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From National to European Regulation:

Towards European Financial Supervisory Authorities

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Single Financial Market in Europe

Financial reform is needed now in the EU not only to reduce the likelihood of another financial crisis in the coming years but also to reinforce the internal market. A primary financial as well as political goal should be to create a truly single market in Europe for financial services and institutions. The current state of affairs is, however, still too far removed from this goal.

Europe actually faces a financial 'trilemma':[1] consisting of a combination of three elements:

a) financial integration, particularly liberalisation of financial services;

b) stability of the financial system and

c) regulation and supervision of financial institutions which is still predominantly based on autonomous policies and decisions of the individual member countries.

This combination of three crucial elements of financial policy goals contains fundamental tensions and inconsistencies, and consequently dangers. I consider it unavoidable that Europe should change the third element by switching from the current, essentially *national* regime of bank regulation and supervision to a system with a substantial degree of decision-making by *European* authorities: not only for crisis prevention but also for management and resolution of ailing banks with a European character: large and active cross-border. If not, the financial crisis – and even more so, a next crisis – may undermine the integrated financial market as an essential component of the European internal market in general.[2]

Bank Crises and Sovereign Crises

Europe today is confronted with two major, almost simultaneous financial crises: a bank crisis and a sovereign crisis related to highly indebted national governments. It is true that many private institutions, private individuals and governments suffer adverse, and frequently cumulative, financial consequences from both categories of crises. It may also be true that they assume that the causes are the same as well, but that would be incorrect. Whereas banks themselves carry a fair share of the blame for the financial problems many banks find themselves in, this is different for the prevailing crises of sovereign debtors. Governments, such as Greece, that are having trouble staving off default, should blame mainly themselves for irresponsible macroeconomic and particularly fiscal-budgetary policies followed for years. Banks may in some cases have contributed to a sovereign crisis by lending too easily, through buying bonds or otherwise, but they are not the main culprit.

However, it is also true that the two categories of crises mutually reinforce each other. A sovereign debt problem weakens many creditor banks further, both domestic and foreign banks. And the cost of bank bail-outs compounds government deficits and debts.

Rogoff and Reinhart found in their book on financial history[3] "that international banking crises are almost invariably followed by sovereign debt crises". They think it is extremely difficult for the eurozone to escape this fate. I wonder whether the reverse link is applicable as well: sovereign debt crises are almost invariably followed by international banking crises. The crisis of several Latin American countries and

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subsequently American and European banks in the 1980s provide an example. The pending drama surrounding Greece and perhaps other Southern European Euro-area countries may indeed lead to another round of bank crisis.

Priorities for Bank Reform

One can observe major differences of view with regard to the priorities that are needed for bank reform to prevent new financial crises – or at least to reduce the likelihood of such crises erupting again.

My own priorities for reform consist of a set of four areas of action all of which are indispensable:

1. Strengthen the capital and liquidity requirements for banks to provide a stronger buffer against failure. This implies:

- increasing the existing capital ratios, particularly the minimum ratio of tier I capital to risk weighted assets;
- improving the quality of bank capital by reducing the amounts of 'hybrid' forms of capital that qualify for minimum tier I capital and by applying stricter standards for hybrid capital to qualify;
- increasing capital requirements for more risky types of bank activities, including for trading books;
- introducing a new maximum 'absolute' or 'gross' leverage ratio to reduce excessive growth of the total balance sheet in relation to core capital – as was practiced e.g. by American investment banks; and
- including off-balance sheet assets and liabilities in the calculation of capital adequacy requirements.

The Basle Committee on Banking Supervision and Regulation is likely to propose changes on a global scale broadly along these lines.

2. Improve the risk management of banks – in addition to internal measures by bank management and bank (supervisory) boards – by ensuring that bank supervisors have sufficient instruments and authority at their disposal to induce banks to adopt stricter risk management. And also to ensure that supervisors actively and even proactively use their instruments and authority to prevent banks from putting their continuity at risk.

3. Create in Europe a more European-based system of bank regulation and supervision. This should go beyond the prevailing coordination of *national* supervision and should create truly *European* bank supervisory authorities. The report of the de Larosière Committee provides the essential basis for these European authorities. In addition to other valuable recommendations the report focuses on two proposals:

a) to improve macro-prudential supervision: create a European Systemic Risk Council (ESRC) to protect the stability of the financial system; and

b) to improve micro-prudential supervision: create a European System of Financial Supervision (ESFS) to protect the solvency and liquidity of individual banks. This ESFS will be entrusted a.o. with legally binding mediation authority to resolve disputes between national bank supervisors. Later, the Regulation adopted by ECOFIN gave the ESFS the legal form of three "parallel" Authorities, for the three financial sectors: "European Banking Authority" (EBA), "European Insurance and Occupational Pensions Authority" (EIOPA) and "European Securities and Markets Authority" (ESMA). To my satisfaction the de Larosière proposals have been subsequently adopted grosso modo – in substance although with regrettable weakening of the applicable procedures, such as appeal and escape clauses for dissenting member countries – by the ECOFIN Council of Ministers in December 2009. These proposals are now being reviewed by the European Parliament. I hope that the EP will restore the stricter procedures as proposed by the de Larosière Committee and subsequently the European Commission.

