BANKING SECTOR IN THE CONTEXT OF THE NEW WORLD FINANCIAL REFORM

Valentina Mazurenko, Yegor Tkachenko
Kyiv State University of Taras Shevchenko, Ukraine

Abstract

The main purpose of this paper is to analyze the efficiency of the measures taken by different governments to improve the existing flaws of the financial regulations in order to prevent the repetition of the economic crisis we could witness recently and which might have led to a catastrophe. Special emphasis in this research is made on the banking sector as in the existing market exactly banks as the institutions on whom the sustainability of the financial flows depends play the most prominent role among all other financial institutions. Judging by the most recent developments in the world economy it is the financial market that to larger extent determines the economic trends. By considering in this paper the role of the banking sector (the integral part of the financial market) in support of a stable economic environment, authors investigate the true reason of the financial turmoil and analyze the blame for it put on the banking institutions. The perspectives of the development of the financial market in general and of the banking sector in particular are explored, the presumable effects of different institutional financial reforms on the economic environment are researched. This work can be quite useful for understanding of the true origin of the financial crisis, the real role of the banks during the recent events and the nature and the purpose of the steps that are taken by governments - not only from the economic but also from the political point of view.

Key words: banking sector, banks, financial crisis, financial reform

Introduction

It is widely recognized that the financial system performing a set of functions in the economy has an active impact on it. So does the banking sector as its integral part. And it is exactly the widest range of functions performed by banks that determines the fault which laid on these institutions in the context of the recent global financial crisis. Indeed, the banks are one of the main factors of the financial market stability.

It was an overheated demand of banks (especially investment banks) and other financial market participants for the mortgage securities incorrectly assessed by rating agencies as a highest paper-class AAA, as well as an extremely illiterate policy of risk differentiation by some banks, that led to the mortgage crisis of 2007 - 2008.

In response to the incident at the first summit of the Great Twenty in Washington, held on November 14-15, 2008, the decision on the need of global financial reform, which would have a direct effect on the banking sector, was made. Later the ideas of financial architecture reformation were developed at 2 subsequent summits of the Great Twenty in London (01.04.2009), and then in Pittsburgh (24-25.09.2009).

In the recent past both the EU and the U.S. authorities published their preliminary programs of financial reforms. Let us analyze and compare their basic provisions.

1. The EU financial reform

The draft of the EU reform implicitly touches on many important issues, with an emphasis on the creation of 2 major regulatory bodies:

1. The European Systemic Risk Board, which includes the Central banks of the EU and national supervisors. The Board will be engaged in monitoring the overall financial system and inform the European Commission of any, even minor signs of an impending crisis, and the existence of systemic risks. However, its powers will be limited to recommendations only. A significant disadvantage of this regulatory body is that monitoring of risks is limited to the territory of the EU, while the risk zone may be located outside it. Obviously, taking into consideration of the nature and the structure of portfolios of the major players in the financial market, which could not long have been placed into the narrow territory of the EU, the effectiveness of this body will be quite low.
2. The European System of Financial Supervisors will unify a network of national financial supervisors, as well as

three new pan-European agencies on monitoring the financial market that will be created on the basis of the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA). This group will exercise control over the implementation of pan-European banking procedures, as well as the adoption of emergency anti-crisis measures, act as an arbitrator in disputes between national supervisors, have the opportunity to request information directly from European companies, make its projects on financial regulation. Significantly, this group will also have the powers to direct observation and control over the activity of rating agencies. Thus, the financial monitoring agencies will be able to conduct their own investigation and ongoing monitoring of the financial market at the micro level. But the problem is that here the volume of made decisions will be advisory in nature, and the system of financial supervisors will become, in fact, a network to gather information only. Moreover, it is difficult to imagine how it will be possible to carry out constant monitoring of all financial market participants (it is physically challenging), while selective control, which is assumed in the draft reform, clearly will not be sufficiently effective.

The future of the EU financial reform is uncertain. In autumn 2009 the conference within the EU Central bank, at which the representatives of Hungary and Ireland officially declared that the intention to unite the bodies of control over different sectors of the financial market, in their opinion, was erroneous, took place. The authorities of Poland, England, Austria and Germany have similar views. Thus, the financial reform, inevitably, encountered instinctive fear of the EU member states to give their power and leverage over pan-European bodies of control over the financial sector.

Besides, the creation of supervisory bodies does not solve the problems of the financial system structure, does not diminish the willingness of its participants (including banks) to take excessive risks in pursuit of excess profits.

