How sound are banks today?

Mathias Dewatripont

Solvay Brussels School and ECARES

Université Libre de Bruxelles

Universiteit Antwerpen Masterclass

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Outline

1. To what extent has regulation been corrected since banking crisis that started in 2007-2008, in terms of liquidity, solvency and resolution?
2. Where do Belgian banks stand, also in comparison with the rest of the Eurozone (EZ)?
3. How serious is overcapacity (esp. in terms of employment) given technological evolutions?
4. EZ-wide banking advocated by some/many: good idea? Will it allow for more risk diversification or instead exacerbate the Too-Big-To-Fail syndrome?

Banking challenges

- Banking is useful: banks provide liquidity, and lend to households and SME's.
- Banking is risky: (1) banks lend long, borrow short; (2) are very leveraged; (3) no creditor/ depositor discipline (but risk of volatility).
- Therefore, need for regulation that: (1) strengthens solvency & liquidity; (2) deals with systemic risk; (3) makes resolution credible when things go wrong.
- Idea: replicate corporate control of 'regular' firms (see e.g. Dewatripont-Tirole, 1994, 2012, Dewatripont, 2014a).

1. Regulation
(see e.g. Dewatripont et al., 2010)

- Regulation in 2008 (Basel II) was clearly insufficient, in terms of solvency (equity/assets), but also in terms of absence of liquidity or systemic regulation and in terms of resolution (therefore huge bailouts).
- Better now (Basel III): higher solvency ratios, new liquidity ratios (liquid assets/volatile liabilities), 'macroprudential' regulation. See BCBS (2016, 2017a).
- On resolution front, progress ('bail-in') even if still some unfinished business.

Regulation (2)

- Since January 2016, Banking Recovery and Resolution Directive (BRRD) asks for 'bail-in' of at least 8% of balance sheet before a bailout.
- Now finally requires 8% of long-term subordinated claims (equity + junior debt) for all banks with at least €100 billion of balance sheet + ability of national authorities to require it for smaller banks: Belgium rightly requires it, but not everybody does.
- Key however for financial stability: need to avoid bank runs, which could be hugely costly for taxpayers (see Dewatripont, 2014b).

2. Belgian banks (*: billion €)
(NBB Annual Reports)

	Dec. 2008	Sept. 2018
Assets*	1,422	1,038
Loans-to-assets	39%	59%
GDP*	354	450
Assets-to-GDP	4.0	2.3
Equity (& min. interests)	49	77
Equity-to-assets	3.4%	7.4%

ROE: between 8.6 and 10% each year since 2015 (8.6% in Sept. 2018), close to cost of capital.

Belgian versus EZ banks

(European Banking Federation, 2019)

- Outperform EZ banks EBA stress tests.
- Return On Equity: Netherlands close to Belgium, while France closer to 6% and Germany to 3% (worse than Spain and Italy, which are around 7%).
- Some badly-performing large banks, e.g. Deutsche Bank.
- More generally, much heterogeneity (e.g. in Italy).
- US banks in much better shape than EZ banks.

Selected EZ banks

	Total assets (end 2017, billion €)	Market cap (14-3-2019, billion €)	Ratio (%)
BNP Paribas	1,960	54.5	2.8
ING	953	42.6	4.5
Deutsche Bank	1,769	16.3	0.9
Commerzbank	543	8.8	1.6
Unicredit	834	26.1	3.1
KBC group	292	25.5	8.7

Conclusion

- Belgian and Eurozone banks more solid than in 2008.
- Significant heterogeneity in performance.
- System potentially fragile in case of negative macro shock (which may come endogenously or be the result of policy/political shock).
- And this while facing technological ‘disruption’.

3. Overcapacity: The digital challenge

- Banks are busy restructuring and cutting employ-ment (e.g. ING Belgium, Fortis).
- Process clearly not over yet, especially since: (1) on number of branches, Belgium significantly ‘lags’ the Netherlands; and (2) EZ lags other parts of the world (e.g. Alibaba extends loans to 11 million SME customers and all of this is done by AI algorithms …).
- Worsens overcapacity in banking (general phe-nomenon, esp. acute in Germany).
- One question: who should pay restructuring cost?

