Sound at Last? by Bolton, Cecchetti, Danthine and Vives

Discussion

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Introduction

- Very nice, and very rich, report !
- Team combines academic expertise and high-level policy experience.
- In agreement with most points.
- Will especially make remarks relevant for Eurozone (EZ), with four topics: health of EZ banks, capital markets union, bail-in, and cross-border banks.

1. Health of EZ banks

(European Banking Federation, 2019)

- Return On Equity: Netherlands and Belgium around 8.5%, 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).
- Cost of equity: 10%? (because high leverage …).
- US banks in much better shape than EZ banks.

Selected EZ banks

	Total assets (end 2017, billion €)	Market cap (19-6-2019, billion €)	Ratio (%)
BNP Paribas	1,960	51.9	2.6
ING	953	39.1	4.1
Deutsche Bank	1,769	13.3	0.8
Unicredit	834	23.4	2.8
KBC	292	23.6	8.1

2. Capital Market Union

- Clearly needed given our ‘excessive bank (and thus debt) focus’.
- Why are we indeed always complaining about excessive leverage while subsidizing debt over equity through the tax system?
- Remark: need more precise definition of sha-dow banking: asset management more like equity …

3. Bail-in

- Potentially VERY costly if leads to financial instability*.*
- ***Lehman*** in September 2008 ***was bail-in***.
- Best metaphor is ***Diamond-Dybvig***.
- Reality involves a mix between 'pure sunspot-like coordination' and rational inference, especially given ***lack of transparency*** of bank balance sheets.

Principle: concentrate the pain on claimholders whose money is 'stuck' in the bank

- Indeed, 'orderly resolution' no panacea: key is reaction of depositors of ***other banks***, not the bank under resolution.
- Key there is often not 'mechanical intercon-nection' (implicit focus of the law when it addresses bank systemicity), but '***informational interconnection***'.

Implication: TLAC is better designed than BRRD

- Because its ***sequencing is better***: first build up ***long-term subordinated bail-inable claims***, before introducing (excessively rigid?) no-bailout rule.
- Explains why BRRD not implemented today. Downside: ***when bailout is out and bail-in is not in, denial is the only option left***.
- Why this contrast? Because the Euro-area is not a Nation. ***But procrastination is costly***!

Good news: BRRD is getting better

- BRRD revision good (better late than never …) with: (i) stricter subordinated MREL require-ments for banks bigger than €100-Billion ba-lance sheet, and (ii) the ability for national resolution authorities to go below that number: crucial to avoid ‘informational contagion’ !
- How relevant is EDIS, given super seniority of deposit insurance fund in BRRD (BRRD priorities: equity, junior debt, non-preferred senior debt, senior debt, non-insured retail deposits, and then insured retail deposits)?

4. Cross-border banks

- Increased push for cross-border mergers in the Eurozone (SSM, ECB, not to mention big banks themselves).
- Could reduce overcapacity (and accelerate restructuring), and should help monetary transmission.
- But will it also allow for more risk diversification?
- Or instead exacerbate the Too-Big-To-Fail syndrome?

Cross-border M&As in Eurozone

- Limited: 9% of deals in 2016 (slightly more in 2017), 15% in 2011-2015.
- US: cross-state deals between 31 & 52% during 2000-2015 (versus between 5 & 19% in Euro-zone).
- 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%.

Cross-border banks and home bias

- Advantages go further than just home sovereign bias and ‘doom loop’.
- 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 e.g. BCBS 2017a).
- Makes it harder politically for Eurozone to tackle it, except possibly through ‘concentration risk weights’.

Cross-border banks and home bias (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 level.

Cross-border banks and TBTF

- Don’t underestimate potential Too-Big-To-Fail: problem, given that Eurozone already has 8 very large banks (G-SIBs).
- 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 Eurozone G-SIBs (see BCBS 2017b).

A digression on Basel III

- Was the January 2018 'Basel IV'? No, rather Basel 2.8 …
- Usefulness of multiple ratios? There is some complementarity, but four may be too many indeed.
- Leverage ratio not optimal, but useful as a way to get around 0 risk weight on sovereign (Dexia).
- Calibration hard. 'Static balance sheet' assump-tion not optimal, … except for political economy reason.
- Stress tests useful indeed, but politics can play a role too, just like with internal models.

Cross-border banks and TBTF (2)

- Risk especially relevant for takeover battles, 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.
- Example: hostile takeover of ABN-AMRO by RBS-Santander-Fortis.
- Of course, did happen at 'wrong time' and with excessive optimism by bidders, but not atypical ...
- And not obvious Basel III and Banking Union would have prevented it, despite banks enjoying now more capital and liquidity.

Conclusion: should policy do more to foster cross-border banks?

- Pros (diversification, competition) and cons (TBTF fragility) do co-exist.
- What about regulatory impediments? They do exist as far as subsidiaries are concerned.
- What about branches? Wouldn't branchification provide a solution?
- Lack of comfort about waivers by host supervisors understandable in a world where big banks not that capitalized and where market not 'truly European' (cf ING-Commerzbank HQ discussion).

References

- Basel Committee on Banking Supervision (2017a), *BCBS Discussion Paper on Regulatory Treatment of Sovereign Exposures.*
- Basel Committee on Banking Supervision (2017b), *High-level Summary of Basel III Reforms*.