A REVIEW OF FINANCIAL REGULATIONS TO AVOID THE NATIONALISATION OF LOSSES IN THE BANKING SYSTEM

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ABSTRACT: *This article investigates the regulations which should be applied in the financial system in order to minimize the losses. The subject is based on the banking policy of "privatisation of profits and nationalisation of losses" and it is debated mainly from trade articles point of view. Even when taxpayers do not agree, governments choose either to bailout influential banks or to cover their losses with a deposit insurance. Banks would take advantage of any opportunity to increase earnings, even in the insolvency stage, and thus certain regulations and limitations must be provided to minimize the moral hazard occurred. The most important problem that deepens financial regressions relates to the losses spillover effect on the worldwide economy, and although a perfect global banking model cannot be implemented, the paper suggests regulations which improve the financial systems.*

KEY WORDS: *profit privatization; losses nationalization; financial crisis; liberalization; recapitalization; financial regulations.*

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1. INTRODUCTION

The current banking crisis is very similar to past crises, as it started when the lending process was too superficial and did not provide any coverage. The significant difference is that the problem began in one of the most secure markets and it spread quickly all over the world. Nowadays, the worldwide question is whether the banks should be saved or not. The economic system stimulated banks through an unsuitable policy based on the privatisation of profits and nationalisation of losses.

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The aim of this paper is to find regulations to avoid future nationalisation of losses during crises. Such regulations and limitations depend on bank deficiencies and include factors such as capital, risk, liberalisation or transparency.

2. BANK PERFORMANCE AND PROFIT SHARING

Entrepreneurs performance represents the driving factor behind investment banking, and they share the profits, but not the losses. Bankers save bonuses while losses accumulate, inducing a financial crisis for whom nobody can be held responsible. Unfortunately, the claim back resolution is not a recovery solution (Taleb, 2009).

Smith and Watts (1992) argued that incentive compensation is practiced more in organisations with continuous development, and that growth is expected in banking firms more than in non-financial companies. On one hand, compensation does not depend on firm performance in restricted and controlled systems. On the other hand, in unrestrained industries, compensation is overburdened, and it is kept secret through management discretion.

Hubbard and Palia (1995) summarized the payment structure dependent on the economic environment. Organisation should have a well established regulation system with remuneration based on performance. When a bank deals with low level of risk, pay figures are lower as well. However, when the environment has a high level of risk, remuneration is higher. Therefore, managers prefer to keep safe contracts and low sensitivity between performance and risk. The shareholders' interests need to support managerial bonuses, because when executive officers are not satisfied with their payments, the effectiveness may decrease. The equilibrium can be found when the shareholders maximize their wealth, while managers are fully protected from risky actions.

Remuneration system and shareholders' large amount of bonuses have been the main problems related to banks for a long time. During financial crisis, although banks registered increasing losses on their balance sheets, managers wanted to raise the bonus pools. For example, at the beginning of 2008, Morgan Stanley declared $9.4 billions losses for the last quarter, but increased its bonuses with 18% for the reason that employees should not suffer from the subprime market mistakes. It was discovered that managers had shared bonuses incorrectly, and the previous years amount was higher than the limit. Unless the explanations were plausible, the firm had to return the supplementary money and reconsider the bonus pool. Therefore, the compensation practices may deepen the financial crisis (Rajan, 2008).

John Thain, the former chief executive of Merrill Lynch, described bonuses as a "reward talent" and a key element for market liberalisation, but not a way to enrich bankers while their bank fails (Taleb, 2009). Besides the basic role of achievements reward, bonuses are supplemental revenues for managerial positions, and this second use is rapidly expanding. Also used for motivation, bonuses are claimed to be a fundamental incentive system.

