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**Doctrine of public good in banking versus state
intervention**

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Doctrine of public good in banking versus state intervention

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Abstract: This article has a following thesis: changes in banking and a role of banks in real economy in last years, give an argument for treating banks as public good.

Banks received a great support from governments as a result of the subprime crisis. G-20 and European Commission recommended new regulations for this sector after crisis.

As consequence of banking development more than 90% of population use banking services in many countries. New social functions of banks appeared. Doctrines about recovery and government support for banks were changed in parallel (e.g. LoLR). Presently there are some arguments for recognition of public good doctrine in banking such as: a very big area for state regulation, state banking supervision, state system of deposits insurance, realization of task delegated by the state, social responsibility of banks and others.

These arguments confirm that banks' activity has a particular importance for society and economy and would be public good.

Introduction

Presently financial services became common; for those who do not have access to them there are programs for counteracting financial exclusion. The new considerations for banking, new risks and new dimension for potential financial crises create a question whether the banking has become a public good. State intervention on a great scale during the subprime crisis indicates that the governments and international institutions treat banking as a special good. Not a single bank went bankrupt in Europe during last crisis.

Answers to the following questions seem to be important from the point of view of a banking company: what criteria should determine the public nature of financial services; what can be treated as public good in banking;

should bank assume receiving public help in the event of crisis? Presently everyone agrees: a bank was and still is an institution of public trust.

The goal of this article is to prove that present banks should be treated as a public good.

Methodology of the research

In this paper the following scientific methods were used: national and international literature analysis, statistical analysis, comparative analysis and legal analysis.

1. Public goods – concepts, definitions, references to banking

A good is defined, as everything to what one can assign a positive value and at the same time is a value itself. (W. Krajewski, R. Banajski 1996) Different definitions of good in the general social meaning appear in the literature: common good, public good, impure public good, global public good, regional public good – in contrary to them there are private goods and so called club goods. Common and public goods may be considered as the same.

J. Buchanan named public good as a good that has two characteristics from the economic point of view: (Buchman J.M. 1968)

- it is a non-rivalry good – meaning that from the moment it is created and available it can be consumed by others without incurring any additional cost to anyone,
- it is a non-excludable good – meaning that the potential clients cannot be excluded from its consumption.

Originally the public goods were associated with the ones financed (created) by the State; Presently iunctim of terms such as subsidized, free and public goods is not justified. Some supporters of the public goods theory think that creation of public goods may successfully happen in private sector, yet the majority's opinion those goods are created thanks to the State's activity (R. A. Musgrave, P. Samuelson). (Fijor J. M. 2011)

P. Samuelson defines current shape of the public goods concepts; they mean that there is no rivalry expressed by the joint delivery of a good and ineffectiveness in attempts to exclude anyone from its consumption. (Samuelson 1954)

Public goods issue is present in economic literature for a century; national currency and stable prices are considered to be public goods. In

J.K. Solarz's opinion today "there's a space for dialogue about public goods in financial sector instead ruling of the market or the State". Thesis presented already in 1992 by G. Corrigan: banks are perceived not only as public trust institutions, but even broadly as public good; therefore whole society should bear the costs associated with it (system risk is a whole society's risk) – caused lots of discussion and criticism. (Corrigan 1992)

J.K. Solarz created a typology of financial services as public and private goods. (Solarz 2008, p. 159) The purposefulness of such classification for policy towards banking is important and necessary; even though assignment of goods to particular types is questionable. However, one should consider volatility of the matter; for instance the ongoing democratization of brands. In this author's opinion blurring in practice the distinction between public and private goods in financial sphere causes theoretical disputes around that who is to blame of market or state inefficiency; therefore an intermediate category of impure public goods is growing. (Solarz 2008, p. 158)

It should be considered, what may and ought to be a public good in banking? Few options may be mentioned here:

- whole banking industry (loans and deposits institutions),
- only universal banks,
- only the safety of client deposits,
- only the retail customer's operations or selected products,
- system stability or institutional system of its protection (e.g. Financial Safety Net in the EU),
- common and small scale operations (e.g. up to the amount of 50 thousand EUR in the EU within the framework of deposit insurance).

In W. Szpringer's opinion, the public good category may be applied to the banking system, not to the individual bank that may go bankrupt after all. (Szpringer 2001, p.11)

A. Greenspan treated financial stability as a public good. He stated that the LoLR function is and will be essential because "the markets mostly work efficiently but from time to time they collapse. When it happens the State's intervention is necessary in order to preserve stability, which is a public good". (Greenspan 1988) If one should recognize that banking is a public good only in the event of crisis – questions arise whether it should be in the event of system or individual bank's crisis; what to consider as conditions of crisis; what level of public help is allowed? It seems that the licensed banks should be treated as public good.

