

RESOLUTION OF INTERNATIONAL BANKS: CAN SMALLER COUNTRIES COPE?

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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 options – ring-fencing versus 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 $\approx 8\%$ GDP

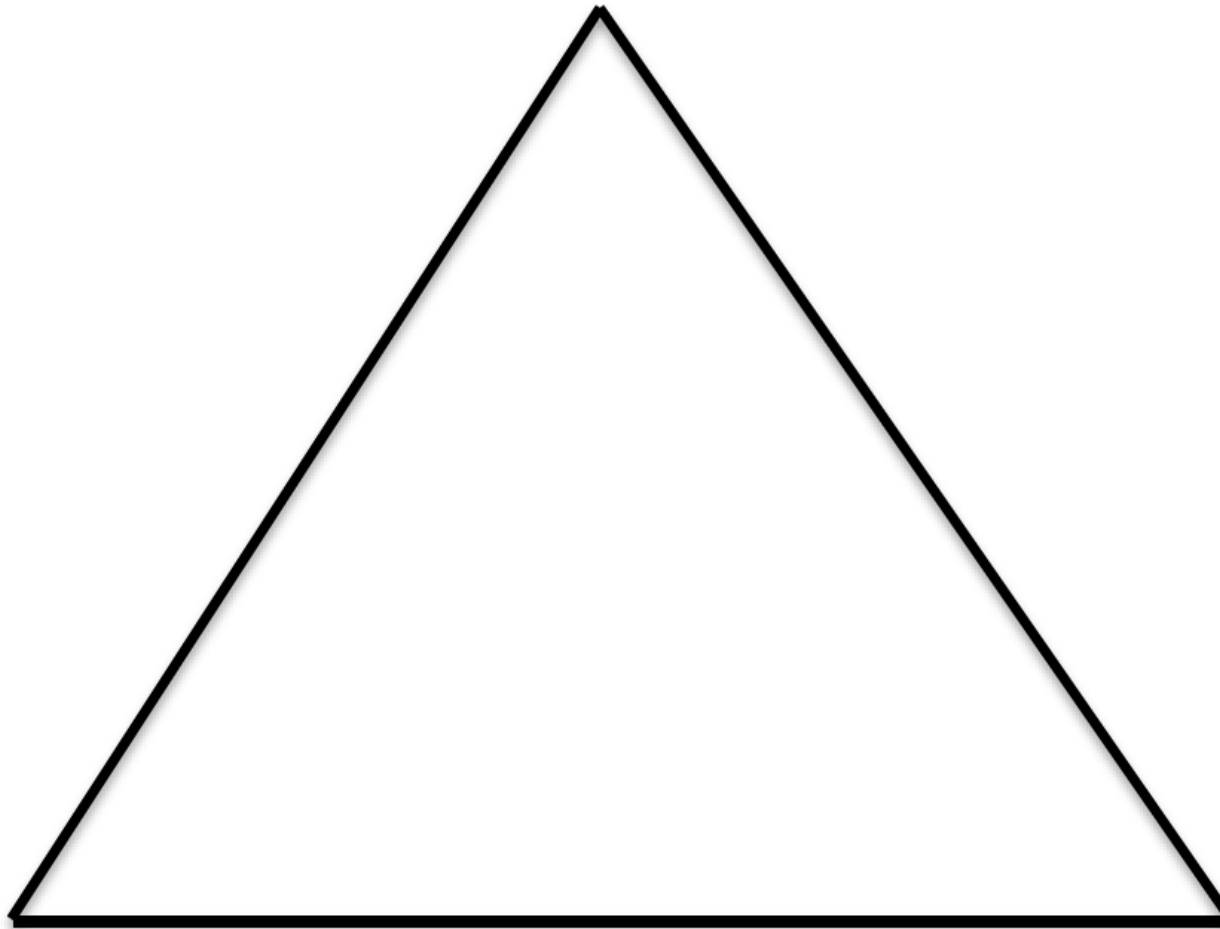
Table 3: Potential fiscal costs for selected countries, 2015/2016 (as a % of GDP)

Countries	Assets (in US\$ billion)	Recapitalisation (in US\$ billion)	Fiscal costs (% of GDP)
Top 3 banks China (2015)	8,991	405	3.7%
Top 3 banks US (2015)	6,287	283	1.6%
Top 3 banks Japan (2015)	6,023	271	6.6%
Top 3 banks European banking union (2015)	5,785	260	2.3%
Top 3 banks UK (2015)	5,288	238	8.4%
Top 3 banks Switzerland (2015)	1,989	90	13.5%
Top 3 banks Australia (2016)	2,033	91	7.6%

