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REFLECTIONS ABOUT *TOO BIG TO FAIL* BANKS AND MORAL HAZARD

INTRODUCTION

The main source of the financial crisis which started in 2008 was moral hazard. Both big institutions and populist politicians gambled.

We understand moral hazard analogically to Paul Krugman, i.e. as “any situation in with one person makes the decision about how much risk to take, while someone else bears the cost if things go badly”[1]. This term is a negative one if the costs of the risk borne by third parties is without their consent. Risk transfer which takes place by mutual agreement between parties is not a negative type of moral hazard. Such situations are common on the insurance market, capital market, and especially the options market. The line between risk transfer and immoral moral hazard is a classical legal maxim *volenti non fit iniuria* (Latin: “to a willing person, injury is not done”) formulated by Ulpian[2]. In other words, if parties of a transaction agree to possible spending consequences and are aware of the risk taken, there is no immoral moral hazard.

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[1] Krugman, P. *The return of Depression Economics and the Crisis of 2008*, WW Norton&Company Inc., 2009.

[2] *Volenti non fit iniuria*, wikipedia.org.

The question of moral hazard's morality is of interest to business ethics scholars and depends on the world view of an evaluator[3]. It is often, and erroneously, identified with fraud intention. However, independently from ethical evaluation, moral hazard aids recklessness and carelessness in business decision making, because it creates an environment where profits become private and losses – public.

It is articulated more explicitly by professor Marek Belka: "Stimuli appear to decriminalize excessive risk, and even to take it. Everyone engaged – creditors, shareholders, employees – win. The rest, i.e. the majority, including the proverbial tax payer, cover losses. As a result, there is capitalism of profits and socialism of losses"[4]. There is no doubt that moral hazard causes interference and anomalies in market functioning and, as a consequence, it may lead not only to financial crisis, but also to justified civil disturbances and social conflicts.

Immoral moral hazard on financial markets, unfortunately, accompanies globalisation. Through the so called contagion effect it may cause situations in which crisis in one country triggers disruption in another country and as a result it may not only stimulate anti-globalists, but also lead to tension in international relations and even wars. Internationalisation of costs is accompanied by nationalisation of losses.

Moral hazard is especially dangerous under flawed systematic solutions because it may cause ineffectiveness of corrective and remedial measures (including regulatory actions).

Globalisation of financial markets is accompanied by at least two systemic errors which undermine those markets' credibility and limit the effectiveness of corrective measures and regulatory actions. Those errors are:

- ❖ paying rating agencies by issuers,
- ❖ paying auditors by the audited.

As a result we deal with a defective market economy and an environment that aids moral hazard, which causes persistent crisis of confidence on financial markets, the phenomena of so-called "short-termism"[5] are accelerating and regulations created may turn out to be ineffective.

The aim of this article is to present several reflections and suggestions connected with implementation of the most important, in the author's opinion, regulations,

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3 Broader: Klepczarek, E. *Czy hazard moralny jest zawsze niemoralny*, ZBP, 2015, http://zbp.pl/public/repozytorium/wydarzenia/images/czerwiec_2015/cosgrove/Praca_Emilii_Klepczarek.pdf, accessed 17/10/2015.

4 Belka, M. *Hazard moralny na rynku finansowym*, public speaking 22nd June 2015 during the 5th European Financial Congress in Sopot, http://www.efcongress.com/pl/materialy/wideo, accessed 17/10/2015.

5 Maciejewski, A. *Short termism* [in:] „Zarządzanie wartością spółki kapitałowej", Bielecki, J.K., Pawłowicz, L. [Eds.], CeDeWU, Warszawa 2015.

which could limit moral hazard of banks counted among TBTF[6], namely: the resolution regime and additional capital restrictions against the group of the biggest global banks (TLAC).

1. WILL *RESOLUTION REGIMES* LIMIT G-SIBS' MORAL HAZARD[7] IN EUROPE?

Recent years showed that Europe is facing an extremely dangerous connection between moral hazard created by *too-big-to- fail* banks (TBTF) and populist politicians. High public debt, which was an expression of politicians' populism, was reflected in deterioration of quality of bank assets which had government bonds at their disposal. When those banks found themselves in a critical situation, their chances to receive public help were getting more and more limited (e.g. Cyprus, Greece, Portugal, Spain).

