Bank Bias in Europe:

Effects on Systemic Risk and Growth

by

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Discussion

by

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Main Results

- Presents evidence that since the mid-1990s European banks have grown much faster than securities markets, GDP, and banks in the U.S. and Japan.
- Shows that an individual bank's systemic risk tends to be higher when its country's financial system becomes more bank-dominated, particularly during real estate crises.
- Finds that when a country's ratio of banks to stock and bond market capitalization rises, it tends to grow slower, particularly following a real estate crisis.

Bank Systemic Risk Regressions

- A bank's *SRISK* regressed on country financial variables:

$$SRISK_{i,c,t} = \alpha_1 \frac{Bank}{Market}_{\;c,t} + \alpha_2 Crisis_{c,t} + \alpha_3 \frac{Bank}{Market}_{\;c,t} \times Crisis_{c,t}$$

  - $Crisis_{c,t}$ = stock market: $\alpha_1 > 0$, $\alpha_2 > 0$, $\alpha_3 < 0$ but $(\alpha_1 + \alpha_3) > 0$
  - $Crisis_{c,t}$ = housing: $\alpha_2 > 0$, $\alpha_3 > 0$

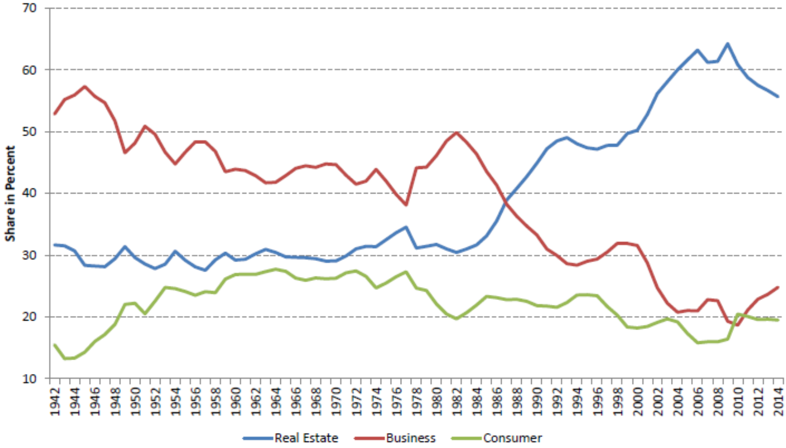
- Are results robust to alternative measures of systemic risk?
  - Majority of $SRISK_{i,c,t}$ are negative and set to zero: trimmed least squares should be benchmark.
  - Examine $CoVar_{i,c,t}$ and $DIP_{i,c,t}$ as alternatives.[1]

- Are reactions to housing crises linked to a bank's mortgages or covered bonds?

[1] Adrian and Brunnermeier (2008) NYFed SR and Huang, Zhou, and Zhu (2009) *JBF*.

Growing Importance of Real Estate Loans

- U.S. commercial banks' relative shares of real estate, business, and consumer loans. Similar for Europe?



Country GDP Growth Regressions

- A country's ΔGDP regressed on financial system variables:

$$\Delta GPD_{c,t} = \beta_1 \frac{Bank}{Market}_{c,t} + \beta_2 Crisis_{c,t} + \beta_3 \frac{Bank}{Market}_{c,t} \times Crisis_{c,t}$$

  - $Crisis_{c,t}$ = stock market: $\beta_1 < 0$, $\beta_2 < 0$
  - $Crisis_{c,t}$ = housing: $\beta_1 < 0$, $\beta_3 < 0$

- Are results robust to making $Crisis_{c,t}$ a continuous, rather than a dummy, variable of losses?

- Might $\Delta GPD_{c,t}$ motivate changes in financial regulations, making them invalid instruments for $\frac{Bank}{Market}_{c,t}$?

Other Comments

- Measurement: Might bank assets be inflated due to loans to, and deposits from, foreigners.
  - Is the U.K. really more bank-based than France (Figure 6)?
- Policy Issue I: Is growth by Europe's largest banks the problem?
  - Even in the U.S.'s market-oriented financial system the largest banks have grown the fastest.
  - The shares of aggregate deposits by the 10 largest U.S. commercial banks were 15%, 44%, and 49% in 1993, 2006, and 2010, respectively.[2]

[2] Wheelock, D. (2011) St.Louis Fed *Review*.

Other Comments (continued)

- Policy Issue II: While political desires to protect Europe's banks undoubtedly play a role, there may be other reasons why banks dominate. For example:
  - Civil law courts are less effective at resolving conflicts, making bank lending more effective than corporate bond and stock markets.
  - Common law courts are better at resolving bondholder-stockholder disputes, making markets relatively effective.[3]
  - Improvements in information technology since the 1990s should have reduced firm opacity and the need for bank credit screening and monitoring.
  - But it might be appropriate for civil law countries to remain less market oriented than common law ones.

[3] Ergungor, O.E. (2004) *JBF* and (2008) *IREF*.

Conclusions

- Excellent, thought-provoking paper!
- Regulatory favoritism toward banks creates a multitude of distortions.
- Leveling the playing field between all financial institutions and markets should improve the allocation of resources and economic growth.