

Re-regulation and the Traditional Banking Model

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**UNIONE BANCARIA E BASILEA 3
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Three ideas to talk about:

1. Risk, Return and Bank Size

- Risk is related to bank size.
- Risk is related to bank business model.

2. Re-regulation of the banking system

- Because of risk-taking by large complex banks.
- Should we also re-regulate small non-complex banks?

3. Failed bank resolution

- Important distinction:
- ***Ex ante*** regulation (capital rules, liquidity rules, supervision)
- ***Ex post*** regulation (failed bank resolution)

An important note:

- I use ***US banking data*** in this presentation.
 - Thousands of US banks.
 - Very detailed financial statement data.
- US banks are ***not a perfect laboratory*** for evaluating European bank regulation. However:
- US and European banking industries are similar:
 - Large number of small “traditional” banks.
 - Small number of large “non-traditional” banks.
- US and European banking industries face Basel III rules.
- European Banking Union modeled on US regulatory system.

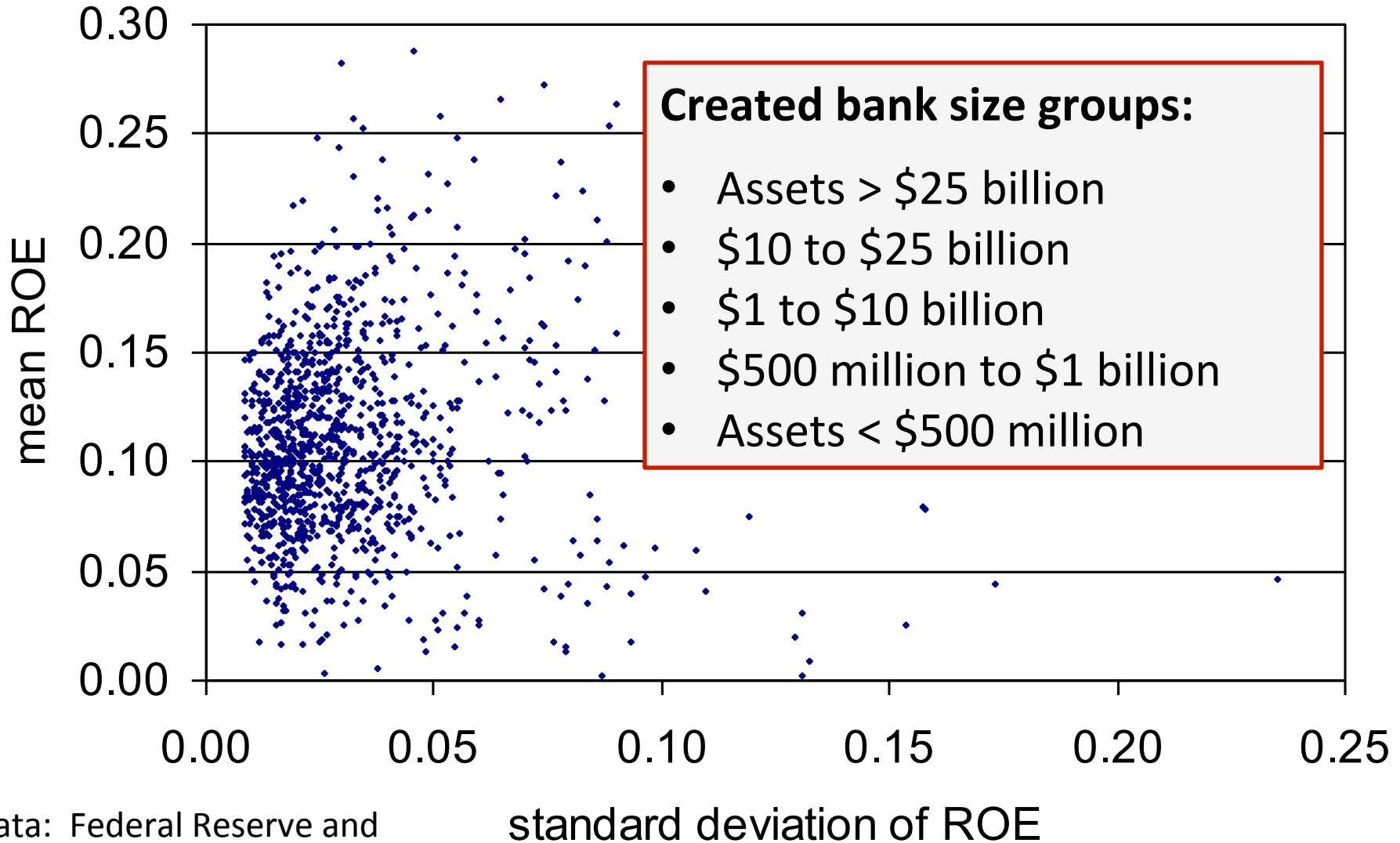
1. Risk, Return and Bank Size

A simple exercise:

- I collected data for every mature, tax-paying US bank in continuous operation from 1998 to 2007.
- I constructed a risk-return profile for each bank:
 - **Return** = average quarterly ROE.
 - **Risk** = standard deviation of quarterly ROE.
- I plotted the **Risk-Return** combination for each bank.

