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Is Burden Sharing Needed for International Financial Stability?

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Outline

- Reform after the Great Financial Crisis
- Need for fiscal backstop -> how for international banks?
- Theory: Equilibria of international banking
- Empirics: International banking in practice
- Policy conclusions – need for burden sharing!

Reform after crisis

- Much has been done:
  - ❑ More capital, including systemic surcharge G-SIBs
  - ❑ Key principles for resolution of international banks, but soft law
  - ❑ Bail-in: yes for idiosyncratic failures, but for large systemic banks?

- We take the presence of large banks as given
  - ➢ Still need for fiscal backstop for (large) banks

- How to solve coordination failure in resolution of international banks?
  - ➢ Hard law: *ex ante* binding 'burden sharing' agreement to organise fiscal backstop

Potential fiscal costs

Assumptions: 1) Restore equity at 4.5% of total assets

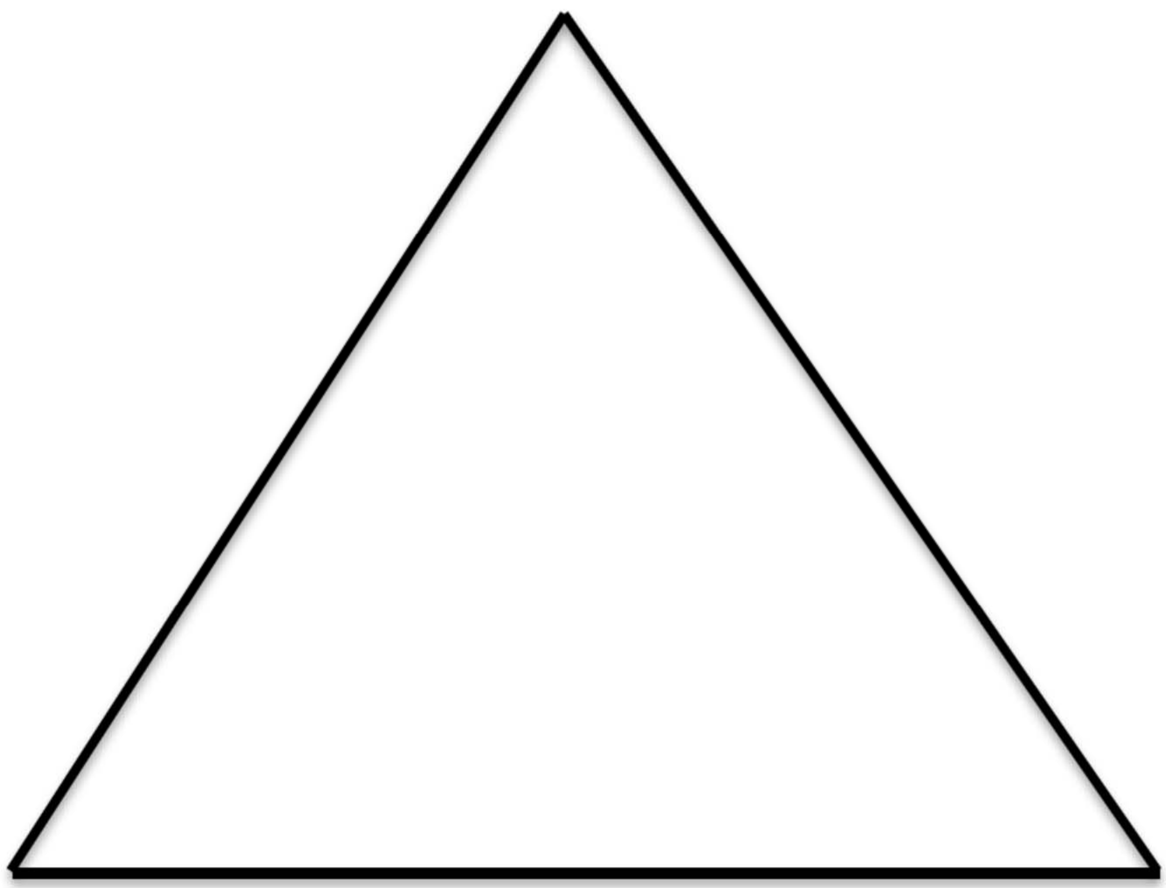
2) Capacity to rescue up to 3 largest banks

