Is Bigger Really Better?
Moral Hazard Issues in Expanding Financial Safety Nets
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Ten years after: Where do we stand?

Small is beautiful: The German „Three Pillar System“

Moral hazard and safety nets: Better incentives for bank managers
What has changed since 2007?
Private sector deleveraging, high public deficits

Private net financial balances (% of GDP)

Fiscal balances (% of GDP)

Private net financial balances = Current account minus Fiscal balance (Source: IMF)
Bank lending stagnant with the exception of China

Bank lending to private non-banks (percent of GDP)

Source: BIS
Business models have become more conservative

The height of each bar shows the aggregated capital shortfall considering requirements for each tier (ie CET1, Additional Tier 1 and Tier 2) of capital for the major internationally active banks monitored by the BCBS (BCBS (2018)).
NPL declining, but still high in Southern Europa

Source: ECB, Financial Stability Review November 2018
Expanding Safety Nets?

• Lender of Last Resort is already unlimited for countries indebted in their own currency
• Global dimension: Presentation by Helene Schuberth
• Considerable progress in extending the safety nets of the euro area:
  • ELA (Emergency liquidity): Country specific lender of last resort
  • European Stability Mechanism (500 billion Euro): Lender of last resort for member state governments indebted in a “foreign currency“.
  • Single Resolution Mechanism (SRM), backed by Single Resolution Fund (SRF). ESM serves as backstop for SRF
  • Work in progress: European Deposit Insurance Scheme (EDIS) with a target size 0.8 percent of deposits is grossly overrated
Small is beautiful: Germany’s „3 Pillar System“
Is bigger better? The German „Three pillar system“

Source: Deutsche Bundesbank
Smaller is more profitable

Advantages of the smaller banks

- Long-term orientation due to independence from capital markets
- Local anchoring combined with centralized service centers
- Support of social and cultural activities at the local level
Who is saved by financial safety nets?

Source: Presentation Edward J. Kane
Profits private, losses social?

Stock prices of German Banks and DAX (14 May 2007=100)
Setting the right incentives for bank managers (Dudley-Proposal)

Compensation

Immediately

Deferred (5-10 years)

Equity

Debt

Unsecured Debt

Performance bonds, security deposit for fines

William C. Dudley: Enhancing Stability by Improving Culture in the Financial Services Industry, New York, October 2014
The world has changed dramatically since 2007

- Net private lending has almost vanished (China is the exception)
- Bank business models have become more conservative
- No obvious need for expanding safety nets

The German experience: Diversified banking systems (“Three Pillar”) with small banks provide stability and to low costs for customers (=low profitability of banks)

The problem is not that banks were safed, but that the managers were not held responsible for their mistakes

- Share holders made huge losses
- Instead of increasing capital requirements to prohibitive levels, change the compensation of bank managers (Dudley Proposal)
- Responsible divers are better than more and speed limits
Why we need strong banks