

DOCTORAL DISSERTATION
‘REGULATION OF GLOBAL SYSTEMICALLY IMPORTANT BANKS IN THE
USA AND IN THE EU’

SUMMARY

Global systemically important banks (G-SIBs) constitute a group of internationally active, huge banking conglomerates that are so complex and important to the global economy that the collapse of one of them could drastically impair financial stability. These institutions not only grant loans and accept deposits, but also often conduct investment and advisory activities, organize financing for many projects and companies on the capital markets, coordinate payment systems and provide custody services. Most of them come from the United States and the European Union.

The aim of this dissertation is to take a closer look at these institutions and their regulations in said regions and to answer the question whether these rules have been properly tailored to avoid the mistakes from the time of the global financial crisis. This analysis is based on recent years' data on the functioning of G-SIBs, as well as on a comparison of legal solutions and supervisory reports from the USA and the EU. Also, consultations with professors and practitioners in the field was an immense help and provided a broader perspective on the topic.

The first chapter characterizes G-SIBs as financial institutions, starting with the global transformation of the banking sector, through the formation of these conglomerates, to their current activities. Despite their many common features, G-SIBs greatly differ from one another. Historically, each of these banks has chosen a different path to reach their present magnitude. Also G-SIBs' current diversified activities, their various approaches to risk, their financing, company structure or majority shareholder influence turn them into a very heterogeneous group.

This became apparent especially in the context of the global financial crisis, discussed in the second chapter. It exposed the main flaws of the legal regime binding G-SIBs at that time. First of all, many aspects were not regulated at all (e.g. systemically important status, leverage limits, liquidity). Second, the rules in place were too general and did not take into account the systemic aspect of these banks, nor their diversity. In terms of capital, restructuring and supervision, small local financial institutions and large, complex G-SIBs were subject to the same provisions.

It was because of these regulatory deficiencies and overly general regulation that the banks adopted different pre-crisis strategies. Some G-SIBs were cautious about increasing risk, securitization and investing in innovative financial instruments. However, other banks took advantage of the loopholes and bet on profit earned by bending the applicable standards. Such

institutions invested in extremely risky financial instruments, took on debt disproportionate to maintained capital levels, relied heavily on unstable sources of funding and engaged in securitization of real estate market-related instruments as well as in trading in over the counter (OTC) derivatives. They generated profit for the price of financial stability.

As a result, after the crisis, reform of financial law began both in the USA and in the EU. Currently binding G-SIB-oriented rules, which are analysed in the third chapter, constitute an outcome of this reformatory movement. The most important standards were set at the global level by the Basel Committee on Banking Supervision and the Financial Stability Board. Individual countries implemented these rules at the regional level. Said changes covered many aspects of the functioning of the G-SIBs, ranging from institutional novelties in the context of supervision and internationally formulated methodology for G-SIB designation, through special capital buffers, tightening of leverage limits, reduction of exposures between the G-SIBs, to specific restructuring requirements and Pillar 2 powers. In each of these aspects, described banks are regulated differently from other banking institutions. Although the creation of this improved legal regime is an undeniable achievement of the legislators, the new provisions still do not take into account the diversity of the G-SIBs. They only distinguish these banks from all other financial institutions. Within this group, however, the level of diversification remains insufficient. Very different entities are obliged to meet the same requirements, which potentially makes it possible to repeat the situation from the times of the crisis, when some G-SIBs stretched overly general rules and as a result violated the stability of the financial system.

Fortunately, the solution to this problem is built into these standards. Namely, the G-SIBs' supervisors in the USA and the EU (the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation and the European Central Bank in cooperation with the national authorities) have discretionary powers to adjust specific legal provisions to the individual characteristics of the G-SIBs. Such tools are prescribed in every aspect – additional capital buffer, leverage limits, restructuring requirements and Pillar 2 obligations.

The fourth chapter analyses these discretionary mechanisms, starting with their positive potential. Described powers of supervisors constitute a very universal solution. Apart from the opportunity to adjust the provisions to the individual character of G-SIBs, they also enable supervisors to make far-reaching interventions, such as reducing the assets of a given institution (divestiture) or restricting a given kind of operation. In addition, these tools allow supervisors to increase capital buffers and the overall level of capital, which is often formulated as a desired improvement of the binding minimum levels. Further, discretionary tools create an opportunity for supervisors to react faster and more easily adapt existing standards to the needs of the real economy. Since the G-SIBs constitute an indispensable source of liquidity and are crucial in the process of monetary policy transmission from the central banks to the real sphere, the ability to adjust G-SIB-specific rules allows supervisors to swiftly introduce desired changes, if the economic situation so requires.

Despite the advantages of this solution, the data from recent years shows clearly that the supervisors hardly use their powers. Legal uncertainty and unpredictability, always linked to the supervisory discretion, are probably the most important obstacles. In the case of these G-SIB-related powers, uncertainty has been exacerbated by the lack of clear and precise guidelines for their exercise, as well as by potential coordination problems between supervisory agencies. Against this background, there are also concerns about the arbitrariness of the chosen solutions and about the increasing risk of regulatory capture. Therefore, the introduction of certain improvements that will mitigate or eliminate said obstacles and thus enable supervisors to exercise their powers is crucial for the entire G-SIB-oriented regulatory system in the USA and EU.

The changes are recommended in five main areas. First, supervisory agencies should receive higher funding to bridge the budgetary gap between them and the G-SIBs subject to their supervision. In this vein, supervisors should also receive in-depth training to know more about the individual characteristics of the G-SIBs under their supervision. Increasing their salaries would mitigate the risk of regulatory capture and 'revolving doors'. In addition, they could receive part of their remuneration in the form of shares of the supervised entities. That would both increase their salary and make them feel more responsible for their decisions. Second, the guidelines for the exercising of these discretionary powers should be formulated in a clear and precise manner. At present, they mainly repeat the characteristics of G-SIBs already taken into account in the process of their designation. Attention should be paid, for example, to such aspects as business model, capital structure and its intrafirm flows, and place in the inter-institutional network. Also many quantitative factors have been omitted – among others retail financing, short-term financing, or the number of jurisdictions in which a given G-SIB provides services. Thirdly, in each of the discretionary procedures, one supervisory agency should play the role of the ultimate decision maker, in order to avoid potential coordination problems present in cases where the consent of two (or more) entities is required. Fourth, it is important that the entire process of exercising these powers is transparent, from guidelines taken into consideration to the consequences of adjusting given provisions. Finally, it would also be beneficial to establish an international non-governmental institution to oversee the progress in shaping these G-SIB-specific rules.