The results of this disastrous connection, in which increasingly insolvent countries became more and more indebted in increasingly insolvent banks have been held off by the establishing of the European Stability Mechanism, which, in the intention of its creators, should contribute to breaking the connection between the debt of sovereigns and the situation of banks[8]. Finally, ESM has to allocate capital of 700 bln euro (including 620 bln euro of callable capital) and will probably become the largest global financial institution. Until now, Cyprus and Spain have benefited from ESM's help. Without denying reasonableness of establishing of ESM it is worth noting that it constitutes another protection for banks and governments from market risk and threat of bankruptcy. Therefore, it may cause relocation of TBTF bank's moral hazard from a national to European level.

It seems that there are only two reasonable ways to solve the problem.

- ❖ The first one is to split TBTF banks into smaller units which can go bankrupt without posing a danger to financial stability. However, this division is hard to implement in European conditions.
- ❖ The second option is to develop special procedures of resolution of TBTF banks in such a way that does not destabilises the financial system.

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6 Ben Bernanke (quot.) "*A too-big-to-fail firms is one whose size, complexity, interconnectedness, and critical functions are such that, should the firm go unexpectly into liquidation, the rest of finanscial system and the economy would face serve adrese consequences*", "Bernanke-Causes of the Recent Finanacial and Economic Crisis", Federalreserve.gov, accessed 02/09/2015.

7 G-SIBs – Global Systemically Important Banks.

8 European Stability Mechanism (ESM) was erected in 2012 with the treaty signed by 17 countries of euroland, mainly because of fear of the collapse of the euro area. *Factsheet – European Stability Mechanism*, http://www.eurozone.europa.eu/media/582311/05-tesm2.en12.pdf, accessed 17/10/2015.

As for now, the second option, i.e. resolution, dominated in the regulatory initiatives aimed at solving the problem of moral hazard created by TBTF banks. The Financial Stability Board published a report in November 2011 entitled "Key Attributes of Effective Resolution Regimes for Financial Institutions"[9]. The document contains rules that should be included in the regulations concerning bank recovery and resolution. The rules were used by the European Commission, which developed the BRR Directive aimed at harmonising the legal regulations of EU member states in the area of resolution. The resolution process, according to the BRR Directive, will ensure such restructuring, recovery or resolution of insolvent, systemically-important banks, which will allow for the continuity of a bank's critical functions[10], protection of public finances and protection of depositors covered by the scope of 2014/49/UE Directive.

A unified mechanism of bank resolution serves as an emergency management. Its main aim is to allow for such a resolution of banks threatened with insolvency, that will bear the lowest possible costs for the taxpayers and the real economy. It should, among others, minimise the negative connection between banks and countries through implementing market discipline towards TBTF, which would limit their feeling of impunity.

The BRR Directive contains a couple of significant rules for handling the process of *resolution*. These are, in particular:

- ❖ ensuring that the shareholders of an insolvent institution take first losses;
- ❖ guaranteed deposit protection;
- ❖ treating creditors that belong to the same category in the same way (*pari passu*);
- ❖ guarantee that no creditors will bear more losses than those which they would bear if the bank were liquidated (*no creditor worse off*);
- ❖ replacement of the Management Board of the institution in *resolution*;
- ❖ personal responsibility of the top management for bringing the institution to insolvency.

Adoption of such rules in EU member states will probably strengthen the market discipline and limit moral hazard on the side of some TBTF banks.

However, the Directive does not solve the main problem connected with the real possibility of implementing the *resolution* procedure with regard to the

9 *Key Attributes of Effective Resolution Regimes for Financial Institutions*, www.financialstabilitboard.org/.../r_111105cc pdf, accessed 17/10/2015.

