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The New Banking Sector. Towards Reforming the Too Big To Fail Banks

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Abstract

The banking system has passed over time, through an intense process of invention and innovation. This process has allowed banks to diversify their activities, to create new and more complex products and to take excessive risks in order to gain profits. All these, however, were not accompanied by an appropriate legislative framework to protect banks in case of economic imbalances. In this context, since the beginning of the economic crisis, a strong concern has been voiced about the reform of the banking sector. New rules were put in place with a view to reduce the risks within the financial system. A major responsibility for the crisis was attributed to the too big to fail banks. Thus, many of the newly adopted regulations targeted this specific segment of the banking sector. Authorities in Europe and the United States have received significant powers including the power to impose banks downsizing if the authorities evaluation shows that the banks in question pose a serious risk for the stability of the system. However, after four years from the adoption of the first reform measures, the banking system remains large relative to the gross domestic product, with banks too big to fail and with no real prospects for change. The efforts made so far treat superficially the too big to fail problem and sill leave many questions regarding the banking system's ability to cope with future shocks manifested in the economy.
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1. Introduction

The main purpose of any study undertaken in economics is to understand how the economy works, to find solutions to the newly emerged failures and to undertake measures that support economic development. All these

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cannot be achieved without a critical and rational analysis of the banking sector since this sector represents not only an essential factor for economic development but also a disruptive factor, generator of instability. The evolution of the banking sector allowed the creation of large financial institutions whose failures generated serious repercussions on the economy. For this reason, many economists have attributed much of the blame for the emergence of the 2008 crisis, to these institutions. In this context, banking reform also meant the need to take measures that would allow to control the too big to fail banks and to mitigate the risks undertaken in their activities.

The present paper is structured in two parts. In the first part, the author discusses the changes that occurred within the banking activity aiming to capture the stages that led to the practice of risky activities. The second part, analyses the legislative measures adopted within the new banking reform, measures that target the too big to fail problem.

2. Changes in the banking activity

The current legislative framework has allowed the creation of multiple types of financial institutions, from non-bank financial intermediaries to investment or commercial banks. Although each of the financial institutions present in the market carries out an important activity, commercial banks present a special interest due to their contribution to the money supply.

The financing of economic activity undertaken by banks involves on the one hand the granting of borrowed money, which implies the bank's obligation to take responsibility for executing future payments on behalf of a borrower. The liquidity needed to honor the assumed obligations derives either from the cash flows received from previous granted loans or from other transactions such as loan-making, attracting deposits etc. On the other hand, engaging in such a contract involves a commitment taken by the entity making the loan, to pay back to the issuing bank a certain sum in the future. Thus, the banking activity creates two cash flows, an initial one through which funds leave the bank (granting the loan) and a second one, generated by the first, which takes place at a later point in time and through which funds enter the bank (repayment of the loan).

The efficient functioning of the economy depends on the possibility of the realized investments to generate the necessary profits for the service of the contracted debt and the ability of the financial system to identify those loan applications posing the fewest risks.

Prior to the development of modern industrial capitalism, lending activity was much more restrictive, banks having to resume leading to finance the trading activity and the goods in the production (stocks) and distribution process. This restriction was based on a certain theory that stated that as long as banks maintain credit lines to this type of goods, only the right amount of money would be present in the market. The label *commercial banks* reflected the original dominance of this type of financing (Minsky, 2011).

With the development of economic activity, appeared the need for financing durable fixed capital assets thus, the payment of the debt to the bank in a relatively short time frame was no longer possible. For the purpose of financing such activities it appeared the investment banks. The activity of the investment banks can be divided in two parts, a procurement part (buy side), which involves providing consulting services to institutions that wish to invest and a sales part (sell side), which implies transacting securities for cash or of other securities or the promotion of securities.

The evolution of the banking system over time, lead to a certain state of affairs in which the present financial institution maintain only a small part of what we call traditional banking activity, defined as the activity of attracting deposits or other repayable funds from the public and granting of credits. The global banking system underwent a process of invention and innovation in the last decades. Although initially, the banking system was considered a mechanic and static one, influencing the economy mainly through the amount of money in circulation and through movements in the interest rates, in reality, the banking system is a dynamic and innovative one, profit-oriented. Thus, the evolution of the banking sector led to significant changes in the market structure and in the activity carried out by banks.

