The European International Model United Nations 2018

Group of 20 (G20)

Topic A: Too big to fail

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<u>Welcoming Letter</u>

Dear delegate

Welcome to The European International MUN 2018!

For 31 years, TEIMUN has been a great platform for everyone to develop skills and enhance knowledge. For six days, we will not only be involved in a series of thought-provoking debates, but also a series of socials and excursions. The spirit of multiculturalism will make us understand the world better and the stories that each of us has will help to build our world. You will experience the balance between a continuous learning process and having fun, especially in this council, the G-20

Within this council, we will be discussing two topics: "Too Big To Fail" and Climate Change. We are hoping that throughout the conference, you will have a more comprehensive understanding about the world and get excited for international affairs. We will work tirelessly to ensure the substantive excellence in this council, as well as a fun experience to enjoy multiculturalism and kinship with one another. If you need any assistance from us in answering your queries, please do not hesitate to contact us, Kevin and Dominique. We look forward to getting to know you in person

Warm regards,

Kevin and Dominique
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Introduction

Money, something everyone comes into contact with on a day-to-day basis. A fundamental concept of human society since the beginning of trade. Yet, despite the fairly straightforward concept of a means to exchange goods and thereby the ability to equate goods with each other, the notion of money has not been as stagnant as one would think. One of the biggest transformations of currency began with the rise of banks. An institution where you had the possibility to lend money and deposit your means in order to safeguard your potential possessions. In principle this seems simple, you loan money and pay the same amount back. But slowly, due to the continuous and exhaustive usage of the banking system, banks themselves saw an opportunity. With enormous amounts of cash in the vault, why not use them to earn even more through lending fees, also known as interest? Thus, the institution shifted from a simple construct which largely served a communal goal, to an undertaking aimed at making a profit.

Over the course of humanity, the discrepancy between the primary communal goal and the entrepreneurial aspect of banks grew. Eventually, several problems arose which led to several financial crises of which the last one occurred in the period of 2007-2009, which affected hundreds of thousands of people worldwide. It became clear with our current international interdependent economies and the heavy dependence of the world on banks, that some monetary institutions are simply too big to fail as it would have a significant negative impact on the global financial system. Too Big To Fail (TBTF), also known as too important to fail, with regards to banking has generally been described as "a bank that is perceived to generate unacceptable risk to the banking system and indirectly to the economy as a whole if it were to default and unable to fulfil its obligations."[1] Yet, the question still remains what the origin of Too Big To Fail institutions is and what we can do to prevent future problems that may arise from this concept.

Background of the G20

The Group of Twenty (G20) is a global forum of countries with major economies, aiming to discuss policy pertaining to the promotion of international financial stability. The origin of the Group of Twenty can be traced back to September 1999, at a G-7 (Group of Seven) summit meeting, comprising of seven countries with major world economies. G-7 was originally expanded from the Group of 5 (G-5). The original members of G-5 were France, Germany, Japan, the United Kingdom, and the United States, all developed countries. It began its first meeting in the mid-1970s, discussing the economic challenges faced by countries,

[1] Kazandjieva-Yordanova, Irina Petkova. "Does the Too Big To Fail doctrine have a future?". *Economic alternatives* 2017; issue 1, p. 51.

particularly the oil shocks and the collapse of the Bretton Woods[2] system of fixed exchange rates.[3] In the mid-1980s, Canada and Italy were included and formed G-7, which then focused in discussing macro-economic policies, such as exchange rates, balance of payments, globalization, trade, and economic relations with developing countries.[4]

Triggered by the 1997-1998 Asian economic crisis, the finance ministers and central bank governors, who represented these seven countries, held a ministerial meeting to address international financial stability. These countries then recognized the need to address the world's financial challenges through a more inclusive body with broader representation.[5] The economic crisis that affected the developing countries in Asia also had an impact on financial markets in developed countries. G-7 marked the acknowledgment of countries with emerging economies in addressing economic crisis. This triggers the initiation of G20. As the leaders of G-7 acknowledged the key-role of developing countries with emerging economies to address economic crisis, the establishment of G20 was then initiated.

The aim of G20 is to create a broader dialogue platform to promote cooperation to achieve stable and sustainable world economic growth that benefits all.[6] To achieve this aim, G20 has its annual summit among their leaders, as well as frequent meetings among lower-level officials. Its main goals are to coordinate macroeconomic policies to strengthen the global economic recovery, to reshape the international financial architecture, and to promote financial regulations to help prevent another crisis, such as the one in 2008, from occurring again.[7]

The first G20 Ministerial Meeting was held in Berlin, in December 1999, with Paul Martin as its first chairman.[8] As the G20 doesn't have any permanent Secretariat, the responsibility to set the Summit agenda relies on the host country, or the so-called

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[2] The Bretton Woods system consists of three institutions on international economic and monetary, which are the World Bank, the International Monetary Fund (IMF), and the International Trade Organization (ITO). These institutions were established after a meeting of 43 countries in Bretton Woods, New Hampshire, USA, in July 1944. At the end, the ITO failed to be established, but it became the beginning of the World Trade Organization (WTO).

[3] Rebecca M. Nelson, "The G-20 and International Economic Cooperation: Background and Implications for Congress," *Congressional Research Service*, p. 2, https://fas.org/sgp/crs/row/R40977.pdf. Accessed on June 8, 2018.