2. Banking and state intervention

W. Bagehot's doctrine (19th century) stipulated that in bank crisis - the central bank or the government becomes the essential Lender Of Last Resort (LoLR). In compliance with this doctrine central banks of many countries took the LoLR role on themselves. S. Heffernan thinks that "if LoLR judges that the source of the problem is run or bank panic, not the financial situation of the bank, it may lower its requirements concerning capital adequacy and apply smaller penalty interest rate. As a matter of fact, arguments for LoLR existence resemble nuclear bogeyman: it is a tool that is meant to prevent panic that could happen." (Heffernan 2007, p. 574) During subprime crisis FED, ECB and central banks of the EU countries broadly performed LoLR function. (Masiukiewicz 2008) The first institution to take up function of international LoLR was the International Money Fund, by granting credit line for countries affected by financial crisis in the 90'.

20th century was quite rich in banking crises. At the same time the development dynamics, social reach of banking and attempts to calculate social costs of bankruptcy (E. Altman) were undoubtedly the causes of wide spreading new doctrines. Ch. James' research indicated that liquidation of insolvent banks is more expensive than its recovery, takeover by healthy bank or even nationalization. (James 1991) E. Gardener and P. Molyneux gave much attention to the "Too Big To Fail" (TBTF) and "Too Important To Fail" (TITF) doctrines. (Gardener, Molyneux 1998) Those authors were proving that due to the importance for the system risk, some banks (so called strategic) deserve rescue by the State (not excluding nationalization), and doctrines TBTF and TITF became practice. (Gardener, Molyneux 1998) Opponents of such approach stated on the other hand that this certainty about public bailout would lead to strengthening moral hazard.

In the end of the 20th century a new approach appeared in the literature, treating financial stability, as well as the banks themselves as public good (G. Corrigan, S. Heffernan, P. Krugman, J.K. Solarz, J. Stiglitz); what would justify its bailout during crisis. (Masiukiewicz 2010(2))

G. Kaufman defined banking crisis as a situation that is characterized by bank run, financial institutions collapses or massive state intervention as well as broad disruption of safety of other institutions. (Kaufman 1999) This definition clearly focuses on elements of panic and state help in crisis. System risk and threat of panic epidemic – according to the S. Heffernan – are the key causes to the State for having inclination to special treatment of banks, and to central banks for serving as the LoLR or delivering, so called, lifeboat rescue operation. (Heffernan 2007, p. 41)

There are many cases – what is proved by crises history – in which central banks and system regulators were intervening to save individual bank or group of banks; protecting at the same time other entities of the financial system. (Hefernan 2007, p. 209) J.K Solarz claims that the banking crisis (and social response) may even force authorities to intervene and provide significant help to this sector. (Solarz 2008, p.101) Financial crises showed how far governments can go to prevent bank from collapsing, how broadly doctrines TBTF and TITF can be applied. (Hefernan 2007, Gardener, Molyneux 1998) As a part of the fight against subprime crisis, governments and central banks of USA and Europe reached for the most radical measures, including nationalization of financial institutions and using vast funds from taxpayers. (Krugman 2008) Even D. Strauss-Kahn (former president of the IMF) sided for the interventionism: “necessity of public intervention becomes even more obvious. Government intervention – regardless whether it’s on securities or real estate market or banking industry – would act as “third line of defense” supporting the fiscal and monetary policies”. (Guha 2008) In M. Diekmann’s opinion (the then president of the Allianz Group) the debate should focus not on whether the state should intervene, but rather on how to do it. (Diekmann 2008)

Also the experience of polish banking crisis from the 90’ clearly indicate that without subsidies (as a restructuring bonds) and tax reliefs many banks would go bankrupt causing domino effect, i.e. enterprise bankruptcy.

New measures of the European Commission are introduction of CRD/CRR directives that tighten norms of banks operation and preparation of draft of the resolution and recovery regime procedure for big banks – that enables scheduled liquidation; that is to not allowing a sudden collapse. (Masiukiewicz 2013(2)) A new concept is also a creation of Banking Union as a part of the EU. (Masiukiewicz 2013(3))

Also a question arises about admissibility of public aid for banks in the EU countries. W. Szpringer points out that the member countries that bailout threatened banks are not only bound by the art. 87-89 of TEC, but also by the instructions of the European Commission regarding rules of public aid for financial institutions in connection with the global financial crisis. (Szpringer 2009(2), p. 23) One of the forms of States’ aid for financial sector are the government guarantees for banks’ liabilities. The guarantees relate usually to all retails deposits and selected categories of wholesale deposits as well as medium term debt instruments.

