Newsletter
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Lead Article

Conference DNB/EBC/CEPR "Avoiding and Resolving Banking Crises, Amsterdam, Netherlands, 20-21 April 2017

On April 20-21, De Nederlandsche Bank, the European Banking Center-Tilburg, and CEPR organized a conference which brought together academics and policymakers to discuss topics related to how to avoid and resolve banking crises. The program included the presentation of eleven selected papers and two keynote speeches given by Javier Suarez (CEMFI) and Stijn Claessens (BIS).

The conference was opened by Marc Roovers (division director, Resolution) who introduced the topic of the conference and highlighted the practical perspective of the resolution regimes. He pointed to the time dimension of the paradigm shift we are going through, arguing that resolvability is not something that can be achieved overnight as the discussion is not only about bail-in vs bail-out procedures, but involves also other issues such as reducing complexity, interconnectivennes, operational readiness of authorities and firms. He concluded with a discussion on the consequences of regulation and innovation (i.e., fintech) on bank business models, which poses challenges from the resolution point of view.

The session started with a presentation by Diana Bonfim (Banco de Portugal, joint work with João Santos) on the importance of ex-ante credibility of deposit insurance schemes. Using bank level data on deposits at banks operating in Portugal, the authors find that depositors actively react to events that raise doubts about the reliability of such insurance. In particular, after an incident that threatens the credibility of deposit insurance scheme, depositors move their savings to financial institutions whose deposits are guaranteed by other countries, or to intrinsically sounder banks. These effects suggest that the depositors actively monitor banks, even in the presence of deposit insurance.

Next, Helmut Stix (Österreichische Nationalbank, joint work with Martin Brown and Ioanna Evangelou) discussed the reaction of households to an unprecedented banking crisis in Cyprus where bank customers experienced in a short period of time the temporary closure of all banks, the resolution of the two main banks (which ended up with a bail-in process of uninsured depositors), and the introduction of capital controls limiting withdrawals. The authors provide novel evidence on the consequences of bail-in on depositors' behavior by documenting a significant 'flight to cash' which affected mainly the bailed-in banks and those customers who personally suffered a bail-in. Furthermore, they show that in medium term the bail-in may erode the confidence in the banking sector, suggesting that from a policy perspective it is very important to weight carefully the benefits and the costs of the bail-in process.

Ansgar Walther (University of Warwick, joint work with Lucy White) concluded the first session of the conference with insights on the optimal design of regulatory regimes from the perspective of bail-in policies and the resolution of banks. The authors argue that regulatory discretion may create incentives for regulators to act too late and to conduct interventions with limited impact in order to avoid signaling bad news to the market. In this context it is optimal to make the extent of regulatory discretion contingent on the realization of public signals: discretion is beneficial after good news, while commitment to rules is desirable in the aftermath of bad news. Finally, the authors argue that the optimal regime can be implemented by supplementing bail-in powers with contingent capital instruments.

In the first keynote speech of the conference, Javier Suarez (CEMFI) discussed about the cyclical implications of the new international accounting standard for the measurement of financial assets and liabilities (known as IFRS 9). The central innovation of IFRS 9 relates to the measurement of impairment allowances, which will shift from incurred loss approach to the more forward-looking and comprehensive expected loss approach. Javier stressed the striking features of the new method, highlighting the existence of different stages in evaluating the quality of credit rating. He has also pointed to some unintended consequences of IFRS 9, such as the increased correlation between the volume of banks' impairment allowances and prospects for the economy, which may affect the banks' credit supply.

Saverio Simonelli (University of Naples Federico II, joint work with Carlo Altavilla and Marco Pagano) presented the first paper of the afternoon session. The paper discusses the nexus between the government and banks during and after the euro-area sovereign debt crisis and shows how the publicly-owned and recently bailed-out banks responded to sovereign stress by increasing their holdings of domestic public debt significantly more than other banks. Furthermore, the authors argue that banks exposures to domestic sovereign risk amplified the transmission of stress to the banking system and had a negative impact on lending.

Next, Andre Silva (Cass Business School, joint work with Thorsten Beck and Samuel Da-Rocha-Lopes) provided empirical evidence for the real effects of a bail-in of a major Portuguese bank (i.e, Banco Espirito Santo). He showed that those banks that have been more exposed to the bail-in significantly reduced credit supply. While the affected firms were able to compensate this credit contraction with other sources of funding (e.g., new bank relationships with less exposed banks), there were significant negative real outcomes in form of reduction of investment end employment (in particular by SMEs).

Concluding the day, Olivier De Jonghe (Tilburg University, joint work with Hans Dewachter and Steven Ongena) addressed the impact of bank specific capital requirements on banks. The authors find that higher capital requirements may lead to balance sheet adjustments as well as to lower credit supply to corporations and strong contraction in supply of mortgages and term lending. These effects are more pronounced for smaller, riskier and less profitable banks for which the cost of raising capital is higher.

On the second day of the conference, Giovanni Dell'Ariccia (IMF, joint work with Tito Cordella and Robert Marquez) presented a model of bank risk taking and government guarantees. The paper focuses on the distortions associated with the provision of guarantees and highlights a key trade-off between risk insensitiveness of debt and banks' charter value. The author showed how the extent of moral hazard depends on bank's opaqueness, with higher risk-taking incentives at more transparent banks. The paper delivers interesting policy implications on the interaction between guarantees, transparency and the role of capital regulation. The theoretical implications of the model suggest a need for coordination between resolution and prudential regulation policies, with a special focus on how to design efficient bailouts and not necessarily on the right balance between the bail-in vs bail-out.

