Lev (approximately 5,000 Euros) in Bulgaria, 3,000 Euros in Belgium, and 1,500 Euros in Greece. In other countries such as Germany, Malta, Slovenia, the UK, Sweden, Austria, and Iceland, however, no such limit exists.

**Cost reductions:** In the past, credit institutions paid high salaries and bonuses. Salaries have now been aligned with those in the rest of the labor market. Doing so has reduced costs. Banks have also reduced the number of people they employ, especially in operations that add little value, such as balance inquiries. The use of ATMs and online banking has made these cost reductions possible, as well as reducing the number of branches. In short, banks have substantially reduced their costs by reducing salaries, personnel, and branches. These cost reductions have freed up resources, aiding financial sustainability.

**Financial innovations:** The financial crisis has led to a reduction in the number of loans granted in recent years. In contrast, the number of microcredits to fund startups has increased [8], thereby boosting the innovative banking sector and improving financial sustainability. Likewise, ethical banking has grown. Although it is still in its early stages, ethical banking has great business potential because it offers customers access to investments in socially responsible projects. The ethical banking sector, which targets socially aware consumers, presents a new way of improving the financial sustainability of the banking sector.

**Regulations:** The goal of the new regulations for investment services (MIFID II) is to ensure sustainable, efficient, risk-resistant, transparent securities markets that inspire investor confidence, especially among small investors [8]. MIFID II covers practically all financial products sold by credit institutions. Such products include fixed- and variable-rate debt instruments, derivatives, and investment funds. One of the key changes under MIFID II is that credit institutions must increase training for employees who sell these types of products. This requirement will help banks inform customers and will prevent customers from investing in products that they perceive as too risky. In short, MIFID II will improve the public perception of banks.

### SWOT Analysis of the Sustainability of the European Financial System

SWOT analysis consists of identifying strengths, weaknesses, opportunities, and threats. Whereas strengths and weaknesses

Institution(s)	Sanction/cost	Year of sanction	Details of sanction
JPMorgan, HSBC, Crédit Agricole	485 million Euros	2016	EU sanction
Deutsche Bank, Barclays, RBS, Société Générale	1.71 billion Euros	2013	EC fine for interest rate fixing
Deutsche Bank	7.2 billion USD	2016	Sale of toxic mortgages
Bankia	Cost of more than 4 billion Euros	2015	IPO voided
Spanish credit institutions	Cost of 5 billion Euros	N/A	Voided sales of hybrid products to non-sophisticated investors
JPMorgan, Citigroup, Barclays, RBS, Bank of America, and UBS	5.2 billion USD	2015	Fined by US Department of Justice and the Federal Reserve for forex manipulation
Deutsche Bank	2.5 billion USD	2015	Manipulating base lending rates over a four-year period
Spanish credit institutions	Unquantified	2017	Retroactive cancelation of "ground clauses" (clauses fixing minimum interest rates)

Table 2: Sanctions/costs arising from improper bank management.

correspond to features of the system, opportunities and threats depend on external factors. SWOT analysis is a useful method because it can be used to develop guidelines and actionable proposals. In this study, SWOT analysis was used to identify weaknesses of the European financial system and offer ideas for mitigating these weaknesses. Similarly, SWOT analysis was used to identify strengths that can be enhanced and exploited to ensure financial sustainability.

## Strengths

**European union:** The policies of the Economic and Monetary Union (EMU) have gradually corrected the weaknesses in the European financial system and have avoided a larger crisis with graver consequences [33].

**Liberalization-liquidity:** The European financial system is characterized by liberalized financial markets. This liberalization encourages greater liquidity and greater efficiency in channeling resources from economies with surpluses to economies with deficits. Market economies, economic growth, and regional development have thus been encouraged.

**Competitiveness:** The implementation of the Euro removed currency exchange commissions and led to a new trans-European settlement system, TARGET, which has greatly reduced costs.

**Globalization of debt:** The European debt markets issue debt in Euros, reducing risk and costs [34,35]. The risk premium of periphery countries has fallen considerably, causing periphery countries' unit costs for public financing to converge with those of core countries. According to Martín and Rey [36], a larger public debt market means greater profits. Likewise, Economides and Siow reported a tradeoff between liquidity and number of markets [37], and Issuing found evidence that investors prefer large, liquid markets [38].

**Stability and support:** Stability mechanisms are an essential tool for the stability of economies in the European single market. The first fund, which was created in 2010 to safeguard against instability, was used to lend money to Greece, Ireland, and Portugal [39]. Permanent stability mechanisms for specific countries have subsequently been established using European public debt. For instance, a memorandum of understanding on financial-sector policy conditionality was signed by the EU and Spain in 2012 to provide financial support to certain Spanish credit institutions with solvency issues [40]. The new systems designed to solve systemic problems relating to financial institutions and the new institutional structure, which is better suited to macroprudential policy, have encouraged stable financial integration and development. Furthermore, monitoring of large credit institutions is now the responsibility of the European Central Bank (ECB), which will help considerably when dealing with adverse situations [41].

