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

<table>
<thead>
<tr>
<th></th>
<th>Total assets (end 2017, billion €)</th>
<th>Market cap (19-6-2019, billion €)</th>
<th>Ratio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BNP Paribas</td>
<td>1,960</td>
<td>51.9</td>
<td>2.6</td>
</tr>
<tr>
<td>ING</td>
<td>953</td>
<td>39.1</td>
<td>4.1</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>1,769</td>
<td>13.3</td>
<td>0.8</td>
</tr>
<tr>
<td>Unicredit</td>
<td>834</td>
<td>23.4</td>
<td>2.8</td>
</tr>
<tr>
<td>KBC</td>
<td>292</td>
<td>23.6</td>
<td>8.1</td>
</tr>
</tbody>
</table>
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 shadow 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 interconnection’ (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 requirements for banks bigger than €100-Billion balance 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 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%.
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’ assumption 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 (2017b), *High-level Summary of Basel III Reforms.*