BANKS TOO BIG TO FAIL: CAUSES, CONTRADICTIONS AND CONSEQUENCES

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Abstract

One of the most important problems of financial sector development is the existence of the banks too big to fail (TBTF) – financial institutions, which are so systemically important, that their failure would cause negative externalities and unacceptable disruptions to the overall financial system.

The paper investigates historical features, major consequences, as well as the contradictions of banks TBTF development. The main points are focused on essential international approaches to regulation systematically important banks. It is determined, that TBTF problem can be partly solved with the use of more strict prudential requirements; increasing the intensity and efficiency of control and supervision; efficient regulation of insolvency of banks without involvement of taxpayers' funds; increasing the stableness of systemically important entities of the financial market infrastructure etc.

Keywords: *global financial regulation, systematically important financial institutions, global systemically important banks, domestic systemically important banks, too big to fail problem, Banking Union*

JEL classification:

1. Introduction

One of the important problems of financial sector development in the post-crisis period is the existence of "too big to fail" banks – financial institutions, the systemic significance of which involves substantial negative

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externalities and a threat of the national financial stability in case of their bankruptcy.

Expansion of the financial and economic crisis in 2007–2009 in many countries revealed contradictions in functioning on the national markets of powerful super-big banking institutions with a significant capital stock. Before the spread of global crisis phenomena, widely supported was the idea that big (systematically important) banks, to a greater extent, are inclined to minimize risks of their transactions and that they are too big to fail, since in view of their significance, under any circumstances, they will be provided with state assistance by regulatory authorities. However, the situation of crisis produces the risk of impossibility for recapitalization of a banking institution if the amount of the bank assets significantly exceeds the amount of the gross domestic product (GDP) of the country, i.e. banks may appear to be too big to save.

Experience has shown that large-scale programs aimed at support of the banking industry in the period of 2007–2009 (capital inflows, assets buyout, provision of securities, increase of insurance coverage under liabilities, extension of transactions on providing liquidity) result in significant fiscal expenses of the leading world countries, such as 5.4% of the GDP in Great Britain, 4.8% of the GDP in Germany, 3.6% – in the USA, and, as a consequence, the amount of their budget deficit and the national debt increases (Association of Regional Banks of Russia, 2010).

Under the said circumstances, developing efficient approaches with respect to overcoming the negative consequences from the big banks' existence appears to be an important issue of the economic science and business practice.

2. Literature review

The issues of defining the notion of systematically important banks and developing approaches to their regulation are reflected in scientific research, recommendations and reports of such super-national regulatory authorities as the Financial Stability Board, the Basel Committee on Banking Supervision, the World Bank, the International Monetary Fund etc.

Certain questions of super-big banks' functioning and development of evaluation methods of their systematic importance have been studied by such prominent economists as S. Aivazian, I. Andriievska, H. Penikas, and R. Connolly (2011), J. Barth, A. Prabha and P. Swagel (2012), O. Goncharova

(2012), L. Hudjakova and E. Sidorova (2014), G. Kaufman (2013), M. Labonte (2013), J. Thomson (2009), P. Wallison (2012) and others.

3. Actuality

So it is important to systematize existing international approaches to regulation of systemically financial institutions activity and analyze current changes in global and national legal standards concerning solving "banks too big to fail" problem.

4. Aim

Objective of the proposed article consists in research of the historical peculiarities, detection of the principal contradictions and consequences of appearance of the too big to fail banks, and familiarization with approaches existing in the world practice with respect to regulation of activity of systematically important banks in the context of ensuring national and global financial stability.

5. Results

The problem of appearance of too big banks became especially acute during the crisis of 2007–2009, when the bankruptcy of certain financial institutions was one of the reasons for expansion of the global financial instability in the world. This refers to the regulators' underestimating in the pre-crisis period of the notion of too big to fail financial institutions in the result of moral hazard of super-big banks taking unreasonable risks while having no adequate risk management system but relying on the state support.

