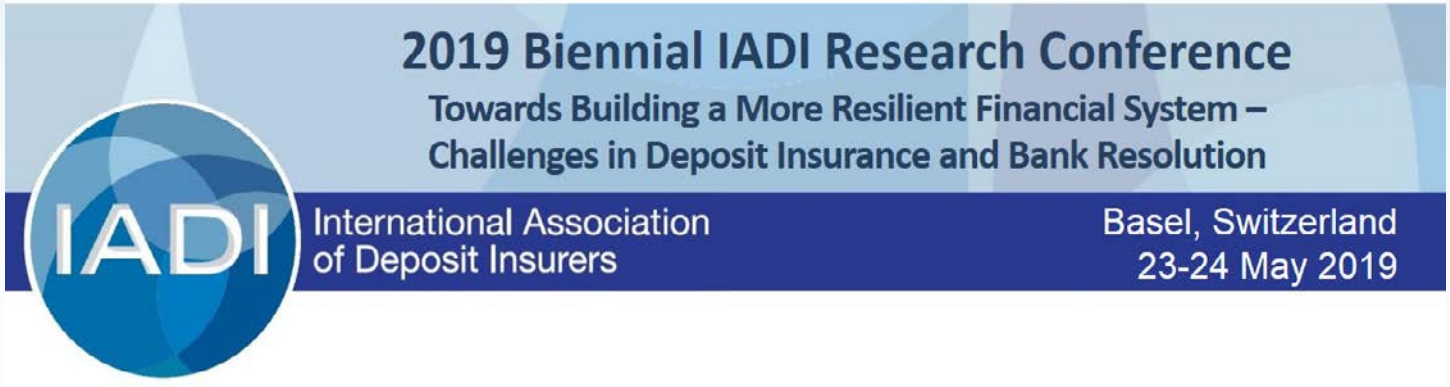

The Spillover Effects of Forced Bank Recapitalizations and Government Guarantees

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Outline

1. What the paper does

2. What was done by others

3. What the contribution of the paper is

4. Suggestions for improvement and further research

Conclusion

1. What the paper does - Hypothesis

The paper examines how Bank Holding Companies (BHC) react to enforcement of capital requirements at the subsidiary level.

There are three possible actions to recapitalize an under capitalized subsidiary: issue new shares, transfer capital from high capital subsidiaries to undercapitalized ones and reduce assets or asset growth.

The hypothesis is that due to market frictions and imperfections, BHCs will be reluctant to issue new shares and will respond by a mix of the two other possibilities.

1. What the paper does - Methodology

It is an event study using accounting data to characterize balance sheet management around the Financial Institutions Reform, Recovery and Enforcement Act of 1989 which implemented a cross-guaranty provision. This provision was de facto an incentive to recapitalize undercapitalized subsidiaries. .

The model is set up as difference-in-differences estimation using an explanatory variable which is the product of a post event dummy and a dummy identifying a high capital subsidiary having an undercapitalized sibling. Five dependent variables are regressed using 3 specifications each, one of which matches regions of treatment and control high capital subsidiaries.

1. What the paper does - Sample

It uses a sample of 730 BHCs, 131 of which having at least one undercapitalized subsidiary. In total, there were 2852 high capital subsidiaries, 1135 of them having an undercapitalized sibling.

There were 179 under capitalized subsidiaries.

Quarterly observations from 1987q1 to 1993q1

1. What the paper does - Results

The results are presented in 5 tables: T4 to T8.

T4: There is relative capital extraction from high capitalized subsidiaries having an undercapitalized sibling (-.16%).

T5: There is no significant difference in share issuance by BHCs having an undercapitalized subsidiary and those having none.

T6: High capitalized subsidiaries with an undercapitalized sibling have a significantly lower growth in lending (.70% per quarter).

T7: Undercapitalized subsidiaries have a significantly lower growth in lending (-1.50% per quarter).

T8: BHCs with an undercapitalized subsidiary have a significantly lower growth in lending (-.94% to -1.17% per quarter).

1. What the paper does - Conclusion

The empirical results support the hypothesis that to recapitalize an undercapitalized subsidiary, the managers of BHCs prefer not to issue new shares, but rather adjust by transferring capital internally and curtailing lending growth.

The conclusion suggests that if countries enforce subsidiary-level capital requirements on foreign banks a similar curtailing of lending growth may occur.

1. What this paper does - Comments

The hypothesis is well stated.

The sample is large.

There are plenty of descriptive statistics and graphs.

The econometric methodology is elaborate and sound.

The results are clear, robust and interesting.

The text is generally fluid and well written.

Let us note that the paper is only indirectly about deposit insurance, which would be exploited by undercapitalized subsidiaries.

2. What was done by others

Billett et al. (1998) perform an event study on US BHCs around a debt downgrade. They provide a graphical model to predict that BHCs should increase their reliance on insured deposits and shrink their asset size. Their empirical results (Table 5 p.350) support their predictions.

Jackson et al (1999) reviews various studies analyzing the impact of the first Basle Accord on bank behavior. The paper concludes:

«Available research suggests that, in order to meet minimum capital requirements, banks are likely to cut back lending when it would be too costly to raise new capital» p.3.

2. What was done by others

Michelangeli and Sette (2016) study the effect of bank capital on the supply of mortgages in Italy. Their conclusion is:

«We find that higher bank capital is associated with a higher likelihood of application acceptance and lower offered rates; banks with lower capital reject applications and lower offer rates to safer ones. Finally, non-parametric estimates of the probability of acceptance and of the offered rate show that the effect of bank capital is stronger when capital is low.»

Excerpt from the Abstract p.1

2. What was done by others

Mustilli and al. (2017) test the impact of the Basel III Accord on bank lending in Europe using a sample of 2,964 banks.

«Based on their results, the authors conclude that the need to comply with newly-enforced Basel III requirements is responsible for a fall in aggregate bank lending and the prioritisation of forms of investment other than the lending business (for example, financial market transactions).»

Excerpt from the Abstract p.47

3. What the contribution of the paper is

The relationship between higher capital requirements and lower credit supply has been studied by different researchers for at least 20 years. So, the topic of this paper is not new and its conclusion of reduced credit supply is not either.

However, its claim on p.7 «To our knowledge, this paper is the first to identify the internal capital market and lending spillover effects that occur when parent holding companies are pressured to recapitalize weak subsidiaries.» is also consistent with my knowledge. The contribution is indeed very valuable as it provides information about the process in BHCs of adjusting to new capital requirements.

4. Suggestions for improvement

1. Enrich the review of the literature by including the references presented in our section 2.

2. At the end of the paper, better position the contribution of the paper relative to previous research.

3. Enrich the conclusion by exploring more the implications and possible extensions.

4. Suggestion for further research

For example, the research could be pursued by performing an event study using market data.

It would ask the question: «Were stock prices of BHCs affected differently by FIRREA according to their having or not an undercapitalized subsidiary?».

The potential greater loss in value could be an indirect estimate of the value of the forgone exploitation of deposit insurance and/or caused by rationally lowered growth expectations.

Conclusion

The paper is very good. It has a fairly large sample, an original methodology and significant and relevant results.

It provides a valuable contribution to the literature on the effects of capital requirements.

It is written very clearly and the well crafted development is easy to follow.

Nonetheless, it could be further improved and extended along the lines suggested.

References

Billett M.T., Garfinkel J.A. and O'Neal E.S., «The Cost of market versus regulatory discipline in banking», Journal of Financial Economics, 48 (1998) p. 333-358

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THANK YOU
FOR YOUR ATTENTION

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