Behavior of Systemically Important Banks on the financial market

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***Abstract* – This paper investigates costs and benefits associated with systemic size of the bank for different stakeholders' interests. Author of the research studying the behavior of systemically important banks on the financial market of Ukraine, firstly, identifies systemically important banks (first stage), secondly, analyzes behavior characteristics of these banks to find their specific features (second stage).**

Key words – behavior, systemically important banks, stakeholders, regulation, financial market.

I. Introduction

Today one of the key issues of economic recovery in Ukraine is to ensure the stable functioning of the banking sector. Bank losses, significant outflow of deposits, the panic on the currency market and lack of solvent bank customers has led to disastrous consequences in the banking sector of Ukraine, as a result, bankruptcy over a third of all banks. One of the burning issues is economic and social effects of the large banks bankruptcy. Set of bank failures provokes on the one hand the loss of a substantial amount of household savings causing low confidence to the national banking system and the lack of prerequisites for the economic growth resumption on the other hand social inequity escalation in view of taxpayer-funded bailout of large banks ("moral hazard risk").

II. Systemically important banks

Addressing systemic risk in banking is at the heart of new financial regulation in the world (such as the Dodd-Frank Act in the US and the new Basel III agreement). Today great progress has been made in solving the problem of systemically important banks - from their identification through to their regulation. Under the Financial Stability Board's coordination, methodologies to identify global systemically important financial institutions (SIFIs) have been developed ("Global systemically important banks: Assessment methodology and the additional loss absorbency requirement" (BCBS, November 2011), as well as guidance to help national authorities identify banks that pose systemic risks to their domestic economies ("A framework for dealing with domestic systemically important banks" (BCBS, August 2012).

III. Situation in Ukraine

In the context of the problem of distinguishing the country's systemically important banks, it should be noted that during the financial crisis of 2008-2009 the Ukrainian banking sector demonstrated its vulnerability and the need for financial assistance from the state and international financial institutions with a necessity of supporting the largest banks in order to prevent the spread of the crisis processes. The most troubled banks in Ukraine were the joint-stock company "Prominvestbank", the joint-stock company "Nadra bank", the limited liability company "Ukrprombank", "Ukrgazbank" and the joint-stock company "Rodovid Bank", which belong to the first group of banks. Unlike the causes of problems at international systemically important financial institutions, the main reason for the occurrence of problems in Ukraine was the lack of liquidity due to the massive outflow of deposits (according to the National Bank of Ukraine, within ten days of October 2008 the total liabilities of banks decreased by 18 billion US dollars) and the crisis of trust in the banking system of Ukraine. In order to prevent the further realization of systemic risk and insure the timely payments, the National Bank of Ukraine adopted anti-crisis measures by implementing the programs of banks' refinancing, including their recapitalization by means of the budgetary resources received under the "stand-by" program of the International Monetary Fund. On the whole, to recapitalize the troubled banks Ukraine initially spent 9.5 billion Hryvnias with subsequent infusion of 25 billion Hryvnias. In addition, in the beginning of 2012 nearly 20 banks were in the process of liquidation - mostly medium-size and small banks that could not withstand the wave of the financial crisis in Ukraine. Despite the first steps taken by the National bank of Ukraine towards the identification of systemically important banks (SIBs) in Ukraine (National bank of Ukraine, December 2014) it is less clear whether there are specific costs or benefits associated with systemic size for different stakeholders' interests.