Liang (1989) studied profits and their connection with market concentration and risks. Empirical studies demonstrated a close link between risk and profits. Higher profits involve higher risks and therefore a series of supplementary costs, like higher payments to compensate the risk taken by investors with risk aversion. A second important link between the level of concentration and profits was discovered through the fact that banks obtain higher profits in concentrated markets because the environment implies less risk. This idea is known as the "quiet-life" theory and it suggests that "firms in concentrated markets have low ratio of profit variability to expected profits" (Liang, 1989, pp.297). The relationship between risk and profits is usually a direct one, as risk averse entrepreneurs may choose loans with low rates, but the profit rate expected is lower as well. A negative risk-profit relation occurs when losses follow banking actions and managers need to liquidate capital in order to pay debts. In this case, a higher risk implies a decrease in the bank profits. When the transparency of information is high, Houston and James (1995) observed that shareholders might constrain managers to take risks to gain more, but the risk averse managers would act only if they are protected with high compensation.

Over time, bankers took advantage of the system deficiencies in order to increase their profits. Even if high risk was involved, banks bet for their earnings, and in the unfortunate situation of insolvency, they waited to be rescued by the state.

3. BANKING ACTIONS WHICH DETERIORATE THE FINANCIAL SYSTEM

The following section will refer to banking issues, which deteriorate the financial situation and increase the losses.

3.1. Insolvency stage

Since the beginning of the twentieth century, the United States have been confronting with constant bank failures due to the lack of diversification. The majority of banks were unit banks, established as one office only. Recently, the banks go down for much more complicated reasons. When loan portfolios are too concentrated, negative results in bank balances may appear, but central bank governors do not realise the problems in the incipient phase as banks are opaque. For this reason, in 1990s, the US crisis reached shortly $150 billions from loans and savings and the losses were already too big when the authorities realized the situation.

In his paper, Lastra (2008) summarised the British law for bank insolvency. Over the last months of 2007, The Northern Rock Bank received help consisting of liquidity assistance, deposits guarantee and nationalisation. The support given was not enough to recover, and thus the authorities started the insolvency procedure based on the Special Resolution Regime (SRR). The objectives of SRR were "financial stability, minimization of costs in the light of public interest considerations […] the protection of the confidence in the banking system" (Lastra, 2008, pp.169). An important thing to consider when a bank is legally insolvent is the contagion effect on other organisations. The losses will have an effect on shareholders and government, creditors or insurance companies, and this transforms insolvency into an issue of public interest.

3.2. Deposit insurance

Mayes (2005) described a black hole created when the process of bad lending leads to "largely valueless assets and a major contingent liability" (Mayes, 2005, pp.162). The author analysed the bank insolvency in transition countries and found out that some governments could not help troubled banks due to the lack of resources. This is the reason why banks tend to be small and choose not to diversify risk. It is important for banks to invest in a deposit insurance fund, which covers possible losses, otherwise, the insolvency process is the only situation considered. The security blanket of deposit insurance would increase depositors and creditors trust in bank and it would diminish the uncertainty and risk to be bailed out in case of bankruptcy. Usually, if individual banks deal with bankruptcy, the government would not try to help them. However, if many banks are endangered at the same time, public authorities have to support them. If some banks turn out to be indispensable, this high level of concentration may become a disadvantage of the banking system. This means that any changes in the policy of the bank will affect the rest of the system. This spillover effect is known as the "too big to fail" feature of banks.

Kaufman (2004) agreed on the importance of deposit insurance and analysed the activity of the Federal Deposit Insurance Corporation (FDIC) since 1980. The deposit insurance was defined as a government aid, which guarantees in general all the obligations of large and influential financial companies. When deposits and other debts are above the assets of a bank, the capital becomes negative and the bank is considered to fail. FDIC is a federal government agency and when the losses of a bank surpass its reserves and other supplemental revenues, additional help is required from government and taxpayers. The author understood that in case of insolvency the most important thing is to minimize losses because "it is the losses from bank failures more than the bank failures themselves that are most damaging to both most stakeholders of the failed banks and the FDIC" (Kaufman, 2004, pp.13). Walter (2005) stated in his work that FDIC first started insuring the deposit just before 1934 and it was created because the banking failure in the US was contagious. Before the FDIC existed, the depositors always checked their bank activity and in case of vulnerability signs, they withdrew their deposits. This way, the American government was always conscious of the banking activities. Once the FDIC started its activity, clients ceased to monitor their banks due to a feeling of protection. Unless they were insured, the most troubled and risky banks would have failed or had to pay higher interest rates to depositors.