[4] *Ibid.*

[5] G-20 Official Website, "What is the G20?", https://www.g20.org/en/g20/what-is-the-g20. Accessed on June 8, 2018.

[6] "The Group of Twenty: A History," http://www.g20.utoronto.ca/docs/g20history.pdf. Accessed on June 8, 2018.

[7] Matt Rosenberg, "What is the G-20?" March 6, 2017, https://www.thoughtco.com/what-is-the-g-20-1435403. Accessed on June 8, 2018.

[8] Istituto Per Gli Studi di Politica Internazionale (ISPI), "G20's History and Membership," September 2, 2016, http://www.ispionline.it/it/pubblicazione/g20s-history-and-membership-17116. Accessed on June 8, 2018.

presidency.[9] Instead of an organization, the G20 is an informal forum. Aside from the Summit agenda, the presidency also organizes working processes, meetings, and events.[10] The working processes are operated at below summit level, compared to the G20 Summit which involves heads of states and governments. These working processes include Sherpa meetings[11] (meetings of chief economic advisors of heads of state or heads of government), nine ministerial meetings, and meetings of study and working groups which are comprised of governmental officials and experts. These working and study groups prepare joint initiatives and ministerial decisions, initiate groundwork for the G20 Sherpas, and follow up the progress on implementation at the national level.[12]

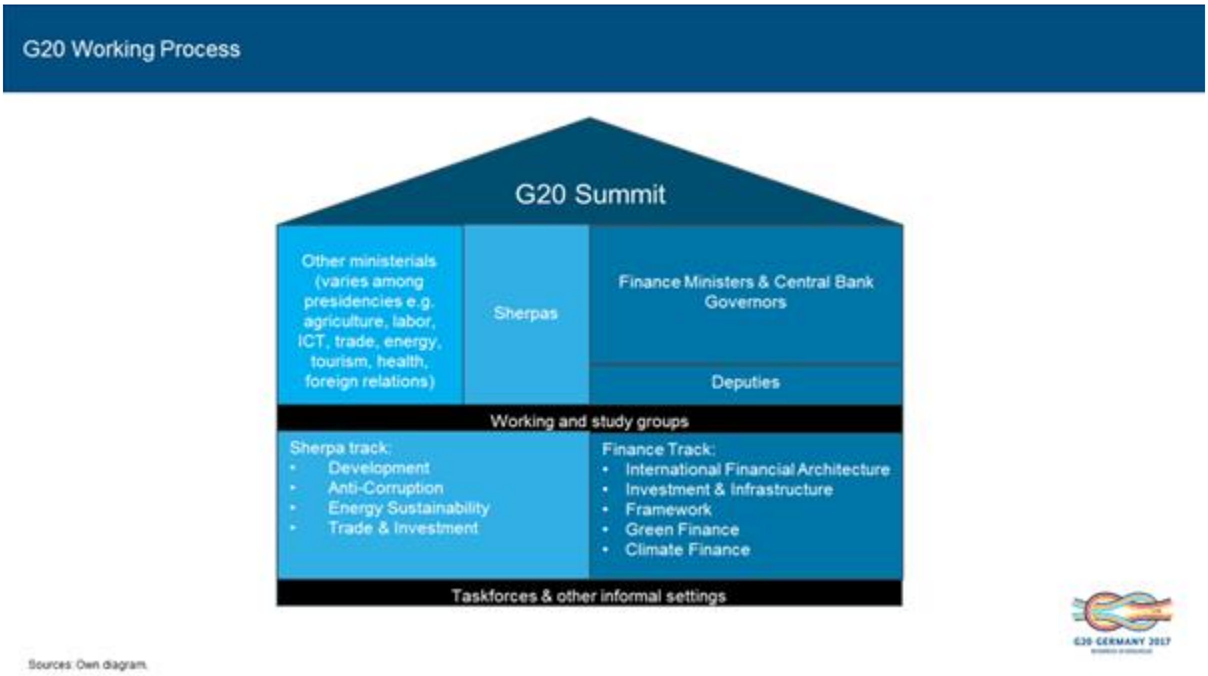

Figure 1.

Source: https://www.b20germany.org/the-b20/about-g20/

The official mandate of G20 is to promote "open and constructive discussion between industrial and emerging-market economies."[13] At the end of every summit, G20 always have

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[9] *Ibid.*
[10] G20 Germany 2017, "About the G20," https://www.b20germany.org/the-b20/about-g20/. Accessed on June 8, 2018.
[11] Sherpa are chief economic advisors of heads of state or government.
[12] G20 Germany 2017, "About the G20."
[13] CBC News, "The G20," June 1, 2010, http://www.cbc.ca/news/world/the-g20-1.941894. Accessed on June 8, 2018.

its final recommendations called communiqués. These communiqués would include measures that can be implemented by its members, though it is not legally binding.[14] These communiques are taken by consensus, whose implementation relies on the willingness of Member State to compromise. The diverse interests of Member States and the informal character of its decisions trigger effective compromises of Member States, thus, making 71 percent of all G20 decisions implemented by its Members. Furthermore, the G20 is also guided by ground principles[15], which were set out in the Framework for Strong, Sustainable and Balanced Growth, adopted at the Pittsburgh Summit in 2009. Though it was originally established to address economic and financial issues, G20 has developed to become a more holistic forum for global governance with a comprehensive agenda, covering most of the world's issues.[16]