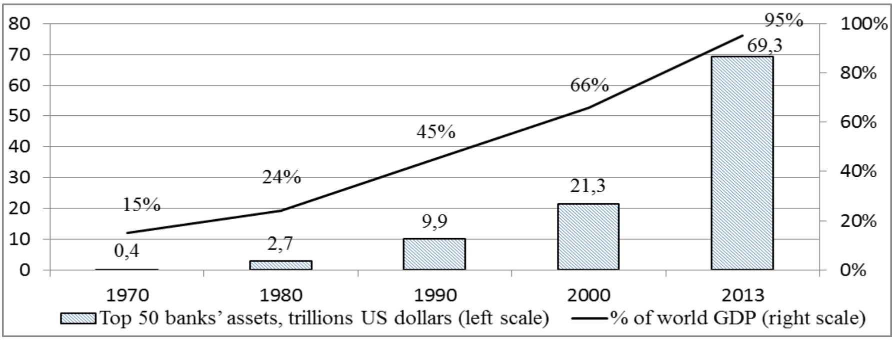
At the same time, the question of systemic importance of the banks was first raised in the 1980s and was related to the 1984 reorganization of the American Continental Illinois National Bank (by means of capital inflows and increase of the amount of the insurance coverage), which faced the threat of insolvency due to imprudent crediting activity (Association of Regional Banks of Russia, 2010; Labonte, 2013). And the need for its recapitalization was related to the importance of interest protection of small banking institutions holding their funds on accounts with the said bank.

Nowadays, modern economic literature provides different interpretations of super-big banks, which are often called "too big to unwind", "too big to liquidate", "too important to fail", "too complex to fail", "too interconnected to fail", and, most recently, "too big to prosecute or jail". Each of the mentioned definitions explains certain reasons for providing state support to such institutions in case of their insolvency (Kaufman, 2013).

According to provisions of the international legislation, systemically important financial institutions are those financial institutions, which are characterized by a substantial number and complexity of transactions, global interdependence, complication in their substitution. At the same time, weakening of the financial standing or violation of activity of such institutions may lead to material losses of the whole financial system and of the country's economy in general (FSB, 2013).

There exists a distinction between global systemically important banks – G-SIBs and domestic systemically important banks – D-SIBs. The latter, similar to global systematically important banks, in case of financial insolvency, may lead to destabilization of the financial schemes and affect the development of the real sector of national economies (Deloitte, 2013).

Figure 1: Dynamics of assets of the top 50 world's biggest banks, 1970–2013



Source: Compiled by the author according to data (Barth, 2012; SNL, 2013; World Bank, 2014).

At the same time, the emergence of such powerful institutions and strengthening of their position in the financial markets is concerned with the spreading of globalization processes, and, as a result, activation of consolidation and capitalization of the bank equity through reorganization and restructuring, incorporation, mergers and acquisitions, establishment of banking associations etc. According to the Forbes Annual Global 2000 ranking, 8 out of 20 the world's biggest public companies in 2014 are banking institutions: ICBC (China), China Construction Bank (China), Agricultural Bank of China (China), Wells Fargo (USA), Bank of China (China), Bank of

America (USA), HSBC Holdings (United Kingdom), Citigroup (USA) [9]. The share of the top 5 world's biggest banks in 2011 comprised 14% of all global banking assets, while the top 10 most powerful banks possessed 26% of all banking assets, 20 and 50 banks correspondingly 44% and almost 70% of assets of the global banking system (Barth, 2012).

It should be noted that as far as in 1970 assets of the top 50 biggest banks of the world amounted to merely 0.4 trillion USD or 15% of the GDP, but yet in 2000 their assets had been increased up to 21.3 trillion USD and consisted 66% of the world GDP. In 2013 the value of assets of the top 50 world's biggest banks is estimated at 69.3 trillion USD, which is equal to 95% of the world GDP, figure 1.

When analysing the geographical distribution of the world's biggest banks, which is represented in table 1, it should be emphasized that in the 1970–1980s the list of the most powerful global financial institutions was prevailed with banks of the USA and Japan.

Table 1: Geographical distribution of the top 50 world's biggest banks by the amount of assets, 1970–2013

Country	**Share in the total bank assets, %**				
	1970	**1980**	**1990**	**2000**	**2013**
U.S.A.	40	16	3	14	14
Japan	18	23	48	21	13
Italy	10	4	4	1	3
U.K.	9	8	7	11	13
Canada	7	3	-	-	3
Germany	7	17	12	18	5
France	5	17	12	10	13
Brazil	2	2	-	-	-
Australia	1	-	-	-	4
China	-	-	3	7	20
Hong Kong	-	-	1	-	-
Switzerland	-	5	5	6	3
Netherlands	-	5	5	6	3
Spain	-	-	-	3	4
Belgium	-	-	-	2	-
Sweden	-	-	-	1	1
Denmark	-	-	-		1