Next, Michael Koetter (Leibniz - Institut für Wirtschaftsforschung Halle, IWH) discussed a novel channel through which banks can bridge political connections: the purchase of government debt. Using security-level data from German banks, he finds that holdings of state-government-issued bonds increase strongly and significantly after an election that leads to the loss of state-owned banks' political connections. Moreover, the authors uncover the existence of a bailout insurance mechanism, by showing that state-owned banks that are not politically connected are more likely to be bailed out by the state government when they hold larger stocks of state sovereign debt.

Stijn Claessens (BIS) gave the second keynote speech of the conference and provided an overview of the core issues in financial systems from the perspective of financial stability. He argued that financial structure matters for efficiency and risk and that regulation should take account of financial structure. A special focus in his speech has been given to the discussion of the two faces of market-based finance, which may act both as a stabilizer as well as an amplifier of pro-cyclicality. In this context the macroprudential policies are seen as important components of the regulatory toolkit despite their limitations. In his speech Stijn has also argued that regulators and supervisors should ensure the systemic oversight of non-bank financial markets and extend the macroprudential approach to non-bank finance.

Next, Christopher Martin (Federal Deposit Insurance Corporation, joint work with Manju Puri and Alexander Ufier) discussed the depositor behavior at a distressed US bank. The authors find that uninsured depositors are more likely to withdraw their funds and that outflow of deposits may be mitigated by the government deposit guarantees. Interestingly, the failing bank has been able to attract large quantities of new insured deposits thus raising concerns about the effectiveness of market discipline.

Todd Keister (Rutgers University, joint work with Yuliyan Mitkov) presented the first paper in the last session of the conference. He proposed a theoretical model which highlights the interaction between the ex-post government's bailout policy and the bank's willingness to impose losses on their investors via a bail-in procedure. The authors argue that when the government cannot commit on a bailout policy, the expectation of a bail-out may create incentives for a delayed (bail-in) response to an unfolding crisis. In this context, even the complete contracts are less likely to solve the bank run problem.

Finally, Hans Degryse (KU Leuven and CEPR, joint work with Johannes Bersch, Thomas Kick and Ingrid Stein) presented evidence on how bank distress may affect borrowers' probability of default as perceived by an external credit rating agency. Using firm level data from Germany over the period 2000 to 2012, the authors find that a bank bailout leads to a bank-induced increase in the firms' probability of default, and that the direction and magnitude of the effect depend on firm quality and the bank business model (i.e., relationship or transaction banks). These documented effects were more pronounced during the 2008/2009 financial crisis.

Selected Publications

Altavilla, C., **M. Pagano** and S. Simonelli. Bank Exposures and Sovereign Stress Transmission. *Review of Finance*, forthcoming.

Braggion, F. and **S. Ongena**. Banking Sector Deregulation, Bank-Firm Relationships and Corporate Leverage. *Economic Journal*, forthcoming.

Brown, M., **R. De Haas** and V. Sokolov. 2017. Regional inflation, banking integration and dollarization. *Review of Finance*, 1-36.

Calomiris, C., M. Larrain, **J. Liberti** and J. Sturgess. 2017. How Collateral Laws Shape Lending and Sectoral Activity. *Journal of Financial Economics*, **123**(1).

Castiglionesi, F., F. Feriozzi and G. Lorenzoni. Financial Integration and Liquidity Crises. *Management Science*, forthcoming.

van der Cruijsen, C. and **M. Diepstraten**. Banking Products: You Can Take Them with You, So Why Don't You? *Journal of Financial Services Research*, forthcoming.

Eijffinger, S., R. Mahieu and **L. Raes**. 2017. Can the Fed talk the Hind Legs Off the Stock Market? *International Journal of Central Banking*, 13(1): 53-94.

Ellul, A., **M. Pagano** and F. Schivardi. Employment and Wage Insurance within Firms: Worldwide Evidence. *Review of Financial Studies*, forthcoming.

Giannetti, M., **J. Liberti** and J. Sturgess. 2017. Information Sharing and Manipulation: Evidence from a Credit Registry Expansion. *The Review of Financial Studies*, **30**(9).

Horvath, B. and **W. Wagner**. The Disturbing Interaction between Countercyclical Capital Requirements and Systemic Risk. *Review of Finance*, forthcoming.

Huizinga, H., J. Voget and **W. Wagner**. Capital Gains Taxation and the Cost of Capital: Evidence from Unanticipated Cross-Border Transfers of Tax Bases. *Journal of Financial Economics*, forthcoming.

León, C., C. Machado and **M. Sarmiento**. Identifying Central Bank Liquidity Super-spreaders in Interbank Funds Networks. *Journal Financial Stability*, forthcoming.

Liberti, J. Initiative, Incentives and Soft Information. *Management Science*, forthcoming.

Liberti, J. and J. Sturgess. The Anatomy of a Credit Supply Shock: Evidence from an Internal Credit Market. *Journal of Financial and Quantitative Analysis*, forthcoming.

Other news

Lars Norden became the Latin America member of the Distinguished Scholar Advisory Committee of the International Banking, Economics and Finance Association (IBEFA), which is hosted by the Federal Reserve Bank of Atlanta.

Upcoming Conference

9th European Banking Center Network Conference Lancaster, September 29-30, 2017
https://www.tilburguniversity.edu/research/institutes-and-research-groups/ebc/events/show/item-nine-european-banking-center-network-conference/