As a platform of dialogue to facilitate the negotiation of compromises in various global policy areas, rather than a decision-making body, the G20 has initiated a preliminary stage to more formal resolutions in formal international organizations, such as the United Nations. One example is the adoption of governance reform by the executive board of the International Monetary Fund (IMF), negotiated at the Gyeongju meeting of the G20 finance ministers and central-bank governors, prior to the Seoul Summit in November 2010.[17]

G20 comprises of 19 members and the European Union; the original members of the G-7, BRIMCKS (Brazil, Russia, India, Mexico, China, South Korea, and South Africa), and Australia, Argentina, Indonesia, Saudi Arabia, and Turkey. These countries currently account for about 85% of global economic output, 75% of global exports, and two-thirds of the world's population.[18]

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[14] *Ibid.*

[15] There are six guiding principles, which are:

- country-owned and country-led, based on the members' assessment and with the input of independent third-party evaluations (by the IMF and other international organizations);
- based on a rigorous 'comply or explain' approach, which recognizes that policy actions take time and policy priorities may need to change;
- concrete, using quantitative measures where possible to help focus the discussion and assess progress;
- consistent across members, to ensure comparability of treatment, while at the same time allowing for country-specific circumstances where relevant;
- fair, by encouraging an open dialogue between members through self-assessments and by providing objective, third-party analysis;

open and transparent, with the overall outcomes communicated to the public after agreement by the G-20.

[16] G20 Germany 2017, "About the G20."

[17] "Briefing Paper. The G20: Its Role and Challenges," *Deutsches Institut fur Entwicklungspolitik*, 2011, https://www.die-gdi.de/uploads/media/BP_16.2011.pdf

[18] Rebecca M. Nelson, "The G-20 and International Economic Cooperation: Background and Implications for Congress," *Congressional Research Service*. https://fas.org/sgp/crs/row/R40977.pdf

Background

In order to fully understand the origin of the Too Big To Fail (TBTF) concept, one must first become acquainted with the construct of banks. Therefore, we will start with a short history on banks in order to understand how they have developed over the centuries and how we arrived at the current situation. After that, it seems relevant to understand how modern banks work in practice and which legislation is involved. Lastly, the supervision on banks and their regulation in practice will be discussed so that a proper understanding of modern day banking will be present before the issue of TBTF will be addressed.

A Brief History

The origin of banking has been difficult to trace since the notion of loaning goods has been present since the start of humankind. Yet, the first traces of institutions accepting deposits and loaning goods has been found around 2000 B.C. in Mesopotamia.[19] Temples and palaces were a place where people could deposit valuables and wealth with the requirement of paying a certain percentage of their deposit in fees.[20] Moreover, temples were known for lending valuables in their possession if repaid in full with additional interest.[21] Over the centuries the practice of banking was widespread from the earliest forms of banking in China[22] to the first recorded manifestation of a credit system in Egypt where transfer of wealth and goods was possible through a trade-credit system through a centralized institution.[23] These practices were present during the entire graeco-roman period until the fall of the Roman empire.[24]

The concept of the trade-credit system remained buried until it's revival during the crusades when the need arose for traders to transport large sums of money, without the common risk of robberies along the way.[25] This eventually brought the first banks into existence. These were established in Venice, Italy in 1157, and facilitated the crusaders of the Pope at that time.[26]

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[19] Davies, G. "A History of Money from Ancient Times to the Present Day", Cardiff: University of Wales Press, 1996.
[20] *Ibid.*
[21] *Ibid.*
[22] Wagel, Srinivas R. *Chinese Currency and Banking [2015]*. Cambridge: Harvard University Press, 2005.
[23] Abbot, J. *History of Cleopatra*. New York: Harper & Brothers, 2006.
[24] Ellis, Simon P. *Graeco-Roman Egypt*. Oxford: Osprey Publishing 1992.
[25] Davies, G. "A History of Money from Ancient Times to the Present Day", Cardiff: University of Wales Press, 1996.
[26] Gilbart, James W. *The History and Principles of Banking: The Laws of the currency*. London: Longman, Rees, Orme, Bwon, Green and Longman, 1866.

These banking practices continued until the manifestation of modern day banking, which answered the demand of a more practical way of funding the newly emerged commercial and industrial practices in the 17th century.[27] This was mainly done through the issuance of bank-debt. Instead of loaning out their privately owned currency, they started lending out other depositors assets, which produced the necessity of a liquidity coverage ratio.[28] Essentially, the notion of banking hasn't changed much over the centuries, yet modern day banking in the 21st century has become more complex with ever increasing facets.

Banks in Practice

One important aspect relevant to the system of modern day banking with regards to TBTF is capitalism. In a nutshell, only a system which entails a free transfer of currency and wealth combined with private ownership allows for the practice of banking which might lead to a TBTF bank. The relevance of capitalism to the TBTF issue will be discussed in the next chapter. For now it is enough to know that within a free market banks can be generally divided into commercial and investment banks.

