

Voluntary Support and Ring-

Fencing in Cross-Border Banks

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Any views expressed are only the speaker's own and should not necessarily be regarded as views of the ECB or the Eurosystem.

What the paper does

Provide a framework to analyze the impact of different supervisory architectures when considering interventions in cross-border banks

- national architecture gives rise to inefficient ring-fencing of assets
- no *ring-fencing* with supranational architecture, but increase in risk convergence of banks' assets (ambiguous impact on risk-taking)
- supranational architecture would induce convergence of the default risk among cross-border banks

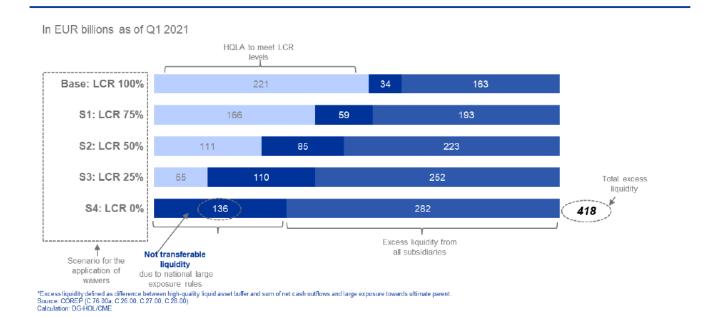
Costs of barriers to capital and liquidity movements

Nontransferable liquid assets are "trapped" liquidity

(Enria, 2021)

Chart 3

Excess liquidity held in the euro area by non-domestic subsidiaries of SSM significant institutions



Key features of the model

Two most important parameters

- γ riskiness of assets risk-taking
- ρ correlation of assets' payoff exogeneous

The setup in the euro area and the SSM

 The model provides a framework to analyze the implications of the two supervisory architectures in a context of "recapitalization/resolution"

- The objectives of the SSM are
 - ensure the safety and soundness of the European banking system
 - increase financial integration and stability
 - ensure consistent supervision

 This model does not provide insights about the role of supranational supervision as an institutional device to increase resilience ex-ante

Supranational supervision and banks' resilience

- What do we know about the impact on banks' risk-taking of supranational supervision in Europe?
 - Decrease of lending (Fiordelisi, Ricci and Lopes, 2017) and of total assets and reliance on wholesale funding (Eber and Minoiu, 2016) before the establishment of the SSM
 - Increase in risk-weighted assets for banks supervised by the SSM (Haselmann et al., 2019)
 - During the pre-SSM period, about 30% of the banks around the threshold decrease their assets to fall back into "national supervision" (Ben-David et al., 2018)
- Supranational supervision can limit banks' discretionality, for example in the use of internal models
 - after the revision of banks' internal models (TRIM), banks increased the risk weighting of their riskier lending exposure, lent to safer borrowers, and recovered more from defaulting entities (Fiordelisi et al., 2023)

Implications of payoffs' correlation

- If the correlation of payoffs is low, both institutional architectures lead to identical outcomes
 - no gains from adopting a supranational architecture (cross-border support is more valuable from an ex-ante perspective)

• If the correlation is high, supranational architecture maximizes aggregate welfare (welfare gains from higher banker effort and a more efficient supervisory intervention process)

- However, welfare gains are hump shaped in asset correlation welfare gains from supranational architecture are limited
 - Avoiding ring-fencing does not "justify" supranational supervision

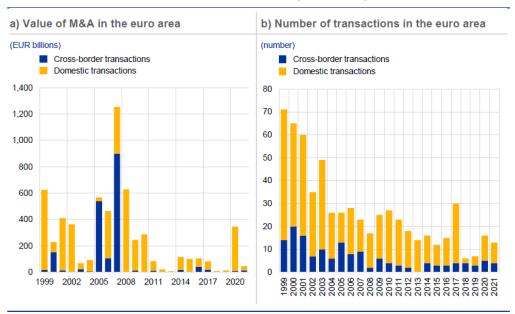
Payoffs' correlation

- What is affecting payoffs' correlation?
 - convergence of supervisory criteria
 - increase in integration of banking markets
 - increase in M&A

Is there more integration in banking markets?

In Europe, banking markets remain segmented. Cross-border transactions and M&A very limited

Chart 7
Value and number of bank M&A in the euro area (1999-2021)



Source: ECB calculations based on Dealogic and Orbis BankFocus.

Notes: The sample includes M&A transactions involving significant and less significant institutions in the euro area, excluding some private transactions and transactions among small banks not reported in Dealogic. Transactions associated with the resolution of banks and distressed mergers have been removed from the sample. Transactions are reported based on the year in which they were announced

More integration in banking markets?

There is a general call from policy makers to

- remove barriers (legal and prudential) that create obstacles to the free circulation of capital and liquidity within banking groups in the euro area
- increase standardization and a consistent implementation of regulatory and supervisory standards

What are the consequences of these actions on the increase in correlation of assets' payoffs?

Other benefits of supranational supervision

 It makes it easier to assess the interactions and spillovers between regulatory and macroeconomic policies affecting the same geographical areas

- Covid-19 pandemic (crisis management)
- we have taken unprecedented supervisory decisions quickly, in close coordination with monetary policy measures (Enria, 2021)

Relevant in the current financial and economic environment

Ring-fencing in banking groups

Ring-fencing may affect also the provision of support (liquidity) to non-bank intermediaries that are part of the same banking group

- no deposit insurance, but national and supranational authorities may have different incentives linked to the financial stability of their domestic financial sector
 - intragroup support (liquidity) may be instrumental to avoid deeper crisis, especially since non-banks have limited (or none) access to central bank liquidity intragroup liquidity may be LOLR