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# Bank Risk, Governance and Regulation

Edited by
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# List of Figures


1.1 Dispersion of betas across countries, banks and time 15
1.2 Banks' betas and sectorial betas: residual vs fitted plot 16
2.1 Distribution of original CaR measures and their Box-Cox transformation 47
2.2 Time trend and heteroskedasticity 51
2.3 Individual effect evaluation 52
3.1 Liquid assets/Deposits and borrowings % for 2,986 EU and 326 US banks in 2007/2013 92
3.2 Loan-loss reserves/Gross loans % for 2,986 EU and 326 US banks in 2007/2013 92
3.3 Loan-loss reserves/Impaired loans % for 2,986 EU and 326 US banks in 2007/2013 92
3.4 Equity/Net loans % for 2,986 EU and 326 US banks in 2007/2013 93
3.5 Equity/Customer and short-term funding % for 2,986 EU and 326 US banks in 2007/2013 93
3.6 Equity/Liabilities % for 2,986 EU and 326 US banks in 2007/2013 93
3.7 Equity/Total assets % for 2,986 EU and 326 US banks in 2007/2013 93
3.8 Tier 1 ratio % for 2,986 EU and 326 US banks in 2007/2013 94
3.9 Total capital ratio % for 2,986 EU and 326 US banks in 2007/2013 94
3.10 Z-Score for 2,986 EU and 326 US banks in 2007/2013 94
3.11 ROAA for 2,986 EU and 326 US banks in 2007/2013 97
3.12 Z-Score for 2,986 EU banks for each country in 2007/2013 97
4.1 Bank capital and nonperforming loans 109
4.2 Profitability 115
4.3 De-risking and deleveraging 116
4.4 Debt and equity (millions) 116
4.5 Loans and deposits (millions) 117
4.6 Country weighting of EuroStoxx banks 119
5.1 Distribution of number of banks to total innovation areas (all years) 138
7.1 The EU supervisory architecture for credit institutions since November 2014 199

# List of Tables


| | | |
|---|---|---|
| 1.1 | The sample | 14 |
| 1.2 | Description of the variables | 17 |
| 1.3 | Descriptive statistics | 20 |
| 1.4 | Pairwise correlations of the variables | 21 |
| 1.5 | Fixed effects panel data model | 24 |
| 1.6 | Test of strict exogeneity | 26 |
| 1.7 | Arellano-Bond regression model | 27 |
| 2.1 | The empirical distribution of observations in years | 46 |
| 2.2 | Bank type distribution | 46 |
| 2.3 | Explanatory variables used in the CaR analyses | 49 |
| 2.4 | VIF test results | 50 |
| 2.5 | The conditional summary statistics for CaR transformed measures | 51 |
| 2.6 | Model 1 – Idiosyncratic CaR | 55 |
| 2.7 | Model 2 – Total CaR | 56 |
| 2.8 | Model 1 – corrected p-values | 58 |
| 2.9 | Model 2 – corrected p-values | 58 |
| 3.1 | The evolution of European regulation | 74 |
| 3.2 | The evolution of the US regulation | 80 |
| 3.3 | Characteristics of the sample banks | 82 |
| 3.4 | Composition of the sample | 82 |
| 3.5 | Statistics for 2,986 EU and 326 US banks in 2007 | 84 |
| 3.6 | Statistics for 2,986 EU and 326 US banks in 2008 | 85 |
| 3.7 | Statistics for 2,986 EU and 326 US banks in 2009 | 86 |
| 3.8 | Statistics for 2,986 EU and 326 US banks in 2010 | 87 |
| 3.9 | Statistics for 2,986 EU and 326 US banks in 2011 | 88 |
| 3.10 | Statistics for 2,986 EU and 326 US banks in 2012 | 89 |
| 3.11 | Statistics for 2,986 EU and 326 US banks in 2013 | 90 |
| 3.12 | Statistics for 2,986 EU and 326 US banks in 2007/2013 | 91 |
| 3.13 | Statistics for 2,986 EU and 326 US banks in 2007/2013 | 96 |
| 4.1 | Full list of key risk indicators | 112 |
| 4.2 | KRI versus risk factors in the risk dashboard | 114 |
| 4.3 | Sample banks | 120 |
| 4.4 | Market coverage of the sample | 121 |
| 4.5 | Description of selected variables | 122 |