Commercial Banks

Of all the different types of banks, the commercial bank is probably the one most people are familiar with. Particularly because they center around providing financial services to the general public and small businesses. These provisions entail services such as deposits, savings and checking accounts, mortgages, personal loans and debit/credit cards, also known as core banking services. Another important aspect of commercial banks is their ability to create credit. This happens through what is known as the money multiplier, where the bank allows multiple claims to assets on deposits. Broadly speaking, when a client deposits money with the bank they are essentially lending the bank money in return for interest. At the same time, this gives the bank the possibility to loan-out or invest the made deposit in order to make more profit, thereby creating more credit than originally present.

This is one of the main reasons why at any given time banks have more outstanding creditors than cash in the vault. This may cause a problem if more depositors withdraw their

[27] Davies, G. "A History of Money from Ancient Times to the Present Day", Cardiff: University of Wales Press, 1996.
[28] Davies, G. "A History of Money from Ancient Times to the Present Day", Cardiff: University of Wales Press, 1996.

cash than the bank can provide. In the past such cases have led to a 'run on the bank' which led to insolvency on more than one occasion.[29] In principle, this was caused by a lack of trust by depositors that their savings would be accessible over a longer period of time. This would cause depositors to withdraw from their respective banks thereby creating a snowball effect in which the lack of trust of some depositors further diminishes the trust of others and consequently leading to withdrawals en masse eventually contributing to an insolvency. Thus, more regulation and certain restrictions were placed on commercial banks over the years, such as depositors insurance and liquidity coverage ratio, also known as the reserve ratio, in order to prevent future bank-run caused defaults.[30]

However, with regards to the TBTF issue, these banks play a marginal role due to their finite market share and severe restricting regulations.[31] Thus, the continued exploration of the commercial banking system seems less relevant to this paper as a whole.

Investment Banks

Investment banks however, are per definition involved in large high-net worth investments and transactions. Normally these banks assist in large, complicated financial transactions. Other services of investment banks involve advice as to how much a company is worth and assistance in acquisition, mergers or sales. Furthermore, these banks are able to issue securities as a means of raising money for a client and in many cases as an agent for a client.

With regards to the TBTF issue, one of the more important services of investment banks concerns their trade with derivatives. Basically, a derivative is a financial security with a value that is reliant upon or derived from the underlying asset. It's price may fluctuate in accordance with the underlying asset. The most commonly underlying assets of derivatives are stocks, bonds, commodities, currencies, interest rates and market indexes. However, considering the financial crises, the most relevant derivatives are those that entail a speculatory aspect.[32] Namely, the credit derivatives have had a major impact on the overvaluation of certain assets.[33]

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[29] Wicker, E. *The Banking Panics of the Great Depression*. Cambridge: Cambridge University Press, 1996.
[30] See for example: Glass-Steagall Act of 1933 in the US.
[31] Barth, James R., Wihlbourg, Clas. "Too Big To Fail and Too Big To Save: Dilemmas for Banking Reform". *National Institute Economic Review* 235; issue 1 (2016), p. 30.
[32] The Financial Crisis Inquiry Commission. "Final report of the national commission on the causes of the financial and economic crisis in the United States". *The financial crisis inquiry report*, 2011.
[33] *Ibid.*

The crux of credit derivatives consists of a bilateral contract that allows the seller to limit the risk of a certain underlying asset by sharing or selling the applicable liability. Normally, said liability is transferred from one party to the other without the transfer of the actual underlying asset. One example of credit derivatives is the trade of mortgages. When one bank is afraid that the debtor will be insolvent or otherwise unable to pay-off their loan, they may try to spread or sell said mortgage to other parties as to ensure their (partial) investment return. Another type of credit derivative is the forward contract. This contract is an arrangement between two parties that obligates one to sell an asset to the other at a specified price on a specific future date. Moreover, the underlying asset of a forward contract derivative may include any commodity and amount without restrictions.

Essentially, investment banks can be seen as a middleman in the financial world that deals with the securities of large markets and corporations thereby creating the possibility of devaluation or overvaluation of securities. However, at the same time they are liable to the same risks that commercial banks have. In particular when the value of their liabilities exceeds that of their assets, so that their net worth is negative. The financial stake of the bank's equity shareholders is wiped out and the unsecured creditors, who have not managed to run, share in the remaining losses according to their legal priority, thus creating a bank-run on a large scale involving important publicly owned institutions or other banks.[34]

Financial Stability Board

The danger of overvaluation and devaluation of certain assets has been made clear in the global financial crisis of 2007-2009 (GFC). During the period before the GFC, the US housing market got overvalued due to the rigorous trading in mortgage-backed securities.[35] Eventually, this led to a financial bubble which ultimately collapsed causing one of the biggest financial crises witnessed in the modern era. Partially in response to that, the Financial Stability Board (FSB) was erected in 2009.[36]

It's predecessor, the Financial Stability Forum (FSF), was founded in 1999 by the G7 Finance ministers and Central Bank Governors.[37] The goal was to enhance cooperation

[34] Kaufman, George G. "Banking and Public Policy: Too Big To Fail". *Economic Inquiry* 53; issue 1 (2015), p. 2.
[35] *Ibid*.
[36] Downs, A. *Real Estate and the Financial Crisis: How Turmoil in the Capital markets is Restructuring Real Estate Financing*. Washington: Urban Land Institute, 2009.
[37] Financial Stability Board. "Our History". http://www.fsb.org/about/history retrieved 3/6/2018.

