DO WE STILL NEED BANKS?

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BANKING SECTOR AND FINANCE FOR GROWTH

- Finance-growth relationship non-linear! Limited (if any) growth gains from financial deepening above certain threshold
- Banking sector not necessarily in best position to support twin transition
  - Debt contracts (with collateral) more appropriate for existing technologies
  - Intangible investment not ideal for bank financing
  - Uncertain technologies better to be funded by equity/hybrid contracts, non-bank intermediaries/markets
  - Funding innovative firms might undermine existing asset portfolio of banks
- Need for non-bank players

FROM BANKING TO CAPITAL MARKET UNION

- Need diversification of financial intermediaries and markets
- Scale economies – need for European rather than national approach
- Long reform/policy/institutional agenda
- How do we get there? Strong national resistance on all level; no crisis as reform trigger
- Need for champion
- Need for political bargain

CAPITAL BUFFERS AND LENDING – A TRADE-OFF?

- NO: Admati-Hellwig: costs will adjust as more capital is required
- But: market frictions in raising equity
- But: subordinated debt has a role to play in market discipline
- But: adjustment process

Empirical evidence:

- Long-term: no negative relationship between capital requirements and lending
- BCBS review of Basel III: no negative effect of higher capital buffers on lending (but lower cost of capital)
- FSB report on Basel III and SME lending: in general, no negative effect, except for most capital-constrained banks
- Important caveat: argument holds within boundaries (100% would move away from banking concpet)

GROWTH VS. STABILITY – A MORE GENERAL TRADE-OFF

- (Cyclical) increase in capital requirements: lending becomes more expensive; firm most likely to be affected: smaller, higher-risk firms
- Empirical support in Ayyagari, Beck and Martinez Peria (2018)
- Purpose of higher (cyclical) capital requirements: building resilience
- Welfare trade-off: growth vs. stability; or: short-term growth vs. longer-term stability?
- Effect of increase in capital requirements dependent on macrofinancial situation

THE 2023 BANKING TURMOIL

- Several mid-sized banks in the US failed
  - Did not comply with Basel III rules, but not under Basel III regulation
  - Dubious business model, failed risk management
  - Supervisory failures
  - Concentrated funding base
- Credit Suisse
  - Long-standing governance problems
  - Resolution plan not applied, rather forced merger with UBS
- EU/euro area: no spillover effects

LESSONS LEARNED FROM THE 2023 TURMOIL

- Rapid growth continues being a good fragility predictor
- Natural interest rate hedge due to banks' deposit franchise vulnerable to deposit runs
- Concentration of depositors, indirect linkages between depositors (common venture capitalist funder); more generally: business models important for fragility
- Most deposit runs a mix of solvency concerns and 'coordination failure'
- Speed of deposit runs (social media, access 24/7, instant payments) has increased

IMPLICATIONS FOR POLICY DESIGN

- Prudential treatment of interest rate risk in the banking book from the perspective of a fundamentally solvent bank should vary according to fragility of funding structure
- Too-big-to-fail is alive and kicking – hard to get around it
- Need mix of supervisory and market discipline
- Role of deposit insurance – trade-off between market discipline and inducing confidence and stability

THE ROLE OF SUPERVISORS

- Business models and governance structures matter!
- Interaction between capital and liquidity buffer might imply stronger reliance on pillar 2 requirements
  - trade-off of rules vs. discretion
- Stress tests that are severe, flexible, and appropriately transparent to improve measurement of capital….
  - …also: liquidity and interest rate stress tests
- Stronger focus on resolution and recovery! The more options to recover/resolve, the fewer incentives to delay intervention….
  - Also has implications for communication

DO WE STILL NEED BANKS?

- YES, but was also need a more diversified financial system
- Bank regulation and supervision requires constant adjustments to new developments and new (potential) sources of fragility
- There is still an important reform agenda for the EU in financial sector – how do we get political attention and consensus?

THANK YOU

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