Completing the European Banking Union: Capital Cost Consequences for Credit Providers and Corporate Borrowers

by

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Summary of the main findings

- The first part of paper undertakes an event study regression between 2010-2018 of the impact of the Bank Recovery and Resolution Directive 2014 (BRRD) on the weighted average cost of capital by looking at changes to cost of capital pre-and post-adoption of the instrument.

- The BRRD leads to a higher probability of bail-in of shareholders and creditors and so impacts the cost of capital and debt which is then, to varying degrees, passed on to the corporate borrower.

The argument in the paper

- The implementation of the BRRD reduces probability of disorderly resolution and reduces the use of public funding costs. <u>BRRD improves but does not ‘prevent’ bank insolvency it rather provides the means for an orderly resolution.</u>

- The current resolution cases indicate bail-in has been utilized less frequently than expected. A form and substance outcome. See, EBA notifications and SRB decisions.

The paper findings

- The first, reduction of moral hazard risk: state centered bailouts provide implicit benefits to banks by reducing their cost of capital. The adoption of the BRRD reduces the chances of using bailouts and so increases the cost of risk premia by investors and so improves market discipline. The paper fills a gap on the impact of regulatory reforms on banks funding costs.

- The second, looks at the spillover effects of regulatory changes on banks cost of capital and lending behaviour and the extent to which this is passed on to corporate borrowers.

- Reforms to regulatory and supervisory oversight of multinational banks should address efficiency of oversight and reduce regulatory arbitrage – implicitly centralized decision making minimizing the home and host bias.

Key features of the data

- The research focuses 15 EU member states which are divided in to three groups:
    - EMU Core
    - GIIPS
    - Non-EMU

- 59 commercial banks are selected according to their size from across the 15 EU Member States.

Key features of the data – Impacts according to regions: Pre and Post BRRD – ’capital cost responses’

- EMU Core – Slower response to changes to increases in refinancing cost (equity levels) – lower increases in WACC after implementation of BRRD

- GIIPS – Quicker response to changes to increase in refinancing costs (equity levels) – significant increases in WACC after implementation of BRRD

- Non-EMU Quicker response to changes to increases in financing costs (equity levels) – significant increases in WACC after implementation of BRRD

General conclusions

- Banks overall increased the relative weight of equity and reduced leverage.
- The threat of ‘likely to fail’ increased the need for higher equity levels
- Increase in bank capital costs have been pushed on to corporate borrowers
- Overall the resilience of the EU banking system is improved and reduces the probability of state bailout

Thank you!

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