among the various national and international supervisory bodies and international financial institutions so as to promote stability in the international financial system.[38] However, the GFC showed the international community that this forum lacked the mandate and efficacy in order to fully realise a strong and stable financial system. Therefore, in November 2008, the leaders of the G20 countries called for a larger membership of the FSF. A broad consensus emerged in the following months towards placing the FSF on stronger institutional ground with an expanded membership in order to strengthen its effectiveness as a mechanism for national authorities, standard setting bodies and international financial institutions to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability.[39] In the end, this led to the establishment of the FSB in April 2009, which assumed a key role in promoting the reform of international financial regulation. In 2012 the Heads of State and government of the G20 endorsed the FSB's restated and amended Charter which reinforced certain elements of its mandate, including its role in standard setting and in promoting Members' implementation of international standards and agreed G20 and FSB commitments and policy recommendations.[40]

Defining Too Big To Fail

It seems clear that certain aspects of investment banking and the capitalistic free market have created a problem which significantly influences the financial markets. Some causes of said issues have been discussed briefly. Nonetheless, the question still remains as to what the causes precisely are of TBTF and the possible consequences when a bank becomes too big to fail.

Causes

In order to fully understand the causes of TBTF, it seems preferable to view this issue from a retrospective stance. Analyzing what classifies as a TBTF bank and understanding how they came to be, might give more insight into the causes.

[38] Financial Stability Board. "Our History". http://www.fsb.org/about/history retrieved 3/6/2018.
[39] *Ibid.*
[40] *Ibid.*

Capitalism

First off, capitalism needs to be discussed so as to understand why TBTF banks mostly originate in free markets. Basically, capitalism is defined as an economic market system in which every financial decision is made by individuals and private owners, and where prices and the distribution of goods and services is determined mainly through competition without state intervention.

The reason why TBTF banks mainly exist in free capitalistic economies is mostly due to the fact that through state intervention, banks are often regulated to such a degree that they can't default despite being a TBTF bank. For example, the banks in Europe in the late 20th century were heavily concentrated in a free market economy very similar to the essence of capitalism. However, these banks were heavily regulated and viewed more as a public utility before the liberalisation and decentralization wave that swept Europe in the 1980's.[41] Yet, these banks were not scrutinized through insolvency laws or any other regulations. It was simply assumed that heavily regulated banks, despite the free market and their position within it, were simply unable to fail.[42]

The preposition that heavily regulated banks won't become TBTF held true in principle, especially when banks are more considered as a public utility. Such is the case in China and The Russian Federation, their banks can simply not be compared to banks in capitalistic market economies, since the distinguishing features of a public utility is that they are heavily state regulated and as such have less room for experiments that could lead to failure.

The Origin of TBTF

In the US, one of the first cases of TBTF came into view as the Bank of Illinois, which defaulted in 1984.[43] The US spent around $4.5 billion to bail-out the bank. This specific incident has been viewed as the first case of TBTF since the US Congress reported that "the federal government won't currently allow any of the nation's 11 largest banks to

[41] Barth, James R., Wihlbourg, Clas. "Too Big To Fail and Too Big To Save: Dilemmas for Banking Reform". *National Institute Economic Review* 235; issue 1 (2016), p. 29.
[42] *Ibid.*
[43] Kazandjieva-Yordanova, Irina Petkova. "Does the Too Big To Fail doctrine have a future?". *Economic alternatives* 2017; issue 1, p. 52.

fail."[44] In essence, this meant that the government created a new category of institutions within their country. A corporation which was too significant and too big to fail.[45]

Differential Treatment

The differential treatment of large banks has been formalised in the designation of banks as globally systemically important banks (G-SIBs) and a larger number of systemically important financial institutions (SIFIs).[46] These designations have implications for their regulation and supervision, as well as for the degree to which these financial institutions may enjoy implicit subsidies.[47] Additionally, the systemically important banks and institutions have the tendency to receive higher credit ratings that represent the possible government support that they may receive in cases of difficulty.[48] One of the results of such a differential treatment is that these larger banks generally have less trouble raising funds at a lower price on the capital market than smaller banks.[49]

Financial Safety Net

During the GFC the TBTF issue raised the necessity of reconsidering the role of the financial safety net, especially the deposit insurance. At heart, the financial safety net is an emergency fund set aside in case of the event of a financial dilemma, with the purpose of improving financial security. The deposit insurance, which stems from the safety net, ensures depositors that their assets will be secure up to a certain amount. This policy was brought in to existence as to prevent bank runs which happened in the past. Nonetheless, despite good intentions, the financial safety net encouraged banks and depositors to take more risk since this net provided guarantees for certain depositors that they would receive back their investment up to a certain amount and within a certain period of time.[50]

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[44] Barth, James R., Wihlbourg, Clas. "Too Big To Fail and Too Big To Save: Dilemmas for Banking Reform". *National Institute Economic Review* 235; issue 1 (2016), p. 29.
[45] *Ibid.*
[46] Kazandjieva-Yordanova, Irina Petkova. "Does the Too Big To Fail doctrine have a future?". *Economic alternatives* 2017; issue 1, p. 52.
[47] *Ibid.*
[48] *Ibid.*
[49] *Ibid.*
[50] Kazandjieva-Yordanova, Irina Petkova. "Does the Too Big To Fail doctrine have a future?". *Economic alternatives* 2017; issue 1, p. 52.

