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# Sovereign Debt and Banks: Need for a Fundamental View on the Structure of the Banking Industry

Arnoud W.A. Boot

The credit crisis has made us all aware of the fragility of banks, and the financial sector at large. These very same banks also show up in the Euro sovereign debt crisis. EU banks outside Greece, Portugal and Ireland may own a few hundred billion euro's of the total outstanding public debt of those three countries. Any debt restructuring will therefore have serious consequences for the balance sheets of those institutions. For EU (and Euroland) policymakers this has further complicated their decision making on the financial problems of some of the member states.

Debt restructuring – possibly in all three countries – might be inescapable. Since many of the banks that hold the sovereign debt will be considered systemic in their home country, the countries involved might feel compelled to help these banks deal with the losses on the sovereign debt that restructuring implies.

A key concern is with the size of domestic financial sectors. This particularly applies to many EU countries where the total balance sheet of the domestic financial sector often is a staggering multiple of the national product of the country. Moreover, there exists no mechanism for burden sharing in case of failure of EU-wide operating banks. In case of a failure of a bank, its home country is essentially left on its own. Also this complicates a debt restructuring: no real EU-level procedures are in place to deal with failing banks. While some improvements are being made in EU level supervision (based on the 2008 de Larosière Report), the EU level arrangements cannot do much more than provide for some coordination. No burden sharing is in place and national supervisors remain in charge together with the national Ministries of Finance (for dealing with the potential financial consequences).[1]

Against this backdrop strengthening the resilience of the financial system is a paramount concern. In my view we need to deal with the complexity of the financial sector, and measures affecting the structure of the industry might have to be taken. Let me offer some thoughts on how to deal with the complexity of financial institutions.

*Dealing with size and complexity: breaking-up banks and living wills*[2]

The issue of complexity of financial institutions is heavily debated. In other industries one is tempted to say that market forces will figure out what the optimal configuration of a firm might be (subject to anti-trust concerns). However, in banking complexity can induce and worsen externalities that one might want to contain. More specifically,

i. complex institutions might be difficult to manage and supervise, and effective market discipline might not be expected (problem of opaqueness);
ii. a complex financial institution may have many, difficult to

1 At the EU level European Supervisory Authorities are being created, including the European Systemic Risk Board. Some exposure on sovereign debt is being assumed by the European Financial Stability Facility as well as the ECB.

2 Adapted from my paper "Banking at the Crossroads: How to deal with Marketability and Complexity?", prepared for the April 5-6, 2011, FED Atlanta 2011 Financial Markets Conference, Navigating the New Financial Landscape.

discern linkages with the financial system at large. This may augment TBTF, or rather too-interconnected-to-fail concerns;

iii. as a consequence systemic concerns might become more prominent;
iv. complexity might paralyze supervisors and put them in a dependent position; e.g. how is timely intervention possible if the complexity of the institution cannot be grasped by supervisors?

On the latter point, one element of the current reform proposals asks financial institutions to have a living will available, i.e. a detailed recovery and resolution plan that would allow for an orderly and efficient resolution of financial difficulties when they may arise. Such a living will aims at overcoming the complexity of an institution, and the paralysis it may cause with the supervisor when problems emerge. Taking this concept seriously should probably mean that all relevant financial institutions organize themselves in a way that they can be easily dissolved when problems arise. So the complexity might have to be dealt with upfront, and would then have direct implications for the organizational structure of the business, i.e. for a bank's business model.

One is tempted to conclude that one way of dealing with the complexity is to disentangle activities and put them in separate legal structures ('subsidiaries'). Those subsidiaries could deal on an arms-length basis with each other, with each being adequately capitalized without recourse on each other. This would resemble the non-operating holding company structure that is discussed in some OECD studies. With such a structure supervisors could possibly more easily (and timely) target, i.e. rescue, systemically important parts of a financial institution in case of distress; other parts could be sold or dismantled.

In this spirit one could look at the arrangements in New Zealand. In that country much of the banking system is in the hands of foreign players. New Zealand's authorities were skeptical about this lack of control, and instituted structural requirements to address them. The requirements entail enforced organization of activities within subsidiaries, but on top of that requirements that make the New Zealand based subsidiaries operationally independent from their foreign parents. Without effective pan-European arrangements, this might be necessary for individual EU countries to contain risks.

*Can separate legal structures under one corporate roof be effective?*

Whether such separate legal structures are really effective is unclear. In the market there might still be reputational spillovers between the different parts. Similarly, the market may still expect intra-group cross subsidization or joint risk bearing with the group's financial strength being perceived behind any individual activity.

In practice, financial institutions typically have corporate structures that include a myriad of legal entities. It cannot be emphasized enough that banks in this way have become horrendously complex. HSBC for example has in excess of two thousand entities. These are typically not designed to augment transparency and/or reduce complexity, but rather to engage in regulatory arbitrage (e.g. capital management) and economize on taxes. The legal structures themselves are typically not stand-alone in any meaningful way but linked together through intra-group transactions, joint back offices and other shared facilities and activities. While these interlinkages might help in obtaining synergies, the complexity that comes with it seems at odds with having effective living wills, or having a business structure that is receptive to supervision or market discipline.

Complexities are even more magnified once we take into account cross border activities and differences in bankruptcy regimes across countries. Potential conflicts are enormous in case of a crisis considering problems associated with burden sharing. Note that living wills and the timely intervention they could facilitate might be really valuable in these cross border situations especially when intervention occurs before losses become overwhelming.

One may expect that the industry will vigorously oppose such transparent and arms-length structures that – in their view – would limit synergies. The incentives of financial institutions might also be to seek complexity and in doing so hold supervisors 'hostage.' The implicit TBTF (or too-complex and/or interconnected-to fail) backing may further amplify disagreements between the bankers privately optimal choices and those of society. The reality is that the non-operating holding company structure as envisioned in the OECD studies – with transparency via arms-length contracts, no recourse and separate capitalizations – is a far cry away.

*Breaking up banks?*

A valid question is whether in face of this opposition one should not be more active and possibly go for a more radical break-up scenario. This refers to structural measures that seek to prescribe the structure and allowable businesses of banks and other financial institutions. Several policymakers have advocated such measures. The British have arguably been most adamant. Both Mervyn King (Governor Bank of England) and Adair Turner (Chairman of the Financial Services Authority) have both hinted at the need to split up banks. However, the UK Independent Banking Commission (the 'Vickers Committee') seems to shy away from break-up scenarios.

If the complexity makes it impossible for supervisors to (credibly) intervene in a timely fashion, one may start thinking about the desirability of breaking-up banks. One question is whether this is really possible. And the other is how breaking-up banks squares with the broader objectives of supervision, and particularly the lessons learnt from the financial crisis. At least two lessons could be identified:

- Contagion should be addressed;
- Core commercial banking functions might have to be safeguarded.

The latter typically refers to the payment system and local deposit and lending operations. If a break-up indeed increases transparency and reduces complexity, timely intervention might become easier and this could help serve both lessons.

*What to do?*

In my view the complexity of banks together with the sizable risks that banks impose on the economy at large (and EU countries in particular) necessitate actions that simplify the structure of banking institutions. With the enormous complexity of existing institutions and the difficulty that regulators (and legislators) have in grasping the intralinkages (within) and interlinkages (across) financial institutions, much could be gained. Also, well known problems like how to deal with the cross border operations of banks (international coordination) and the shadow banking system at large would need to be addressed.

What does not help is that there are no well established prescriptions on how to go about redesigning the financial architecture. Hopefully, for the foreseeable future, the design of the financial system will (continue to) be high on the research agenda of academics as well as regulatory and other public bodies.