4.6 Descriptive statistics of selected variables 123
4.7 Correlation matrix of selected variables 124
4.8 Random-effects generalized least squares regressions panel data 124
5.1 Summary statistics for banks 135
5.2 Innovation areas per year (all banks) 137
5.3 Test for equality of means – main variables (innovating and less-innovating banks) 139
5.4 Test for equality of means – control variables (innovating and less-innovating banks) 143
5.5 Correlation matrix 146
5.6 Bank-specific, banking system and country-specific determinants of innovation 147
5.7 Geographical and financial crisis effects on innovation 149
5.8 Robustness test 154
6.1 Summary of the sample of banks 170
6.2 Variables under consideration for studying efficiency, risk and corporate governance (CG) in European banking 171
6.3 Summary statistics of the efficiency, risk and corporate governance variables; values from 2013 174
6.4 Three-stage least square regressions on governance variables to risk and efficiency, when Z-score is the risk measure 175
6.5 Three-stage least square regressions on governance variables to risk and efficiency, when risk is the one-year beta 176
7.1 MAP authorities: key requirements 189
7.2 A taxonomy of the ESRB toolkit 195
8.1 Literature review – synthesis of the main analysed aspects 213
8.2 Sample data – capital, risky assets, dividend payout ratio and profitability (percentage values) 214
8.3 Profitability needed to reach and keep the Tier 1 ratio stable over time at 11% (stabilizing ROA) (percentage values) 219
8.4 Level of risk-weighted assets needed to reach and keep the Tier 1 ratio stable over time at 11% (percentage values) 221
8.5 The value of dividend payout ratio needed to reach and keep the Tier 1 ratio stable over time at 11% (percentage values) 223

8.6 The assets' growth needed to reach and keep the Tier 1 ratio stable over time at 11% (percentage values) 224
8.7 Stabilizing values and results obtained in 2011, 2012 and 2013 (percentage values) 226
8.8 ROA's banking groups between 2004 and 2006 and between 2008 and 2010 (percentage values) 228

# Preface and Acknowledgements

*Bank Risk, Governance and Regulation* offers studies pertaining to three interconnected, relevant areas of research in banking: the analysis of banking risks and their determinants, both at micro- and macro-level of investigation; the exploration of the existing relations among bank risk management, governance and performance; and the regulation of systemic risks posed by banks and the effects of novel regulatory sets on bank conduct and profitability. The research findings in this volume relate predominantly to European banking systems, but there are also stimulating contrasts with the US banking system. The chapters were originally presented as papers at the annual conference of the European Association of University Teachers of Banking and Finance (Wolpertinger 2014), which was held during 3–6 September 2014 at Università Cattolica del Sacro Cuore in Milan, Italy.

In Chapter 1, Josanco Floreani, Maurizio Polato, Andrea Paltrinieri and Flavio Pichler investigate the impact of loan loss provisioning (LLP) together with a wide array of credit-risk exposure and performance variables on systematic risk measured by betas. The study is based on a sample of European banks over the period 2006–11. The authors develop a model for assessing whether management behaviour, accounting policies, such as LLP, and the quality of loan portfolio play a significant role in explaining the banks' systematic risk exposure. The results suggest that financial performances do not have a direct, significant relation with betas; rather, measures of risk exposures (risk-weighted assets on total assets) substantially affect systematic risk. During the crisis, systematic risk is significantly responsive to provisions and their impacts on performances. Such results have several implications, in particular in light of changing European regulation on non-performing exposures reporting and forbearance practices along with regulators forcing banks to strengthen their capital bases.

In Chapter 2, Federico Beltrame, Daniele Previtali and Luca Grassetti propose an application of the Capital at Risk Model (CaRM) for banks' cost of capital estimation. CaRM, which belongs to the Implicit Cost of Capital (ICC) methodology, is particularly suited for banks as it is based on an asset side approach and makes use of a Value at Risk model. CaRM is based on the theory of investors' under-diversification and enables the pricing of both the systematic and specific risk. The authors test the model over 141 European listed banks, and their findings confirm that the CaRM is robust and able to perform significantly in the banking industry. CaRM could represent a useful alternative metric to banks' cost of capital estimation for all those investors who are not fully diversified.

Chapter 3, by Elisa Giaretta and Giusy Chesini, deals with the regulation of deposit guarantee schemes (DGSs) during the recent financial crisis. In the aftermath of the crisis DGSs have become more common and implemented in countries where the schemes did not exist, such as Australia and New Zealand. On the other hand, in countries in which the schemes were already adopted there began an overhaul of the main characteristics of these schemes. In this chapter the authors aim to answer two main research questions. The first one aims to analyse the main characteristics of a prospective harmonized European DGS by comparing how the US Federal Deposit Insurance Corporation (FDIC) works. More importantly, the second research question considers the fact that the new European directive requires that the funding arrangements of DGSs are risk-based pricing systems able to minimize the moral hazard risk. This is something new, which tends to make banks evaluated/supervised by the DGSs similarly to the firms evaluated by the banks when the latter lend money to the former. In particular, this requires taking into consideration the risk of each individual bank and, so, bank riskiness becomes very relevant in the funding arrangements of each national DGS.