Increased Complexity

Furthermore, SIFIs generally have complex organizational structures and operate cross-border both nationally and internationally. Due to these circumstances many of these banks are subject to different legal and regulatory jurisdictions.[51] Other aspects which increases the complexity of SIFIs is a further lack of consistency between legal, functional and financial organisation within the bank.[52] Most banks are organized in such a way that they have little semblance to the legal organization behind it, thereby increasing the complexity of the valuation and identification of defaulting assets and liabilities.[53] When such a component of a bank fails, it not only takes a long time to identify the responsible element, but the failing segment usually also partakes in a large number of different domestic and foreign legal entities.[54] Moreover, ordinarily there exists a certain amount of financial complexity within SIFIs with regards to funding, debt allocation and equity. This is mainly because it is divided between the parent cooperation and amongst all the separate entities.[55] This results in the fact that if one functional entity becomes insolvent, default proceedings will most likely drag other subsidiaries with it. Also, the financial complexity present in SIFIs can be a source of financial contagion between its own separate legal entities.[56] To illustrate, most SIFIs in the US and Europe are legally organised in hundreds, sometimes thousands, of legally separate subsidiaries with little resemblance to the functional organisation.[57]

The consequences of TBTF

Ultimately, most of us are more interested in the possible consequences of TBTF. Despite the necessity to understand the causes of TBTF in order to form a comprehensive solution to the issue, it is the effects of TBTF that influence the financial market and sovereignties. An institution that is simply very big, does not necessitate a solution unless it has negative foreseeable consequences.

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51 Kaufman, George G. “Banking and Public Policy: Too Big To Fail”. *Economic Inquiry* 53; issue 1 (2015), p. 3.
52 Carmassi, J., Herring, R.J. “Living wills and cross-border resolution of systemically important banks”, *Journal of Financial Economic Policy* 5 (2013), no. 4, p. 368.
53 *Ibid.*
54 *Ibid.*
55 *Ibid.*
56 *Ibid.*
57 Barth, James R., Wihlbourg, Clas. “Too Big To Fail and Too Big To Save: Dilemmas for Banking Reform”. *National Institute Economic Review* 235; issue 1 (2016), p. 31.

Unfair Market Position

One of the major problems generated by banks being TBTF is that competition between banks of different sizes and degrees of complexity become distorted. If the non-insured creditors of some banks perceive that these banks are less likely to fail than other banks, the costs of funding for the relatively safe banks become relatively low.

Furthermore, the existence of a TBTF doctrine creates competitive advantages for the banks which are too big to fail. The TBTF doctrine and classification itself stimulate the existence of informal guarantees for depositors and investors that a bank is going to be saved when it experiences financial difficulties which may lead to its bankruptcy.[58] One of the consequences when a bank is determined as TBTF is morally hazardous risk taking. When a bank feels that their assets and depositors will be protected, regardless of their investments, they tend to spend more on high-risk/high-reward investments.[59]

As such, the TBTF doctrine implies an implicit subsidy, which may result in the fact that banks gain a strong incentive to achieve sufficient size and/or complexity to actually enjoy this competitive advantage.[60] This takes place, among others, when SIFIs and G-SIBs concentrate large amounts of deposits above the insured level within themselves.[61]

Bailout and Banking Resolution

One of the more common approaches to the TBTF dilemma when banks default has been the bail-out. In such cases banks are rescued from insolvency through the injection of sufficient capital by the government to maintain or restore positive net worth. Such a bailout generally takes the form of preferred stock and of implicit capital in the form of guarantees of depositor and creditor claims. Normally in these cases losses accrue to any party but shareholders.[62] This can be seen, among others, during the GFC when the European Central Bank and the US Federal Reserve bailed-out several institutions by buying for more than $1.5

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[58] Kazandjieva-Yordanova, Irina Petkova. “Does the Too Big To Fail doctrine have a future?”. *Economic alternatives* 2017; issue 1, p. 51.
[59] FSB (Financial Stability Board). 2010. “Reducing the moral hazard posed by systemically important financial institutions.”, *FSB Recommendations and Time Lines*.
[60] Barth, James R., Wihlbourg, Clas. “Too Big To Fail and Too Big To Save: Dilemmas for Banking Reform”. *National Institute Economic Review* 235; issue 1 (2016), p. 28.
[61] Kazandjieva-Yordanova, Irina Petkova. “Does the Too Big To Fail doctrine have a future?”. *Economic alternatives* 2017; issue 1, p. 52.
[62] Kaufman, George G. “Banking and Public Policy: Too Big To Fail”. *Economic Inquiry* 53; issue 1 (2015), p. 3.

trillion in newly issued stock from their most preeminent banks.[63] This process falls largely under the concept of a bailout, where the firm is failed but some or all creditors and stakeholders may receive (partial) loss compensation. Loss allocation is not determined by the usual rules. The difference between the amount paid to creditors at resolution and the corresponding lesser pro-rata recovery amount received is the loss funded by a third party, for example, the government.[64] Notably, the majority of bailouts in the US were completely unconditional.[65]

Another possibility with insolvency is that certain banks are still permitted to continue to operate despite their default, also known as the bank resolution. In such cases the bank is restructured by a resolution authority through the use of resolution tools. This is commonly executed in a careful and controlled manner, so as to ensure the critical functions of the bank are continued and that its customers retain access to payment services and their deposits. Finally, banking resolutions aim to prevent other banks from collapsing.