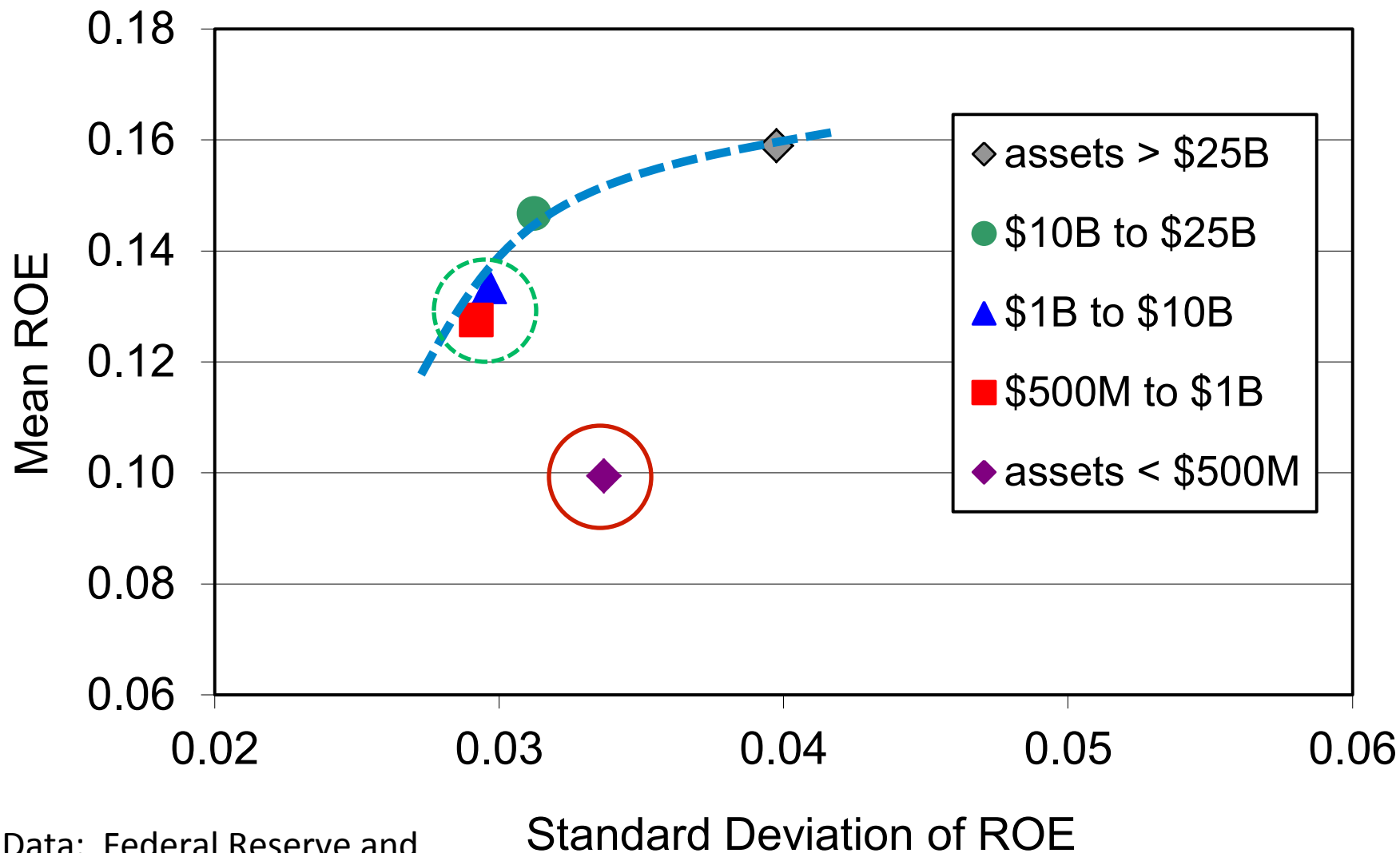
NOTE: This exercise is similar to DeYoung and Rice, “How do banks make money? A variety of business strategies” Federal Reserve Bank of Chicago, *Economic Perspectives* 2004.

1. Risk, Return and Bank Size



Data: Federal Reserve and author's calculations.

1. Risk, Return and Bank Size



Data: Federal Reserve and author's calculations.

1. Risk, Return and Bank Size

Data for US banks and thrifts

Asset size	# of banks in 2007
More than \$10 billion	119
\$1 billion to \$10 billion	549
\$100 million to \$1 billion	4,425
Less than \$100 million	3,440

Data: Federal Deposit Insurance Corporation, author's calculations.