Source: Compiled by the author according to data [Barth, 2012; SNL, 2013]

Thus, in 1970, among the top 50 biggest banks, 40% of all assets were in the possession of banks registered in the USA, 18% possessed by the Japanese banks. Starting from the 1980s, share of the American banks in the assets of the top 50 most powerful banking institutions has been incessantly falling, and in 1990 their share made up only 3%. Today, according to data of 2013, share of the American banks comprises about 14% of assets. Whereas, the share of assets owned by the Japanese banks, which in 1980 and 1990 made up 23 and 48% correspondingly, since the turn of the 2000s has been falling too, and in 2013 amounted only to 13%. Therefore, in 2013 the top 50 world's biggest banks included only 5 banks form the USA and 1 Japanese bank.

Instead, the share of banking institutions from China is increasing. Thus, in 2013, among the top 50 world's biggest banks, 7 are registered in China, and their share comprises 20% of the global bank assets, while in the late 1990s there was not even one Chinese bank on the top 50 list (SNL, 2013).

Alongside this, we would like to draw your attention to contradictions related to the existence of too big banks. We mean either positive or harmful peculiar characteristics related to the system of banking institutions. Thus, owing to significant scope of activity, big banks offer a wider range of products. They hold extensive networks of territorial branches enabling to engage a substantial number of clients. Besides, the economy of scale, better opportunities of access to the international capital markets and a higher level of risk diversification at the cost of crediting various industrial and geographical business directions serve as additional competitive positions on the market. Thus, such banking institutions have a higher credibility level on part of the banking services customers.

At the same time, among the negative consequences of the loyal national policy with respect to systematic banks there are: breach of interbank competition, increase of the inducement for unreasonable risks, absence of incentives for crediting the real economy because more profitable alternatives are available for the investment of funds due to speculative trading and generation of the fictitious capital. Apart from that, secured state support leads to loss of motivation for improvement of business processes and risk management systems, decline in the market discipline and, as a result, to an increase in the amount of the state deficits and national debts in case of expansion of the crisis disturbances.

As it has been already mentioned, imperfection of the existing institutional regulation of the world economy during the crisis of 2007–2009 caused the implementation by the world community of a series of measures regarding overcoming the global financial and economic instability and preventing further spreading of crisis phenomena. One of the most important directions of reformation of the global system of financial regulation was strengthening supervision and regulation of all financial institutions, the bankruptcy of which could affect the financial stability (G-20, 2009). Thus, in November 2010 (Seoul, South Korea), the G-20 leaders formulated the chief directions of reducing risks of misconduct on part of all systemically important financial institutions, including banks. Namely, the following were offered as the top priority measures: development of reorganization mechanisms for such institutions, increasing capital and liquidity requirements, limitations on formation of complex corporate structures for performance of financial operations, limitation of the list of authorized transactions for systemic banks, introduction of taxes on the systemic risk (Association of Regional Banks of Russia, 2010). Such taxes have been planned to be introduced in the United Kingdom, Sweden, Germany, the USA, though these countries further limited themselves only to reinforcement of capital requirements to systemically important financial institutions (Goncharova, 2012; Labonte, 2013).

Today, the Financial Stability Board (FSB) has developed a procedure for regulation of financial insolvency of systemically important financial institutions, its principal directions being:

1) increasing the intensity and efficiency of control and supervision;
2) efficient regulation of insolvency of financial institutions (banks, insurance companies, entities of financial markets infrastructure) without involvement of taxpayers' funds;
3) introduction of additional requirements to the sufficiency of capital of systemically important financial institutions;
4) increasing the stableness of systemically important entities of the financial market infrastructure (FSB, 2010).

At the same time, in order to define the list of global systemically important banks in accordance with the methodology approved in November 2011, the Basel Committee on Banking Supervision (BCBS) applies the scoring approach on the basis of evaluation of the 5 indicators: 1) size; 2) interconnectedness; 3) transborder activity; 4) substitutability, i.e. absence of competition in services provision; 5) complexity (complicacy) of operations.