4. What is now of crucial importance is agreement on the necessary next steps *beyond* the recommendations of the de Larosière Committee.[4] My two highest priorities for additional European arrangements relate to:

a) burden-sharing for rescue operations for large, cross-border banks and,

b) legal provisions to enable a new form ('third way') of bank resolution.

From the four priorities outlined above, one may conclude that I do *not* consider the following official measures as appropriate or indispensable for creating a solid bank reform:

1. Imposing forms of new bank taxes (that is: distinct from mandatory contributions by banks to deposit guaranty funds or schemes), nor

2. Introducing far-reaching restrictions on the overall size and/or type of activities of banks. In other words: 'narrow banking'.

A Third Way: Special Resolution of Ailing Banks

Authorities today have a limited choice when they are confronted with a bank close to collapse: either they decide to bail-out the bank or to let it fail. The first solution contains two major disadvantages. A bail-out can be very costly to the national Treasuries and therefore the taxpayers. Moreover, it leads to the 'too-big-to-fail' dilemma: both large banks themselves and the financial markets as well as the customers-creditors of these banks assume – even without any guarantee or explicit government commitment to do so – that governments will provide them with financial support if need be. An informal list of 'too-big-to-fail' or 'systemic banks' is being composed by the markets. It creates, however, the moral hazard danger. This implies that the banks, the financial markets and the bank customers all adjust their decisions to the likely financial support 'solution'. Consequently, they engage in riskier financial transactions based on the principle: "Gains are for me and losses are for the taxpayer." In doing so, they contribute to the next financial crisis. The second solution of default and "classic" bankruptcy leads to chaos and large losses, not only for the bank's shareholders, bondholders and other creditors, but also for the bank's professional counterparties in derivative and trading contracts and even for the financial markets in general (see the Lehman Brothers collapse).

Therefore we need to create a 'third way': a special or enhanced bank resolution mechanism.[5]

It implies official interference, through a 'resolution authority', in the fate of an ailing bank which is in-between, on the one hand, no action and bankruptcy and, on the other, a bail-out and survival. Its goal is to avoid the serious disorder in the financial markets when a bank of large, but even of moderate, size collapses.

There are two reasons why the bank resolution alternative will substantially reduce the financial burden of the government – compared to a traditional bail-out. First, the shareholders, the subordinated bondholders and probably other creditors – including senior bondholders but excluding all guaranteed retail depositors – will be 'wiped out', that is, they will not receive any payment. The second reason is that the official authority entrusted with handling the resolution can intervene much earlier, *ex ante*, before insolvency occurs in accounting terms, than the bankruptcy court in a traditional, *ex post* bank default.[6] This resolution authority may decide to seize the bank when it is still functioning, take control and separate or sell certain parts or assets of the bank, remove its management, freeze the rights of shareholders and creditors and reorganize or wind down the bank. It may agree on deals with the bank's counterparties, etcetera. All this will reduce the disorder and damage in the financial markets and result in an orderly liquidation or merger.

This solution requires in most countries changes in bankruptcy laws to create special legal instruments for the bank resolution authority – either a new specialized administrative authority or the existing bank supervisor, but not the regular bankruptcy court – to take measures as described above. This legislation will apply to banks only.[7]

This resolution mechanism will to a substantial degree take care of the too-big-to-fail dilemma by reducing – although not eliminating! – the politically no longer acceptable risk of a 'traditional' bank bail-out with a heavy contribution from the taxpayers. And it also will restore market discipline and reduce the moral hazard of too-big-to-fail, because it will become much less likely that governments will intervene in a 'systemic bank' failure through a bail-out, thereby allowing shareholders and bondholders as well as other creditors to escape without (heavy) losses.[8] We should no longer distinguish between systemic or too-big-to-fail banks and other banks.