3) Hurdle rate for fiscal capacity ≈ 8% GDP

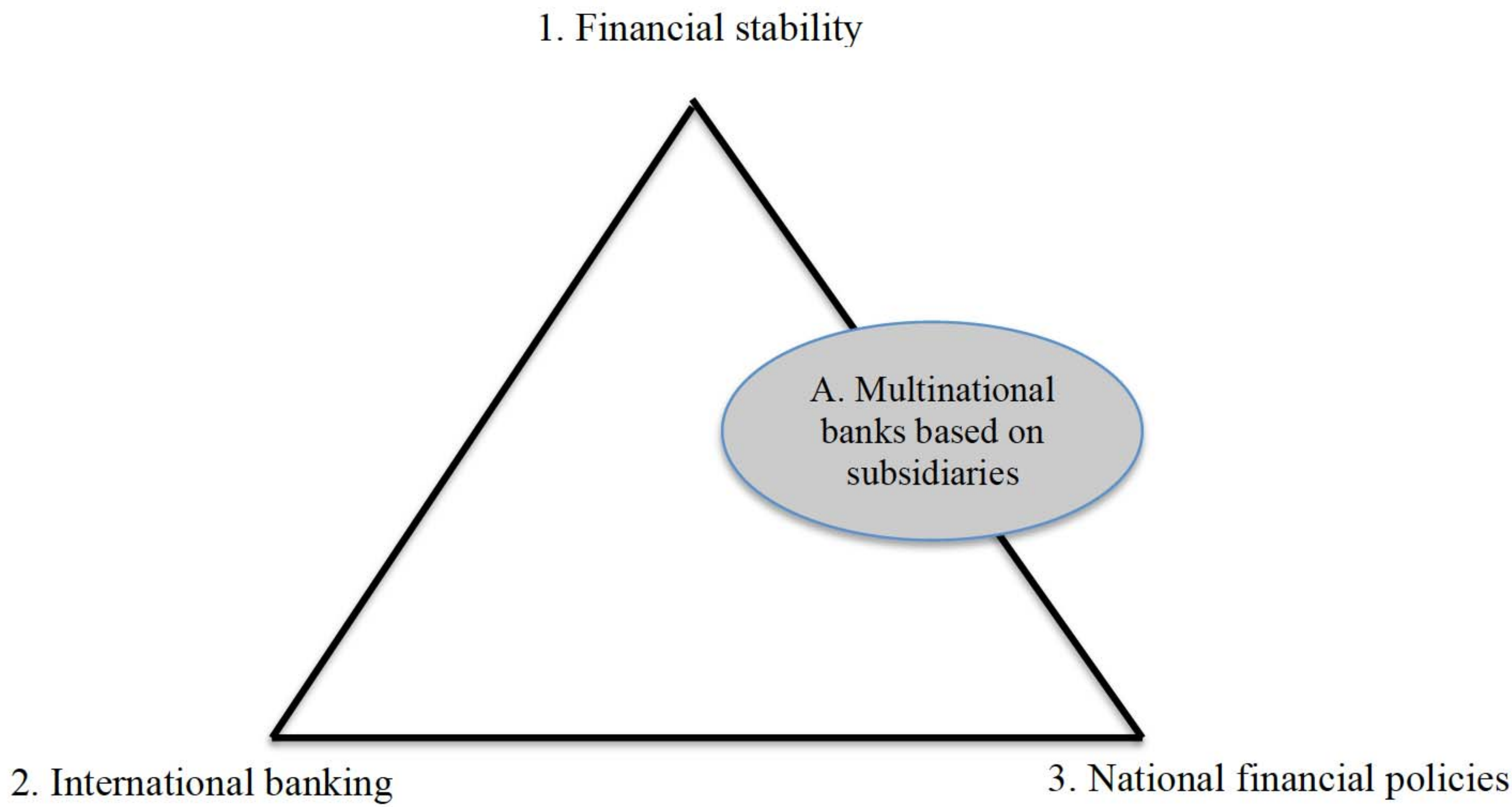
Table 2. Potential fiscal costs for countries with large systemic banks, 2015 (as a % of GDP)