The bank guarantee is very similar to deposit insurance, protecting the banks and their lenders from potential losses. During the 1990s crisis in Sweden, no bank reached the bankruptcy stage because the government decided to help all of them. It was considered that a large number of banks collapsing at the same time would greatly affect the system stability. Market players needed assurance for their activities; hence, to maintain confidence in the banking system, public authorities undertook a general bank guarantee. This way, the process of lending to banks is risk-free and taxpayers are the only ones to pay the price of guarantees. In the future, strict regulations must be applied, as the moral hazard is most probable to arise (Viotti, 2000).

3.3. Moral hazard

Newman (2004) considered that moral hazard represents the selection between risk sharing and incentives. Moral hazard raises both market players' fortune and their risk bearing. No matter what the necessary effort level is, operations governed by moral hazard imply more risk. Wealthy customers do not usually perform in these conditions if they consider that the risk exceeds the effort. Therefore, it is presumed that the moral hazard in case of risk aversion generates risk aversion for the wealthy players while the poorer become risk-takers. Banerji and Van Long (2007) disagreed with this idea and considered that in a market suspected of moral hazard, only intermediate individuals would take actions, whereas the wealthier and poorer would not take any risk in lending procedures.

When the deposit insurance is not efficient, the financial component of the system is jeopardized. The deposit insurance is designed to cover small depositors' potential losses and to limit the banks' risky behaviour. The price of deposit insurance has a big impact on banks' behaviour and consequently when banks are not charged for their hazardous actions, the government will be held responsible and forced to lavish them. Moral hazard is reluctant to solutions that include government bailout or other public resources' contribution. Sometimes the system disorders may be the cause of a political abuse, which happens when the state invests money from general budget to keep banks afloat and avoid their bankruptcy (Beck, 2003).

Hellmann, et al. (2000) analysed the moral hazard induced by the security blanket and argued that regardless of the deposit insurance forms, during financial crisis a bailout would be necessary. The authors explained how state bailout encourages banks to "gamble on resurrection", a possible action when depositors cease to monitor their bank activity. The gamble consists in creating a bank portfolio with risky assets in hope of increasing earnings; if the bet fails, customers and insurers will incur the losses. The solution for this problem is to find the Pareto-efficient equilibrium, which assumes an equal quantity of gambling and smart assets. The Pareto limit is not usually met because banks destabilise one another, creating the market-stealing effect. When banks want to raise the market share, they practice the same interest rates as their competitors, but they buy safe assets. On the other hand, if they want to raise their profits through gambling, banks should attract deposits hence practice a higher interest rate. To attract customers and overcome the competitors' market share, the first choice for banks is to raise the deposit rate. One of the causes of this fierce competition is the liberalisation of the banking system.

3.4. Liberalisation process

The process of liberalisation diminishes systems barriers, by opening the market for foreign banks or reducing the interest rates. Banks become more flexible when influenced by strong competition, and the market stealing effect grows, as a potential crisis deepens (Hellmann, et al., 2000). A cause-effect relationship between liberalisation and financial crises is proved by major losses consisting of non-performing loans and foreign debts. In the liberalisation process, banks with negative net worth were allowed to get short-term loans and gamble for recovery. The government encouraged the international loans by keeping their costs at very low level and ensuring no consistent currency depreciation. The authorities permitted this loan process with no supplementary regulations or guarantees of risk management. The liberalisation process is essential for government, as it avoids entrepreneurs' monopole by building new institutions which connect the state with key businesses. Additionally, the international market failed on monitoring this short-term lending, and could not resist the market pressure, so it pressured small financial markets to open. Therefore, liberalisation is the result of political pressures from both domestic and foreign countries.