The dissociation of banking activity from its traditional role is based on several justifying arguments provided by the literature. Firstly, the provision of a service by the bank allows it to obtain information about the respective

client which can create the premise for new future transactions. A second argument that supports engaging in complex banking activity takes into account the possibility of reducing the risks assumed costs. Furthermore, the applied regulations aiming to create a more competitive and undistorted environment determines the banks to diversify their activity in order to withstand competition and to better meet consumers' needs (Ayadi et al., 2011).

Although at first glance the diversification of banking activity appears profitable, it is not free from risks. Engaging in speculative activities, with large sums of borrowed money can produce dangerous financial crisis, this was the case of the 1929 crisis. Based on these considerations, in 1933 was enacted the Glass-Steagall Act, which separated the commercial banks form the investment banks, putting a greater focus on the protection of ordinary citizens. The demarcation line between commercial and investment banks became then increasingly unclear, remaining relevant rather from a legal perspective. The economic functions of the two types of institutions were no longer exhibiting major differences as commercial banks started to finance positions in fixed capital assets, while investment banks develop deposit-type liabilities, which indirectly provide funds for financing businesses (Minsky, 2011).

Glass-Steagall Act remained in force until 1999 when it was repealed. The main arguments that formed the basis for its repeal identified a more fragile banking system in contrast to the rival systems, especially the European ones. With the adoption of the Second banking directive, EEC no. 646/1989, European banks were allowed to conduct within a single institution different types of financial activities.

Even if the Glass-Steagall Act considered by many one of the most effective measures taken in the banking sector, remained in force for a long period, changes in the sector regulation were taking place soon after the Second World War. The economic recovery after the Great Depression, the relative stability of the banking system and the increasing capital accumulated especially by the investment banks, determined a race for deregulation. This, along with prolonged monetary constraints, whose purpose was to reduce the inflation level, objective achieved, but at the cost of raised unemployment, determined new financial instability in the period between 1970 and 1980, culminating with the economic crisis of 2008.

3. The new banking regulations

The reformation of the banking system, a post-crisis central concern, should target two key elements that generated this major imbalance. The first element refers to the reckless lending and borrowing, which creates a bubble of debt, which will need to explode at some point. The second element it is represented by the too big to fail banks, or too important to the whole system, that their salvation, by the state in case of crisis is inevitable in order to prevent an economic meltdown (Johnson and Kwak, 2012).

The financial crisis has highlighted the excessive size of the banking systems, both the European and the American one, this fact was a starting point for banking reform. The total value of the European Union (EU) banking sector assets, reached in 2013 the level of over 300% of gross domestic product (GDP) based on the data available on Eurostat and OECD. The United States (US) banking sector, calculated as the total assets of the Federal Deposit Insurance Corporation (FDIC) insured institutions to GDP, reached the level of 90%. This not only highlights the size of this sector but also the enormous costs involved in rescuing the financial institutions in case of economic imbalances (see Figure 1 and Figure 2).

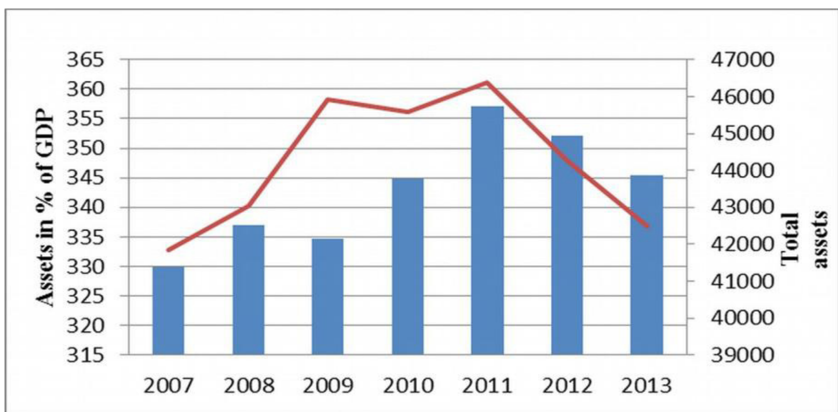

Figure 1. The size of the EU-27 banking sector to GDP (€ bn)