Financial trilemma



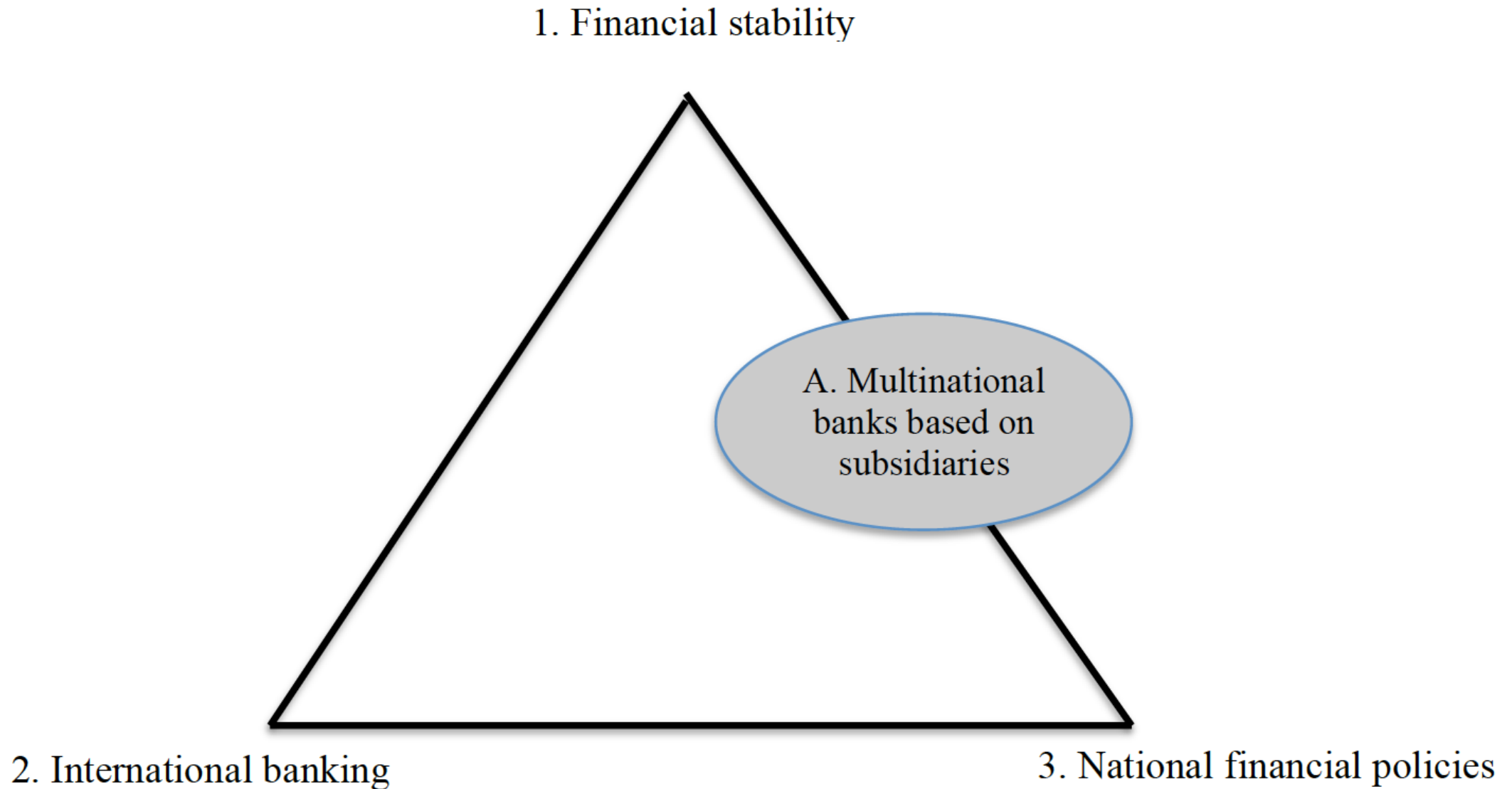
1. Financial stability



2. International banking

3. National financial policies

Equilibrium A. of financial trilemma



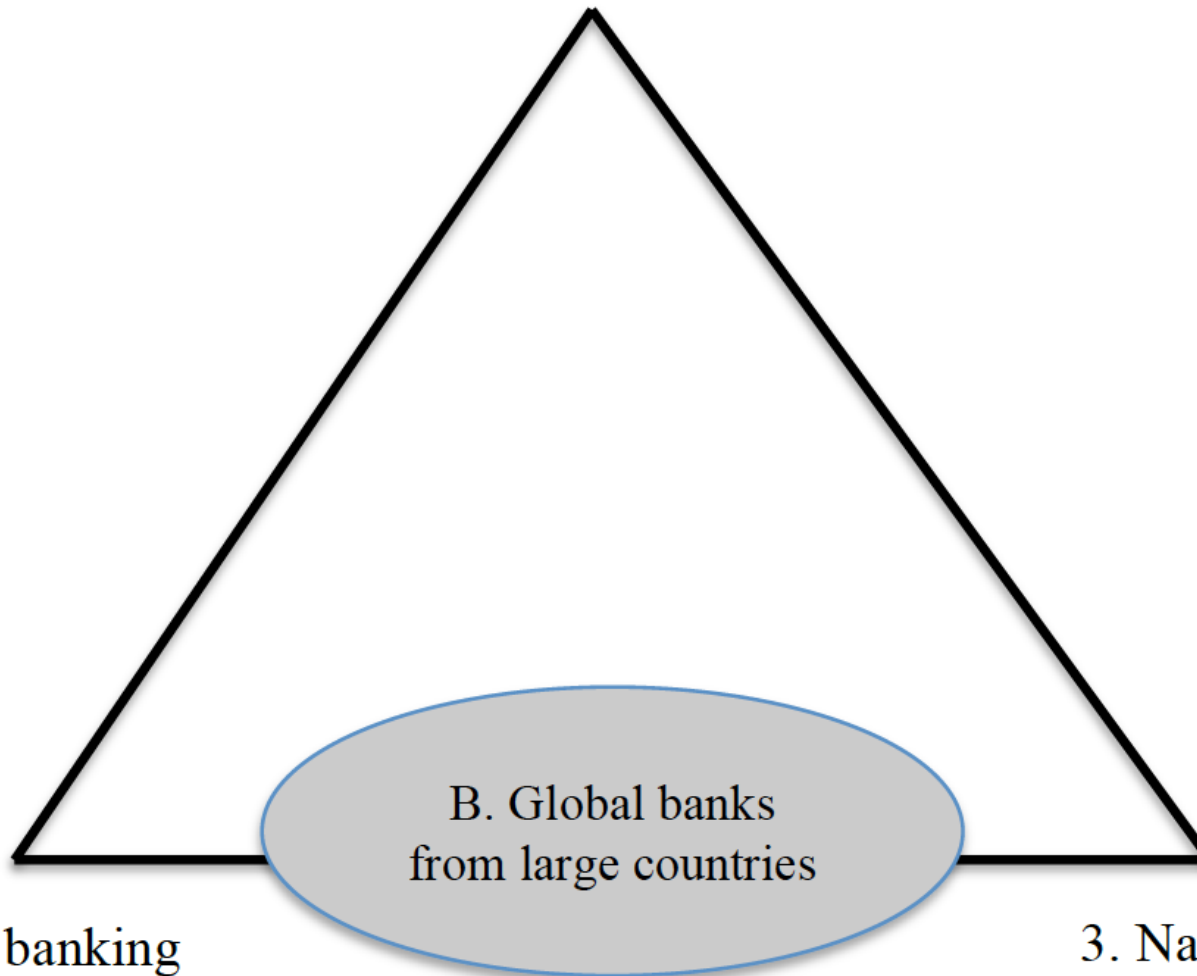


A. Multinational banks with national subs

- 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

1. Financial stability



2. International banking

3. National financial policies

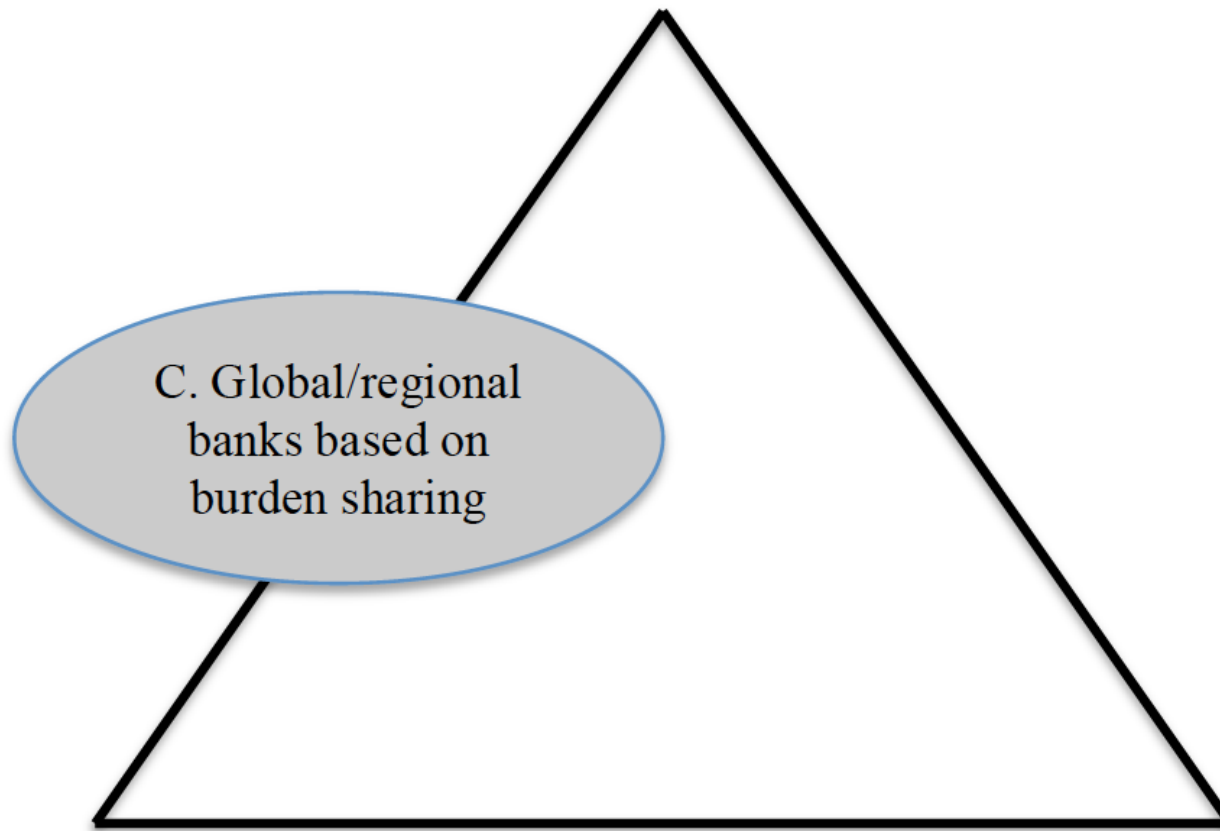


B. Global banks from large countries

- 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 and subs?
 - ☐ 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

1. Financial stability



2. International banking

3. National financial policies



C. Global banks with burden sharing

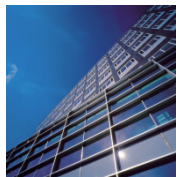
- Idea:
 - ☐ Give up on national policies: joint supervision + burden sharing for resolution based on **hard law**
 - ☐ Facilitates SPE (single point of entry)
- Technically easy, but politically difficult
 - ☐ Tightly connected group of countries: European Banking Union
