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REFLECTIONS ON "TOO BIG TO FAIL"

1. THE ORIGIN AND SCOPE OF "TOO BIG TO FAIL" CONCEPT

A hundred years ago the first famous debates about the role and responsibility of the state for the consequences of private mismanagement that would have negative impact on the public interest appeared.[1] At that time the case was how to provide financial aid to New York City.

The issue of too big to fail banks came back in 1984 at the Congressional hearing, when the government rescued Continental Illinois Bank. The Congressman Stewart McKinney raised the point that the government had created a new class of banks, those too big to fail.

From the nineties, increased interest in exploring the issue of too big to fail was observed. It was both from the scientific and the policy making sides.

The concept of too big to fail may refer not only to the scale of the activity of the specific financial institution. It also takes into consideration both the public and economic aspects of the whole economy. State aid is nothing but taxpayers' money. When the state decides to rescue a bank, it is de facto weighing the social and economic consequences of such an action. In the case of the too big to fail dilemma, it might be more profitable to invest public resources in saving the institution than

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1 Louis D. Brandeis, "Other people's money, and how the bankers use it", Frederick A. Stokes Company Publishers, New York, 1914.

to allow it to fail. Big failures can even lead to riots. They diminish the reputation of the state and weaken the economy.

The consolidation and globalization processes were bringing a lot of benefits of scale for the financial sector institutions. The profitability advantage was additionally strengthened by the arguments that this process is risk-lowering. It was argued that big size should increase the stability by higher resistance to the shocks. Additionally, higher products range and regional diversification should create negative correlations that diminish sensitivity to local volatilities and lack of synchronization in business cycles. In the times of crisis, this way of thinking turned out to be wrong.

Huge financial institutions changed their role from market players to market makers. They became the market. As a result they accumulated a large systemic risk. The conclusion is that growing the size should cause increased responsibility. It should be especially visible in the costs of activity.

Recent developments of G20 and Financial Stability Board emphasize the issue of systemic and moral hazard risks associated with systemically important financial institutions (SIFIs).[2] List of 29 key global SIFIs[3] was presented based on BCBS[4] methodology. Additionally, the focus was on establishing general policy measures addressed to all the too big to fail entities. Four major policies were agreed: resolution regimes should be equipped with powers to resolve failing financial firms, strengthen cross-border resolution management, increased loss absorption capacity adjusted to the impact of possible default, increased supervisory powers and expectations in the area of risk management functions, data aggregation, internal control, etc. The purpose of the reform is not only to increase the efficiency of resolution regimes. Another issue is to diminish the possible contagion risks.

Security is a cost, but it brings benefits in the long run. It means that providing banks with capital is a cost for their owners. The same can be said about the fulfilment of liquidity norms and the increased diligence in the process of checking creditworthiness (which additionally makes the process lasting longer). However, the latter factor fairly quickly brings benefits in the form of a better credit portfolio and lower overall costs.

The lack of well-organised regulatory architecture for the financial system in the EU generated an enormous capital shortfall which would have been at

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2 Financial Stability Board (FSB), "Policy Measures to Address Systemically Important Financial Institutions", Nov. 2011.

3 Bank of America, Bank of China, Bank of New York Mellon, Banque Populaire CdE, Barclays, BNP Paribas, Citigroup, Commerzbank, Credit Suisse, Deutsche Bank, Dexia, Goldman Sachs, Group Crédit Agricole, HSBC, ING Bank, JP Morgan Chase, Lloyds Banking Group, Mitsubishi UFJ FG, Mizuho FG, Morgan Stanley, Nordea, Royal Bank of Scotland, Santander, Société Générale, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group, Wells Fargo.

4 BCBS – Basel Committee on Banking Supervision.

present necessary for covering the losses resulting from banks bad investments and engagements. The results of stress tests and the autumn estimates of the EBA for the key European banks indicate that the shortfall is no lesser than €100 bn. Much bigger amounts appear in private sector analyses (Credit Suisse estimated that the capital shortfall amounts to €400 bn).

