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The Organization of Banking and Supervision; Introduction and Overview

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1. Introduction

The focus of this Special Issue is on organizational reforms in the financial sector in the aftermath of the financial crisis 2007-2009 and the subsequent euro-zone crisis. In particular, the perception that many banks were too big and too complex to fail during the crisis, which led to very costly bailouts at tax-payers expense in several countries, has fueled a number of proposals to limit the size and the complexity of financial institutions, as well as proposals to reorganize public authorities responsible for supervision and crisis management.[1]

The responses of EU policy-makers to the euro-crisis have also been driven by fear of large banking failures. The costly bailouts in, for example, Ireland and the strong link between banking risk and sovereign risk have created a new attitude among policy makers that many banks are also 'too big to save'.[2] The policy dilemma in this situation can only be solved with reforms addressing the size and complexity of the banks, and/or the organization and funding of supervision and crisis management on the systemic as well as the individual bank level.

It is not only concern with tax-payers that drive policy makers' desire to reorganize the banking system so as to avoid having to bail out banks in distress. The perception in financial markets that banks in distress will not be allowed to fail is a source of implicit protection of banks' creditors beyond the explicit protection afforded by deposit insurance schemes. The protection of banks' creditors leads to a degree of subsidization of debt financing. If large and complex banks have stronger implicit protection, they have a competitive advantage relative to other banks. Thus, banks are given incentives to become large, complex and highly leveraged. An important research issue is to analyze to what extent implicit protection of banks' stakeholders have contributed to the size and complexity of banks.

The explicit and implicit protection of banks' creditors implies that banks' shareholders are given incentives to shift risk to tax payers and deposit insurance funds. The probability that individual banks will become insolvent increases and the likelihood that a large macro shock will lead to a banking crisis increases as well.

The pre-crisis approach to remedying the distorted risk-taking incentives in banking relied on supervision and capital requirements. The failure of this approach is discussed next. The emerging approach focuses on separation of different types of activities performed by banks and separation across jurisdictions, as well as on the organization of supervision and crisis management across jurisdictions. In Section 3 it is argued that the organizational reforms of banking activities are inseparable from organizational reforms of supervision and resolution procedures for distressed banks. The concluding section provides an overview of the papers in this Special Issue.

2. The pre-crisis approach to bank regulation and supervision

Since the first Basel Capital Accord, Basel I, was issued in 1988 policy makers have relied on capital requirements and supervision as the primary instruments to limit banks' insolvency risk. The Basel Committee has developed and refined its approach to calculating capital requirements since that time. Basel II that allows "sophisticated" banks to use internal ratings to assign risk-weights to assets was issued in 2004. The financial crisis exposed weaknesses in the Basel II framework. As a result, Basel III was issued in 2010. Liquidity requirements were introduced and the capital adequacy framework was expanded to incorporate counterparty credit risk and a simple leverage ratio in addition to the risk-weighted asset ratio. Required capital ratios were increased, they were given a cyclical component and one component applying specifically to systemically important banks. The Basel III requirements are in the process of being implemented over a period of several years.

The Basel framework for capital adequacy has been criticized on several grounds.[3] Already before the crisis it was pointed out that the capital requirements were too low, they could be manipulated by banks, they favored large 'sophisticated' banks' and they did not make it clear whether the required capital was a buffer or an absolute minimum (and therefore a tax). Benink and Wihlborg (2005) argued that the Basel II framework did not pay sufficient attention to market discipline. Others pointed to excessive complexity (Haldane, 2012) and the risk of 'regulatory capture' as a result of close cooperation between banks and supervisors in the development of internal ratings based risk weights.[4]

A possibly devastating critique is developed in the paper by Blundell-Wignall and Roulet in this issue. They point to the ability of banks to use derivatives to achieve any desired risk level while satisfying capital requirements. This critique refers to the most recent Basel III as well.

The Basel Capital Adequacy Framework focuses on keeping the banking system sound to the neglect of what happens when a bank fails or an economy wide crisis erupts. This neglect is revealed by the lack of clarity about the role of capital. If capital is considered a buffer against unanticipated losses one must recognize that circumstances may arise when the buffer is insufficient and some actions must be taken by supervisors and banks. By the same token, the need for capital depends on what procedures will be put in place to resolve a situation of insolvency.