What is more, a few suggestions, still coming from the representatives of various EU countries, are very unconstructive and rejected by the majority members of the EU (for example, the proposal of the Prime Minister of Great Britain to introduce a Tobin tax on financial transactions - in particular, on banking - to counter speculations in the financial market, is more like a fire in the air, because in the economic circles the opinion of its inefficiency has long been ingrained). Thus, the reform proposed by the EU, does not address specific problems, as a result of which the financial crisis emerged, does not offer effective solutions to them - largely because of the lack of consensus among the EU members. Moreover, it almost does not address the problems of banks.

2. The US financial reform

The financial reform proposed by the Ministry of Finance in the United States of America is much richer in specific, substantive proposals, and is a well-structured plan of action; it differs from the European Reform in that many of its proposals involve changing the regulation standards on the financial market. Its minimum officially declared objectives are:

- to reach a new level of protection for consumers and investors;
- to create more stable, secure financial system, less prone to crises;
- to protect American taxpayers from the necessity to „pay” for struggle with future crises themselves.

This reform is based on one main assumption of the existence of systemic risks in the economy, that are the risks associated with the failure of one of the market participants to fulfill their obligations, which leads to impairment of other participants. In fact, the problem of enterprises being „excessively big for the bankruptcy” is reduced to the concept of systemic risk. In other words, it is assumed that certain enterprises which are very closely related to other market participants in the case of the alleged bankruptcy may lead to hyper terrible consequences for the very economic system, so their salvation is self-evident to the state. That is what happened when the state actually saved from the bankruptcy the largest U.S. insurance corporation „AIG”, Bear Stearns investment bank, and it is confirmed when the bankruptcy of Lehman Brothers investment bank (which the U.S. authorities allowed to occur) had nearly resulted in the total collapse of the U.S. financial market. To minimize such risks within this reform it is proposed to increase the capital requirements, make the requirements for leverage (financial leverage) more severe, set strict rules on risk management, give regulatory bodies of the financial market the opportunity to divide the corporations having hyper size and over-complex internal structure into a few companies to eliminate the excess risk of financial stability of the United States. It is also planned to compel corporations being a significant systemic risk carriers to make the so-called „funeral plans", i.e. plans, based on which the procedure of bankruptcy will be performed and which will allow the state to minimize losses and quickly take control over the bankrupt corporation in its own hands.

Significant changes are planned to be implemented in the off-exchange derivatives market, as at the end of June 2008 the total volume of this market for all types of derivative securities reached 683.7 trillion dollars.

Putting to blame this lack of transparency in this market (currently trading in off-exchange derivatives are virtually recorded nowhere, without going through the clearing system, having the nature of private contracts), the U.S. authorities made a proposal about the mandatory clearing of all transactions in derivatives trading. No doubt, the overheated speculative demand for derivatives and the lack of a reasonable approach to forming their portfolio of assets among the most financial market participants caused the financial crisis, and low transparency and lack of data on this market limited the opportunity of investors, and states soberly assessed the risks, but the very physical possibility of the clearing of assets worth hundreds of trillions of dollars arouses doubts. Besides the mandatory clearing will only give information about who are the direct participants in this market, and more detailed data about its size, but it definitely won't reduce the trade in derivatives considering its high cost, and what is more evaluation of the market structure because of its volume will be quite relative.

The U.S. Financial reform envisages the creation of Consumer Financial Protection Agency, which would supervise honoring the rights of financial institutions' customers. Although this proposal is not central, it is very sober and will help solve the existing problem of customer insecurity before financial giants, including banks.

Specifically in the banking sector this reform involves the following:

1. all the above listed changes, because they are directly related to banks, influencing the environment in which they operate;
2. elimination of „holes" in the legislation which allows certain subsidiary saving institutions of holding banking companies to avoid „bank" regulation;
3. creation of the National Bank Supervisor, which would combine functions of banking regulation, currently divided between 4 existing financial regulators - the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Office of Thrift Supervision (OTS), which essentially cover the various depository institutions, and would be given additional powers, particularly with regard to increasing access to internal information;
4. increase of capital requirements in proportion to the size of banking institutions, as well as in proportion to risks common in the activities of a bank (the structure of assets portfolio, leverage).

It should be noted that the banking reform of the U.S.A. is particularly rational, because ultimately it will lead to a simplification of the system of supervisors and elimination of loopholes in the legislation that allowed banks, through creation of derivative mortgage securities with the aid of intermediaries (such mortgage companies as Fannie Mae and Freddie Mac), lay the foundations for future crisis.