Discipline of Market Forces Failed

It is generally agreed that a breakdown in responsible risk management was a primary cause of the financial crisis and that many banks were at the centre of this breakdown. Equally, it is widely agreed that the financial regulation and supervision in almost all countries did not act with sufficient vigour and speed to contain this mismanagement of financial institutions. Also, the role of the credit rating agencies in enabling wrong financial developments to continue by erroneously granting their highest ratings to fundamentally flawed financial assets or products. What, however, is generally less realized is that the financial markets and non-bank investors also made a substantial contribution by their own inadequate risk management. This became evident when many investors were willing to buy and hold financial instruments where the risk-reward ratio did not reflect the fundamentals: this was particularly the case with many bonds issued by intrinsically weak borrowers, without demanding a sufficiently high interest rate, or more precisely, a sufficiently high spread over the benchmark interest rate charged to top-quality borrowers like German government bonds ('Bunds'). Not only did many investors over time suffer from substantial realized or unrealized losses on these investments when their market values took large hits, but these developments also enabled many borrowers to continue their own irresponsible behaviour for far too long by financing their own uncreditworthy and unsustainable activities for too large amounts at too low prices. In other words, if the financial markets would have exercised more financial discipline and expertise, they would have saved themselves substantial losses and they would have prevented the financial crisis from exploding so forcefully.[9]

The undisciplined practices of many investors manifested themselves in the markets of bonds issued by both banks and governments. For several years now, it has surprised me that investors were willing to buy bonds issued by structurally weaker governments such as Greece, Portugal and Italy at interest rates that were very close to the yield on 'Bunds'. Part of the explanation could probably be found in the very high ratings given by the credit rating agencies and the high credibility that these ratings used to enjoy, and another part in the assumption that a member country of the euro area – or, to a lesser extent, of the entire EU – would, in some form or another, be bailed out by its fellow-member countries, even though the European treaties do not contain any clause to that effect.

In academic and banking circles it was advocated for many years that banks should issue substantial amounts of *subordinated* bonds. This was based on two motives. First, they would contribute to efficient capital management for banks to raise – up to the maximum amounts permitted by bank regulation – 'hybrid capital', including subordinated bonds, preferred shares and certain forms of perpetual bonds. They would provide less shareholders' dilution and less expensive capital to banks, after tax, which is after deducting the interest charge, than traditional core capital: shares or equity. The second advantage was supposedly the discipline imposed by the financial markets on the banks and their risk management. Many professional investors were assumed to be sufficiently knowledgeable and critical of the different risk profiles of the various banks and the different risk profiles of senior and junior, subordinated bonds of the same bank. These judgmental differences should be reflected in substantial differentials in interest rates on the various bonds. Banks with weak or overly aggressive risk management or with low capital ratio's would not be able – according to this analysis – to attract their target amount of subordinated bonds and/or would be forced to pay penalty-level of interest rates. These outcomes would negatively affect the growth opportunities for this category of banks. In reality, however, the market forces did not exercise the needed discipline and consequently permitted banks to further increase their risk profile and the likelihood of failure. The amended Basle rules are likely, and correctly so, to curtail sharply the recognition of subordinated bonds as tier I-capital. So, the traditional, non-convertible subordinated bank bonds will play a less important role in the future.

Very recently a different technique is being tested. In essence, it aims at issuing subordinated bonds in the capital markets that are accepted by the bank regulators, under their new rules now being drafted in Basle, as tier I (hybrid) capital because they will be mandatorily and automatically converted into common shares, and therefore core tier I-capital, in the event that the bank's capital ratio's fall below a predetermined threshold. This compulsory debt-equity swap is a fundamental innovation compared to the traditional convertible bonds where the holder has an option but no obligation to convert later into shares.

Such a new category of mandatorily convertible bonds responds, to a certain extent, to the frequently heard criticism that bank bail-outs often lead to bond holders being repaid in full, at the expense of taxpayers.[10]

I agree that it would be helpful if banks were to issue large amounts of this type of convertible bonds. It would lead to contingent capital: an increased capital buffer precisely at the time of a threat to the financial stability of a bank, thereby reducing the risk of default, and it would ensure that unguaranteed or unsecured bank creditors would share in any losses in case of default, rather than merely the taxpayers and the shareholders.[11][12] The role of contingent capital would be greatly enhanced if bank regulators require banks to issue a certain amount of mandatory convertibles.