Prior to the financial crisis only a handful of countries had implemented procedures for resolving banks in insolvency with the intention to minimize contagion effects while allocating losses to creditors.[5] Other countries relied on regular corporate insolvency laws. The US was one of the countries with a *lex specialis* for banks. Nevertheless, large systemically important banks like Citibank and Bank of America were exempted from these procedures and bailed out.

3. Towards organizational reform

The investment bank Lehman Brothers was not bailed out. Since the *lex specialis* for banks did not apply to investment banks, Lehman Brothers was but put into bankruptcy under US Chapter 11 intended for restructuring of corporations. Foreign subsidiaries were resolved under host countries' insolvency laws. The paper by Carmassi and Herring in this volume discusses problems that arose during the resolution of Lehman Brothers in the US and abroad. In particular, they argue that the mismatch between Lehman Brothers' legal organization in cross-border subsidiaries and its operational integration was an important source of value losses in foreign subsidiaries, in particular.

On the European side a similar mismatch between the legal organization of cross-border banks and the functional organizations developed as cross-border banking expanded within the EU's Internal Market. Cross-border banking takes place overwhelmingly in subsidiaries, which are legal entities in the host countries, while the banks functionally and operationally are highly integrated. As a result, the failure of one part of a bank cannot be handled as a separate insolvency event without severe operational repercussions on the whole organization. As in the

Lehman Brothers case, the resolution of a bank's failure will be complex, associated with value losses and contagion among the different entities of the cross-border bank.

The same reasoning applies on financial conglomerates with a variety of financial activities, which may be highly integrated while organized in hundreds of subsidiaries. In the European case, the resolution problems are accentuated by the absence of *lex specialis* for banks in most countries.

The original EU vision as expressed in the Banking Directive was that EU banks would be able to operate cross-borders in branches with a single license under home country control and supervision. This vision has been realized only to a limited extent. It met resistance from both home country and host country supervisors. One reason for this resistance may be the absence of effective and non-discriminatory resolution procedures in the home countries. Host country authorities lack trust that their interests will be safeguarded in home country resolution proceedings.

The European banking system has become dominated by relatively few, very large banks organized in complex functional organizations, which do not correspond to legal organizations. Jurisdictional responsibility would be unclear even if individual countries were to implement resolution procedures for banks.

The near-impossibility of resolving large European banks in distress in an orderly manner has influenced the EU approach to the euro crisis. The avoidance of bank failures as a result of the sovereign debt crisis became a severe constraint on crisis management. The paper by Benink in this issue provides a view of how the EU could manage the latent banking crisis in the near term.

EU policy makers along with many observers have drawn the conclusion that the EU must form a banking union with a central EU supervisor, an EU wide deposit insurance scheme and an EU bank resolution authority. This longer term goal implies that the vision of cross-border banking in branches under a home license has been rejected. The response to the cross-border complexity is to accept it and to create central EU authorities with the ability to supervise and resolve large cross-border banks.

Already before the euro crisis international organizations such as the IMF, the Financial Stability Board established by the G 20 and the Basel Committee, as well as national policy makers, awakened to the need for a regulatory framework for dealing with banks in distress;

including large and complex financial institutions with cross-border operations in traditional commercial banking as well as investment banking.

There are a number of different approaches to resolving the problems associated with a financial system dominated by banks that are both too big and too complex to fail, and too big to save. These approaches can only be mentioned briefly here. Several are analyzed in greater detail in the papers that follow.

(i) Bail-ins implying that a bank's creditors take a part of the capital shortfall in insolvency. The burden on tax-payers would be reduced correspondingly and groups of creditors would become sensitive to insolvency risk and, thereby, contribute to market discipline. Subordinated debt and contingent convertible bonds (CoCos) are two examples. By issuing subordinated debt a bank obtains a group of creditors that should be credibly unprotected in insolvency. CoCos (contingent convertible bonds) convert to equity in a distress situation when a bank's capital falls to a trigger level. Thereby, the equity position is improved and insolvency delayed or averted.