Banks, which are included in this list, are to meet especially strict requirements regarding the sufficiency of the bank stock. Apart from the standard of 7%, which is applied to all financial institutions, additional requirements are set depending on the extent of the bank's significance in the world economy. Thus, in the result of application of this methodology and the cluster analysis by the Basel Committee on Banking Supervision, 5 groups of G-SIBs were formed for determination of the value of indicator of additional requirements to the amount of their stock. Stepwise "escalation" of the additional requirements value to the stock sufficiency starts from 1.0% ("lower" group), 1,5% (second group), 2.0% (third group), 2.5% (fourth group) up to 3.5% ("higher" group). Additional requirements to the stock may be fulfilled only with the basic core equity, which includes only common shares and undistributed profit, and they shall serve as a part of the capital conservation buffer, i.e. they shall not be summed up with the standard of sufficiency of the basic core equity but they shall determine limitations on the bank's distribution of the net profit. Additional capital requirements are to be applied starting from 2014 with their stepwise introduction up till 2019 (FSB, 2013).

In 2013 the annual list of systemically important banks, the bankruptcy of which carries a threat for the global economy, included 29 banking institutions from the United Kingdom (4), France (4), Switzerland (2), Spain (2), Germany (1), Italy (1), the Netherlands (1), Sweden (1), China (2), Japan (3) and the USA (8). Whereas, there are no banks in the fifth (higher) group (3.5% additional requirement); there are 2 banks in the fourth group, which shall additionally increase their capital by 2.5% by 2019 (JPMorgan Chase i HSBC); the third group with the 2% additional requirement comprises 4 banks (Citigroup, Deutsche Bank, Barclays and BNP Paribas); the second group of banks, which shall increase the sufficiency level of their stock by 1.5%, included 8 institutions (Bank of America, Credit Suisse, Goldman Sachs, Credit Agricole, Mitsubishi UFJ, Morgan Stanley, Royal Bank of Scotland and UBS); and 15 banks (Bank of China, Bank of New York Mellon, BBVA, Groupe BPCE, Industrial and Commercial Bank of China Limited, ING Bank, Mizuho FG, Nordea, Santander, Societe Generale, Standard Chartered, State Street, Sumitomo Mitsu FG, Unicredit Group, Wells Fargo) fell within the last group with the 1% additional requirement (FSB, 2013).

At the same time, in October 2012, the Basel Committee on Banking Supervision developed the principles of mechanism for regulation of domestic systemically important banks (D-SIBs), which are not too significant at the global level but their insolvency may affect the financial stability of certain economic systems. According to the said principles, domestic authorities shall develop the valuation methodology of systemic importance of banks at the national level, which shall take into account the specific peculiarities of certain national economies. At the same time, the influence of D-SIBs' bankruptcy on the national economy must be evaluated with consideration of such factors as size, interconnectedness, substitutability and complexity, including global activity. With respect to D-SIBs it is proposed but not mandatory to apply the increased capital requirements as well as other measures, which, in the national regulators' opinion, are necessary for minimization of activity risks of the domestic systemically important banks (FSB, 2013).

Apart from that, other structural reforms are being introduced in order to regulate systemically important financial banks, including implementation of the International regulatory framework for banks and international settlements –Basel III standards, which define new prudent requirements to banks to be applied upon their stepwise introduction during 2013–2019 (BCBS, 2013), implementation of the Dodd-Frank Act, enforcement of the Volcker (USA) and Vickers (UK) rules, establishment of the Single Supervisory Mechanism for the Eurozone banks (Goncharova, 2012; Hudjakova and Sidorova, 2014), etc.

Thus, scientists and practitioners emphasize the principal importance of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) provision, which was first introduced in the world practice in July 2010, and which is a special legal mechanism of "excluding from the market" or "orderly liquidation" of big systemically important financial corporations, the assets of which reach or exceed 50 billion US dollars, with no significant negative effect on other economy participants (Association of Regional Banks of Russia, 2010).

Also, an important step towards regulation of systemic banks' activity was introduction in the USA in the end of 2013 (though formally it was proposed as far as in 2010) of the so called Volcker rule, which shall be fully implemented by the second half of 2015. This refers to the separation of investment banking services, private capital and owned hedge funds of financial institutions from the consumer lending. The Volcker rule aims at minimizing conflicts of interests between banks and their clients, due to which different types of business practice of financial institutions are singled out (Goncharova, 2012; Hudjakova and Sidorova, 2014). Today, the reasonability of the Vickers rule (UK) introduction is under discussion, which also involves separation of deposit transactions from the investment business in order to protect depositors and taxpayers from the negative consequences in case of super-big banks' bankruptcy.

