Discussion of Bruno-Marino

Mark Flannery
University of Florida

Università Bocconi - Centro Baffi-Carefin

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- I received two documents as the basis for my discussion today.
  - “Size and Profitability in European commercial banks” by Brunella Bruno and Imma Marino, sponsored by Banca Passadore. Short English summary.
  - “A discussion of regulatory burdens for small vs large banks ”, by Rainer Masera and Marco Onado.

- Masera and Onado argue
  - Small banks provide different services from large banks and are better for community development.
  - But they are threatened by over-regulation.

- Bruno and Marino study whether smaller banks can compete effectively with larger ones.

The two papers are complementary

Can small banks survive … ?

Market Competition	**(No)**	**(Yes)**
Over-Regulation	(No)	(No)
Net Effect?	(-) but who cares?	Ambiguous: don't let over-regulation kill a good thing!

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Bruno-Marino

Bruno-Marino Empirical Work (Tables 2 and 3)

- All banking firms in Italy, 2000-2019, except those below €500 mn.
- VERY IMPORTANT: "The final sample is composed of banks homogeneous by type of activity (commercial banking being their core business), but heterogeneous in terms of size." (page 1)
- What determines whether a bank's ROA is in the top half of all banks?
  - Not Size.
  - "Loan portfolio quality and operating efficiency are … more relevant to explain performance gap, and this independently on bank size." (page 2)
  - An interesting aside: Capital (Tier I) tends to increase the probability of a bank being "top performer".

Evaluation

- Are the sample banks truly homogeneous banks, except for size?
- The sample includes more Savings and Cooperative institutions than Commercial Banks.
- Do these non-commercial banks differ from commercial banks in terms of
  - Product mix?
  - Lending based on hard vs. soft information?
  - Incentives?

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- The sample includes far more Savings and Cooperative institutions than Commercial Banks.
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Specialisation/ Ownership structure				
Cooperative	50.01%	-0.083	-0.007	0.074
		(3.22)***	(0.25)	(2.56)**
Savings	38.97%	-0.293	-0.222	-0.150
		(10.13)***	(7.71)***	(4.96)***

- Suggest further investigation about the effects of these sample characteristics. Are we comparing small savings banks to large commercial banks?

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A more conceptual question

- Profits are scaled by <u>book valued</u> equity or assets.
- But we know that market and book values differ: many European banks trade with a market-to-book ratio well below 1.0.
- Suppose larger banks have larger un-booked losses than smaller institutions do:
  - The ability to earn net income is driven by a firm's market value.
  - For the same net income, using book equity makes the larger banks look less profitable in terms of {Income/Assets} or {Income/Equity}.
  - ➔ large banks in this sample MIGHT perform <u>better</u> than small ones.
- Suggest looking into the same profitability measures with equity market values, for the banks that are traded.

U.S. Evidence that small banks are different

- Overall relationship value, from Andres Shahidinejad 2022:

  "This paper develops empirical evidence that Credit Unions charge lower interest rates on mortgages and their members achieve better outcomes than if they had originated with a comparably-sized bank."

- Small banks are important sources of loans to small businesses (SMEs)
  - Following a merger,
    - The acquired bank cuts back SME lending
    - New banks enter, to make up for the large banks cut-back.
  - More broadly, large US banks have withdrawn from the SME loan market since 2009.
  - Hard vs. Soft info technology for such lending
  - Fintech won't compete with small banks' "soft info" lending models. So small bank lending will continue to differ from the large banks' loan processes.

Regulation of small US banks today

- Today, smaller banks have a lighter regulatory burden on acount of Dodd Frank (2009) and Economic Growth, Regulatory Relief and Consumer Protection Act of 2018. Banks under $10 bn now have NO
  - stress tests
  - living wills
  - formal capital adequacy plans
  - bail-in debt
  - buffer capital
  - countercyclical capital buffer.

- Lighter reporting burden for banks with assets < $5 bn. The new quarterly Call Report (**FFIEC 051)** is still substantial, but it includes
  - Fewer required data items
  - Less detail
  - First and third quarters permit more aggregated reporting of some items.

- Deposit insurance pricing
  - Dodd Frank Act (2010) changed the insurance “base” from domestic deposits to total liabilities. This shifted insurance premia toward larger banks and away from smaller banks)
  - The FDIC has instituted two different sets of risk measures for smaller vs. Larger banks.

Small banks' capital adequacy standard

- Simplified standard of capital adequacy: Tier 1 capital / total assets > 9%
  - For banks with assets < $10 bn
  - Off balance sheet (OBS) < 25% of total assets
  - Trading account < 5% of total assets

- Sounds like capital standards from <u>before</u> Basel I. Ironic!

- Result of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 for "community banks" (assets < $10 bn.)

<u>Why</u> do smaller banks require less regulation?

- What is the goal of prudential regulation?
  - Prevent systemic risk
    - Threat to financial markets and/or to government solvency.
    - Even one large bank's failure can endanger these markets and solvency
    - Therefore need to control risk-taking at largest banks.
  - Protect the insurance fund or the public purse
    - Same reason to examine largest banks carefully
  - The methods for resolving bank failures work much better for small banks than it does for large ones.
    - This is probably more true for the US than for Europe.

Conclusions

- Small banks do indeed provide different services from large ones.
- Bruno and Murano have investigated an important question related to the optimal scale of banks.
- Yet it is hard to compare banks of very different sizes.
- The US argument for lighter regulation of smaller banks recognizes
  - the burden (fixed costs) of "full" Basel compliance vs.
  - the need for such compliance.