1. Risk, Return and Bank Size

Data for US banks and thrifts


Asset size	# of banks in 2007	# of banks failed in 2008-2015
More than \$10 billion	119	13
\$1 billion to \$10 billion	549	53
\$100 million to \$1 billion	4,425	327
Less than \$100 million	3,440	125

Data: Federal Deposit Insurance Corporation, author's calculations.

1. Risk, Return and Bank Size

Data for US banks and thrifts

Asset size	# of banks in 2007	# of banks failed in 2008-2015	Failure rate
More than \$10 billion	119	13	10.9%
\$1 billion to \$10 billion	549	53	9.7%
\$100 million to \$1 billion	4,425	327	7.4%
Less than \$100 million	3,440	125	3.6%




Data: Federal Deposit Insurance Corporation, author's calculations.

1. Risk, Return and Bank Size

Data for US banks and thrifts

Asset size	# of banks in 2007	# of banks failed in 2008-2015	Failure rate
More than \$10 billion	119	13	10.9%
\$1 billion to \$10 billion	549	53	9.7%
\$100 million to \$1 billion	4,425	327	7.4%
Less than \$100 million	3,440	125	3.6%



New research:
Small “traditional” banks more resilient
than small “non-traditional” banks.

Data: Federal Deposit Insurance Corporation, author’s calculations.

1. Risk, Return and Bank Size

Ongoing research with Vincenzo Chiorazzo, Vincenzo D'Apice and Pierluigi Morelli at Italian Banking Association.

- **We study 545 US banks between 1997 and 2012.**
- **These banks have assets between \$500 million and \$10 billion.**
 - Large enough to be efficient
 - Small enough to use the “traditional banking” model
- **About half of these banks use a “traditional banking” model:**
 - Relationship loans, Relationship deposits, Traditional activities, Branching systems
- **Results:** Traditional banks were 15 to 29 percentage points more likely to survive (***did not fail, were not acquired***) from 1997 to 2012 than small non-traditional banks.

2. Re-regulation of the banking system

Basel III

- More capital; buffer capital; countercyclical capital
- New liquidity rules

European banking union

- Harmonized deposit insurance
- Harmonized capital requirements
- Single Supervisory Mechanism
- Recovery and resolution framework

US re-regulation (Dodd-Frank Act)

- Focus on SIFIs (banks with assets > \$50 billion)
- Stress tests, resolution plans, more power for FDIC
- New financial product protections for consumers

2. Re-regulation of the banking system

Size Distribution of US Banks, 2014

	asset size	# of banks	% of banks	% of assets
SIFIs	larger than \$50 billion	36	0.6%	77.5%
	\$10 to \$50 billion	65	1.0%	7.6%
community banks	\$1 to \$10 billion	582	9.1%	8.0%
	less than \$1 billion	5,725	89.3%	6.9%
		6,408	100%	100%

2. Re-regulation of the banking system

Much of the re-regulation applies only for large banks:

- Liquidity coverage ratio for banks > \$10 billion only
- Stress tests for banks > \$10 billion only
- Consumer protection exams for banks > \$10 billion only
- Resolution plans for banks > \$50 billion only
- Countercyclical capital buffer for banks > \$250 billion only

Legislation has been introduced in US Senate to further reduce some of these asset-size thresholds.

2. Re-regulation of the banking system



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2. Re-regulation of the banking system

July 2014, US Senate Banking Committee Hearing

- Committee Chairman was Sherrod Brown, a Senator from the state of Ohio.
- Senator Brown repeatedly asked the panel: ***“We currently define a SIFI as a bank with more than \$50 billion in assets. Do you think this threshold should be increased?”***
- ***The three largest banks in the state of Ohio:***
 - Huntington Bancshares: Assets = \$66.1 billion.
 - KeyCorp: Assets = \$91.8 billion.
 - Fifth Third Bancorp: Assets = \$136.3 billion.

3. Failed bank resolution

- The FDIC **resolved** over 500 failed banks in 2008-2015.
 - FDIC seizes the bank.
 - Shareholders, board and executives lose everything
 - FDIC sells the failed bank or sells the bank's assets
 - Minimal economic disruption