3.5. Political interests

Besides problems of political interest such as banks bailout and liberalisation, Sapienza (2009) stated in his work that state-owned banks usually practice lower interest rates than private banks because the political party associated with the bank has greater impact on the lending process. Sapienza conducted a research in Italy and found out that state-owned banks give rates with 44 basis points less than the private ones. The difference between interest rates has either social or political causes. The social view considers that these banks have lower costs, and they are more efficient. The political view considers that state-owned banks help firms which cannot take a loan because this is too expensive or difficult. The author considered that "both the social and political views would support the fact that state-owned banks apply higher discounts in southern Italy, which is poorer and characterized by widespread political patronage" (Sapienza, 2009, pp.380).

3.6. Information transparency

Information clarity in the financial system is compulsory, as a disciplined market permits its investors to access all the information related to organisations, and it offers investors the possibility of influencing the managerial actions. When a market is monitored it emits signals, which are captured by the managers, and this way it occurs the process of influencing: when signals are positive, the investors are satisfied with the market; otherwise, if managers are advised to make changes in their organisation, the signals are negative. Moreover, when authorities rule a laissez-faire policy in the financial system, banks are not monitored. Therefore, they will try to disguise "the amount of bad debt on their balance sheet by rolling over and rescheduling loans that are in default" (Corbett &Mitchell, 1999, pp.2). This asymmetric information is always discovered during financial crises, when banks gradually disclose their bad debts, aggravating the banking sector problems.

3.7. Recapitalisation

Chandrasekhar (2009) considered banks are the key element in the financial sector, as they represent the principal depositary institutions. In 1950 bank activity covered more than 80% of the financial system. The first operations to be considered by a government in case of a financial system failure are "guaranteeing deposits, providing refinance against toxic assets and pumping in preference capital" (Chandrasekhar, 2009, pp.1). Toxic assets may incur losses which are so big that banks need to accept insolvency. These assets have low prices and banks are constraint to eliminate them in order to continue operating. Governments protect banks from the bad assets losses by injecting capital into them. This process, known as nationalisation or recapitalisation, "prevents the spread of fear and uncertainty among creditors or investors in the liabilities of banks, such as insurance and pension funds" (Chandrasekhar, 2009, pp.7). A way to infuse capital is by investing in senior preferred stocks and retrieve warrants. This way, the government has the right to buy common stocks at a price set in advance. A recapitalisation strategy should be accompanied by an insurance policy to control any losses from contaminated assets.

To increase banks assets, government may also allocate bonds, which compensate the liabilities of insolvent banks or represent new equity. Bonds can also be offered to the central bank, as a reward for helping commercial banks. Nevertheless, this second support reduces the commercial banks' liabilities.

4. AN EXAMPLE OF GOVERNMENT HELP DURING THE ACTUAL FINANCIAL CRISIS

During this financial crisis, banks considered "too big to fail" asked for help, but the American government refused to stabilise all of them. International Monetary Fund declared in January the sum of $2.2 trillions for toxic assets in the United States, an amount that rose with $0.8 trillion in two months. The domino effect created after the collapse of a particular organisation depends not so much on the firm's size, but on its role in the market on that specific time. Therefore, the government helped Fannie Mae and Freddie Mac because the bank supported 80% of the new mortgages and the process either continues or the housing market would be in even more difficulty. Their holders kept $5.4 trillions in bonds, which needed to be reassured. Otherwise, Freddie and Fannie would have increased the mortgage interest rates or even reduce the mortgages loans. If government would not have get involved in Freddie and Fannie situation, lower estate prices would affect the fiscal position deepening the recession. By August 2009, the government promised to keep Fannie Mae and Freddie Mac solvent. At that time, Fannie stated its losses for the second quarter – $14.8 billions – and asked for $10.6 billions more. Freddie had $64 billions of net losses since 2007 and used $50 billions from the government aid (Scholtes, 2009). At the end of the same month, the shares of the two companies "burst into flames" because the US housing market stabilised and the short sellers bought shares to minimize their losses (Stacey &Scholtes, 2009). At the beginning of November, Fannie Mae declared $19.8 billions loss, the ninth consecutive deficient quarter and said that even more is expected. The company said it needs another $15 billions, but the Treasury did not agree because the effect on tax receipts would have been too big compared to Fannie results.