Ad hoc bail-ins at the time of insolvency are also possible if policy authorities choose to allocate losses to particular groups. In the case of Cyprus authorities decided that creditors of failing banks should take losses. Such ex post bail-ins lack predictability and there is an obvious risk that losses will be allocated according to political criteria.

Predictability and credibility of bail-ins exceeding subordinated debt and CoCos require insolvency law with mandated procedures for allocating losses to creditors according to priority rules.

(ii) Recovery and Resolution Plans (Living Wills) have become prominent in the reform work worldwide. For example, the US Dodd-Frank Act introduces a requirement for Living Wills for Bank Holding Companies and for non-bank financial companies with assets greater than $50 billion. These companies are required to submit periodic reports regarding plans for rapid and orderly resolution under the bankruptcy code in the event of distress or failure. The living will requirement is intended to help regulators develop a comprehensive and coordinated resolution strategy for complex financial institutions.

Avgouleas et al (2010) argue that Living wills have the potential to contribute to the simplification of organizational structures and, thereby, to greater transparency of large banks.

The discussion about Living wills illustrates the close connection between organization of banking and resolution procedures.

The paper by Carmassi and Herring in this volume discusses the potential contribution of Living wills in greater detail.

(iii) An increasing number of countries have implemented or are in the process of developing *lex specialis* for resolution of insolvent banks. There is great uncertainty whether it will be possible to develop effective and credible resolution procedures for banks operating cross-border and for large banks with complex operations in a variety of financial services. This uncertainty can potentially be alleviated by reforms requiring banks to simplify their organizations. The paper by Mayes in this issue analyzes the New Zealand approach to resolution including both a *lex specialis* and organizational requirements for foreign subsidiaries operating in New Zealand.

(iv) Prompt operational separability of subsidiaries from a parent bank in distress. As discussed in Mayes' article such separability, if practical, would enable host and home countries to resolve their subsidiaries separately without creating serious spillover effects and value losses. The potential cost of such separability would be difficulties of taking advantage of operational economies of scale and scope. The New Zealand approach implies a multi-point approach to resolution. It stands in contrast to the single point approach now favored by the EU.

(v) Separation (ringfencing) of different types of financial activities in independent entities that can be resolved separately in distress. There are a number of different proposals for separability motivated by distorted incentives for risk-taking. The paper by Blundell-Wignall and Roulet in this issue analyzes the feasibility and risk consequences of different proposals for separation. The Volcker rule in the US emphasizes separation of proprietary trading. The Vickers report in the UK focuses on separation between traditional commercial banking and investment banking. The Liikanen proposal in the EU is designed to reduce interconnectedness by ringfencing trading activities within a holding company structure. The OECD proposal presented in Blundell-Wignall and Roulet focuses on activities in markets for derivatives.

Separability requirements can be more or less strong depending on whether they take the form of ringfencing within a corporate structure or prohibition against involvement by the bank in certain activities.

(vi) The banking union as proposed in the EU accepts the complexity and size of cross-border activities and financial conglomerates. Instead the EU appoints the ECB as the supervisor for, at least, the systemically important European banks. Conflicts among supervisors and information gaps between supervisors can be closed this way. On the other hand the ECB must gain expertise with respect to banking systems and practices in a heterogeneous group of countries. As discussed in Berglund's contribution in this issue there are also important political economy aspects of the choice of jurisdiction of supervisors.

The proposal for a banking union also envisions a common resolution procedure for all member states and a common pre-funded resolution fund to support critical operations for a period of time. At this point in time resolution remains a national responsibility. This incongruity between the organization of supervision and the organization of resolution has the potential for creating incentive conflicts between the supervisor and the resolution authorities.

(vii) A alternative to the single point approach to resolution in the proposed banking union would be to return to the EU vision of banks operating in branches across the EU with a single license from the home country. The single point for resolution of one bank would then depend on the home country.