Looking back to the evidence of last years, unfortunately, risks generated by the largest financial institutions – the systemically important ones – have not decreased since the financial crisis. That requires revision of the effectiveness in the behaviour of the government institutions at the national and European levels.

2. ACTIVE ROLE OF THE STATE

The role of the state is to maximize the social welfare and the stability of the economy and its growth. If instability occurs in the financial sector, it is expected from the state to react and diminish its negative consequences. The financial stability is treated as a public good.[5] The state may not be passive if the consequences of failures of financial institutions were damaging to the stability of the whole economy. It should be active especially, if the cost of government bailout was lower than the scope of bankruptcy negative consequences to the whole economy. On the other hand, the state is using public money for those purposes. Public money is taxpayers' money. Moreover, taxpayers may not be accused of those failures.

If it is the state that pays for the consequences of the mismanagement in the financial sector, then the state should in advance protect itself from possible significant failures or diminish the cost of their economic consequences by introducing proper regulatory framework.[6] It should cover a number of areas. First of all it should decrease the profitability of too risky activities and include the implications of scale into prudential analysis. Next, higher transparency of complex financial groups and their portfolios should be expected. Additionally, the role of the deposit guarantee schemes should be strengthened to collect preventive funds for crisis management purposes. Fast track for bank resolution regimes should be established. The new regulatory architecture should emphasise that the state's

[5] Stanisław Kluza, "New Regulatory Architecture towards Safety and Stable Growth", Subtitle: "Role of regulating and monitoring the financial system in strengthening the financial stability of the EU"; European Integration Process in the New Regional and Global Settings, Wydawnictwo Naukowe Wydziału Zarządzania Uniwersytetu Warszawskiego, Warszawa, 2012, pp. 205–222.

[6] Jacques de Larosiere, "The high-level group on financial supervision In EU", European Commission, Brussels, Feb. 2009.

interest does not accept the too big to fail entities. Everyone, regardless to size, who is not meeting the free market competition rules, should be allowed to fail. It is necessary to convince the financial sector that the taxpayers will not pay for its accidents and that this is going to be benchmark behaviour of the state during the financial crisis. Otherwise it will create unnecessary moral hazard.[7]

The central focus of any new regulatory initiative should be on how to prevent institutions from becoming too big to fail and how to make them resolvable in case of a failure. The list of necessary and possible actions seems to be long.

- The problem of too big to fail should be addressed at the level of the whole group and of its components. Consolidated supervision (though needed) will not solve problems of subsidiaries. With the European authorities still lacking sufficient supervisory tools, national supervisors are the key instance capable of dealing with too big to fail institutions and its components. We should not forget about those local supervisory mechanisms that proved to be effective.[8] We should ensure that regulations do not create incentives for large and complex institutions to grow even bigger and more complex. It is important to bear in mind the danger stemming from the enhancement of the already strong inter-linkages within financial groups. Additionally, liquidity management at the consolidated level would bind entities within groups even more tightly to each other. This way the parent company will strengthen its status as too-big-to-fail. This must be avoided. Too-big-to-fail financial institutions distort competition and deliberately create complexities and fragilities.
- The European New Regulatory Architecture should limit benefits of scale within financial sector. Fewer incentives for becoming large would stop the trend of becoming too big to fail. Additionally, higher risk of scale should be recalculated and represented in capital requirements.
- It is necessary to control and reduce possibilities of regulatory arbitrage: not only within the group's products and legal entities but also between countries. Capital requirements should be established on a risk-based approach. The capital is more expensive than other forms of financing. As a result financial sector companies shifted their activities to unregulated intermediaries (e.g. banks set up a number SIFIs in recent times). On the other hand, if systemically important financial institutions are required to keep substantially more capital, their incentive for moral hazard is growing.