10 Critical functions are defined as "such type of activity performed by an institution for third parties which is vital for functioning of real sphere of the economy and for maintaining the stability of public finances, and which sudden disappearance or distortion can have a major negative effect on third parties, and can be a cause for loss of a general market trust", Szczepańska, O., Dobrzańska, A., Zdanowicz, B. *Resolution, czyli nowe podejście do banków zagrożonych upadłością*, NBP, Warsaw 2015, p. 23.

biggest financial institutions, the so called G-SIBs. It can be narrowed down to a question: who will pay for insolvency of the transnational financial institutions (G-SIBs). The financial resources provided by the Directive for financing the *resolution* mechanism are small. National resolution funds should be as high as 1% of guaranteed deposits. The European Resolution Fund, so called single fund for bank recovery and resolution will take 8 years to set up and it is estimated that its budget will be approx. 55 bln euro. This amount is far a from sufficient for effective implementation of bank recovery and resolution of even a single G-SIB, not to mention the systemic risk costs in case of insolvency of more than one such institution. It is also worth to note the scale of disproportion between the target budget of the EMS fund (700 bln euro) for saving insolvent banks and target budget of European Resolution Fund (55 bln euro), part of which is allocated for liquidating the TBTF banks[11].

The European Resolution Fund is, from the financial stability point of view, a complement of banks' own capital and those obligations which, during crisis, can fulfil the same role for creditors as own capital. It is a strengthening of safety buffers for some creditors and clients of the banks in case of their insolvency. It undoubtedly increases confidence in the banking sector and, what is most important, it moves some of the responsibility for the decisions from a national to European level and makes the decisions international. The biggest advantage of the solution is therefore an attempt to move competences and responsibilities to the same level of decision-making.

However, the solution brings a different type of risk. Creation of *resolution* funds on a national or international level is an alternative for all more expensive in terms of capital requirements posed on individual banks. The same funds could be used for increasing the individual banks' capital. In such a case the temptation of abuse (moral hazard) would be lower. Creating joint funds that guarantee the safety for the surrounding, especially for the creditors, weakens market discipline and can stimulate the *free rider* effect for some individual banks. *Resolution* funds can be seen in the individual banks not as complement of their own capital but as a substitute of their capital.

Still, it is undeniable that macroeconomic and systemic importance of the *resolution* funds and especially of a bank resolution fund is much bigger than its macroeconomic flaws.

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[11] We cannot forget that EMS fund is created form public money, while European Resolution Fund is created from banks' own money. The basis for calculating the contribution for bank recovery and resolution fund will be banks' liabilities minus bank's own funds and guaranteed deposits, corrected by the risk taken by the bank. The basis for calculating the contribution for the EMS fund is EBC capital, which is arithmetic mean of country's share in the total population and euro area GDP.

2. WILL TLAC REALLY BE THE END OF TBTF?

In a situation of a protracted crisis of confidence on the financial market, the Financial Stability Board (FSB)[12] initiatives focusing on the reduction of the propensity for moral hazard by the biggest transnational financial institutions should be appreciated. Those initiatives are a compliment for the Basel III Agreement (Basel III). Basel III includes also issues regarding additional matters regarding equipping banks with significant own capital and the quality of that capital, their liquidity, and policy of disclosure and supervision, which should limit the systemic risk but does not include any regulation concerning institutions that are systemically important on a global scale.

Moral hazard connected with systemic risk, mainly a transnational one, poses a serious challenge for the stability of the global financial system, therefore it seems reasonable to focus on FSB and G-20 level actions.

In the European Union the problem of TBTF banks is especially important due to a high degree of dependency of the European economy on bank financing and the ratio of bank assets to GDP, which is higher than anywhere else. This ratio is approx. 350% of GDP and is significantly higher than in other well-developed economies[13].

The FSB's proposal assumes introducing new safety requirements for the 30 biggest banks, which will be identified as the most important in terms of systemic risk they generate. Those requirements, named *total loss absorbency capacity* – TLAC, are aimed at increasing the possibility of re-capitalising the banks in a situation of their resolution. In his letter to G20 leaders Mark Carney, Chairman of FSB, used the words "ending too big to fail".

According to the proposal, Globally Systemically Important Banks (G-SIBs) identified by FSB should, starting from 1 January 2019, have a reserve of capital and debt instruments of at least 16–20% of risk weighted assets to be converted into capital during a crisis.