European Commission announced new guidelines for recapitalizing financial institutions by governments. They stipulate that the capital aid from the State cannot affect competitive advantage of banks from one member country over institutions from another EU countries. (Szpringer

2009(1), p. 24) Implemented in 2008, the European Plan for Economic Recovery, even though it did not bind anyone was treated as additional guideline for admissibility of public intervention aid. (Szpringer 2009(1), p. 25) After subprime crisis many EU countries founded Recovery Funds, also in Poland, the bill on Banking Guarantee Fund (BFG) provides possibility aid for banks and credit unions in form of a long term loans for recovery programs in the event of crisis. (Masiukiewicz 2013(1))

Economics theorists recently express a need for redefining role of the State in the economy – in the circumstances of global companies and products, global shortages and global crises. G. Rae presents a thesis that the State has to return to the subjective role in the united Europe's economy; also laying out a number of arguments supporting it. (Rae 2008)

Regarding banking industry, there are opinions claiming its overregulation by the State. Basel III recommendation and CRD/CRR directives introduced a number of new limits on banks, and the regulators have rights to accept a president and vice president, to accept shareholders with more than 10% shares of the bank, to ban selling selected products, may also suspend the bank, liquidate it or compulsorily merge it with another bank as well as number of other rights. (Masiukiewicz 2013(1))

It is necessary to point out that the consequences of new banking crises may be only comparable to the costs of nuclear strike; it is estimated that the medium size banking crisis costs about 15-20 % GDP – for which taxpayers will pay. (Masiukiewicz 2009)

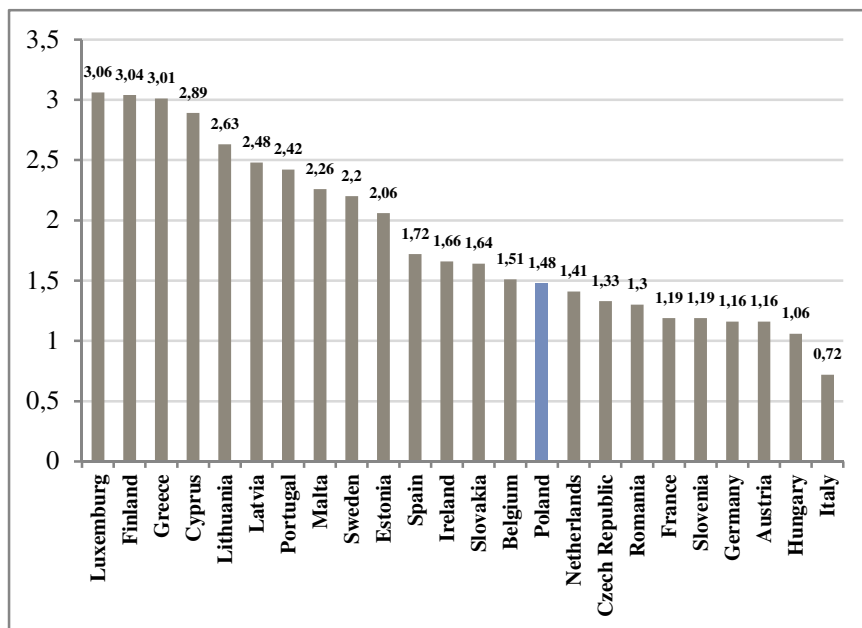
3. Arguments for and against recognizing banking as public good

Recently in literature some researchers raise the issue of social responsibility of banks and costs related to their quasi-social mission. The following are typical costs that banks cover in this area nowadays:

- costs of restructuring bankrupting enterprises,
- risk and costs of premature deposit withdrawal by customers (bank run),
- costs of maintaining customer deposit insurance system,
- crediting endeavors in area of public procurement and public-private partnership,
- granting preferential loans (agricultural, student, environmental and other),

- costs of overdue receivables from public institutions and economic consequences of consumer bankruptcy for banks,
- costs of counteracting financial exclusion that is recommended by authorities (e.g. in EU).

Graph 1. Amount of bank accounts in the EU per capita in 2011.



Source: ECB Statistical Data Warehouse (2014, November 14) retrieved from: <http://sdw.ecb.europa.eu/>

A significant argument for considering banking as public good is the level of access to and use of banking services. Provided in 19th century 1-5% of society had access to financial services, presently in highly developed countries banking access indicator reaches 95% (in Poland 80%), and the number of accounts per capita surpassed 1 long ago (graph 1). Highly developed countries implement governmental programs to counteract with financial exclusion – to achieve banking access factor close to 100%. For instance, in some EU countries central bank may assign duty to open bank accounts to homeless and poor. Presently broad access to financial services, assurance of funds safety, and facilitations in performing transactions and cash flows cause that in highly developed countries it is nearly impossible to function without bank.