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7 Benton E. Gup, "Too Big to Fail: Policies and Practices in Government Bailouts", Westport, Connecticut: Praeger Publishers, 2003; Stern Gary H., Feldman, Ron J., "Too big to fail: the hazards of bank bailouts", Brookings Institution Press, Washington DC, 2004.

8 Avinash Persuad, "Dear prudence: Regulation needs to be more macro and more national", in Dialogue on Globalization occasional paper no 42 "Re-Defining the Global Economy", Friedrich Ebert Stiftung, New York, April 2009, pp. 59–65.

- ❖ Higher capital requirements should also be connected with the size of leverage on risk based analysis. Proper stress tests should disclose weaknesses of financial institutions. In case of worse institutions stress tests should be performed more frequently on a regular basis (e.g. quarterly).
- ❖ Poland can be shown as a good example of implementation liquidity requirements. They were launched in 2008[9], even though it was not predicted then, that turbulences in banking sector would have come so quickly. The experience shows that liquidity norms should be the standard for conducting banking activity. Implementation of quantitative limits should allow managing liquidity risk.
- ❖ Countercyclical buffers at country level should be implemented. The purpose is to flatten the roughness of the business cycle with special focus on prosperous and lean periods. It is important to remember that every single economy is different and sources of crises have local origin. Then all the capital add-ons must be kept at the local level.
- ❖ There is an increasing need to clarify the relations between powers vs. responsibility. First, between home and host countries. Second between EBA and local supervisors. It is not prohibited to transfer powers between authorities. However, shifts in powers should be followed by shifts in responsibilities. The responsible authority should be obliged to cover all the costs of consequences of wrong decisions or decisions not taken but if no action caused negative consequences.
- ❖ The "arm's-length" principle ought to remain one of the cornerstones of the initiatives towards financial stability. This is the best way to ensure that global systemically important financial institutions will not endanger solvency of the countries in which they operate. The current principles of a clear legal separation between entities belonging to the same financial group should be preserved.
- ❖ Managerial benefits should be lagged. The later payoff should take into account the postponed and distributed in time effects of managerial decisions. The concern about this issue is growing with the scale of entity's activity.
- ❖ Contagion effect can be limited by imposing more restrictions on single-counterparty engagements. It should decrease the negative effects of high interconnectedness within the financial sector. Additionally, higher capital buffer related to the size should be considered. The cost of this buffer in good times can be less expensive than lack of capital in a recession. From policy making perspective it is easier to enforce "contingent capital" in prosperity periods.

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[9] Komisja Nadzoru Finansowego (Polish Financial Supervision Authority), „Polski rynek finansowy w obliczu kryzysu finansowego w latach 2008–2009", May 2010.

Resolvability in the case of failure should be among the key criterions in the benchmarking of systemically important financial institutions. Measures to enhance resolution and bail-in within the resolution regimes can effectively reduce moral hazard associated with the too big to fail problem. The likelihood that the institution would be resolved or restructured in an orderly manner if it were to fail should also be fundamental theme in the benchmarking of these institutions. It is important to preserve the rights for competent national authorities to conduct resolution at local level.

3. CONCLUSIONS

It is crucial to ensure that differentiating between the systemically important institutions and other market players does not result in a perception that big institutions are safer, which could distort the level playing field. It must be clear that even the largest bank can fail and that authorities have instruments to liquidate them in an orderly manner. The rule of "too big to fail" violates the free market conditions. The market economy should always allow the possibility of bankruptcy. If something is not able to fail then it is not fully private. Actually, the financial stability is a public good. Historical accidents and the current crisis show, that the state has no choice and has to intervene in critical moments.[10] Such an expectation is the reason why the state should protect its taxpayers from potential future costs of financial market turbulences. The state ought to be especially proactive in preventive initiatives. The state should establish the "rules of the game" that will not allow to "privatize the profits" of the financial sector in prosperous years and as a consequence "nationalize the losses" in lean periods.

[10] Louis D. Brandeis, "Other people's money, and how the bankers use it", Frederick A. Stokes Company Publishers, New York, 1914.