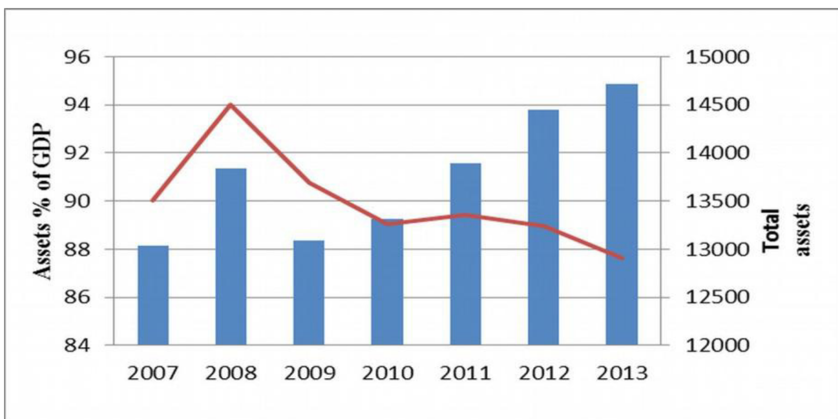

Figure 2. The size of the US banking sector to GDP ($ bn)

The 2008 crisis required urgent measures, and the principle of action applied, that of not letting the banks go into bankruptcy implied finding alternatives to save the financial institutions in distress. Thus, the measures implemented have led either to a deepening in the budget deficit or to the creation of even greater banks through mergers and acquisitions. Most of the exits shown in Figure 4 are mergers of banks and not actual bank failures. The data refer to FDIC insured commercial banks for the US and to Monetary Financial Institutions (MFIs), as definite by the European Central Bank, for the EU. In the EU the number of MFIs it was also influenced by the accession of new member states.