The fact that this reform implies stricter control over credit rating agencies is of a great importance. It is proposed to create the Office of Credit Ratings, which would have the authority even to withdraw the license of those rating agencies that provided the wrong ratings. The reform envisages the change in methodology of different ratings setting, the use thereat of information provided not only by the company, which activity is assessed, but also data from other sources. In this case, the problem is that an objective assessment of asset quality and success of a company does not require a simple modification of existing calculation formulas, but a radically new theory, which would include the calculation of the so-called systemic risk, other risks.

Moreover, the situation where banks and other financial market players, when placing an order for ranking of the companies or certain securities, created by them, pay themselves for this service, still remains without solution. Perhaps, one could observe a certain correlation between the payment for these services and the level of rating. To solve this problem a dramatically new rating system is required both in the U.S.A. and around the world at large, for example, the system of state rating agencies, which would be objective to greater extent than private ones, because the state itself (at least in the USA) is extremely interested in realistic indexes of market functioning (to avoid the situation where derivative mortgage securities were assigned AAA rating).

There is another question, which arises to whether it is really worth imposing significant restrictions and deterrent factors upon development of financial institutions. This casts doubt on the very much-popularized idea of systemic risk. In fact, the systemic risk presupposes that the default of one person who has obligations to other persons may provoke them to default and so forth. Thereat the largest banking institutions, which are characterized by the greatest systemic risk, become the scapegoats. However, it should be clear that it is impossible to avoid systemic risk, as the systemic risk is a natural aftermath of a company's development, its interaction with economic environment, while the link between development of a company and its interdependence with other market participants is inevitable. Reasonably it is possible to fight only the group of risks that can lead to an „initial" bankruptcy, which, in turn, leads to a domino effect, which we observed after the bankruptcy of Lehman Brothers.

Although the actions taken by the state are required in case such „chain of defaults" is launched so that the state could become a buffer for the entire economic sector, after all it is necessary to concentrate the main forces on finding the ways to prevent the circumvention of the legislative regulations by banks and other organizations, as well as finding the way of how to give risk managers of these organizations the opportunity to see the situation on the whole financial market in an undistorted light, and thereat the situation of rating agencies unreliability arises. It is also neglected that risk and asset management, in general, may be performed many times better by bigger banks than smaller banks.

3. The populist disease

Strain generated by the general disquiet of the society provokes many countries of the world to take unwise steps in order to satisfy the lust for blood of their peoples. Thus, the offshore zones, age-old traditions of banking secrecy, and significant bonuses for bank managers have already fallen under the hot hand of governments. Unfortunately the effectiveness of all the actions taken is questionable as all of them do not directly impact the root causes of the crisis, what is more, most of them have got a rather populist nature.

Particular attention should be paid to the tax on banks, whose assets exceed $50 billion, proposed by the President of the U.S.A., Obama, in order to return 117 billion dollars from 700 billion cost of the state anti-crisis program TARP back to taxpayers. This tax has been dubbed „payment of the responsible for the economic crisis" that in some way contradicts the fact that these banks (number of which is about 50) will be subject to the aforementioned tax regardless of whether they used the state aid or not. It indicates that while still being largely supported by the public politicians are ready to do anything to raise additional funds.

Thus it is not a wonder that as recent data from the financial markets show, the financial reform itself (largely due to its populist nature), in fact, has not had any significant impact on condition of the banking sector. Among many banks, despite the crisis, for the period from 2007 till the present day, one could observe the growth. BNP Paribas Bank, the largest bank of the world by assets, has shown growth in its balance sheet by 59% to 2,29 trillion euro (3,5 trillion dollars) since the beginning of 2007, which equals to 117% of the GDP of France. The assets of Barclays bank in London for the same period increased by 55% - to 1,55 trillion pounds (2,6 trillion dollars), which is equivalent to 108% of the GDP of Great Britain. Thereat, it should be remembered that this growth is explained by a significant decrease of interest rates by central banks. Considering that the EU governments have no right for direct control over the banks, which did not have direct financial assistance, it is clear that such banks as BNP Paribas and Santander are in an advantageous position in relation to its competitors, and use the situation to make new acquisitions.

According to the data of Bloomberg in early 2007, 353 banks of the EU increased their assets, but one should not forget that thereat risks increased as well.

Surely, there is also the back side of a coin. UBS AG Bank lost 57 billion and received the aid from the Swiss government in the amount of $6 billion. Thus, its assets decreased by 37% since the beginning of economic crisis.