In Chapter 4, Rosa Cocozza analyses the recent managerial and supervisory concerns on credit risk by means of consistent allowances and impairments. The analysis offered by the author aims at verifying this focus perception, as well as at verifying whether the supervisory suasion can be effectively regarded as proactive within European banking. The main findings reveal an effective and widespread focus on credit risk as leading risk driver, both from an institutional perspective and a market appraisal. Another result concerns the focus on a "coverage" risk management by means of allowances and impairments. The evidence seems to be confirmed even by the listed banks' dataset, thus supporting the hypothesis that a credit risk focus is not only a question of banks exposed to proper asset-quality review, but it is a sort of proactive target within the market. The results give rise to a major consideration: the focus on credit risk could create a disregard of other fundamental risk drivers with reference to both managerial practices and recovery devices. The sustainability in the long run of a credit-risk control by allowances and impairments could really be extremely difficult, especially when profits are not high. As a consequence, prospective risk management could not be really sustainable risk management.

In Chapter 5, Francesca Arnaboldi and Bruno Rossignoli study the main characteristics of financial innovation in 81 listed commercial banks in Europe and the United States from 2005 to 2008. They use annual reports to identify six broad innovation categories, from the launch of a new product to the implementation of a new organizational structure. The authors document the relationship between bank-specific features and innovation. Higher market share in less concentrated and less traditional banking systems is positively related to innovation. In addition, banks with a lower quality of loan portfolio exhibit a significantly higher level of innovation. The impact relationship between market share and innovation is stronger for banks incorporated in the United States, while a lower quality of loan portfolio is positively related to innovation for European banks. When the financial crisis hits, less-risky banks take the lead on innovation.

Chapter 6, by Magnus Willeson, aims to empirically evaluate the challenges for banks due to the new detailed regulation of the "management body", which predicts a reduced bank risk at low cost. In this chapter, the author determines the relevance of the above statement, testing whether the corporate governance of banks influences banking risk and banking efficiency. The results reveal a relationship between efficient banks and risk. However, the corporate governance variables considered in this chapter reveal limited evidence of the effect on risk, although corporate governance attributes can explain banking efficiency.

In Chapter 7, Elisabetta Gualandri and Mario Noera offer a survey of the state of the art of macroeconomic policies (MAP) with a focus on the case of the European Union (EU). The authors provide a detailed description of the institutional and operative frameworks of MAP. The operational framework, targets and toolkit are specifically analysed in relation to the case of the European Union and the introduction, in 2011, of a macro prudential supervisory pillar based on the European Systemic Risk Board, ESRB. Finally, there is an interesting focus on the main challenges facing the new European supervisory system and the MAP after the introduction in 2014 of the Single Supervisory Mechanisms (SSM).

Chapter 8, by Franco Tutino, Giorgio Carlo Brugnoni and Maria Giovanna Siena, analyses and tests the strategies adopted by Italian banks to face the new capital requirements imposed by Basel 3. Higher profitability, lower risk-weighted assets, higher retained earnings and lower loans to customers represent some of the strategies that could be adopted by banks in addition to a shareholders' equity increase.

Each one of them, however, could exhibit different cost and benefits in terms of costs and benefits themselves and could produce different impacts on the financial system and the real economy. In this chapter, the authors adopt an accounting model based on a sample of ten Italian banking groups and analyse each of these possible strategies, making a comparison between what should have been done to achieve higher capital requirements, what banks actually did between 2011 and 2013 and what they are going to do in the upcoming years, as pledged in their business plans. The aim is to investigate how banking strategies have recently evolved and how they could or should change in perspective in the context of an already weak performance. The research shows that in order to achieve higher capital requirements banks analysed in this chapter would need to increase their profitability by, on average, at least 1 percentage point or, alternatively, to deeply reduce the riskiness and their assets' growth or to decrease their dividend payout ratios. Above all, however, the economic conditions have made, and will inevitably make, the required adjustment process extremely difficult.

As editors we would like to thank all the authors in this volume for their contributions. We are also grateful to all the referees who acted as reviewers for the chapters published in this volume. We also want to thank all the conference participants for their active and constructive discussions during the presentations.

Special thanks to Philip Molyneux, series editor for Studies in Banking and Financial Institutions, for the opportunity to edit this volume, and to the staff at Palgrave Macmillan, especially Aimee Dibbens and Grace Jackson, for helpful comments and guidance.

Finally, as conference organizers, we would like to thank Anthony Saunders, Professor at Stern School of Business, for giving a plenary speech at the conference on "Don't forget the fees", and the speakers at the Jack Revell Session on "Towards the European Banking Union" (Paolo Angelini, Bank of Italy; Federico Ghizzoni, CEO at Unicredit; and Philip Molyneux, Bangor Business School).

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