Countries	Assets in $ billion	'Equity' in $ billion	Equity/GDP
Top 3 banks China	8.991	405	3.7%
Top 3 banks US	6.287	283	1.6%
Top 3 banks Japan	6.023	271	6.6%
Top 3 banks Euro Area	5,785	260	2.3%
Top 3 banks France	5,465	246	10.2%
Top 3 banks Germany	2,794	126	3.7%
Top 3 banks Spain	2,646	119	9.9%
Top 3 banks Netherlands	2,064	93	12.3%
Top 3 banks Italy	1,854	83	4.6%
Top 3 banks UK	5.288	238	8.4%
Top 3 banks Switzerland	1.989	90	13.5%

Financial trilemma



Equilibrium A. of financial trilemma



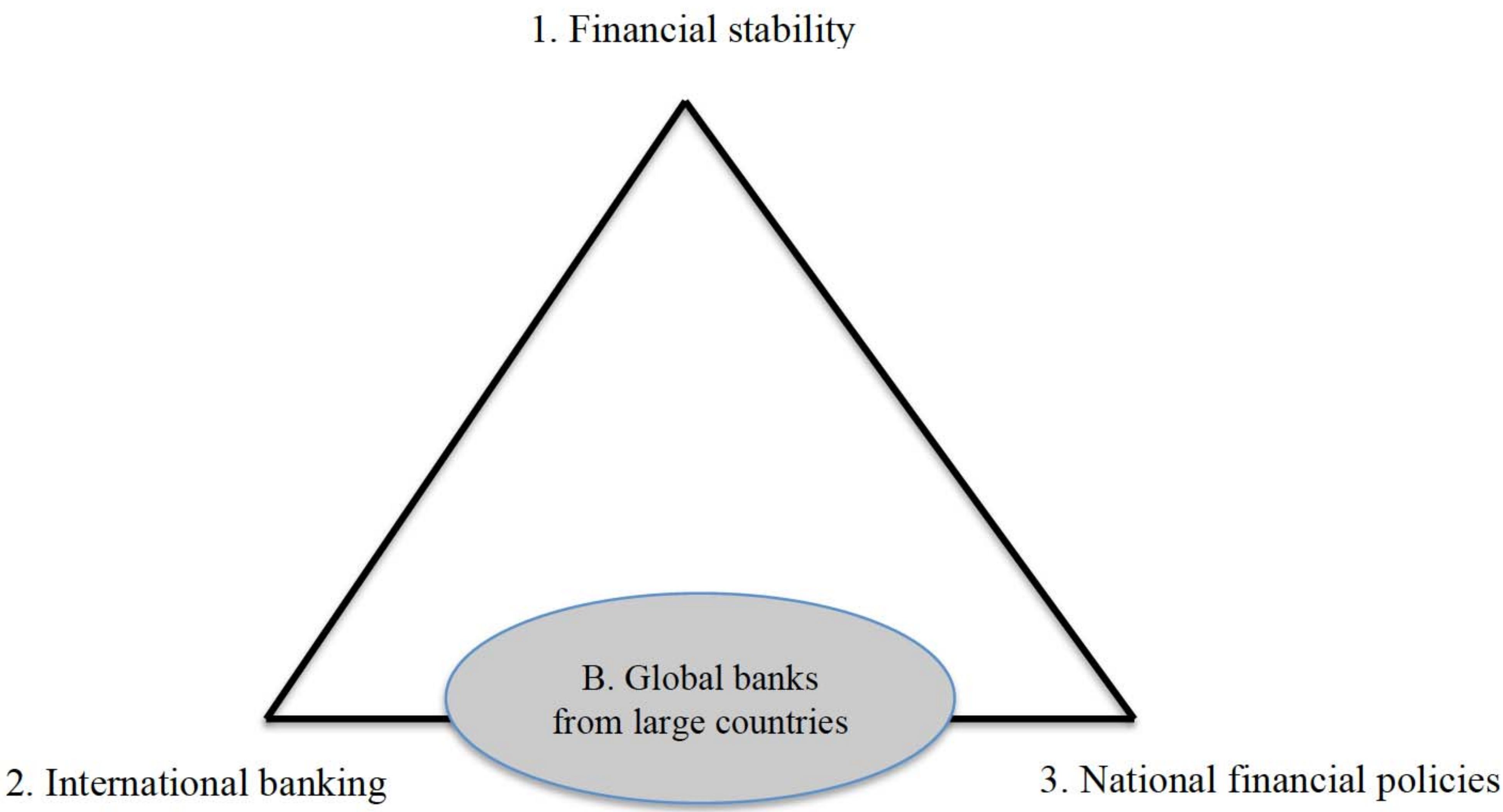
A. Multinational banks with national subs