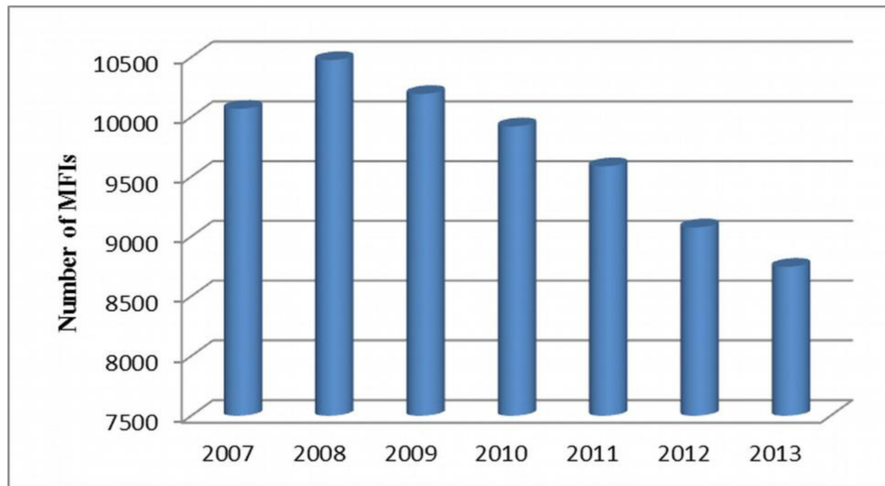

Figure 3. Changes in the number of Monetary Financial Institutions in EU

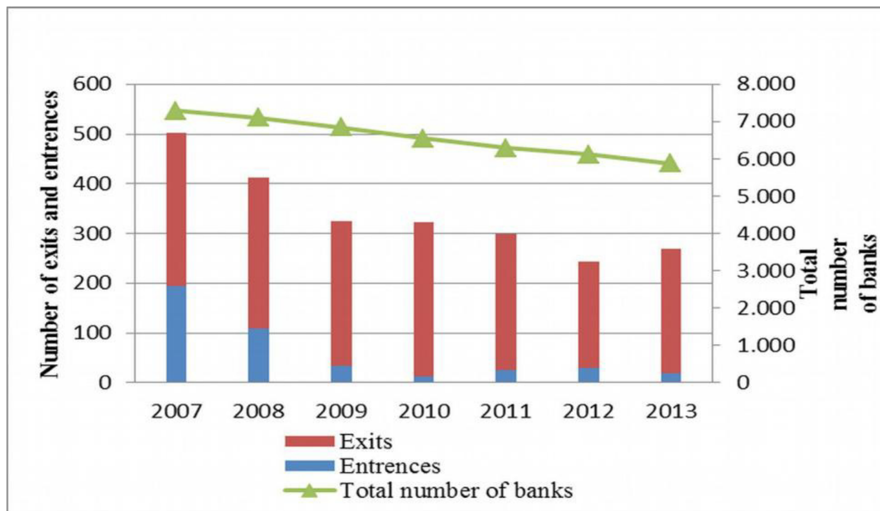

Figure 4. Changes in the number of FDIC insured commercial banks in the US

In this context, the assessment of the need to reform the European banking sector has been attributed to a high-level expert group (HLEG), under the guidance of Erkki Liikanen, Governor of the Bank of Finland. Following the analyses carried out on the European banking sector, the expert group recommended, for the biggest and the most complex banks, the separation of proprietary trading or other significant trading activities and the assignment of these activities to a separate legal entity which can be an investment firm or a bank (HLEG, 2012). The key findings of the report submitted in October 2012, were subject to a Commission review. Following this examination, in January 2014 was adopted a proposal on structural reform for the large banks, which complements the reforms already enacted. The proposal applies to European banks that are identified as global systemically important banks, whose total assets exceed 30 billion euro for three consecutive years, and the banks total trading

assets and liabilities exceed 70 billion euro, or 10% of their total assets (European Commission, 2014). The most important provisions indicated for these institutions, refer to the above mentioned recommendation regarding the separation of proprietary trading or other significant trading activities, to risk mitigation and to a decrease in the complexity and the interconnections of these types of banks. The proposal in question, also gives the authorities the power to impose the separation if the trading activities of the banks and the risks associated exceed certain thresholds and meet some preset conditions.

In the United States, banking reform has mainly focused on the same issues as in Europe. Dodd-Frank Wall Street Reform and Consumer Protection Act, which was adopted in 2010 and governs the American banking system grants manly the same power to the regulators as the ones offered by the European law. Thus, regulators may require banks to reduce their size, if it is found that the banks in question pose a risk to system stability. In this context, banks are required to submit every year living wills, in which to describe how they can be dismantled through bankruptcy without causing panic or major imbalances in the economy. Although this process is in its fourth year of implementation, according to the authorities the data submitted by the banks are unrealistic and don't present much credibility.

Another measure of the Dodd-Frank package which refers to the too big to fail banks is the so called Volcker rule. This rule forbids banks to engage in proprietary trading or in financing hedge funds or private equity funds.

Also, through the Dodd-Frank Act was founded the Financial Stability Oversight Council which has the power to designate certain non-bank financial institutions as systemically important banks if the Council's analysis shows that the institutions in question could create financial instability. In other words, the Council may appoint a non-bank financial institution as too big to fail. This measure does nothing else but to add other financial institutions to the already large number of too big to fail institutions (The Wall Street Journal, 2014).

The legislative provisions adopted both by the European Union and the United States treat softly the too big to fail problem. None of the adopted rules deals directly with the problems regarding the size of the financial institutions, at most, they give authorities increased powers of action in the event of future imbalances.

4. Conclusions

Reforms such as Dodd-Frank Act addresses the issue of too big to fail by creating more plausible methods to dismantle such institutions without causing a crisis. However, their effectiveness has not been yet fully established.

The currently adopted measures fail to deal with the most important problem of all, the size of the financial institutions. A good approach in this direction would be to identify a list of too big to fail banks and to regulate them accordingly, because at this point we no longer have to find ways to prevent this problem, but to actually deal with it.

The too big to fail reform it might be the key to banking regulation. A proper oversight of such institutions would help to prevent a crisis from striking, and it would put the authorities in a much better position to deal with the effects of a crisis, if that would eventually occur.

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