4. An overview of the papers in this issue

The first paper by Adrian Blundell-Wignall and Caroline Roulet, "Bank Business Models, Capital Rules and Structural Separation Policies: An Evidence-Based Critique of Current Policy Trends" examines the roles of capital rules, macro variables and bank business model features in determining the safety of banks as measured by the 'distance-to-default' (DTD). A panel regression study using US and European banks with pre- and post-crisis data is used to explore the issue empirically. A new technique is also used to back out the amount of capital banks would have needed during the crisis to keep the DTD in the very safe zone. The main business model features that matter are 'derivatives and wholesale funding', and 'trading and available for sale securities'. The paper also shows that it is simply not possible for any reasonable capital rule to compensate for the risks created by business model features encompassing large derivative-based activities. The findings are particularly problematic for the Basel policy approach to capital rules. The current approaches to structural separation are discussed. The authors propose a micro-evidence-based approach to reform of bank business models to reduce systemic risk.

The second paper by Jacopo Carmassi and Richard Herring, “Living Wills and Cross-Border Resolution of Systemically Important Banks” focuses on resolution plans and their potential contribution to market discipline through disclosures. Large, systemically important banks are now required to prepare resolution plans (living wills). In the US, parts of the living wills must be disclosed to the public. The analysis of these disclosures shows that they are insufficient to facilitate market discipline and, in some instances, fail to meet the more modest goal of enhancing public understanding of the financial institution and its business. When coupled with the uncertainty over how an internationally active financial institution will be resolved, the authors argue that these reforms will do little to reduce market expectations that some financial firms are simply too big or too complex to fail.

The paper by David Mayes, “Achieving Plausible Separability for the Resolution of Cross-border Banks” considers whether it is plausible to resolve troubled systemically important cross-border banks by dividing them so that the component national authorities can resolve the parts in their jurisdiction separately according to their own priorities. It uses the example of New Zealand, which has chosen just such a route in its Open Bank Resolution policy, to tease out the difficulties and advantages. David Mayes concludes that this is a plausible route for systemic subsidiaries, providing there is deposit insurance. However, it may well not be the minimum cost solution. He argues that this is only likely where the home authority takes responsibility for the whole group and keeps all systemic operations running. It remains to be seen what the new EU-level proposals can achieve in this respect.

In “Optimal jurisdiction of financial supervision” Tom Berglund discusses factors that should be taken into account when designing financial supervision in a socially optimal way. He argues that developments in information technology have fundamentally changed the ways financial intermediaries operate paving the way for giant units. The financial crisis that started in 2008 revealed that these large and interconnected organizations are in a position to extract implicit subsidies from the rest of the society, since letting them fail would be too costly for society at large. The challenge in this situation is to create an institution to handle financial supervision, an institution that should be powerful enough to close down even the largest financial institutions within its jurisdiction, while at the same time not becoming so large and omnipotent that it would stifle further development of firms in financial services by effectively preventing full use of the potential provided by innovations in information technology.

While the four mentioned papers deal with longer term reform issues Harald Benink's "Resolving Europe's Banking Crisis through Restoring Market Discipline: A Note" addresses the near term issue of alleviating the banking problems in the EU. There is widespread consensus among international policy makers that the European banking system is seriously undercapitalized. Unlike the US, Europe failed to recapitalize its biggest banks following the financial crisis of 2007-09. Benink argues that it is now urgent to start recognizing losses on balance sheets to avoid a proliferation of Japanese-style zombie banks in Europe. He advocates new and thorough stress tests, which may have the consequence that losses will be imposed on unsecured creditors. Such an approach to the near term problems could contribute to market discipline in the longer term.

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Notes

[1] The concept of banking is used in a broad sense including, for example, investment banking. In some countries universal banks are financial conglomerates supplying a wide variety of financial services.

[2] Barth and Prabha (2012) show that % of global bank assets are held by largest banks. Barth et al show that the strong link between sovereign risk and banking risk is not specific to the current crisis in the euro-zone.

[3] The literature on the Basel framework is vast. Much criticism has taken the form of Statements by independent committees of academic economists. See in particular Statement No 160 from the US Shadow Financial Regulatory Committee (SFRC, 2000) and Statements No 11 (2001), No 19 (2004) and No 25 (2006) from the European Shadow Financial Regulatory Committee (ESFRC). Danielsson et al (2001) represents an early academic critique focusing on risk measurement.

[4] See European Shadow Financial Regulatory Committee (2003)

[5] See Wihlborg (2012),