How sound are banks today?

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ABSTRACT

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Four themes have been developed:

- To what extent has regulation been corrected since the banking crisis started in 2007-2008, in terms of liquidity, solvency and resolution?
- Where do Belgian banks stand, also in comparison with the rest of the Euro zone (EZ)?
- How serious is overcapacity (esp. in terms of employment) given technological evolutions?
- 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?

The banking challenges can be summarized as follows:

- Banking is useful because banks provide liquidity and lend to households and SME's.
- Banking is risky since banks lend long and borrow short, they are leveraged and there is no creditor/depositor discipline. So, there is the risk of volatility.
- Therefore, there has been a strong need for regulation that strengthens solvency and liquidity, that deals with systemic risk, that makes resolution credible when things go wrong.
- So, the idea was launched to replicate the corporate control of 'regular' firms (see e.g. Dewatripont-Tirole, 1994. 2012, and Dewatripont 2014a).

1. Regulation

We know that 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, a huge amount of bailouts were necessary to rescue the sector. Now with Basel III we do have higher solvency ratios, new liquidity ratios (liquid assets/volatile liabilities) and macro prudential regulation (see Basel Committee on Banking Supervision in 2016 and 2017a). And even on the resolution front there is a big progress with the 'bail-in' rule even if still some unfinished business is ahead of us. Since January 2016, the Banking Recovery and Resolution directive (BRRD) asks for 'bail-in' of at least 8% of balance sheet before a bailout. Now, finally, the BRRD requires 8% of long-term subordinated claims (equity + junior debt) for all banks with at least 100 billion euro of balance sheet. The national authorities now have the ability to require it also for smaller banks. Belgium rightly requires it, but not every country does it. However, the key for financial stability is to avoid bank runs, which could be hugely costly for tax-payers (see Dewatripont, 2014b).

2. Belgian banks

As is shown in table 1 Belgian banks have had a return on equity (ROE) between 8,6 and 10% each year since 2015. In September 2018 it was 8,6%, which is close to the cost of capital. The high level of cost of capital in an environment of extremely low interest rates is due to the high leverage banks still have.

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.

Looking to the performance of the Belgian banks versus the EZ banks based on the stress tests it is clear that Belgian banks outperform their peers. For the return on equity the Dutch banks are close to the Belgian banks while French banks are closer to 6% and German banks to only 3%. The German banks perform less well than the Spanish and Italian banks, which have a ROE around 7%. Some badly-performing large banks, e.g. Deutsche Bank, do have a major impact on these average figures. But it is also evident that there is more heterogeneity, such as in Italy. We may not forget that the US banks are still in much better shape than the 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

All in all, Belgian and EZ banks are now more solid than in 2008 even with a significant heterogeneity. The banking system is still potentially fragile in case of a negative macro shock which may come endogenously or be the result of policy or political shock, and this while the sector is facing a technological disruption.

3. Overcapacity

The digital challenge is very significant. To adapt themselves to this challenge, banks are busy in restructuring and cutting employment (see e.g. ING Belgium, BNP Paribas Fortis). That process is not yet over, especially since on the number of branches, Belgium significantly lags the Netherlands while the EZ lags other parts of the world (e.g. Alibaba extends loans to 11 million SME customers and all of this is done by Artificial Intelligence algorithms). Overcapacity in banking is worsening in most EZ countries but is acute in Germany. The key question is who should pay this restructuring cost?

4. Cross-border mergers: a solution?

We observe an increased push for cross-border mergers in the EZ: the Single Supervisory Mechanism (SSM), the European Central Bank (ECB) and of course some big banks themselves are in favour of such movement. But will this allow for more risk diversification or will it instead exacerbate the Too-Big-to-Fail syndrome? Next to the comments below, a general analysis can be found in Allen et al., 2011.
Looking to the numbers of cross-border M&As in the EZ we note that 9% of the deals were cross-border in 2016, while it was 15% for the period 2011-2015. In the US the cross-state deals were between 31 and 52% in the period 2000-2015 while in the EZ only 5 to 19% was registered. The result is that domestic credit institutions in the 5 biggest EZ countries by banking assets (Germany, France, Italy, Spain and the Netherlands) amount each to more than 90% of domestic assets. Belgium is the interesting exception: 6th country by size but only around 50% of the domestic assets.

According to the ECB in reports published in 2017 and in 2018, the advantages of cross-border banks are: a better monetary policy transmission, better risk sharing, lower home-sovereign bias, faster resolution of the non-performing-loans problem and fewer competition problems.

Indeed, the advantages are all relevant, but what to think of the much-talked-about big merger Deutsche Bank-Commerzbank? It would in fact exacerbate the home bias. As for the home sovereign bias, it is certainly a problem, due, in particular, to the absence of sovereign concentration limits and to zero capital requirements, which was tolerated from the start by Basel. Hoping that Basel will address this soon is unrealistic. So, this makes it harder politically for the EZ to tackle it. The introduction of positive concentration risk weights could be a solution. But note that home sovereign bias is not the only problem. The home economy bias is also problematic. If the sovereign defaults, the 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. An idea could be to introduce concentration risk charges only at the consolidated level, instead of the subsidiary level.

Looking to the same reports of the ECB for the costs of the cross-border banks, we observe that the ECB considers the Too-Big-to-Fail problem less urgent thanks to Basel III and the Banking Union. To accelerate the cost-cutting process the ECB is in favour of more domestic mergers. And to tackle the contagion the ECB looks in the direction of more macro prudential policies.

All costs, as well as mitigants, are relevant. The Too-Big-To-Fail problem may not be underestimated because the EZ has already 8 large banks (G-SIBs) (BNP Paribas, Société Générale, Crédit Agricole, BPCE, Deutsche bank, Santander, ING and Unicredit). Moreover, the Basel III G-SIB surcharge is more than offset by the ability of the large banks to compute their risk weights thanks to internal models with an output floor at 72,5% of the standardized approach by 2027, while it is only 50% in 2022. Furthermore, the non-risk-weighted leverage ratio culminates at 4% for the EZ G-SIBs. There is thus no significant prudential penalty for size and capital buffers do remain limited. This pleads for caution as far as bank mergers are concerned. This is certainly the case for takeover battles where the evidence is that around 100% of the efficiency gains are obtained by the shareholders of the target, and where the winner's curse is not rare. A nice example is the hostile takeover of ABN-Amro by Royal Bank of Scotland, Santander and Fortis. Of course, this takeover happened at a wrong moment and with excessive optimism by the bidders, but these problems can never be ruled out. And it is not obvious that Basel III and the Banking Union would have prevented it, despite requiring more capital and liquidity.

Finally, let us not forget the need for more symmetry on anti-takeover rule: in the Netherlands, the State introduced 'golden shares' to 'protect' ABN-Amro against foreign takeovers. Will the Belgian State do the same with Belfius, especially taking into account that in Belgium 2 of the 4 biggest banks are already foreign-owned?

5. Conclusion

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

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