## Weaknesses

**European union:** The EU is both a strength and a weakness. According to Constâncio [33], correcting the design flaws of the EMU is important to prevent future crises. The author cited banks as the root of the crisis. By channeling large flows of capital toward periphery countries (Greece, Ireland, Portugal, Spain, and Italy), banks created imbalances. These imbalances became unsustainable when the international subprime crisis hit and undermined confidence in the international financial markets. According to Schoenmaker [42], a profound imbalance in European integration in terms of governability causes financial instability. Despite having a single currency, central bank, and common tax policy, the EMU lacks a framework to address

the accumulation of systemic risks, and national regulators lack instruments to restrict flows of private capital. Nevertheless, these problems are being resolved with the transfer of regulatory duties to the ECB.

**Liberalization-liquidity:** Liquidity is a strength, but it is also a weakness. The high liquidity of the European financial system is based primarily on speculative products. On the one hand, this characteristic is positive. Hedging products help counterparts and facilitate the liquidation of assets at any time. On the other hand, the high volume of speculative assets of the European bank could trigger a cascade of defaults, as occurred with credit default swaps (CDS) and subprime mortgages in the US, which contaminated the entire financial system of the developed world.

**Multimarket issues:** In Europe, there are numerous stock markets, and firms are simultaneously listed on different exchanges. This situation is irrational because it leads to different prices for the same stock. To avoid incoherence in stock prices, the UE should create a single European stock market for firms that are simultaneously listed on several exchanges and reserve local markets for firms that are only listed nationally.

**Heterogeneity across countries:** Despite convergence efforts, different countries differ substantially, which creates a barrier that prevents the European financial system from functioning properly. Countries have varying deficits, which have been exacerbated by the recent crisis. The criteria of harmonization are not met in most countries. This lack of compliance increases instability and reduces the likelihood that monetary policies represent the interests of all countries and do not favor the core countries.

**Tax policy:** A loss of competitiveness because of unsuitable tax policy and excessive public debt creates spiraling costs. Similarly, the loss of competitiveness due to uncontrolled unit labor costs and excessive leverage also leads to spiraling costs [33].

**Loss of autonomy:** With the creation of the Euro and the ECB, monetary policy ceased to be the responsibility of each country's central bank. Now, the ECB establishes a single monetary policy. Coupled with the heterogeneity of EU member states, this shift has caused major imbalances.

**Effects of the crisis:** The EU has been molded by crises. The European financial system has also been subjected to these crises. The harmonization required for the system to function correctly differs depending on the business cycle. During crises, volatility increases and weaknesses emerge, especially in countries where uncertainty is greater. During periods of growth, however, harmonization is much simpler [43].

**Returns:** Return on equity (ROE) has been heavily affected by the financial crisis. The mean ROE was approximately 10% before 2007. Since then, it has fallen considerably, dropping below zero in 2011 and 2012. The recovery of the ROE has been slow, and Basel III has aggravated the issue. According to a European Banking Authority (EBA) cost of capital survey of European credit institutions, returns in many cases were below the cost of capital, which leads investors to seek better returns in other sectors. In addition, credit institutions are deleveraging, which curbs growth and therefore returns. Credit has shrunk not only because of deleveraging, but also because of a lack of demand. Borrowers who are potentially attractive to banks do not seek credit. Instead, borrowers with poor credit scores request (and are refused) loans.

## Opportunities

Greater competitiveness and productivity. Following the creation of the EMU, a process of mergers and acquisitions began among credit institutions to create robust banks [44]. Currently, a new round of international mergers and acquisitions is taking place so that credit institutions are strong enough to comply with the strict terms of Basel III. This consolidation, which, in the case of Spain, increases banks' market power, need not necessarily lead to a monopoly. In fact, it may lead to economies of scale and reduce costs in credit institutions, thereby increasing competitiveness [40], stimulating investment, and boosting the economy.

**Effects of integration:** Greater integration can lead to greater product standardization, greater transparency in markets and pricing, and the homogenization of markets and public debt and bank refinancing across Europe [45].

**Cost reduction:** The standardization of products, economies of scale derived from mergers, and the breadth of international networks reduce transaction costs [46]. International credit institutions act in the same way as a national bank with regional branches, which offers a competitive advantage and saves costs. The program of reforms should be a continuous process in which efficiency is constantly improved taking a broader view of how the financial system operates. Higher capital requirements will make financial institutions less likely to fail and will encourage them to take fewer risks [41].

**Basel III:** The new Basel Accord (Basel III) will substantially reinforce solvency and thus the financial strength of credit institutions. This financial strength will give credit institutions greater independence regarding possible market fluctuations and will reduce financing costs. With the new capital requirements, credit institutions will no longer depend on these fluctuations to secure cheap financing.