Lehman Brothers was the fourth largest investment bank in the United States but its "too big to fail" characteristic did not save it from the collapse. Its biggest loss during crisis came from the property-related investments, which included sub-prime mortgages. Lehman tried to get help from the US government or to find a buyer, but investors and trading partners were leaving, although Lehman presented a last minute restructuring plan (Wearden, et al., 2008). Worldwide, the firm had 26,000 employees endangered to loose their job. Its shares fell dramatically in seven months, from $66 in February to $3.65 in September. The dollar lost power to both Euro and Yen and the systems needed to stabilise the markets hence the European Central Bank injected €30 billions and the Bank of England £5 billions. On September 15, Lehman was urged to fill the chapter of the Bankruptcy Code and create a plan to pay its creditors. In six months, Lehman lost $6.7 billions, the assets were continually decreasing, and its debts were more than $600 billions The British Financial Services Authority refused "to import the cancer" even in the possibility of a buyer, like Barclays (Ferguson, 2009). Six months before Lehman collapsed, Bear Stearns faced similar facts, but the Treasury Department intervened. However, the US government saved Bear Stearns not because it was "too big to fail", but too inter-connected for a sudden bankruptcy, and it had derivatives that worth $9 trillion, while Lehman Brothers had a tenth of that exposure. The BBC business editor Robert Peston, considered the bankruptcy of Lehman the "Wall Street's most extraordinary 24 hours since the late 1920s".

Compared to the solutions adopted by the United States, Britain's government tried to help the financial institutions as it considered that nationalisation is not a desirable way to work out. In the first quarter of 2009, statistics considered the UK as the first country in the world on bailing out banks (BBC, 2009).

At the beginning of 2009, the Royal Bank of Scotland stated the biggest loss in the UK's corporate history, beyond £28 billions Although 70% of the bank was owned by taxpayers, the huge losses made government consider the nationalisation. For the recovery of RBS, the Treasury decided to apply an insurance strategy, which covers 90% of the losses in investments (Elliott, et al., 2009). In February 2009, RBS declared that shareholders would share £950 millions as bonuses for 2008, depending on the number of employees that need to be fired. However, the UK did not agree on the fact that losses may be rewarded by bonuses (Eaglesham, et al., 2009). Financial Times reported that the RBS board threatens to retire if the bonuses sum is changed, but the authorities were advised by the Treasury to ignore the threat: "the government will never be taken seriously again on financial policy if it caves in to this blackmail". To repay the government help, RBS had to withdraw £250 billions of its assets in the next four years, sell the insurance business, and dispose of the core business valuing £50 billions (Goff, 2009).

Other British banks were endangered due to one of the biggest mistakes done during the recession, which was investing money in the property development when everybody else withdrew from it. This way HBOS, the biggest mortgage lender in the UK, lost £7 billions and faced a confidence crisis, eventually being bought by the Lloyd TSB for £12 billions (Financial Times, 2008).

5. REGULATIONS TO AVOID THE NATIONALISATION OF LOSSES

As explained above, banks losses are due to complex reasons, and authorities must adopt measures to minimize the system problems. The Banking Law Committee recommends surveillance focused on bank solidity, risk and transparency. In case of financial crisis, The Crisis Management Authority should be ready to act and provide efficient coordination between all institutions managing the crisis (Viotti, 2000).