- Idea:
  - ❑ National subs are separately capitalised and managed
  - ❑ National authorities resolve separately: MPE (multiple point of entry)

- But is this equilibrium viable?
  - ❑ Synergies from centralised risk management + 1 brand name
  - ❑ Legal firewalls cannot prevent indirect contagion
  - ❑ Empirics: correlation default risk parent and sub is 0.2 / 0.3

- Long run equilibrium
  - ❑ Truly stand alone: increasingly high ring-fencing requirements
  - ❑ No incentives for national authorities to cooperate

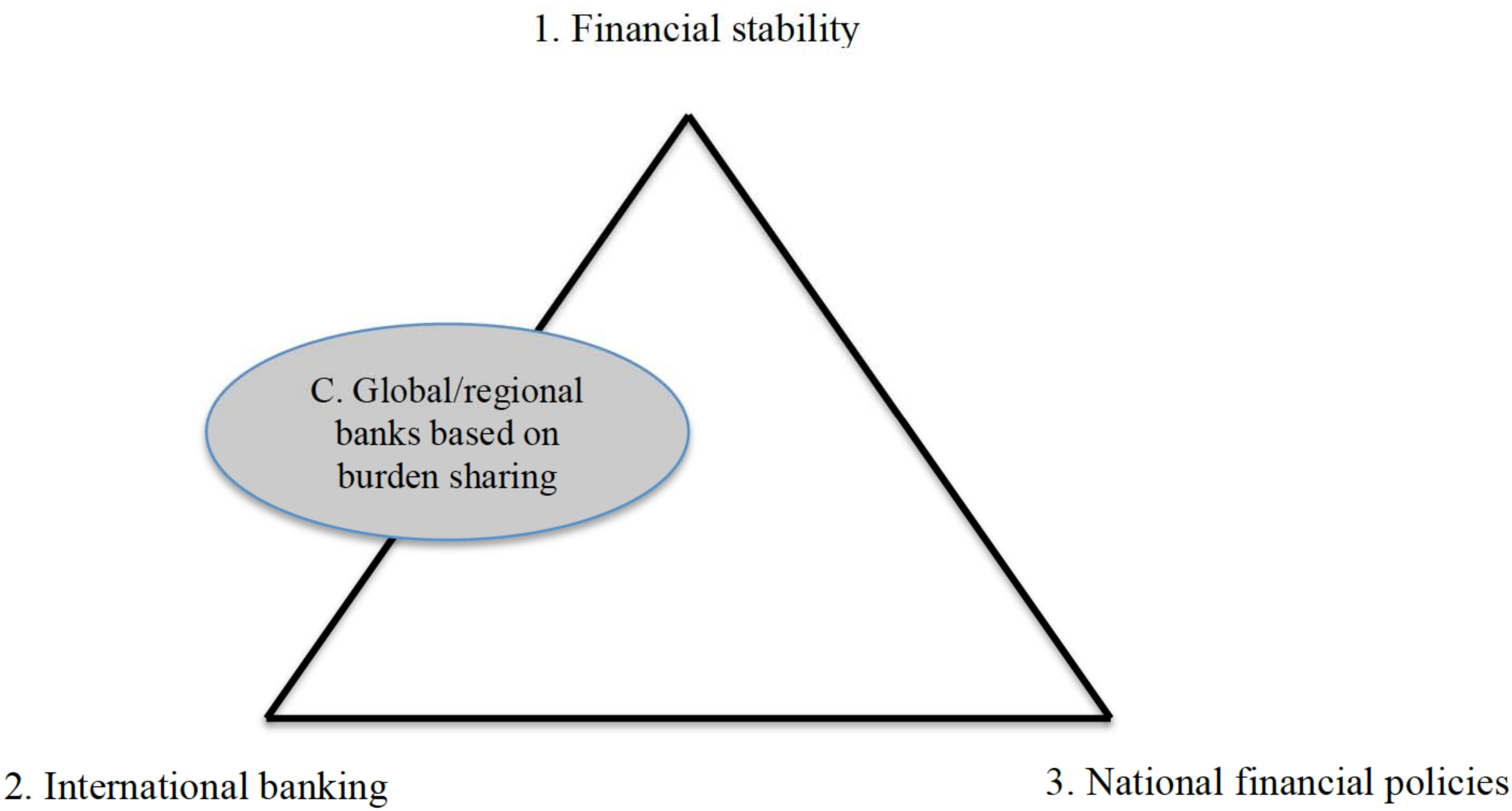
Equilibrium B. of financial trilemma



B. Global banks from large countries

- Fiscal capacity:
  - ❑ Small and medium countries cannot support large banks: downsizing
  - ❑ Only large countries can afford and follow SPE (single point of entry)
- But what about foreign retail branches?
  - ❑ Home country (and parent bank) may choose to support, or not
  - ❑ Incentive host countries to ring-fence -> equilibrium A. (with MPE)
- Long run equilibrium
  - ❑ Geopolitics and powerplay: US + China may impose their model
  - ❑ Nevertheless, host countries may not accept unilateral approach

Equilibrium C. of financial trilemma



C. Global banks with burden sharing

- Idea:
  - Give up on national policies: joint supervision + burden sharing for resolution based on **hard law**
  - Facilitates SPE (single point of entry)

- Technically easy, but politically difficult
  - Tightly connected group of countries: Banking Union
  - Ad hoc (e.g. Joint Vienna) may work if all interests are aligned, but you cannot count on it

- Long run equilibrium
  - Regional groupings (beyond euro area?)
  - Global – safety net from IMF?

Examples of multinational banks

- Australian (parent) banks with New Zealand subs, already established before the Great Financial Crisis
- US requirement for intermediate holding company
