Organisational culture in banking supervision

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Outline

1. Start by very briefly summarizing earlier work with Jean Tirole on a 'holistic view' of regulation/supervision/resolution.
2. Briefly assess SSM performance in the last 10 years : good, even if biggest banks have low market cap.
3. Broad support for SSM push for updated supervisory strategy.
4. Discuss a couple of key attention points to keep in mind.

Bank governance and regulation/supervision/ resolution (RSR): trading off insurance and incentives

(based on *Dewatripont-Tirole* 1994a,b and 2012, and *Dewatripont* 2024)

RSR as an incentive scheme

- Idea of idea of capital structure in nonfinancial firms: in an incomplete-contract setting, when firm performance is bad, management should face the risk that control switches from (nicer) equityholders to (tougher) debtholders.
- Indeed, (less-risk-averse) equityholders have natural tendency to want to keep firm going, while (more-risk-averse) debtholders have more incentive to stop/liquidate.

RSR as an incentive scheme

- ‘Representation hypothesis’: in banks, debt-holders are unable to exert control, so see bank RSR as a way to replicate their role in nonfinancial corporations.
- Even in nonfinancial corporations, the life of debtholders is not ‘easy’,
- However, speed is a specific challenge with banks which, when in trouble, can always grow by raising interest rates on deposits (‘gambling for resurrection’).

RSR as an incentive scheme

- In a sense, Basel regulation has attempted to replicate role of debtholders from the start (i.e. from 1988).
- With 2 well-known challenges: (i) calibration, and (ii) credibility and impact of control switch (which depend on behavior of supervisory and resolution authorities).

RSR as an incentive scheme – remark on macroprudential policy

- Third key issue however: relevant performance is the idiosyncratic one, not the performance linked to aggregate shocks (Holmström, 1979).
- This issue was ignored by Basel I and Basel II.
- It is addressed to some extent by Basel III: countercyclical capital buffer. And further improved with TLAC. (and, gradually, by MREL).
- Punchline : the more stable the ‘system’, the easier the job of microprudential authorities.

What about the 'S' of RSR ?

- Let us remember Charles Goodhart, who said in a (private) BCBS meeting : "super-visor's job is the hardest in the world, be-cause most successes remain private while every failure becomes very much public".
- And supervision is only as good as regula-tion allows it to be (same for resolution).
- Therefore, supervisors do need support, from politicians, bankers and researchers !

Beyond macroprudential policy, how has post-crisis RSR performed so far ?

Research shows Basel III solvency rules not to be ‘excessive’. Several prominent academics argue it is even (vastly) ‘insufficient’.

- See e.g. Cecchetti (2014) and BCBS (2016).
- See also Admati-Hellwig (2023), Admati et al. (2023) and others.

Recent experience

- Last years not without serious macroeconomic shocks : low inflation, covid, then high inflation.
- These did lead to individual problems in 2023 : Silicon Valley Bank and some others in the US, and Crédit Suisse.
- But clearly no new Great Financial Crisis for now.

Recent experience

- Therefore, whatever we think about the ‘optimal core equity ratio debate’ in academia (which would benefit from quantitative research), political momentum is low at this moment for much higher solvency requirements.
- Useful therefore to look for ‘pragmatic avenues’, which take regulation as given. This is in a sense what the new SSM supervisory strategy tries to do.

Going for a 'risk-focused supervisory culture' ?

- Makes a lot sense. In fact, hard to disagree with in general. And 'risk-based supervision' was in fact an objective of SSM from the start.
- But natural after an 'initial phase' where 'level-playing field' was key to ensure a 'common culture'. Even if seemed at times 'too formal' and 'bureaucratic' (example of JSTs being nicknamed by somebody in France 'Je Suis Template' (after 'Je Suis Charlie', which followed terrorist attack on Charlie Hebdo).

Going for a ‘risk-focused supervisory culture’ ?