However, I doubt whether the capital markets are willing to absorb substantial amounts of this type of bank bonds for they contain a significant risk of loss of value, through a decline in the share price, to its holders if the bank in question would find itself in rough waters. The only way to make this paper sufficiently attractive to (new) investors is through offering prohibitively high interest rates.[13]

Too-Big-To-Fail, Narrow Banking and the 'Volcker-Rule'

At the heart of the debate on bank reform is the dispute over whether the fact that a limited number of large, complex and interconnected banks (and other financial institutions) almost brought down the global financial system, should, or should not, lead to a fundamental regulatory change by breaking up large banks or limiting significantly their permissible activities. Paul Volcker is among the strongest proponents of the need for this regulatory change to impose narrow banking.[14] I, on the other hand, share the view of others that such a rigorous step is not warranted.[15]

In the discussion about too-big-to-fail and its perceived solution of 'narrow banking', the Obama-Volcker proposal is playing a major role, at least in the USA.[16] It aims to reduce the activities of regulated banks that have access to federal deposit insurance and the discount window of the Federal Reserve Bank as lender of last resort. Contrary to comments in the media, this Obama-Volcker proposal does not imply a full return to the era of the Glass Steagall Act of 1933, with the strict separation of commercial or deposit or retail banks from investment banks. But it does lead to a substantial reduction of banking activities that a regulated bank is permitted to engage in. In doing so, it aims at reducing the risk profile of these banks as well as their size, which, in turn, aims at resolving the too-big-to-fail dilemma.

I can accept the Obama-Volcker proposal to prohibit hedge fund and private equity activities or ownership for regulated banks, although these institutions did not play an important role in the origins of the financial crisis, contrary to populist complaints by politicians e.g. in Germany and France. However, their proposal to ban proprietary trading in financial instruments is ambiguous at best and dangerous at worst. Obama-Volcker rightly wants to allow regulated banks to continue trading to serve their clients: executing orders on behalf of clients. But they lump together all other trading activities under the heading 'proprietary trading' which should be banned. The point here is, however, that these other trading activities by banks consist of two categories. On the one hand, there is 'pure' proprietary trading which banks do entirely at their own initiative, with their own capital and at their own risk, in order to take positions and make profits. It is undeniable that this kind of proprietary trading may lead to substantial losses for banks and may therefore require curtailment although this was not a major factor among the causes of the financial crisis. On the other hand, banks also maintain trading books as 'market-makers'. A market-maker performs a vital role to keep financial markets well-functioning and liquid. One cannot serve customers well if one does not simultaneously act as a market-maker in the same financial products the customer wants to sell or to buy. In other words: a ban on market-making activities invalidates the license for trading for clients. So, financial markets as well as non-financial companies need banks to act as market-makers. This latter trading activity indeed entails taking positions and taking financial risks. However, it should *not* be forbidden for regulated banks. The practical problem, however, is that it is very difficult when drafting bank regulation to define the borderline between proprietary trading and market-making.[17]

On the concept of 'narrow banking', I agree that official measures are justified to ban a limited number of specific activities of regulated banks that are perceived to increase disproportionately the risks of banking. I even would reluctantly accept a ban on 'banc-assurance' or financial conglomerates. However, such a combination of banking and insurance activities, as practiced by a limited number of banks, was not among the root causes of the financial crisis. Consequently I do not consider this mandatory separation as an indispensable component of measures of bank reform.

What I do <u>not</u> agree with, is the drive by politicians, authors and some financial experts in several countries to impose a rigorous set of measures towards narrow banking, in the sense of a mandatory limit on the size of a bank, i.e. on the size of its balance sheet or its revenues.

My first argument is that smaller does not automatically mean less risky for governments and taxpayers. I may refer to several recent cases of (near) bank failures in Europe as well as the USA that were rightly perceived as domestic, and not too-big-to-fail banks. Nevertheless, they led to substantial financial support operations of the national governments and/or deposit guarantee schemes in the home or host country: e.g. IKB Bank in Germany, Northern Rock in the UK, DSB Bank in The Netherlands, the Icelandic banks and Fortis in Belgium-The Netherlands. Also, the experience in the USA where in 2009 far more than 100 regional banks defaulted, undermines the validity of the narrow banking preference. Each of these banks did not create a costly clean-up operation but all these 'small' interventions by the FDIC in the USA together led to an enormous *aggregate* burden on the FDIC which exceeded its entire resources. And this string of 'small' failures continues in 2010.

Most of the bank failures in recent years are not cases like Lehman Brothers but rather small or mid-size domestic banks whose losses were not caused by excessive leveraging of their balance sheets or large trading positions or substantial activities in 'innovative' products such as derivatives and securitizations and not even sub-prime mortgages. No, their losses came from traditional commercial and retail banking activities: unwise risk management in extending too much credit to e.g. construction companies and real estate firms in their own region or to holders of credit cards. Among the worst offenders one could cite savings banks in Spain and Germany and building societies in the UK. It is therefore an illusion to believe that the proposed 'narrow-banking' solution of separating these two categories of banks will eliminate the need to rescue regulated banks.[18]

Moreover, I doubt that governments will always successfully resist pressures from financial markets and other interested parties to bail-out a large unregulated financial institution in the capital markets or investment bank category.[19] [20]

My second argument is that it is probably more effective to reduce the likelihood of bank defaults and to address the too-big-to-fail dilemma by focusing on different devices:

a) let the capital requirements of a bank depend on the degree of risk in the balance sheet, the products and the revenues of that bank;

b) let the bank supervisors become more alert and (pro)active, with more appropriate instruments, in scrutinizing and, if necessary, curtailing overly risky activities of the bank in question. The size of a bank may play a role in their assessments of risk; and

c) make it more likely that bank shareholders and creditors (other than savings accounts insured by deposit insurance systems) incur losses in a default.