Another direction in risk minimization is adoption of resolution on the Single Supervisory Mechanism (SSM) in October 2012, which was the first step to establishment of the European Banking Union. All supervisory functions are entrusted with the European Central Bank, which, starting from the end of 2014, will supervise over 130 biggest banks (banking institutions, the assets of which exceed 30 billion euros or institutions with assets equal to 20% of a country's GDP). Apart from that, the ECB shall also control three biggest banks in each of the EU member countries (EC, 2012).

The second stage of formation of the European Banking Union involves the establishment of the Single Resolution Mechanism (SRM) and the establishment of a special fund for its financing, while the third and the last step will be adoption and application by the European countries of a complex scheme for securing deposits, which is aimed at preventing the panic-driven mass withdrawal of bank deposits (EC, 2013; Hudjakova and Sidorova, 2014). The Single Resolution Mechanism is expected to be launched on January 01, 2015. The SRM procedure covers all banks under the ECB supervision according to the SSM, including the EU transnational banks. Also, during 2016–2026 it is planned to form at the cost of banks under the SSM supervision a single recapitalization fund, the amount of which shall be 55 billion euros and around 1% of the clients' secured deposits. In case the banks rescue requires greater amounts, the fund's participation in the SRM will be limited to 10–20%, while, in any case, the amount will not exceed 5 billion euros. In case of need for aid in a greater extent, the decision will be adopted through voting of each country's public authorities. An important aspect is that starting from 2016 p. the Bank Recovery and Resolution Directive will enact the procedure for bank rescue by the bail-in model (Cyprus style), i.e. at the expense of the bank shareholders and creditors, but not by the bail-out model – at the cost of the state, as it was during the global crisis of 2007–2009 and in the post-crisis period. The procedure involves using first the shareholders' funds, then – the funds of creditors under bonds, and at last – the funds of owners of big deposits amounting to over 100 thousand euros.

Deposits up to 100 thousand euros will be state secured. Participation of the state will be limited and will consist maximum 8% of the banking institution's losses (Hudjakova and Sidorova, 2014).

6. Conclusions and Discussion

Thus, the global financial and economic crisis of 2007–2009 revealed the problem of inefficient regulation of powerful banking institutions, the bankruptcy of which may lead to significant negative consequences – threat to the national financial security, increase of vulnerability of the global financial system and, in general, the spreading of global financial instability.

Therefore, the systemic nature of banking institutions together with the positive aspects, such as a wider range of offered services, multi-branch banking, higher level of risk diversification, improved conditions for capital raising etc., may cause such contradictory effects as breach of the interbank competition, inclination to the unreasonable riskiness of transactions, absence of incentives for crediting the real economy, worsening of the market discipline and generation of the fictitious capital.

Under these circumstances, one of the most important directions of reformation of the global financial architecture is strengthening supervision and regulation of super-big – systemically important banking institutions in order to prevent similar disproportions in future. At the same time, introduction of a series of structural reforms with respect to overcoming the "too big to fail" issue is a multi-level process relying on the unified international standards approved at the global level, directives of the EU super-national institutions (regional level), and legislative acts of the national regulatory bodies aiming at increasing the intensity and efficiency of control and supervision over the systemically important banking institutions (global and domestic), efficient resolution of insolvency of financial institutions while using no taxpayers' funds, introduction of additional requirements to the capital sufficiency of the systemically important financial institutions, increasing the stableness of systemically important entities of the financial market infrastructure.

Analysis of approaches existing in the global practice with respect to regulation improvement of the systemically important banks evidences of the development and introduction over the recent years of a series of important initiatives, namely, the implementation of the International regulatory framework for banks and international settlements –Basel III standards, introduction in the USA of a special legal mechanism of “orderly liquidation” of systemically important financial corporations in accordance with the Dodd-Frank Act, approval of the Volcker Rule, introduction of methodology for determining global systemically important banks, and development of methodology for detecting systemically important banks on the domestic level, establishment of the Single Supervisory Mechanism for the Eurozone banks, and declaration of necessity to form the Single mechanism for bank bankruptcy resolution with the purpose of future establishment of the European Banking Union etc.

However constant changes in international low, further working out and development of new methods of supervision and regulation of systemically important financial institutions, implementation of the international organizations’ requirements at national levels require further investigation of these problems. Open for the next research are studying of specific features of G-SIBs regulation according to the announced reforms as well as improvement of D-SIBs regulation mechanisms by individual countries at national levels.

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