An additional requirement is that the capital reserves will need to be at least on the level of double of the leverage, which is another bank capital adequacy assessment tool, irrespectively of the financial risk level. The proposed reserve should allow for continuous functioning of a bank's critical functions in the process of a bank's resolution, and protect the taxpayers from bearing additional costs of bankruptcy through eliminating the need for using the *bail-out* mechanism.

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12 *Adequacy of loss-absorbing capacity of global systematically important banks in resolution. Consultating Document 10 November 2014*, www.financialstabilityboard.org.

13 Broader: Szczepańska, O., Dobrzańska, A., Zdanowicz B. *Resolution, czyli nowe podejście do banków zagrożonych upadłością*, NBP, 2015.

Let us recall that as FSB enumerates as part of its proposition so called external TLAC, which is required from any parent company that can be subject to bank resolution which can be obtained from external sources and internal TLAC applicable to every systemic company registered in different jurisdiction than domineering company. Internal TLAC would allow for recapitalisation of the subsidiaries by the parent company. This solution should be used in order to create confidence for both home and host supervisors that systemically important banks can be resolved in an ordely manner, therefore quieting the concerns of the supervisors about transfering the assets from subsidiaries of the host countries to the parent company in the home country.

According to European Financial Congress experts[14] the TLAC concept can limit moral hazard generated by G-SIBs but it will not eliminate it.

From the research done among Polish expert it can be concluded that the minimum TLAC requirements set at the level of 16–20% of risk weighted assets, but not less than two times the leverage coefficient required in Basel III seems adequate in the present situation. The requirements are not too low, but they may require some simplifying.

The TLAC/MREL should be applied to banks at an individual unit level (to increase safety of specific units) and at the consolidated level (in order to prevent risk transfer to subsidiaries or limit the freedom in using the capital, including creating financial holdings, where the parent entity would be an unregulated institution). The group should have available resources equal to higher of the two amounts: the amount calculated for the group or the sum of amounts calculated for specific banks, allocated at the level of those banks. The manner of determining TLAC should be a derivative of the chosen resolution strategy, and the resolution strategy should be the result of the group's structure and the decision of national resolution authorities from host and home countries.

Polish experts share the FSB's opinion that the financial resources for TLAC should be reallocated from the parent company to subsidiary companies which meet at least on of the risk or size criteria (more than 5% of the group's risk weighted assets, more than 5% of group's profits, more than 5% of the leverage index of the group, or significance for crucial functions of the group). It should be added that the host can choose to extend TLAC requirements on subsidiaries which do not fulfil the above-mentioned criteria, but are systemically important in the host country. TLAC funds distribution method should be accepted by panel of

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[14] *Koniec zasady „too big to fail”*, Rekomendacja Europejskiego Kongresu Finansowego 2015, http://www.efcongress.com/pl/koniec-zasady-too-big-fail and Pawłowicz, L., Broniewski, R. *Nowe propozycje tylko ograniczą moralny hazard w bankach,* http://www.obserwatorfinansowy.pl/tematyka/bankowosc/nowe-propozycje-ogranicza-moralny-hazard-ale-go-nie-wyeliminuja/, accessed 17/0/2015.

home and host supervisors similarly as when using advanced methods for capital measurement.

The price for introducing TLAC will most likely be an increase of costs of obtaining financing. The benefit, on the other hand, a chance to liquidate market ineffectiveness in the form of assumed support from a public institution. In such a situation the rise in costs of financing should not be interpreted as a negative situation.

Professor David Mayes from the University of Auckland, while agreeing with most recommendations prepared by the European Financial Congress, highlights that there is not enough room in TLAC proposition devoted to the question of whether TLAC actually diminish the costs of financial crisis for the public. If pension funds are to be an important part of resources constituting TLAC, then solution suggested by the FSB could mean moving the problem from to big to fail banking sector institutions to the pension fund sector. As a result the risk from financial institutions that are too big to fail for the public will not be eliminated, but it can be significantly reduced.