Financial Destabilization

The greatest consequence, however, associated with a too big to fail default is that it creates a link between bank risk and sovereign risk. The fiscal costs of bailing out a large bank can be enormous and, thereby, contribute to a country's fiscal crisis. For example, the fiscal cost of injecting capital in the Anglo-Irish bank in Ireland in 2009 amounted to 35% of Ireland's GDP. Bank rescues in Spain in 2011 similarly significantly contributed to the debt crisis in that country.[66] Moreover, the fiscal and political costs associated with bank bailouts during the financial crisis from 2007 to 2009 and the euro debt crisis thereafter may suggest that the large banks in many countries are not only too big to fail but might even be too big to save for certain countries.[67] A good example of this can be found in the Icelandic banking crisis in 2009. At that time, Iceland simply did not have the financial resources to rescue three banks with large international operations, which eventually led to their insolvency.[68] Thus, it

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[63] Langley, Paul. *Liquidity Lost: The Governance of the Global Financial Crisis*. Oxford: Oxford University Press, 2015.
[64] Kaufman, George G. "Banking and Public Policy: Too Big To Fail". *Economic Inquiry* 53; issue 1 (2015), p. 2.
[65] Kazandjieva-Yordanova, Irina Petkova. "Does the Too Big To Fail doctrine have a future?". *Economic alternatives* 2017; issue 1, p. 52.
[66] Langley, Paul. *Liquidity Lost: The Governance of the Global Financial Crisis*. Oxford: Oxford University Press, 2015.
[67] *Ibid.*
[68] *Ibid.*

seems clear that a TBTF default can have an humongous impact on the financial stability of a sovereignty.

Too Big To Fail Policies

As can be seen above, TBTF banks and possible defaults can have major consequences. However, an important question remains as to what countries and organizations can do in order to prevent such cataclysmic events. In order to evaluate the most relevant policies revolving around TBTF the US and the EU shall be discussed next, bearing in mind that a TBTF bank default most likely will only occur in capitalistic free markets. This means that several economic powerhouses may be excluded simply because the TBTF issue applies less to their domestic financial system. Another important player which involves policy making is the IMF. They are seen as an international organization specialized in finances and therefore often give analysis and advices regarding financial stability and the financial markets.

The US

First off, the US needs to be discussed seeing how it's the biggest economy in the world. Also, nowadays it's common knowledge that the GFC of 2007-2009 originated in the US and just like the great depression in the 1930's, the US lawmakers responded, among others, through policy making. Yet, the US has always been a strong proponent of a free capitalistic market, which per definition does not allow much meddling by the state. Nonetheless, several legislative acts were introduced with regards to TBTF. One of the oldest and biggest one was the banking act of 1933, also known as the Glass-Steagall act. One of the pillars of this measure was the creation of the deposit insurance. Just like stated in the paragraph regarding the financial security net, this insurance provided a certain protection to depositors of their assets within financial institutions. Moreover, this piece of legislation introduced the Federal Deposit Insurance Corporation, which was responsible for providing the funds for said deposit insurance. Additionally, the banking act posed several restrictions on speculative banking and separated investment banking from commercial banking. All these measures had the objective of protecting consumers and preventing another bank-run.[69] Advocates of this act portrayed the following years as the most stable banking period in US history until its repeal in 1999.[70]

Another enormous legislative reform regarding TBTF banks was the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This act was signed in response to the GFC by the former president Barack Obama. The essence of this act entails restrictions on investment and speculative banking, thereby increasing consumer protection and financial stability. One of these measures was the enactment of the Consumer Financial Protection Bureau, which has federal regulatory jurisdiction over, among others, banks. Nonetheless, currently within congress there are plans to revise this act through a less invasive banking regulation, namely the Financial CHOICE act. Thus, the question remains where the US is headed with regards to the oversight and regulation of SIFIs.

The EU

Outside of the US several other financial reforms have taken place. Especially, since the GFC, the EU has included the implementation of special procedures for bank resolution, with the intention to addressing the TBTF problem as well.[71] One of such reforms was the implementation of the bank recovery and resolution directive in 2014.[72] After it's transposition in 2015 by the member states, they were obligated to first go through a resolution before any other interventions should be considered for defaulting SIFIs.[73]

Furthermore, in the EU other measures were initiated in the field of supervision, implementation of requirements for minimum required eligible liabilities and total loss absorbing capacity (TLAC) for the SIFIs. Other measures were the initiated reforms regarding the bank's structure and the creation of a structure for a stronger deposit insurance scheme to mitigate the TBTF issues by making SIFIs more stable, transparent, resolvable and less complex.[74] These regulations reduced the probability of bailing out SIFIs due to the

[69] Moss, David. "An ounce of Prevention: Financial Regulation, Moral Hazard and the End of Too Big to Fail". *Harvard Magazine* 26 (2009).
[70] *Ibid.*
[71] Barth, James R., Wihlbourg, Clas. "Too Big To Fail and Too Big To Save: Dilemmas for Banking Reform". *National Institute Economic Review* 235; issue 1 (2016), p. 28.
[72] Kazandjieva-Yordanova, Irina Petkova. "Does the Too Big To Fail doctrine have a future?". *Economic alternatives* 2017; issue 1, p. 53.
[73] *Ibid.*
[74] Kazandjieva-Yordanova, Irina Petkova. "Does the Too Big To Fail doctrine have a future?". *Economic alternatives* 2017; issue 1, p. 52.

stronger banking supervision, increased TLACs of those banks, decreased complexity in their structure and the creation of a stronger deposit insurance scheme on European level. Such measures contribute to alleviating the possible risks and the moral hazards which are associated with the default of SIFIs. They also provide policy makers with more options except the bail-out of systemically important banks with public funds.[75]

Other measures were the tremendous amount of regulatory frameworks in the field of banking such as the CRD IV package, the new Deposit Insurance Directive as well as the proposal for the creation of an European deposit insurance scheme.[76] Such measures provide more options for the policy-makers when a SIFI experiences serious financial difficulties.