Market discipline is vital to the national financial system, and it includes investors' possibility to monitor actions and influence managers. The Basel Committee on Banking Supervision (1999, pp.17) considered that "market discipline imposes strong incentives on banks to conduct their business in a safe, sound and efficient manner", and explained that a transparent bank gains more trust from market investors and more help in a secure investing. Market discipline offers information about banks performance, risk profile, risk management, and data which allows entrepreneurs to make well-founded risk-assessments.

The risk taken by banks differs. Commercial banks can easily go bankrupt because they weaken when a large number of depositors clear their accounts. The lost summed from investment banks are times bigger as the commercial banks losses. The effects of the systemic risk should be suppressed with "a brake on its carriers and require all products over a certain volume to be traded on an exchange rather than over the counter or, at a minimum, to create a mandatory central clearing house for them" (Butler &Patrick, 2009, pp.71). When banks figures are beyond banks capital requirements, regulations like restricting bonuses and payments should be applied, until proper ratios are achieved. Reestablishing secured ratios may be realized through raising capital or disposing the high risky assets. Regulators should encourage capital use, but with limitation for its use in investments, for example a percentage of profits. Furthermore, banks must discover risky assets and isolate them (Peter, 2009).

Financial liberalisation made national banks more dependent on international loans, as they became cheaper; hence, the system weaknesses were duplicated between banks, increasing their vulnerability. The liberalisation process ensures the market freedom whilst interest rates go up, raising the credit cost, and finally, causing an economic crash (Krohn, 2008). To avoid becoming "too big to fail", all banks should be monitored, and in case of fraud and corruption, they must be vanished as soon as possible. For a better control, authorities should send signals to bankers to make them conscious of the penalties given in case of improper banking behavior. Poor management may lead to wrong decisions such as allowing bank resources exploitation or taking excessive risks for quick profits. The growth rate in banks needs limitation, otherwise bankers will use gambling to get instant earnings. Another way to prevent bank gambling is to offer better choices to invest money in and lower intermediation costs (Hellmann, et al., 2000).

When deposit insurance is used for non-monitored banks, the risk is transferred to taxpayers. If a society is not ready to protect itself, in order to save insolvent banks another way than providing a security blanket should be used (Mayes, 2005). The market evaluation is more simple and effective when deposit insurance exists, as the authorities quickly observe the troubled banks, but creating a deposit insurance helps even troubled banks increase their profits (Walter, 2005).

As seen from the US and the UK study, governments share different opinions on the consequences of the banks failure if these are considered indispensable for the system. The true part of "too big to fail" myth has been known since the 1930s crisis: when a big bank fails with no consideration to its clients, especially creditors, the breakdown may engage a crucial recession as an effect of panic and surprising market decrease. However, it is crucial to understand the role of that bank in the economy at that certain moment.

6. CONCLUSIONS

The big banks losses undermine the worldwide economy, but even if bank profits are not nationalised, letting the banking system crash is not a solution. Authorities are also responsible when governments fail to monitor banking activities, and losses are so big that they produce a financial crisis.

One of the most challenging things to fulfill is to keep the transparency of information, so that investors are aware of the organisations performance, and the regulators apply new rules and limitations in order to improve the banking activity. Banks take huge risks for profits increase, as their insolvency stage usually transforms into a nationalisation of losses. The moral hazard appears when banks play an important role in the system, they gamble for recovery, or governments set deposits insurance. Either way, banks should be constrained in terms of risk, otherwise the losses continue growing.

During financial crisis, governments used different ways to support banks, but it appears that however big the bailout would be, banks always need more help. Taxpayers usually complain about government help, as individuals do not get any benefits from bank activities. A perfect global banking model cannot be provided, but it is crucial for the economies to monitor their financial systems and provide related regulations in order to avoid future big losses.

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