The result should be that no longer would any bank be considered too-big-to-fail and that even a large 'systemic' bank would be allowed to fail, but in a different way: less disorderly, with different legal instruments, with more elements of market discipline, with less distortion of competition (banks deemed 'systemically important' enjoy lower costs of funding), with less moral hazard and less cost to society.[21] [22]

Bank Taxes

Confusion and disagreement is emerging globally concerning various new taxes to be imposed on banks. On the one hand, proposals vary with regard to the subjects of any new levies: on certain bank transactions (see the old idea of the Tobin-tax) or on the overall size of the balance sheet or the profits or the revenues of a bank. On this matter international coordination is clearly needed to retain a level playing field. On the other hand views differ on the use of the proceeds of a new bank tax. In some countries politicians and others see this as a justified device to let banks pay for the losses the financial crisis has created for the governments and society at large. Although I recognize that this populist approach meets much sympathy from politicians, the general public and media, I see dubious elements in this motivation. First, by far not all banks contributed to the deterioration of risk management and the resulting losses. Second, one should distinguish between banks that received capital injections and various kinds of guarantees from the public sector and banks that did not need this support. Governments in many countries rightly request a tough price for their support by way of interest, dividends, premiums and fees and are possibly able to sell their temporary stake in a bank's capital at a profit. So, bank taxes on top of all that could result in accumulation and overburdening the banks.

Those who favour a form of general bank tax want to transfer the proceeds to the general coffers of the national Treasury which have been depleted in many countries during the financial crisis. Whereas I have some sympathy for this goal of covering the cost to taxpayers for *past* bank failures, I become more critical if one sees a bank tax as an 'easy' way of financing large government deficits in general. This is a major component of a recent IMF proposal to impose a *permanent* tax on banks. I become vehemently opposed to this approach if – as in the case of the recent proposal of the Conservative Party in the UK – the motive for a bank tax is the financing of a hobby horse of a political party, unrelated to financial crises and banks -, like in the British case a tax sweetener for the incomes of married couples.

Some proponents of a bank tax like the IMF believe that it would discourage too much risk-taking by banks.[23] I doubt that this is realistic. On the contrary, it is more likely that banks, faced with declining after-tax profitability, try to *increase* (before tax) profits by raising their risk profile, in the hope that more risky transactions will stimulate revenues. Imposing higher capital requirements on above-average risky bank assets makes more sense to discourage excessive risk-taking.

Bank Funds

If it were decided to impose a bank tax, I would favour transferring the proceeds – up to a maximum amount, to be determined – to a dedicated bank fund or financial stability fund. This was the goal of a proposal recently being discussed in the US Senate, but which was dropped later. Its goal should be to make funds available for the financing of any <u>future</u> official support for banks. This could be done on a purely national basis. In Europe, however, I would favour a European approach in which the banks that are defined as large and cross-border, would be handled at the European level. Decisions whether or not to save an ailing bank in that category and who would finance any support, should be made by a European authority. The solution of the awkward problem of international governmental burden-sharing of bank rescues can be facilitated by transferring a portion of the proceeds of a bank tax to the above-mentioned fund.

European Commissioner Michel Barnier recently spoke in favour of a European 'emergency' fund for future bank rescues to be financed by bank contributions (either bank taxes or annual insurance premiums).[24] This idea is linked to proposals to adapt the existing national deposit guarantee systems or funds. Their functioning varies from country to country but in most cases the goal is to provide financial protection to retail customers, with savings accounts, of banks that are bankrupt. Here too, it makes sense to separate domestic banks from large cross-border banks and to create a new guarantee fund for the latter category only. The banks in that category will be obliged by law or European directive to make annual, *ex ante* contributions in cash into such a European fund, according to both its size and its risk profile. *Ex ante* contributions form a crucial and welcome disciplinary element: banks with high-risk profiles will disproportionately contribute to the deposit guarantee system. If later one of these large 'European' banks would encounter serious problems this bank fund could be used – to be determined on a case-by-case basis – either for a bail-out of that bank to prevent its bankruptcy and/or for payments to its depositors – of course to a pre-agreed maximum amount per account – in cases where it is decided to let the bank in question to go under.