The IMF

The last important player with regards to policy making for the TBTF issue is the IMF. An important competence of the IMF is giving advice on policy making and establishing well documented reports. In the report regarding the financial stability after the GFC, they signaled that one of the causes of the GFC was that "regulation, supervision, and resolution frameworks and bank risk-management systems did not keep up with the changes on the financial market".[77] Furthermore, the IMF emphasized the need for policy changes and increased regulation with regards to the TBTF issue.[78] The most important recommendations the IMF made with regards to policy making concerning the TBTF issue were[79]:

- curbing the ability of financial institutions to become SIFIs by restricting size, structure and the scope of their activities;
- lowering the probability of SIFI failures through enhanced regulatory and supervisory requirements;
- reducing the cost and impact of SIFI failures by enhancing resolvability.

<u>Possible solutions</u>

When thinking of possible solutions to the TBTF issue, one must keep the aforementioned causes of TBTF in mind. Also of importance is the policies implemented by

[75] *Ibid.*
[76] *Ibid.*
[77] IMF (2011). "The Too Important to Fail Conundrum: Impossible to Ignore and Difficult to Resolve", p. 3.
[78] *Ibid.*
[79] *Ibid.*

the world's biggest free markets in the past and the suggestions made by the IMF. Especially, the advices with regards to possible policy making solutions for the TBTF issue from the IMF have significant value, due to their international focus. The most important and usable categories when considering possible solutions are legislation, increased oversight and the decrease of size and complexity of TBTF banks.

Legislation

If a sovereignty is considering legislation with the goal of curbing the TBTF issue, several facets should be kept in mind. First off all, the most important aspect that must be implemented are increased regulations especially when considering the need for more stringent legislation regarding the size and complexity of SIFIs. Also, preventing SIFIs from investing in speculative markets and high risk assets will probably have a significant impact on the possibility of a default of a SIFIs. Furthermore, several enacted measures such as the Glass-Steagall act and the legislatory packages of the EU seem thus far to have a positive outcome on the TBTF issue. Analyzing and considering the aspects of past legislation which played an important part in financial stability, generally provides a good starting point for future legislation.

Oversight

Another important facet of overcoming the TBTF issue has been proper oversight. As mentioned before, evaluating and regulating SIFIs is often very difficult due to the scope of the organizations and their complexity. Therefore, it is of utmost importance that adequate oversight must be in place, so that a proper analysis and supervision can take place. This not only increases the transparency but it also enhances the possibility of better and more specialized legislation and regulation.

The Big Break

One of the final suggested measures to tackle the TBTF issue has been the stimulation of SIFIs to reduce in size and complexity. Not only is this considered preferable but it also makes it more practical for other measures, with regards to the surveillance of SIFIs. One possible solution is dividing the assets of a SIFI into manageable sizes and into homogenous jurisdictions. Also, by decreasing the size and complexity of such an organization, the risk of contagion within a SIFI and internationally becomes much less significant.

Conclusion

Concluding, the global financial crisis of 2007-2009 was one of the worst recessions ever to hit the world economy. It affected every aspect of the economy in almost every country around the world. Yet, the causes of this crisis were rooted in aspects which were often known to lawmakers. One of these causes was the differential treatment most sovereignties held towards financial institutions of different sizes. Furthermore, the fact that many of these governments provided a financial safety net gave the SIFIs the discretion to invest in riskier assets thereby increasing the chances of a default. Lastly, the increased complexity of many SIFIs caused the lack of oversight and the speed of contagion during the last financial crisis.

All of this eventually led to an unfair market position for SIFIs. Moreover, due to their significance many of the defaulting SIFIs were bailed-out with the taxpayers money. Because of the high costs and the degree of interdependence and interconnectedness of financial institutions and the world economy, this eventually led to the destabilization of the financial markets of the world.

In order to curtail the consequences of defaulting SIFIs several measures and regulations were put in place. Yet, most of these are relatively new and take a long time to implement, thus the effect of many of them are still unknown. However, within the literature many economists suggest that the most effective ways of curbing a SIFIs default on the financial stability is through better legislation, increased oversight and the decrease of the size and complexity of SIFIs.

Hopefully, if all these considerations are taken into practice, the future of the financial market might not be so fragile, so that in the end everyone can enjoy a stable and booming economy.

Questions A Resolution Must Answer

1. Is it preferable to reduce speculative investments?
2. How can you decrease the size and complexity of SIFIs?
3. What is the best way to deal with the unfair market position of SIFIs?
4. What is the best way to keep oversight within several sovereignties?
5. How do you prevent contagion within a SIFI and Internationally?
6. Is there a way to protect the financial stability when a SIFI defaults?

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