 - ☐ Ad hoc (e.g. Joint Vienna) may work if all interests are aligned, but you cannot count on it
- Long run equilibrium
 - ☐ Regional groupings: Trans-Tasman Banking Union



Examples of multinational banks

- Australian (parent) banks with New Zealand subs, already established before the Great Financial Crisis
 - ❑ Cooperation in Trans-Tasman Banking Council
 - ❑ Useful, but it is based on soft-law -> legally non-binding
- 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?)

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%



Risk sharing in trans-Tasman Banking Union?

Risk or burden sharing can be:

- Specific: geographic spread of bank assets
- General: economic size (GDP)

Table 4: Burden sharing key (2016)

Burden sharing key		
Country	Bank assets	GDP
Australia	86.3%	86.7%
New Zealand	13.7%	13.3%
Total	100%	100%



Trans-Tasman Banking Union?

Calculations based on joint fiscal backstop

Table 5: Potential fiscal costs in a banking union, 2015/2016 (as a % of GDP)

Countries	Assets (in US\$ billion)	Recapitalisation (in US\$ billion)	Fiscal costs (% of GDP)
Top 3 banks European banking union (2015)	5,785	260	2.3%
• Top 3 banks France (2015)	5,465	246	10.2%
• Top 3 banks German (2015)	2,794	126	3.7%
• Top 3 banks Spain (2015)	2,646	119	9.9%
• Top 3 banks Netherlands (2015)	2,064	93	12.3%
• Top 3 banks Italy (2015)	1,854	83	4.6%
Top 3 banks trans-Tasman banking union (2016)	2,033	91	6.6%
• Top 3 banks Australia (2016)	2,033	91	7.6%



Conclusions

- International financial stability remains elusive – two main options
 1. Soft law approach of trans-Tasman Banking Council is helpful, but will not solve coordination problem
 - ❑ Increasing ring-fencing requirements for NZ subs
 1. Burden sharing based on hard law can solve coordination failure
 - Technically feasible, but political challenges
 - ❑ Give up national policies (differences in resolution and dep. insur.)
 - ❑ Differences in size: 87% vs 13% -> is New Zealand voice heard?
 - ❑ Long-run equilibrium!



References

- Schoenmaker, D. (2017), 'Resolution of International Banks: Can Smaller Countries Cope?', *International Finance*, 20, *forthcoming*.
- Schoenmaker, D. (2017), 'A Trans-Tasman Banking Union?', draft paper.