These fluctuations in the banking sector determine 2 next trends. The first of them - this is a departure of some banks from high-risk activities, so to say - a return to roots - to the traditional banking services. This is the way that Morgan Stanley and Citigroup Banks went as a result of a significant damage caused to them by the financial crisis, turning to the commercial retail banking. It is also explained by the fears evoked by the new regulations, which are introduced and will be introduced by the U.S.A. and the EU.

The second trend is opposite to the first one. Such giants as Goldman Sachs, JPMorgan, Barclays, and Credit Suisse do not see a future different from the past, despite the strengthening of capital and leverage requirements. And looking at them, we see growth: in the first quarter of 2009 Goldman Sachs became a record-holder spending 11.4 billion dollars on personnel on the background of significant growth, turning the wrath of the public against itself due to its „wasteful behaviour".

In fact, the reaction to this was a new, recent draft law proposed by Barack Obama with the support of Paul Volcker, the former head of the Federal Reserve and economic adviser to the President. This reform, called „Volcker's axe", consists of 2 key-points:

1. The division of spheres of banking activity. Financial institutions taking deposits that are insured by FDIC State Agency, as well as having an access to emergency funding from the Federal Reserve, will not be able to invest in profitable but risky operations in the market. Banks will not be able to own hedge funds, equity funds, and invest in them, deal in securities from their own resources for their own profit, take part in operations that do not relate to servicing their clients.
2. Limitation of banks size. Under the current rules one American bank cannot control more than 10% of the national market deposits. Upon the adoption of the reform this limit will be applied to other types of financial obligations, including operations in the wholesale financial market.

This reform can be taken in two ways. Clearly, being efficient, it will reduce the risks associated with banking activities to some extent reduce the concentration in the banking industry, where the four largest U.S. banks own more than a half of all assets in the sector. However, by doing so the reform will weaken the position of the U.S. banking sector on the international arena, striking a major blow to such locomotives of financial growth, as Goldman Sachs and Morgan Stanley Banks. It should also be borne in mind that European countries are unlikely to decide to apply such harsh measures against their banks. This will put the U.S. banks in a relatively no-win situation. Moreover, this reform is not aimed at addressing the real causes of the financial crisis, so the USA authorities should be very careful about its enforcement.

Conclusions

At the moment behind the veil of many accusations and threats, deep and not very deep reforms a bright future for the entire banking sector is seen, because, firstly, after a detailed analysis it is revealed that its fault as of the one who had started financial crisis was overestimated. Secondly, it is explained by that portion of the GDP growth of the U.S.A. and the EU, which the banking sector provides them with. The evidence in favor of such assumptions is a very low interest rate, which is supported by central banks around the world and which provokes an extensive growth of banking institutions (though it isn't going to last for long). It is likely that soon many bold intentions of governments-reformers might be forgotten, and, new investment banks will emerge. This is the main threat.

Even today, according to many experts, the huge programs of stimulating the growth of the economies in different countries create favorable conditions for the formation of new „bubbles" in the financial market. The rapidly growing mortgage market spurred by the state of China evokes particular concerns. The USA commercial real estate market also arouses great suspicion. It is very likely that soon we might see a repetition of the situation that occurred in the U.S. mortgage market, because the initial conditions are basically very similar.

Summing up, it should be noted that the seeds sawn by the financial crisis and subsequent events will be growing for many years. Lower interest rates create favorable conditions for development of banks, and it will be interesting to observe which of them will go what way, unless, of course, some harsh reforms such as Volcker's rule are enforced as they can radically change the settings. The financial reforms, pursued at the moment, have inherently a negative character, though, probably, their influence on the banking sector will not be too great, especially considering their populist nature. The main danger is that the situation will not change, and the financial crisis (a kind of warning) will be forgotten. it is obvious that in case of a possible repetition of the events of 2007-2008 the world's leading economies will not have sufficient funds to prevent a possible catastrophe, as evidenced by the growth of government debts around the world. Considering the size of the U.S. public debt, it is frightful to assume possible consequences. The sign of the increasing nervousness were 200 tons of gold acquired by the Central Bank of India from the IMF, obviously, as an insurance against possible exchange rate fluctuations.

Thereby, now the world's governments bear a tremendous responsibility for the non-distant future of the world financial system (to tell the truth, the recent economic performance doesn't say much for their efforts), and it is clear that the banking sector will play the key role in it, as it has happened until today, in conditions of the new regulation, or without it.

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