

1. Introduction

Over the past few months, everyone has been talking extensively about the issues of the Eurozone. The main difficulty underlying these issues is that Europe is currently facing both a bank crisis and a sovereign debt crisis, which has triggered a vicious circle (see figure 1).

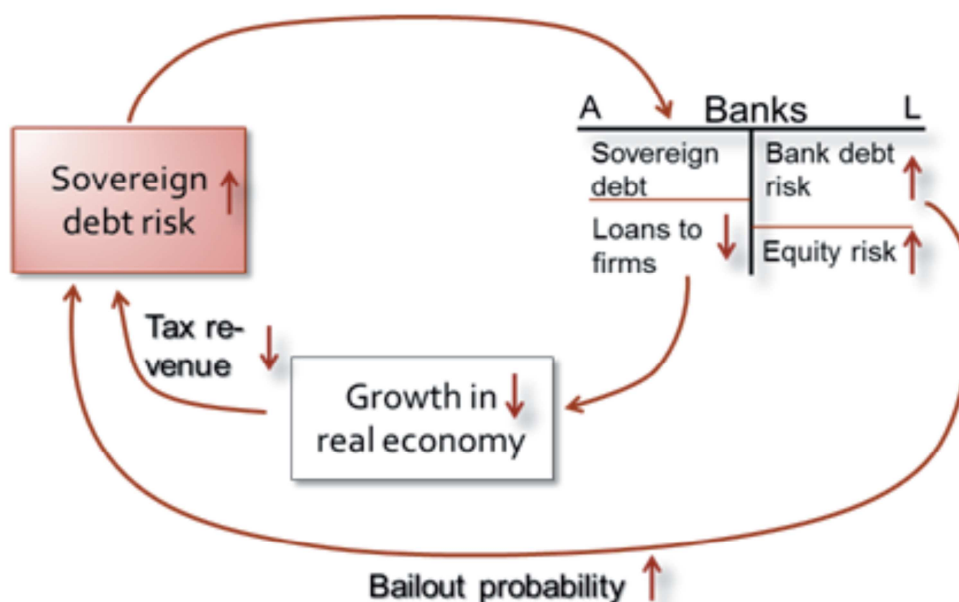


Figure 1 – Relationship between Sovereign Risk and Bank Risk

In order to solve this vicious relationship, several top economists have made a number of suggestions. This resulted in the book "The Future of Banking" (to read the complete version, see: http://www.voxeu.org/sites/default/files/file/the_future_of_banking.pdf), which was the starting point for the Duisenberg School of Finance (DSF) seminar.

2. Main discussion topics

In this document, we will not summarise the complete book. Instead, we will summarize three selected main topics that were discussed during the seminar:

- *Why we have to ring-fence banks*
- *Why European Safe Bonds are a good idea and Eurobonds are not*
- *Why regulation is neither a local nor a one-size-fits-all matter*

On the next two pages, you can find the interesting and sometimes surprising answers.

3. Why we have to ring-fence banks

First of all, due to the financial crisis we have noticed that although financial institutions are private firms from a legal perspective, they actually serve public interests to a great extent. In other words, society has become so dependent on banks to provide e.g. properly functioning payment systems that - as opposed to other companies - we can't let them fail.

However, since the incentives of private and public firms are not always aligned, there is reason to challenge whether all banking activities should remain under the same umbrella.

It was mentioned by e.g. Arnoud Boot – Financial Markets professor at the University of Amsterdam – that areas such as payments serve such an important public interest that it should be separated from riskier banking activities that can provide negative spill-over effects. The latter could be resolved by ring-fencing banks, which implies that banking activities are officially separated.

Although this solves part of the problem, it was also argued that this does not necessarily rule out risk-taking behaviour within the 'ring'. Either way, this will remain an important discussion topic for the coming future.

4. Why European Safe Bonds are a good idea and Eurobonds are not

The newspapers have been writing extensively about the notion of Eurobonds as a solution to the interest rate problems of the southern European countries and as a viable alternative to US treasuries. Why are these two arguments so important?

Because repackaging debt into Eurobonds can lead to diversification benefits and thus better interest rates. However, due to the political resistance this idea has not taken off yet.

A group of US economists have therefore proposed to implement European Safe Bonds (ESBies), which are designed in a similar way as Eurobonds, but do not require political approval to become operational. The latter seems to be impossible in a short notice, thus wiping Eurobonds off the table as a serious option. In short, implementation of the ESBies would look like this:

- A European Debt Agency will buy approximately EUR 5.5 trillion of sovereign debt in the secondary market (equal to 60% of the Eurozone's GDP)
 - The weight of each country's debt would be equal to the contribution to the Eurozone's GDP; hence, each marginal euro of sovereign debt would have to be traded on a single bond market, where prices reflect true sovereign risk
 - This ensures that the right signals are sent to the country's government (to avoid the moral hazard issues that have been mentioned with regards to Eurobonds)
 - To finance the EUR 5.5 trillion, the debt agency would issue two securities: (1) ESBies, with senior claims on interest and principal and (2) 'Rest' securities, with junior claims. The last ones are riskier in nature, but are still investment grade and thus interesting to institutional investors and hedge funds. Banks will be keen to buy the ESBies since it reduces their risk to their own sovereign debt. Given the calibrations of the authors, ESBies would default only once in 600 years, making them AAA rated
 - ESBies are politically feasible since they just repackage existing debt
- Overall, this should help realising the benefits of risk reduction, while avoiding any political influences.

5. Why regulation is neither a local nor a one-size-fits-all matter

Up to now, capital and liquidity requirements in Basel III have been strengthened for all banks. But will this really establish the envisioned outcome?

First of all, it is obvious that regulation should clearly be enhanced due to the financial crisis. It has been clearly illustrated that market discipline, though it could work on an individual basis, was insufficient on a system-wide level due to herding behaviour. This stems from the fact that market participants have fostered banks to make the same bets with risky products (that were highly correlated), as such creating systemic risk. One is tempted to argue that the capital requirements should be further increased to increase solvency, but a recent study by Laeven and Levine (IMF) has shown that the effect of regulation depends on a bank's ownership structure. More specifically, the study showed that banks with more powerful owners tend to take greater risks. Interestingly, higher capital requirements further increased the risk-taking behaviour at these specific banks, while the opposite was true for widely held banks. The same duality in effect applied to deposit insurance. Hence, ownership structure has significant explanatory power for subsequent risk-taking behaviour.

Another difficulty with regulation is that a lot of the current regulation works with ratios. A good example is the liquidity coverage ratio (LCR), which requires banks to hold a fixed percentage of their assets in cash and very liquid securities. As outlined by Professor Perrotti, who is an expert in bank liquidity, this will penalise the more efficient lenders since they will be rigidly (read: expensively) constrained. That is why quotas are usually less efficient than tariffs. Another downside with these ratios is that they are still pro-cyclical.

Besides the fact that regulation should become more tailor made, it should also become more global. Currently, when a Dutch bank collects deposits in Spain, the local supervisor asks for matching assets in Spain. This is sub-optimal. Overall, it is argued that the three objectives of financial stability, cross-border banking and national financial supervision are incompatible. This therefore calls for European supervision by e.g. the European Banking Authority (EBA), which deals with issues such as deposit insurance and resolution of troubled banks. Moreover, it was also discussed that the ECB should obtain a greater mandate to act as lender-of-last-resort in Europe and that the IMF was a suitable option to become such a backstop on a global level. Overall, there is still a lot to do in the area of regulation!