Discussion of the paper "What Happened to Profitability? Shocks, Challenges and Perspectives for Euro Area Banks" by Gong Cheng and Dirk Mevis

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[1] The views expressed are those of the discussant and do not necessarily represent those of DNB.

Summary

- Main question: Evolution of bank profitability in Euro area
- Methodology: panel data model for new dataset of 310 banks in 19 euro area countries 2005-2014
- Main focus:
  - dynamics of bank profitability and cross-sectional heterogeneity
  - main determinants of bank performance:
    - macroeconomic cycle,
    - bank business model, and
    - bank capitalization

Main results

- A big number of results on dynamics of banking sector
  - shift to more liquid security holdings
  - larger CB funding

- Two shocks hit European banks' profitability:

  - **Global shock**: Spillovers from the US 2008 crisis in subprime mortgage market affected banks with more **market-based business model**

  - **Local shock**: European debt crisis of 2011 weakened banks with **traditional lending model** (especially in peripheral Europe).

Contribution

- Detailed database of European banks
  - including net interest and non-interest income and provisions
- Link to the discussion on transaction vs relationship lending
  - Bolton et al. (2015)
- Link to the literature on global shock transmission
  - Cetorelli and Goldberg (2011)
- Interesting policy implications:
  - capital and leverage regulation
  - structural reforms

Challenging model: Methodology

Methodology: Causality

- the model does not allow for causal claim
  - higher equity or retail orientation increases profitability
  - the most mechanical effect: higher profit increases equity
- effect of macroeconomic variables (GDP, gov debt) would be more convincing for larger sample
  - data can be extended to cover more than one macroeconomic cycle

Challenging model: Variables

Variables: Defining business model

- Claim: retail-oriented bank has higher RWA/TA ratio
- But: bank with few loans and corporate debt can have higher RWA/TA than bank with many loans and sovereign debt.
- Interpretation is more related to asset risk

Challenging the model: Extension

Extension:

- Claim: traditional bank model is more popular in southern Europe where local shocks occured.
- Two alternatives:
  - Generally, banks with more traditional model suffer from local shocks more than market-based ones
  - Or banks from countries subject to local shock suffer more than banks in other countries.
- Important to disentangle: interaction terms?

Policy implications

- What are the regulatory tools?
    - capital regulation
    - structural reforms:
        - separating traditional activities to limit spillover effects
        - but what if the local shock occurs in the country where banks have more market-based model?