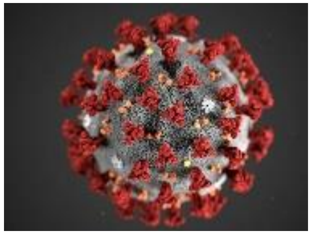
University of Zurich[UZH]

Department of Banking and Finance

Investment after the Pandemic: Finance, Banks and Regulation

On Bailouts, Zombies, Pandemics and Sovereign Risk



By

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EIB's Network on Investment

ENRI Virtual Workshop, May 20, 2020

From Financial Crisis to Corona Pandemic

Somewhat provocatively:

Link some outcomes of the financial crisis

to (currently observed) outcomes and policies during the corona pandemic

All very much work in progress

(citations to the benefit of my co-authors ☺; these papers will cite much other work)

Various elements, not all congruent and carefully-enough checked

(not a structural model, no attempt at second-guessing or blaming, ...)

To help think about the groundwork for productive exit and investment strategies

Main Elements

2007-09

«Better» bank bailouts

Tougher bank inspections

Well-capitalized banks that lend;

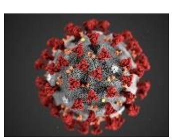
saving treasure for the sovereign

Suppressing Zombie lending

Maintaining quality health care

Youngsters outside of parental homes

Elder in more spacious retirement homes



2020

«Better» pandemic outcomes

Policy can use banks as able and allocatively efficient conduit

Berger, Allen N., Simona Nistor, Steven Ongena and Sergey Tsyplakov, 2020, *Catch, restrict, and release: The real story of bank bailouts*, May

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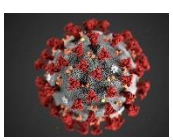

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Catch, Restrict and Release

Bank bailouts are not “one-shot” events but dynamic processes in which regulators:

- “catch” financially distressed banks;
- “restrict” their activities over time; and
- “release” the banks from restrictions at sufficiently healthy capital ratios.

a dynamic theoretical model of socially-optimizing regulators engaging in “catch-restrict-release” capital injection and debt guarantee bailouts

test the model’s predictions using hand-collected data on capital injection and debt guarantee bailouts in the European Union over 2008-2014

observed EU bailouts are qualitatively consistent with optimizing behavior

Restrict Phase Is Very Important

- Dividend bans:
  - suspend dividends on outstanding instrument
  - prohibited from repurchasing their own shares and establishing new share option programs
- Regulatory fees,
- Other operating restrictions
  - Board nominations
  - Executive pay limits, etc.

The harsher the (expected) restrictions,

the higher the capital ratio banks will maintain (to avoid being *caught*)

and the swifter the *release* will be and at higher capital ratios as well

(and the less treasure the sovereign will have at stake)

Bonfim, Diana, Geraldo Cerqueiro, Hans Degryse and Steven Ongena, 2020, *On-site inspecting zombie lending*, May.

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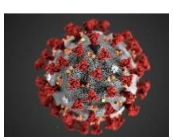

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What We Investigate?

large-scale on-site inspections made on the credit portfolios of several Portuguese banks

how do these inspections affect banks' future lending decisions?

an inspected bank becomes 20% less likely to refinance zombie firms, immediately spurring their default

banks change their lending decisions only in the inspected sectors

overall, banks seemingly reduce zombie lending because the incentives to hold these loans disappear once they are forced to recognize losses

Gropp, Reint, Steven Ongena, Joerg Rocholl, and Vahid Saadi, 2020,
***The cleansing effect of banking crises*, May.**

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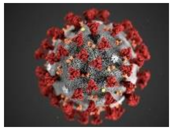

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What We Find

In U.S. regions during the recent crisis

with higher levels of supervisory forbearance on distressed banks

Short term gain

more distressed banks remained in business

less restructuring in the real sector: fewer establishments, firms, and jobs were lost

Long term pain

banking sector is less healthy for several years after the crisis

lower capital, and higher non-performing assets ratios

lower productivity growth path with fewer establishment entries & job creation

lower employment, wages, patents, and output growth

Ongena Steven, 2020,
***From Swiss Finish to Flying Start: Why Switzerland Performed so well in Shoveling Covid-Emergency Loans to its Small and Medium Enterprises?*, May.**

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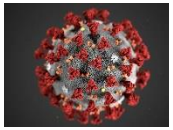

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March 25, 2020, the Swiss Government unveiled a 20 (then 40) bn CHF emergency loan package to support SMEs

1. companies can request an immediate loan, representing up to 10% of their annual income, capped at 500,000 CHF
   - interest-free
   - provided by Swiss banks
   - taken out with a full credit guarantee on the amount by the Swiss government
   - a simple declaration is sufficient.
2. Facility lends up to 20 mln CHF, provided by the banking system
   - the Swiss Government guarantees 85% of the loan, interest of 0.5%.
   - the bank assumes the risk of the remaining 15%, billed at a competitive rate.

Was swift!
At least in «shoveling speed» a success
(and likely with few defaults?)

credit was funneled directly through the banking sector

Banks = informed, specialist, well-capitalized, incentivized

Bank-firm relationships = soft information

Firms = few zombie firms; screening can weed out fraudulent applications

Government = and its dealings with banks are facilitated by the overall high degree of financial regulation, transparency and compliance in the country

Global Financial Regulation, Transparency, and Compliance Index (GFRTCI)

Moreno, Antonio, Steven Ongena, Alexia Ventula Veghazy and Alex Wagner,
Misfortunes Never Come Alone: From Financial Crisis to Corona Pandemic

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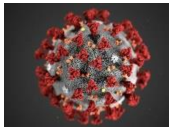

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What We Are Investigating

The impact of the 2007-09 financial crisis on corona pandemic outcomes

- Bank bailouts «expensive»
  - Public health care funding cuts
    - Lower health quality care may lead to worse pandemic outcomes

- Lack of bank credit
  - Lost business, local unemployment
    - Youngsters stay or return to parental home
      - Even when leaving (again) they settle in vicinity of parents because fewer opportunities and parents are now older
        - Due to cross-generational homesteading more infections, also virus more easily brought to retirement home in proximity (maybe also because of lower quality care)

Collecting Data

Cross-country

Local in Spain

Alin Marius Andrieș, Steven Ongena, and Nicu Sprincean,
***The COVID-19 pandemic and sovereign bond risk*.**

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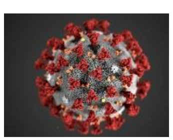

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Sovereign Risk

Pandemic and Sovereign Risk

We assess the impact of the pandemic in Europe on sovereign CDS spreads using an event study methodology.

A higher number of cases and deaths and public health containment responses significantly increase the uncertainty among investors in European government bonds.

Other governmental policies magnify the effect in the short run as supply chains are disrupted.

Pandemic Tests the Robustness of Societies

Sovereign, institutions, health care, households ...

Banking sector: credit granting and especially **allocation**

- Capital adequacy: «saving for a rainy day»
- Zombie lending: undermines market, bank, ...
  - Lack of recognition of losses: loan officer incentives, capital is costly, ...
    - Has a whiff of croony capitalism to it