New, characteristic functioning circumstances of modern banking indicate its risks and its role in maintaining financial stability, therefore also indicate a need for public protection. New opportunities and threats for banking industry are presented in the table 1.

Table 1. Opportunities and threats of modern banking

#	New threats	#	New opportunities
1	Widespread of banking services – amounting to 90% of population determines possible scale of crisis consequences to citizens,	1	Rebuilding trust towards banks
2	Globalization of operations causing easier transmission of crisis threat,	2	Increasing demand from SME's for credits and possible opportunities (especially in developing countries)
3	Range increase of electronic banking, creating new areas of threats,	3	Creating Financial Safety Net – FSN, including repair funds for financial institutions
4	Increase of importance of financial advisory and rating institutions, and at the same time lack of sufficient supervision and scope of their liability,	4	Expanding tasks for national financial regulators and creating European Banking Authority
5	Insufficient pace of improving regulations to follow market changes and financial innovations,	5	Project of creating Banking Union within EU
6	Dynamic development of so called parallel to traditional banking, financial system; it is very poorly regulated,	6	Increasing financial customer's protection (e.g. MIFID directive in the EU, ombudsman's activity etc.)
7	Many interbank connections in global scale and cross-border operations that favors the panic contagion effect (domino effect),	7	Implementing stage increasing of equity capitals and permanent stress tests (Basel III),
8	Part dependence of banking system stability on behavioral factors (lack of social crisis auto regulation system, customer susceptibility to panic etc.),	8	New information technologies
9	Authorities' alienation towards ownership in banking corporations	9	Implementing CSR concept in banking
10	Increase in fiscal burdens – new banking tax.	10	Changing rules of motivational systems for top managers and executive staff selection
		11	Increasing role of ethics in banking

Source: Own

Growth financing, safety of citizen and corporate savings, development of international exchange are served by banks and therefore dependent on bank's standing and more broadly on credit-depository institutions' standing.

Elementary arguments for treating banks as public good are the following: (Masiukiewicz 2010(1), Masiukiewicz 2010(2))

- functions of banks that assure economy and households growth,
- special legal regulations and licensing of banking activity (de Larosiere report that was accepted by the European Commission recommended increasing regulations after subprime crisis),
- public trust as the operation attribute (strengthened institutionally by the State),
- public deposit insurance system,
- setting many market parameters for banks by the State (reference interest rates, reserve ratio, maximal interest rate for consumer credits etc.),
- broad supervisory rights for regulators; broadened even further towards banks in critical situation (orders and bans for banks),
- performing by selected banks state delegated functions and function of restructuring overdue liabilities of enterprises and households,
- operations openness, mass media access to the information – what may in special cases used against the bank,
- banks' high sensitivity for crises and contagion effect (therefore a possible influence on destabilization of whole financial system),
- system of public institutions appointed to protect financial customers (financial supervisors, deposit insurance fund, bank customers' ombudsman, compulsory administration and other),
- bearing costs of maintaining financial safety net as well as costs of bank bankruptcies by taxpayers – customers.

One can also lay out number of arguments against it, among others they are:

- functioning in free market,
- customer's freedom of choice of bank,
- general prohibition of public aid for enterprise in the EU (although with exceptions),
- risk of political pressure concerning scope and structure of public aid for banks,
- moral hazard of management; granting public aid to bank was not always connected with consequences for then top managers.

Problems connected with the matter of concerning banks as public good and consequences of public aid require further research and discussion. Yet in the end it will be up to national and european authorities to decide on voters' behalf about approach and policy regarding this matter.

Conclusions

Common access to banking, its role in financing country's development and at the same time experiences from the number of international crises and bank bankruptcies indicate broad social consequences of possible bankruptcies and justify applying doctrine of concerning banking as public good and state intervention connected with that.

As a consequence of treating banking as public good perhaps it ought to function in the citizen's interest, be under protection and supervision of the State. It also means limiting market influence on this industry, possibility of providing services by the State industry or nationalizing part of the banking industry in a financial crisis. Operations of banks should be based on the Corporate Social Responsibility (CSR) concept.

Treating banking as a public good creates a social and economic justification for:

- strengthening public trusts towards banks,
- state co-financing of deposit insurance system,
- using financial supervisory and regulatory instruments in the interests of the citizens,
- building national and european Financial Safety Net (FSN) and providing aid to the banks in critical situation,
- ensuring common access to financial services (elimination financial exclusion).

Further research of problems connected with the issue presented in this article should among other things answer following questions: how strongly regulated banking industry should be, what instruments of restructuring should be used during system crisis and what are the limits of growth of big global banks and who should supervise them? Protection of financial safety of households and enterprises should be main goal and criterion of State policy in discussed matter.

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