I want to emphasize two essential points. The first is the need to make sure that any future bank problem – both a default with a bail-out of its depositors and a rescue to avoid a default with a bail-out of the bank itself through capital injections – can be financed in the first instance *by the private sector* itself. The resources of the above-mentioned bank guarantee fund, or bank resolution fund, provide the first and hopefully only source of finance for any bank support action. A serious problem arises, obviously, if the resources of the fund are not large enough to finance one or more problem cases of very large banks. In such an awkward situation, the relevant European authority *may* decide to tap the above-mentioned *official* bank fund to finance any residual losses. This should be a fall-back option only and implies a combined private-public financing of failed banks. Dominique Strauss-Kahn of the IMF has made similar proposals.[25]

The advantage of this approach is that the official sector would have already obtained a substantial amount available in its bank fund for rescues of a bank or its depositors, without encountering the notorious need to find ad hoc – on the spur of the moment and in the midst of a bank crisis – new financial resources from one or more national Treasuries. In this way one may avoid or reduce the awkward burden-sharing dilemma.

This brings me again to the concerns of moral hazard: when private sector institutions assume or expect that they will be bailed-out and stay alive through financial support from the public sector. The presence of a fund with public money earmarked for *future* bank rescues may indeed increase this moral hazard with the corresponding danger of irresponsible, excessively risky behaviour of a bank.[26] There are, however, two counter-arguments. First, banks know that their own, private sector money will act as the first buffer to finance any support action. And second and more importantly, the moral hazard issue will diminish if the special 'resolution' alternative will be introduced to address a bank failure. The major feature of this alternative solution is that an endangered bank will not be kept alive and not bailed-out with public money and that shareholders and creditors will suffer losses. Consequently, the moral hazard issue will become less threatening as well.

This analysis makes it clear that there is a risk of confusion about the basic character of 'bank funds' in the current debate.[27] For some, a bank fund should merely retain the current goal of most private sector-funded deposit guarantee systems (DGS), namely to compensate retail bank customers/depositors *after* a bank has defaulted and stopped operations. They want to introduce a European DGS.[28] Others support this approach but want to expand its scope of action to include – as mentioned above – funding of official interventions *before* a bank has defaulted, based on the special bank resolution mechanism. This latter type of support would fundamentally change the character of a DGS.

Dilemmas for Banking Reform

We face several dilemmas in choosing the optimal way forward towards reforming the banking sector. In addition to the ones already mentioned such as the lack of burden sharing, the moral hazard and the too-big-to-fail issues I want to highlight several others.

First, some prefer to focus on measures to punish the banking sector for all the evil it has brought to the world in recent years by restricting bonuses, imposing new taxes on banks and restricting the size of banks and the activities they are allowed to engage in. Others are more forward-looking and emphasize measures that will reduce the possibilities for new financial crises to occur. Those two approaches are not necessarily contradictory and the practical political outcome may be a combination of elements of both.

Second, this reference to a combination of official measures leads to another dilemma. I am afraid that the outcome will be a variety of reforms each of which by itself may make sense to address the causes – or the consequences! – of the financial crisis but which result in an *accumulation* of restrictive measures for banks. This in turn may reduce significantly the activities, revenues and profits of most banks. In particular, a combination of imposing 'narrow banking', including a forced reduction of the maximum size of banks and/or a ban on certain profitable banking products <u>and</u> a substantial increase in the minimum capital requirements for banks <u>plus</u> a new and additional 'bank tax', is likely to lead to a significant reduction in the ability and willingness of many banks to extend new credits to their customers, both retail and corporate. This will negatively affect economic growth. Politicians who are now advocating such an accumulation of measures but who later will criticize the banks for the reduced availability of credit for mortgages, trade finance, new corporate investments etcetera should heed this warning. Another danger is that a victory for those who favour a banking tax may weaken the support for the tough capital and liquidity rules being considered by the Basle Committee. I share the concerns expressed by its President Nout Wellink[29] that these tax proposals "might be a hindrance" to regulatory efforts to make the financial system safer and more stable by toughening capital and liquidity rules. He rightly urges politicians to wait until his committee has finalized their plans.[30]

Third, there is fair chance that decisions to change bank regulation and supervision, to change capital requirements, to impose new taxes etcetera will result in an outcome that differs substantially between the USA and Europe, and perhaps other areas as well. Even if each of these final results may be acceptable in its own right, the divergence is not acceptable if it creates an uneven playing field. The absence of equal – or at least comparable – conditions will imply distortion of competition and banks will engage in 'arbitrage' to carry out activities in the country that is relatively the most attractive one.