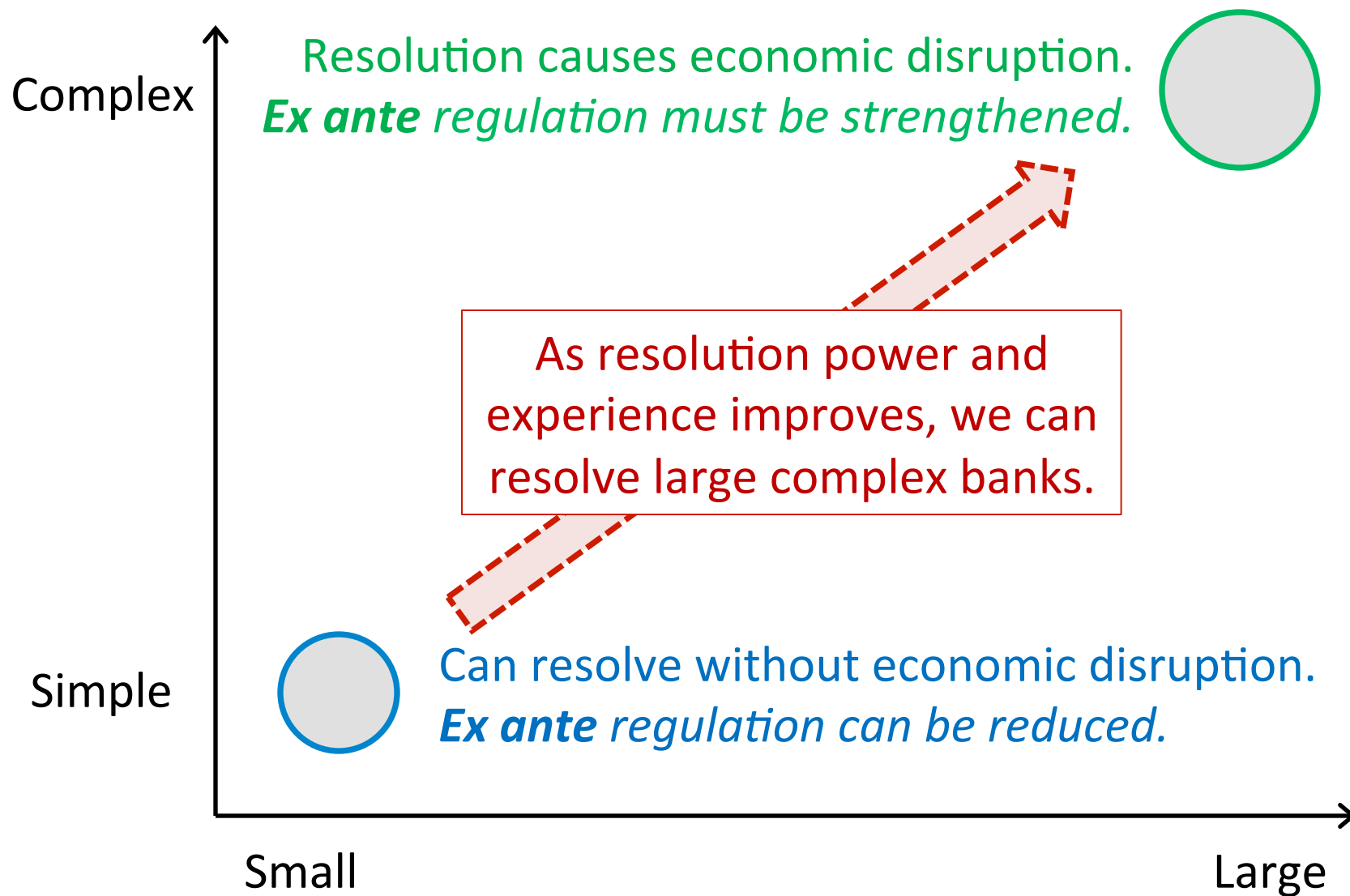
- But some failed banks were too large/complex to be **resolved**.
- To avoid economic disruptions (e.g., Lehman Brothers), these banks were **bailed out**:
 - Citibank
 - Bank of America
 - Bear Stearns
 - Fannie Mae
 - Freddie Mac
 - American Int'l. Group (AIG)

3. Failed bank resolution

10 largest financial firms in US, 2007

Citigroup (insolvent)	\$2,220,866	bailed out
Bank of America (insolvent)	\$1,535,684	bailed out
JPMorgan Chase	\$1,458,042	
Wachovia (insolvent)	\$719,922	acquired by Wells Fargo
Deutsche Bank	\$579,062	
MetLife	\$552,564	
Wells Fargo	\$539,865	
Washington Mutual (insolvent)	\$349,140	Resolved by FDIC!!!
U.S. Bancorp	\$222,530	
SunTrust Banks	\$180,314	

3. Failed bank resolution



3. Failed bank resolution

The typical way that bank regulators think:

- Make *ex ante* regulation stronger
- More capital, more liquidity, more examinations
- Strong *ex ante* regulation →

fewer banks will fail →
ex post

regulation is less necessary

A new way for bank regulators to think:

- Make *ex post* regulation stronger
- Give the resolution authority more legal and political power
- Strong *ex post* regulation →

fewer banks have to be bailed out →
ex ante regulation is

less necessary.

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