## Threats

**New technologies:** Commissions are one of the principal measures that banks have used to compensate for lower net interest margins. Banks' use of commissions has created an opportunity for new businesses to enter the market and threaten incumbent banks. Some new firms have removed or have massively reduced commissions. These firms offer products that are in increasing demand. Examples include Transferwise and PayPal. These firms let users transfer money internationally much more cheaply than traditional banks do. Other companies such as Google, Apple, Facebook, and Amazon also seek to enter the financial system. These companies face weaker regulations and have much lower costs.

**Protectionism:** Despite integration among European countries, there is deeply rooted nationalist sentiment. One of the ways this sentiment manifests itself is through the tax system. Countries such as Ireland attract large firms by reducing corporate tax rates. This practice hampers agreements for large mergers between firms from different countries.

**Divergence of origin:** Europe has two completely different financial systems. The Anglo-Saxon financial system, which originated in the UK, has spread to other countries such as the Netherlands and the Nordic countries. This system has weaker regulation and controls, and its source of financing is focused on the financial markets. In the continental financial system, financing is focused on banks. This system has much tighter controls and regulations [47].

**Basel III:** The new regulations stipulated in Basel III will have

a major impact on the profitability of credit institutions. First, the imposition of a minimum volume of short-term and long-term liquidity will reduce returns because liquid assets offer lower returns. Second, increasing the solvency ratio is based on increasing the bank's equity or core capital-dividends are shared out equally among the holders of this equity. Both changes will reduce dividends.

**Society:** Aligning the goals of financial institutions with economic well-being is challenging. Credit institutions take risks, and the fact that their networks are increasingly interconnected make contagion among banks more likely. This jeopardizes the stability of the entire financial system [41].

**Financial contagion:** Financial contagion exists among banks as well as between banks and the real economy. Alter and Beyer [48] and Popov and van Horen [49] showed that the post-crisis recovery of bank loans in the syndicated loans market was curbed because banks that operated in this market had huge balance sheet risks in sovereign debt issued by periphery countries. Since the start of the sovereign debt crisis, the supply of syndicated loans has been 20% lower than it would have been if there had been less tension in the public debt markets.

**Moral hazard:** During the recent financial crisis, certain banks were deemed too big to fail, which represents a moral hazard. Systemically important institutions might have been tempted to take risks they would not otherwise have taken if they had not been financially backed by the European authorities. Although this article has discussed the advantages of size, the disadvantages must also be considered. The debate over the advantages and disadvantages of large credit institutions has intensified, particularly because of the moral hazard resulting from the belief that these large credit institutions are too big to fail [50-53].

**European regulations:** The ECB plans to limit the scope of the investment banking business. This regulation could considerably reduce the profits of small banks that specialize in investment rather than large, more diversified banks that obtain resources from non-traditional financial sources and usually leverage themselves to a greater degree using wholesale funding [54]. Current European monetary policy, which has established extremely low (and sometimes even negative) interest rates, is another threat. Credit institutions will struggle to generate enough income to cover costs and achieve acceptable returns. The new regulations will also lead to higher costs and require greater investment because credit institutions will have to improve their data management by investing in high-tech resources and qualified personnel.

	Internal factors	External factors
Positive factors	Strengths	Opportunities
	EU membership Liberalization-liquidity EU monetary policy Competitiveness Globalization of debt Stability and support	Greater competitiveness and productivity Greater integration Cost reduction Greater solvency
Negative factors	Weaknesses	Threats
	EU membership Liberalization-liquidity Multimarket issues Heterogeneity of countries Tax policy Loss of autonomy Effects of the financial crisis Lower returns	Innovative competition Protectionism Divergence in origin Restrictive regulations Socials problems Financial contagion Moral hazard

Table 3: SWOT matrix for the sustainability of the European financial system.

Table 3 (SWOT matrix) summarizes the strengths, weaknesses, opportunities, and threats discussed in this article. Certain factors are deemed to be both strengths and weaknesses. Such factors include EU membership and liberalization-liquidity.

## Conclusion

In the aftermath of the financial crisis of 2008, the sustainability of the banking sector finds itself at a critical point. The banking sector is being subjected to a profound restructuring program that seeks to avoid the type of global economic instability caused by the financial crisis. This restructuring program involves a disruptive process that clashes with social sustainability. For example, banks' financial survival requires major changes to the structure of the banking labor market to reduce costs and adapt to the new environment. This process, which began in 2010, has already destroyed more than 36.64% of banking sector jobs. The new financial system must be capable of embracing new technologies to achieve cost reductions and reducing commissions to compete with new lenders with lower processing costs and weaker regulations. Another possibility to improve the financial sustainability of the banking sector is to encourage mergers between banks from different countries. Doing so could produce economies of scale without increasing banks' market power.

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