Promotionskolleg Soziale Marktwirtschaft
der Konrad-Adenauer-Stiftung

PROMOTIONSKOLLEG SOZIALE MARKTWIRTSCHAFT

Konrad Adenauer Stiftung

Restoring Incentives and Liability

Bank Regulation and Bank Risk in the Post-Crisis Era

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Why “Restoring incentives and liability”?

Wer den Nutzen hat, muss auch den Schaden tragen. […]
Die Haftung wirkt insofern also prophylaktisch gegen eine
Verschleuderung von Kapital […]. Nur bei fehlender Haftung
kommt es zu Exzessen und Zügellosigkeit.

Walter Eucken (1952)

How to restore incentives and liability? – Overview of research papers

	Improving resolution regimes		Covering risks
	… what are the implications for bank risk-taking?	**… what are the implications for the real economy?**	**… what is the effect of inadequate capitalization of sovereign exposures?**
Paper (co-authors)	**Wishful Thinking or Effective Threat?**[1] (with Magdalena Ignatowski)	**Catharsis**[2] (single-authored)	**Zero Risk Contagion** (with Sascha Steffen)
Idea/ hypothesis	Improvements in U.S. resolution technology (OLA) increase resolution threat and discipline affected banks	Strong bank resolution policies restore incentives, improve intermediation, benefit real economy (Schumpeter)	Inadequate coverage of banks' EU sovereign exposures (0RW) increases domestic sovereign risk
Methodology/ identification	▪ Dif-in-Dif using differential affectedness by OLA ▪ Placebo ▪ Alternative explanations	▪ "Catharsis indicator" ▪ Instrumental variables ▪ Varying effect with bank dependence (interaction)	▪ Risk-based "sovereign subsidy" (~ cap. shortage) ▪ Correlation of sov. CDS ▪ Falsification, policy change
Main data	▪ U.S. bank data (FDIC, Fed)	▪ Amadeus firm data ▪ Bankscope (30+ countries)	▪ BIS & EBA exposure data ▪ Financial markets (BB, DS)
Results	▪ Improvement in resolution (OLA) leads to less risk-taking ▪ Does not hold for largest/ most systemic banks	▪ Tough insolvency resolution increases real performance ▪ Higher benefit for bank dependent firms and high quality firms	▪ Sovereign subsidy increa-ses home sov and other EU sov CDS correlation ▪ Not for non-EU exposure ▪ Not after introduction of RW

1 ECB Working Paper 1659; published in Journal of Financial Stability (2014)
2 Bundesbank Discussion Paper 21/2013; forthcoming in Journal of Financial Stability (2015)

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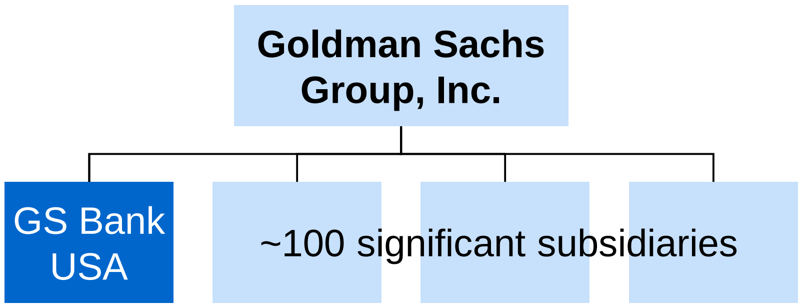
Motivation – Goldman Sachs and the two types of resolution law

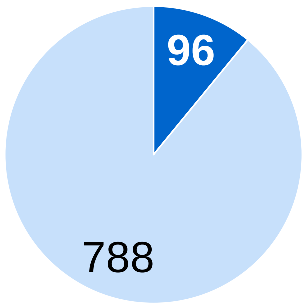
Two types of resolution law in the US (Bliss/Kaufman, 2006/2011; Marinc/Vlahu, 2011)

