Discussion of: "Government Guarantees and Bank Risk Taking Incentives"

by Markus Fischer, Christa Hainz, Jörg Rocholl and Sascha Steffen

Florian Hett

Overview

- **Overall topic:** The effect of guarantees on banks' risk taking
- **Research question:** How does the **removal** of explicit guarantees affect risk taking of banks?
- **Setting:** (Announcement of) removal of "Gewährträgerhaftung" (explicit guarantee) for German Landesbanken
- **Identification strategy:** Exploit differential treatment of Landesbanken and Non-Landesbanken

Summary

The setting

- **2001:** Announcement of removal of (explicit) government guarantees for German Landesbanken
- **2005:** Removal becomes active
- **Inbetween:** Possibility to issue bonds still explicitly guaranteed

Theoretical predictions

- **Franchise value effect:** Increase in expected refinancing costs decreases "franchise value" and increases risk-taking
- **Market discipline effect:** Reduction of guarantees increases market discipline which decreases risk-taking
- **Transition period:** only the franchise value effect can already unfold

Summary

Main findings

- **Prior to 2001:**
  Lower borrower risks for Landesbanken, no differences in loanspreads
- **After 2001 (before 2005):**
  Increased borrower risk for Landesbanken, increased loanspreads for Non-Landesbanken
- Relative risks of Landesbanken increase, relative spreads decrease
- Stronger effect for banks with higher expected downgrades

Interpretation: Results support the franchise value hypothesis

- Higher risk-taking as a reaction to reduced franchise value
- Reduction in franchise value particularly strong for banks with higher downgrades

Overall assessment

Praise

- Topic highly relevant for economic policy
- Well written paper, clear structure
- Robust results
- Interesting and rich setting, already relevant in itself

Discussion

- Are results fully consistent with the interpretation?
- Isn't there a competing explanation that is even more plausible?
- Does the institutional setting correspond to the theoretical framework?

Are results fully consistent with the interpretation?

Franchise value effect:

- Loss of guarantees should increase refinancing costs after 2005
- Discounted profits are thereby reduced
- Bank has "less-to-lose" which increases risk-taking incentives
- Effect the stronger the larger the reduction in franchise value

Risk-taking incentives?

- Increased risk-taking: higher "upside" at the cost of higher default rates
- Predicitons for loans: **increase** in spreads **and** borrower risk
- However, the results indicate that loanspreads even **decreased**
- Thus, Landesbanken took on **worse** risks with **lower** spreads
- No additional upside as compared to loans previously granted
- Results not fully reflect the notion of the franchise value effect

Isn't there another explanation?

Landesbanken before 2001:

- Competitive edge in the market for loans due to cheaper funding

Landesbanken after 2001:

- Incentive to issue bonds to optimally exploit remaining guarantees
- Anticipation of cost increase after 2005

Potential effects

- Anticipated cost increase reduces competitiveness in the loan market
- Loss of "Good projects": Increase in risk, decrease in loanspreads
- Invest additionally raised funds: increase in lending quantity
- These projects should have worse risk-return trade-offs

Prediction: Bond issuance and risk increases, loanspreads decrease

Does the institutional setting correspond to the theoretical framework?

- Franchise value mechanism implicitly assumes banks to behave as if **maximizing franchise value**
- ‘A bank” is not a single decision maker, but an **organization**
- Franchise value should matter for equity holders as it **reflects their wealth**

- **Private banks:** Governance and control mechanisms incentivizing bank managers to maximize franchise value
- Do owners of Landesbanken have incentives to **maximize franchise value**?
- Owner of Landesbanken and the guarantor are approximately **similar**

Further comments

- Additional insights from a deeper discussion on the differential effects **before and after 2005**
- Sample splits based on **ex ante** measures? (Reverse causality of borrower risk and shadow ratings)
- Can we really rule out a **market discipline effect?** (Refinancing of longterm loans)
- Aren't there **spillovers due to competition effects**?
- How representative are syndicated loans? Is **other lending behavior** an important omitted factor?
- **Clustered standard errors** should be reported in baseline results. Can you do twoway-clustering?