- Prime examples: HSBC, Santander, BBVA
  - ❑ HSBC: global MPE (Americas, Europe, Asia) + local SPE
  - ❑ BBVA: MPE + SPE for Banking Union (entering Portugal?)

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Examples of global banks

- Three groups of global banks:
    1. Global banks from large countries (US, China, Japan)
    2. Global banks from the euro area, with (limited) burden sharing
    3. Global banks from mid-sized (UK, Switzerland) -> downsizing

- Key is credible fiscal backstop
    1. Yes, global banks are still growing
    2. Mixed, euro area is building ESM as backstop to banking system (backstop to SRF + direct recap without cumbersome conditions)

- Group 3 has less credible backstop (and no political willingness)
    - ❑ MPE is realistic option (HSBC), but more expensive
    - ❑ Credit Suisse: on paper SPE, underlying MPE

Empirics

Calculation: annualised change in assets, correcting for GDP

Table 3: Development of global banks for major countries, 2007-2015

	2007	2015	2007-15		
Banking groups	Assets in $ billion	Assets in $ billion	Change		
			Assets	GDP	**Net**
Top 5 Chinese banks	3,928	12,684	16%	15%	**+1%**
Top 5 US banks	7,943	8,879	1%	3%	**-1%**
Top 3 Japanese banks	4,344	6,023	4%	-1%	**+5%**
Top 8 Euro Area banks	14,578	11,807	-3%	-1%	**-1%**
Top 4 UK banks	10,600	6,492	-6%	-1%	**-5%**
Top 2 Swiss banks	3,211	1,781	-7%	4%	**-11%**
Total 27 banking groups	44,604	47,667	1%	3%	**-2%**

Conclusions

- International financial stability remains elusive

- Soft law approach of Financial Stability Board will not solve problem

- Burden sharing based on hard law needed to solve coordination failure

- ESM is on its way as fiscal backstop for euro area banks
  - Common backstop to Single Deposit Insurance and Resolution Fund
  - Improve direct recapitalisation instrument
  - Part of broader risk sharing and risk reduction agenda