(Default) Corporate insolvency regime	US Federal Bankruptcy Code, judicial insolvency (ex post, long process, freeze of funds, autom. stay)	**De facto not applicable** without major disruptions
(Special) Bank insolvency regime	FDIA, administrative insolvency (geared to banks' specificities, timely intervention, liquidity/continuity)	**Appropriate** for banks, frequently applied

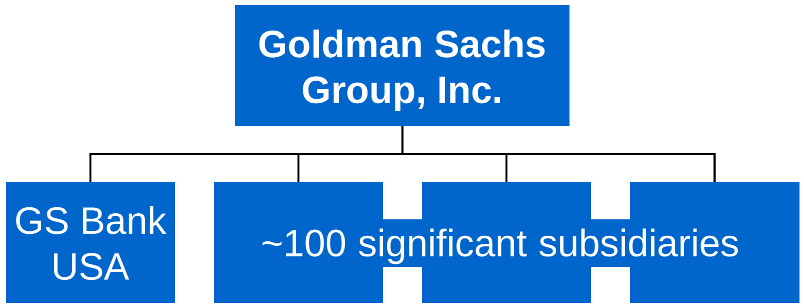
Applicable resolution regimes per 30.06.2010



Total assets of holding and applicable insolvency law
USD bn



Applicable resolution regimes per 30.09.2010



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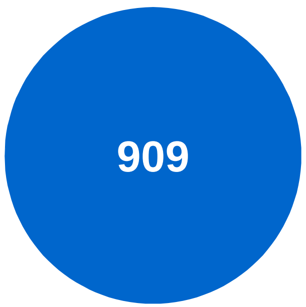

Does this influence bank risk-taking? ?!

Does it really make a difference?
Some indicative evidence on the difference-in-difference effect