4. Cross-border mergers: a solution?

- Increased push for cross-border mergers in EZ (SSM, ECB, not to mention big banks them-selves).
- Will it allow for more risk diversification?
- Or instead exacerbate the Too-Big-To-Fail syndrome?
- For a general analysis, see Allen et al., 2011).

Cross-border M&As in Eurozone

- 9% of deals in 2016 (slightly more in 2017), 15% in 2011-2015.
- US: cross-state deals between 31 and 52% 2000-2015 (versus between 5 and 19% in Eurozone).
- Result: domestic credit institutions in 5 biggest countries (by banking assets) in Eurozone (DE, FR, IT, ES, NL) each amount to more than 90% of domestic assets.
- Note: Belgium is interesting exception: 6th country by size, and one where this number is only around 50%.

Advantages of cross-border banks

(European Central Bank, 2017, 2018)

- Better monetary policy transmission.
- Better risk-sharing.
- Lower home-sovereign bias.
- Faster resolution of Non-Performing-Loan problem (problem which leads to overestimate bank solvency).
- Fewer competition problems.

Comments: advantages

- Advantages indeed all relevant (but big merger talked about now is Deutsche-Commerzbank …).
- Could in fact go further on home bias: home sovereign bias indeed a problem (sovereign concentration, without capital requirements (‘0 risk weight’) tolerated from the start by Basel: ‘original sin’).
- Hope that Basel will address it probably unrealistic (see BCBS 2017b).
- Makes it harder politically for Eurozone to tackle it, except possibly through ‘concentration risk weights’.

Comments: advantages (2)

- But note that home sovereign bias not the only problem: home economy bias problematic too (and if sovereign risks defaulting, home economy will tank too, which makes it rational for sovereign home bias to rise in times of sovereign stress.
- Cross-border banking can address both home biases.
- One idea: introduce concentration risk charges only at consolidated level, not subsidiary levels.

Costs of cross-border banks

(European Central Bank, 2017, 2018)

- Too-Big-To-Fail? ECB answer: less of a problem now with Basel III and Banking Union.
- Excessively slow cost-cutting? ECB answer: need domestic mergers too.
- Contagion? ECB answer: need proper macroprudential policy.

Comments: costs

- All costs, as well as mitigants, relevant too.
- Too-Big-To-Fail: don't underestimate potential problem, given that EZ already has 8 large banks (G-SIB).
- Moreover, Basel-III G-SIB surcharge more than offset by ability of large banks to compute their risk weights thanks to 'internal models' ('output floor' at 72.5% of 'standardized approach' by 2027, while only at 50% in 2022 …). And (non-risk-weighted) leverage ratio culminates at 4% for EZ G-SIBs (see BCBS 2017a).

Comments: costs (2)

- Thus, no significant prudential penalty for size, and capital buffers do remain limited.
- This pleads for caution as far as bank mergers are concerned.
- And especially as far as takeover battles are concerned, where the evidence is that around 100% of the efficiency gains are obtained by shareholders of the target, and where the 'winner's curse' is not rare.

Comments: costs (3)

- Example: hostile takeover of ABN-AMRO by RBS-Santander-Fortis.
- Of course, did happen at ‘wrong time’ and with excessive optimism by bidders, but these problems can never be ruled out.
- And not obvious Basel III and Banking Union would have prevented it, despite having more capital and liquidity (in the above case, the short-term whole-sale financing of the merger was a key problem).
- Need also for symmetry on anti-takeover rules (contrast between ABN and Belfius? To keep in mind in a country where 2 of 4 biggest banks are already foreign-owned …).

Conclusion

- Cross-border mergers have potential advantages as far as financial stability is concerned (esp. to address fragility w.r.t. domestic shocks) and of course in terms of the efficiency/competition tradeoff.
- One should however not underestimate potential costs, especially in a world where bank capital-isation remains modest and where larger bank size does not translate into significantly higher capital requirements.
- Belgian experience has shown that enthusiasm for bank expansion can at times end in tears.

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