Fourth, at the present juncture I see two dangers emerging with regard to bank reforms. At the one extreme, the danger exists of a weakening of the drive towards serious bank reform. This weakening is caused partly by an (incorrect) feeling that the need for action has diminished now that the worst of the financial and economic crisis is over, partly by resistance from the banking sector supported by their strong lobbying efforts and partly by differences of views among the reformers over what precisely should be done, both within countries and internationally. This applies both to the USA and Europe.

At the other extreme, the danger is looming of excessive and overlapping regulation, with too many new measures that may stifle a sound functioning of the banking sector and consequently the growth prospects for the entire economy. Which one of the two – contradictory – developments will prevail is difficult to predict. I am afraid it may be a mixture of both.

Notes

[1] The term is derived from Jacques Pelkmans, "The role of the EU in the financial and economic crisis" (in Dutch), Netherlands Institute for International Relations Clingendael, The Hague, October 2009, p. 32.

[2] Dominique Strauss-Kahn, Managing Director of the International Monetary Fund, made the same point in his speech entitled "Crisis Management Arrangements for a European Banking System" at the recent conference on Building a Crisis Management Framework for the Single Market organised by the European Commission in Brussels, 19 March 2010. He used the term 'integrated banking system'. After hailing the recommendations of the de Larosière Committee, he urged the adoption of an integrated European system of crisis prevention, crisis management, crisis resolution and depositor protection to achieve "a fundamental overhaul of its financial stability architecture".

[3] Kenneth Rogoff and Carmen Reinhart, *This Time is Different: Eight Centuries of Financial Folly*, Princeton, NJ: Princeton University Press, 2009 and K. Rogoff, "Europe finds that the old rules still apply", *Financial Times*, 6 May 2010.

[4] Report by the High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, Brussels, 25 February 2009. In the report (Chapter III, section V, paras. 215-218) the Committee already hints at the need, in a few years time, to adopt additional reforms, particularly wider regulatory powers at the EU level. The report (Chapter II, section VI, paras. 125-143) concludes however, to my regret but realistically, that at this stage of European integration, there does not yet exist sufficient political will in the member states to agree on a European policy to handle crisis management and resolution in the financial sector. This is particularly the case for the absence of an EU-level mechanism for burden-sharing in financing cross-border bank crises.

[5] I refer to the excellent CEPS-Assonime Task Force Report, *Overcoming too-big-to-fail: regulatory framework to limit moral hazard and free riding in the financial sector*, by Jacopo Carmassi, Elisabetta Luchetti and Stefano Micossi.,CEPS, Brussels, March 2010. This study provides an in-depth and convincing analysis and proposals for a regulatory framework to limit moral hazard and free-riding in the financial sector as well as a new European system of deposit guarantees.

[6] Similarly Marek Belka, "Why we need a resolution authority for Europe's banks", *Financial Times*, 22 April 2010. His approach is similar to Dominique Strauss-Kahn, op. cit., 19 March 2010.

[7] The CEPS-Assonime report, op. cit., pp. 41-56, provides a comprehensive and clear description of the national ordinary insolvency procedures and the various special administrative regimes for resolving bank insolvency in some European countries as well as the USA.

[8] Similarly Thomas Huertas, "Policy of too-big-to-fail is too costly to continue", *Financial Times*, 23 March 2010.

[9] Andres Kuritzkes and Hal Scott, "Markets are the best judge of bank capital", *Financial Times*, 23 September 2009, observe that large banks that became distressed during the crisis maintained even larger capital buffers relative to the regulatory minimum called for under Basle. In their view, this strongly implies that capital levels for most banks – and especially for large institutions that arouse systemic risk concerns – are set on the basis of financial expectations, and not according to regulatory rules. They recommend that we should find ways to strengthen market discipline and to complement regulation (Basle) with more effective market discipline. I agree that capital requirements for banks do not eliminate the risk of bank failures and that more effective market discipline is desirable. However, experience tells us that markets are clearly not always the best judge of the appropriate amount of bank capital.

[10] The point is that the market value of these mandatory convertibles declines at times of the bank's distress because the market value of the bank's shares into which they are exchanged is likely to drop significantly.

[11] Similarly European Commissioner Michel Barnier in his presentation to the ECOFIN meeting in Madrid on 17 April 2010.

[12] See also International Monetary Fund (IMF), "Global Financial Stability Report", April 2010, chapter 2, pp. 21-22.