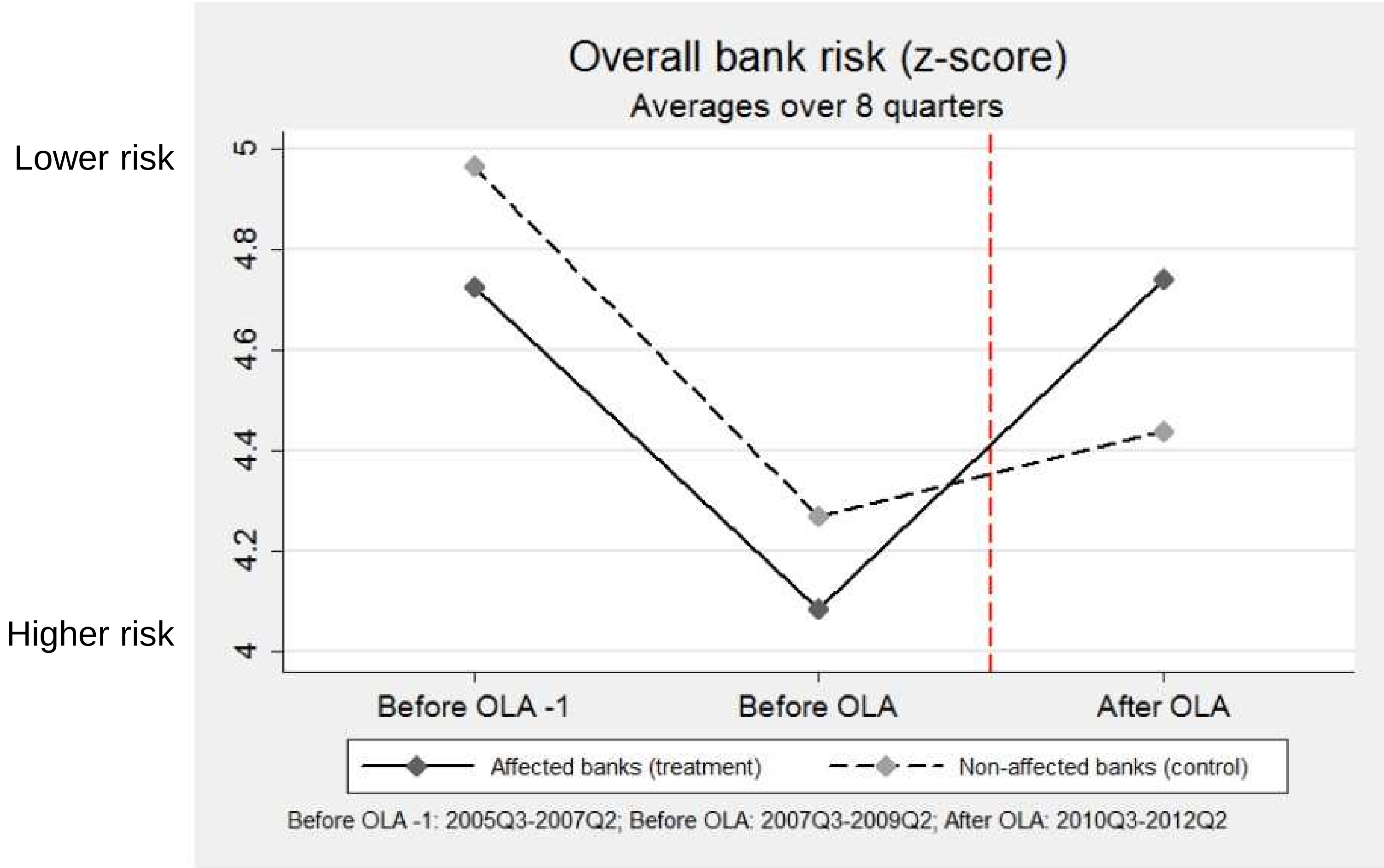

Figure 2: Bank risk-taking before and after OLA

Average bank risk for affected and non-affected bank exhibits a **parallel development in the absence of treatment**, but **affected banks decrease risk much stronger after OLA**

Baseline – Bank/BHC risk measures (accounting and market data)

	(1)	(2)	(3)	(4)	(5)
Level	**Bank level**		**BHC level**		
Dep. variable	**Z-score**	**Asset risk**	**Z-score**	**Asset risk**	**σ Stock**
Affected bank	0.185*	0.0232**			
	(0.0978)	(0.0117)			
Affected BHC			0.195	0.00562	-0.0345*
			(0.192)	(0.0410)	(0.0195)
Affected bank x after OLA	0.530***	-0.0229***			
	(0.0931)	(0.00862)			
Affected BHC x after OLA			0.467**	-0.0178*	-0.0298***
			(0.229)	(0.0103)	(0.00712)
Constant	YES	YES	YES	YES	YES
Controls	YES	YES	YES	YES	YES
Bank FE	YES	YES	YES	YES	YES
Time FE	YES	YES	YES	YES	YES
Observations	52,128	52,346	4,881	5,034	1,263
R-squared	0.789	0.891	0.864	0.897	0.676

Highly significant decline in overall risk between pre- and post-treatment for affected banks as compared to non-affected banks at **both the level of individual banks** and on the **level of BHCs**

Regulation matters! – Bank regulation can help to restore incentives and liability for prudent risk-taking

Improving resolution regimes

… what are the implications for bank risk-taking?

- Generally disciplining effect (less risk-taking)
- Not so if application of resolution is not credible

… what are the implications for the real economy?

- Effective application of resolution rules benefits the real economy

Covering risks

… what is the effect of inadequate capitalization of sovereign exposures?

- Zero risk weight treatment of sovereign exposures increases bank default risk and spillovers to banks' home sovereigns

Design and apply incentive-compatible and credible resolution regimes!

Require banks to hold adequate capital for sovereign exposures!

In other words…

Any aid to a present bad bank is the surest mode of preventing the establishment of a future good bank.

Walter Bagehot (1873)