But the devil will be in the details. Here, I will discuss :

1. Some current risks.
2. Some general remarks.

1. Current risks : lessons from 2023

- US learnt Basel III would have been useful for SVB et al. : clear advantage of SSM here, with its ubiquitous application of Basel III !
- Crédit Suisse showed the risk of procrastina-tion, of slow-moving accounting ratios (and of ‘too-big-to-manage’ banks ?). But also the loss-absorbing value of AT1 and thus the u-sefulness of TLAC (and of (a better) MREL).
- Question : Banking Union has done well in 2023, but has it been ‘lucky’ ?

‘Market leverage ratio’ of US G-SIBs

Add-on	Bank	Market cap*	Assets**	Ratio
2.5%	JP Morgan	605	4143	14.6%
2.0%	B. of America	301	3258	9.2%
2.0%	Citigroup	113	2405	4.7%
1.5%	Goldman	151	1653	9.1%
1.0%	Morgan St.	156	1212	12.9%
1.0%	Wells Fargo	184	1940	9.5%

*: on September 9, 2024; **: June 2024.

‘Market leverage ratio’ of Banking Union G-SIBs

Add-on	Bank	Market cap*	Assets**	Ratio
1.5%	BNP Paribas	78	2893	2.7%
1.5%	Deutsche Bank	32	1448	2.2%
1.0%	Crédit Agricole	48	2393	2.0%
1.0%	ING	57	1116	5.1%
1.0%	Santander	74	1914	3.9%
1.0%	SocGen	20	1706	1.2%

*: on September 9, 2024; **: June 2024.

Towards a ‘risk-focused supervisory culture’

- Situation of biggest Eurozone banks con-sistent with Claudia Buch’s speech in June 2024: CET1 ratio increased from 12.7% in 2015 to 15.6% 2023 but leverage ratio only from 5.3% in 2016 to 5.6% in 2023.
- Useful therefore to tighten the screws on Eurozone biggest banks by focusing on their internal models ?

Towards a ‘risk-focused supervisory culture’

- Note that some of these weaker big banks are ‘universal’, with most probably a compensation structure as detailed by EBA, which favors investment banking rather than the key ‘missions’ of ‘boring’ deposit-taking institutions (‘organizing payment system and lending to entities households and SME’s’).
- Prioritize such ‘business model risk’ ?

European Banking Authority High Earners (HE) 2017 (pre-Brexit)

	BE	DE	FR	UK
Total number HE	22	390	233	3.567
Average Comp. (M€)	1.4	1.6	1.7	2.0
% Investment B.	23	27	61	58
% Retail B.	14	5	3	3
% Asset Man.	5	5	11	12
% Other bus. Areas	58	63	25	27

2. Some general remarks

Several good ideas, including :

(i) Combination of empowering individual teams with horizontal controls (after having introduced two lines of defense).

(ii) Allowing for faster escalation (possibly with more legal risk appetite ?).

Some general remarks : the pros and cons of discretion

- Economists like to talk about 'rules versus discretion'.
- Regulators talk about 'rules versus principles'.
- Rules are not just 'rigid', they are also a protection against 'aggressive' banks (remember you are in a 'strategic game' with their shareholders, whose objective differs more from the common good the higher the leverage of the bank …).

Some general remarks : the pros and cons of risk sensitivity

- A risk-focused culture can have as ‘downside’ a potential ‘complexity’ which can be dangerous when facing aggressive banks.
- Similar to the problem of complexity plaguing Basel III (which they link to ‘risk sensitivity’, see BCBS, 2013). Paradox : banks complain about it, while also insisting, in our jurisdiction at least, to be allowed to keep their internal models …).

Final general remark : on the banker-supervisor relationship

- Supervisors always at risk of being less well-informed than bankers.
- There is evidence of correlation between importance of CRO in bank hierarchy and amount of risk-taking during GFC. And compensation in general is key in this respect too.
- Opportunities to make at least some bank employees ‘allies’ of supervisors (also true for uninsured creditors) ?

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