[13] Recently two interesting launches of this kind of paper were made, the first occurring in November 2009 with the £7.5 billion in COCOs (contingent convertible bonds) issued

by Lloyds Banking Group. Second, in March 2010, €1.25 billion in 10-year contingent bonds were issued by RABO Bank in The Netherlands. They will be automatically written down by 75% if RABO's capital ratio falls below 7%. The reason why these offerings did well is probably explained in the case of LBG by the fact that the new bonds were in exchange for outstanding 'traditional' subordinated bonds that had become less attractive to their holders. In the case of RABO, the nowadays exceptionally high AAA-credit rating of RABO may have convinced investors to subscribe.

[14] Group of Thirty (G-30), "Financial Reform. A Framework for Financial Stability". Report of the Working Group on Financial Reform (chaired by Paul Volcker), Washington, DC, January 2009. Paul A. Volcker, "How to reform our Financial System", *New York Times*, January 31, 2010.

[15] E.g. CEPS – Assonime Report, op.cit., pp. 2, 5 and 20-23.

[16] President Obama announced it in January 2010, and as it is largely based on the views of his adviser Paul Volcker, it is also called the 'Volcker-rule'.

[17] This view is shared by many experts. See e.g. Martin Wolf, "Volcker's axe is not enough to cut the banks down to size", *Financial Times*, 27 January 2010.

[18] The previous Netherlands Minister of Finance, Wouter Bos, endorsed the Obama-Volcker proposals and said that he favored a mandatory splitting of 'safe' banks from 'risky' banks, *NRC Handelsblad*, 25 January 2010. The problem, however, is that in reality his 'safe' banks are not always safe.

[19] Or in the current populist jargon of some politicians: casino banks.

[20] Similarly, Martin Wolf, "Why cautious reform of finance is the risky option", *Financial Times*, 28 April 2010.

[21] See Tony Jackson, "Too-big-to-fail debate makes move in right direction", *Financial Times*, 12 April 2010.

[22] Similarly, Hall S. Scott, Director of the Committee on Capital Markets Regulation, in a letter to US Senators Dodd and Shelby, Cambridge, Massachussetts, 4 May 2010.

[23] "A bank tax as insurance for us all", *International Herald Tribune*, 28 April 2010.

[24] At a conference organized by the European Commission in Brussels on 19 April 2010.

[25] Op. cit., 19 March 2010. In his view, a European Resolution Authority (ERA) is needed to complement the reforms proposed by the de Larosière Committee. It should receive a mandate to deal *ex ante* with failing major cross-border banks. This system should be pre-financed as much as possible by the banking industry, including through deposit insurance fees and levies (taxes) but it needs a "fiscal back-up mechanism for any net resolution costs", based on an EU-agreed burden sharing scheme.

[26] The Netherlands Minister of Finance Jan-Kees de Jager, among others, has expressed this view.

[27] In addition, a distinction needs to be drawn between bank funds to provide financial support to banks and sovereign funds that focus on providing support to governments in financial distress. In the EU, the member countries are now considering some kind of (semi-) permanent 'European Monetary Fund (EMF)'. This fund can decide to extend official credit, hopefully together with the IMF, to member countries of the euro area or the EU where the government is unable to (re-) finance its deficits and debt on the financial markets. See Daniel Gros and Thomas Mayer, *How to deal with sovereign default in Europe: Create the European Monetary Fund Now!*, CEPS Policy Brief No. 202, CEPS, Brussels, February 2010, updated 17 May 2010.

[28] See, for example, the CEPS-Assonime report, op. cit., pp. 9 and 37. One of its authors, Stefano Micossi, wrote a later commentary in which he firmly rejects a bank crisis resolution fund paid for by the financial institutions sector itself. He emphasizes that the only way to avoid the undesirable results of the moral hazard risks of any resolution fund is "to credibly exclude all support for shareholders and creditors of a financial institution going bankrupt." I agree with this latter condition. Stefano Micossi, "Do we need a resolution fund paid for by financial institutions?", EuropEos Commentary, CEPS, Brussels, 17 May 2010. The CEPS-Assonime report (pp. 35, 37, 78, 81 and 85) also proposed to link a new European Deposit Guarantee Fund (EDGF) with the European Banking Authority (EBA) which the ECOFIN has decided to create, in line with the de Larosière Committee. The EBA – already charged with certain bank supervisory responsibilities at the European level – should also be entrusted with the management of the EDGF.

[29] *Financial Times* interview, 4 May 2010.

[30] The Netherlands Minister of Finance Jan-Kees de Jager also and correctly warned against the danger that the accumulation of measures could negatively impact banks' ability to provide credit. However, he simultaneously supported proposals towards new bank taxes! See interview in *Financieel Dagblad*, 19 April 2010.

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