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Discussion

Does the capital structure affect banks' profitability? Pre and Post-Financial crisis evidence from significant banks in France

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The views expressed here are those of the author and not necessarily those of the Banco de España or the Eurosystem

Caveat

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Summary of the paper

- An increase in capital ratios increases profitability of banks (i.e. ROE)
  - The result is robust to different capital and profitability measures
- Control for pure accounting effects (i.e. more equity reduces the denominator of ROE)…
- …as well as for bank variables (asset diversification, liquidity, business model, density of RWA,…)
- The channel through which these effects happen is the efficiency channel: somehow banks with higher capital requirements manage to be more efficient
- In a nutshell, the paper is a dream for banking supervisors

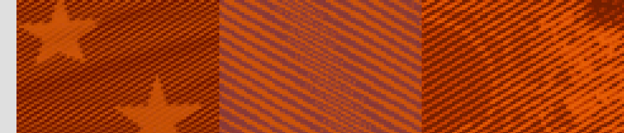
Summary of the paper

- The methodology to test for the more capital more profitability hypothesis is relatively simple
- A panel data where ROE is a function of lagged capital ratios as well as control variables, including the pure equity accounting effect
- The number of observations is relatively small (135), thus results should be read with some caution
- A cross correlation table for all the variables included is missing

Some comments

- Why not to control for the size of the bank?
- Why not to consider Basel 2 IRB models capital requirements? In other words, why to use only parallel Basel 1 information which is probably not driving banks' behaviour as it was not in force from 2008 onwards?
- In order to control for risk, it would be useful to add NPL ratios and/or provision coverage ratios
- Using RWA/TA maybe not a precise measure of risk: in fact it looks more like another business model indicator, together with loan and deposit relative weights

Some comments



- According to authors' interpretation of the results, efficiency drives the results:
  - Increases in capital ratios force banks to increase efficiency which in turn increases profitability (ROE)
- Alternatively, one could think of a different channel: the capital increase forces/stimulates an increase in risk taking that, finally, produces a higher profitability in exchange for it
  - There is no free lunch: the higher profitability is the result of more risk taking
- This alternative view could be easily tested/rejected by the same methodological approach: NPLs and/or provision coverage ratios as a function of capital and the other control variables
  - An extended Table 6 based on ex post measures of risk

Some final comments

- After the regulatory reforms finish, we will (hopefully) end up with a new “normal” level of capital ratios…
- …which in turn will produce, according to the paper, a new “normal” level of expected ROE
- Historically (Table 1) significant French banks show an average ROE of 10%, with unweighted T1 capital ratios of 5% and regulatory (weighted) capital ratios around 10%
- Which is the new ROE with a risk free asset (French bond) below 2%, equity premium for French banks probably below 5%, and a market power/alpha component of 1%?
  - ROE versus cost of capital below 8%?
- Which is the corresponding new “normal” regulatory capital ratio consistent with it?
- Some puzzling conclusion: higher capital levels with lower ROE?

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THANK YOU FOR YOUR ATTENTION

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