From the point of view of limiting moral hazard, there are two key things in the TLAC proposal:

1) will it be practically possible to implement the bail-in concept as part of the resolution process,
2) will the regulatory solutions (TLAC, MREL) stimulate the division of TBTF banks.

The bail-in concept, as opposed to bail-out, assumes that in case of insolvency of bank it will be possible to eliminate or at least dramatically diminish the amount of public funds used. In case of insolvency of the bank, the key point of bail-in is to exhaust the own capital, and if that is not enough for the bank to regain liability, then more and more of a bank's obligations will be converted to capital, which can be used for covering losses or as a capital injection to meet the regulatory requirements. The problem lies in the fact that the share of own capital in a bank's liabilities is very small (few per cent) and most liabilities are guaranteed liabilities, which are, according to the BRR Directive[15], excluded from the bail-in tool. Among others, guaranteed deposits and pledged liabilities (including mortgage bonds) are some of the excluded liabilities.

The wide scope of liabilities excluded from bail-in procedure give rise to concerns whether this instrument can be applied effectively. That is why a necessary condition for bail-in effectiveness is to ensure that the bank is able to absorb losses through maintaining a high level of liabilities that can be converted to capital. On the other hand, limiting the scope of liabilities excluded from the bail-in procedure may increase systemic risk and increase the costs of financing banks significantly.

15 http://eur-lex.europa.eu/legal-content/PL/TXT/?uri=CELEX:32014L0059, accessed 17/10/2015.

It is worth noting that traditional credit and deposit banks finance their activities mainly though the retail deposit market. This market, as opposed to the interbank market, is generally considered a stable source of financing. But the deposits (up to the equivalent of 100.000 euro) are excluded from bail-in. Therefore, those relatively safe banks will be obliged by the TLAC requirements to issue more dangerous debt instruments, and as a result to change their structure of liabilities to a less stable one.

In the end, it is worth noting that the TLAC solutions seem very restrictive in order to stimulate the mechanism of division of banks identified as TBTF, which are burdened with additional capital requirements. The competitive position of those banks in relation to other banks will become unfavourable. In theory the aim of the TBTF banks burdened with additional capital requirements should be to leave this group as soon as possible. The quickest way out of the "nasty thirty" is by division. The division of a TBTF bank will not interfere with the shareholder structure but it can cause a loss of the benefits of scale. Generally speaking from the moment of TLAC introduction it can be expected that some portion of banks will be dividing in order to avoid additional capital requirements. However, if FSB will be announcing the TBTF list annually, the banks on the list should be smaller and smaller with time. This would create an evolutionary limitation of the number of TBTF banks on a global scale.

Such a mechanism will mostly likely not be started by the MREL project, which burdens with regulatory restrictions all banks, not only the Globally Systemically Important Banks (G-SIBs)[16].

CONCLUSION

To sum up, the genesis of the TLAC project was to allow for effective implementation of the resolution process, especially using the bail-in instrument. Implementing additional regulatory restrictions described in TLAC to the group of thirty G-SIBs will probably start the mechanism of division of G-SIBs. Their division would increase the possibility of actual use of relatively small resolution funds (including European Resolution Fund) for countering moral hazard. New regulations bring hope for limiting moral hazard in the banking sector. However, it should not be expected that moral hazard will be eliminated completely in a relatively long period of time. It is important to limit first the most immoral moral hazard.

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[16] Broader: *EBA Final Draft Regulatory Technical Standards*, 3 July 2015, www.eba.europe.eu

Abstract

Several reflections and suggestions concerning the planned regulations aimed at limiting moral hazard done by TBTF banks were presented in this article. The scope of reflection is mainly the effectiveness of implementation of a resolution regime. To allow effective implementation of the resolution process probably the TLAC (Total Loss Absorbing Capacity) mechanism will be used. The mechanism will, according to the author, probably start the division of TBTF banks due to additional capital restrictions. If the division mechanism of two banks from the G-SIB group were to start it would be enough to be moderately optimistic when it comes to limiting moral hazard in banking.

Key words: TBTF, resolution regime, moral hazard, European Resolution Fund, European Stability Mechanism

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