IV. Behavior implications

At the moment there are no comprehensive studies concerning consequences of the systemic size for bank's strategy and behavior in the financial market, motives of the banks' owners, customers, and funding structure of the bank. In particular banks' owners are interested in the question whether the status of the SIB is better for them to get more profit or it is only accompanied by increased risks; financial market regulators are more concerned with differences of the bank business model regarding their systemic size as a consequence differentiated regulation of banks; governmental authorities trouble about opportunities of big banks to ensure credit supply for economic growth. Therefore there is need for providing empirical evidence on whether SIB are different in performance (risk and profit), business model, credit supply capabilities and bailout of large banks ("moral hazard risk").The answer on question "Does the behavior of SIB differ from not systemically important bank?" is valuable for specific groups of bank stakeholders. First of all, it is regulator of financial market - National bank of Ukraine. In response to the financial crisis of 2008, banking industry has been undergoing fundamental regulatory changes focusing authority's attention on risks to the financial system posed by SIFs. The question of SIBs identification and regulation is highly significant for national financial sector supervision system, since wrong understanding of SIBs behavior will bring incorrect measures from regulators. The results of the research will allow to decide whether it makes sense to restrict some activities of SIBs, for example setting higher capital requirements, limiting the leverage of such banks as they are more risk-taking, capital structure. Besides it is important to know whether the mechanism of market discipline is effective for SIBs. In the absence of effective market discipline, regulatory intervention appears to be called for. Such intervention could take the form of a higher taxation of, say, the profits or liabilities of systemically large banks or direct intervention that forces systemically large banks to downsize or split up. Secondly, it is governmental authorities. It is important to know if SIBs are valuable from the point of view of providing the domestic economy with credit resources, and to determine the feasibility of state support (state guarantees, preferential interest rates) for these banks in the future.

Thirdly, it is bank shareholders and management. It is important to understand whether systemically large banks achieve higher profitability and operate with lower risk for understanding in bank shareholders' interest for a bank to become large relative to its national economy.

To find answers on these questions it should be understood what had been done before in the economic literature. Finding answers should touch the literature dealing with 1) systemic risk measures; 2) bank size and its behavior in the market; 3) the stakeholder theory.

Probably the most intensively researched question is the measuring of SIBs. The basis of SIBs identification is founded by the Basel Committee on Banking Supervision by adopting consultative document "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement" (BCBS, November 2011). The methodology for identifying SIBs is based on the indicator-based measurement approach and distinguishes five criteria of banks' systemic importance on a global scale (size, interdependence, uniqueness of services, international activity, business complexity), each of which has the same weight (20%) and is represented by one or more indicators.

Secondly, in economic literature bank behavior usually is regarded through fundamental bank characteristics like profitability, risk, market discipline, business models as to their activity mixes and funding strategies, credit supply.

Thirdly, stakeholder theory suggests that corporations (banks) should look beyond the shareholder theory of profit maximisation, and take into consideration other stakeholder groups that the corporation is associated with, and who contribute to the company's achievements.

Also, Freeman's perspective of stakeholder theory includes that companies should be managed for the benefit of all stakeholders. With reference to the fact that banking sector and SIBs occupy a significant position in the economy in our research bank behavior implications will be analyzed through interests of main stakeholders – shareholders and management (in terms of profit and risk), regulatory authority (in terms of market discipline and business model) and government authority (in terms of credit supply).

Thus investigation of behavior of SIBs in the market should take into consideration interests of main bank stakeholders – shareholders and management, regulator of the banking market, governmental authorities. To gauge systemic size by identification SIBs it will be enough to use a bank's liabilities-to-GDP ratio as it corresponds to a country's maximum expenditure in a bank bail-out relative to its GDP, if all of a bank's assets go completely sour. According to the performed studies bank size is a reliable proxy of systemic importance due to the fact that bank size helps approximate each of more rigorous model-based measures of systemic importance and that indicator approach may be the most suitable route for practical purposes.

Conclusion

Investigation of behavior implications of systemically important banks poses and answers policy relevant questions. Whether the behavior of SIBs differs from other banks and how, will shed light on what kind of policies should be adopted by National bank of Ukraine toward regulation of SIBs aimed at imposing restrictions on the size, capital structure and income mix of such banks. Besides research will beg the question of why today's banks ever became so large. One potential answer is that bank growth can be in the interest of bank managers through higher manager pay and status, even if bank growth is at the expense of bank shareholders. This suggests that it is undesirable for banks to grow to reach large systemic size. If so, the question emerges whether the prevention of bank growth to large systemic size can be left to market discipline or should be the object of regulation.

References

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