

Inside Debt and Bank Risk Taking

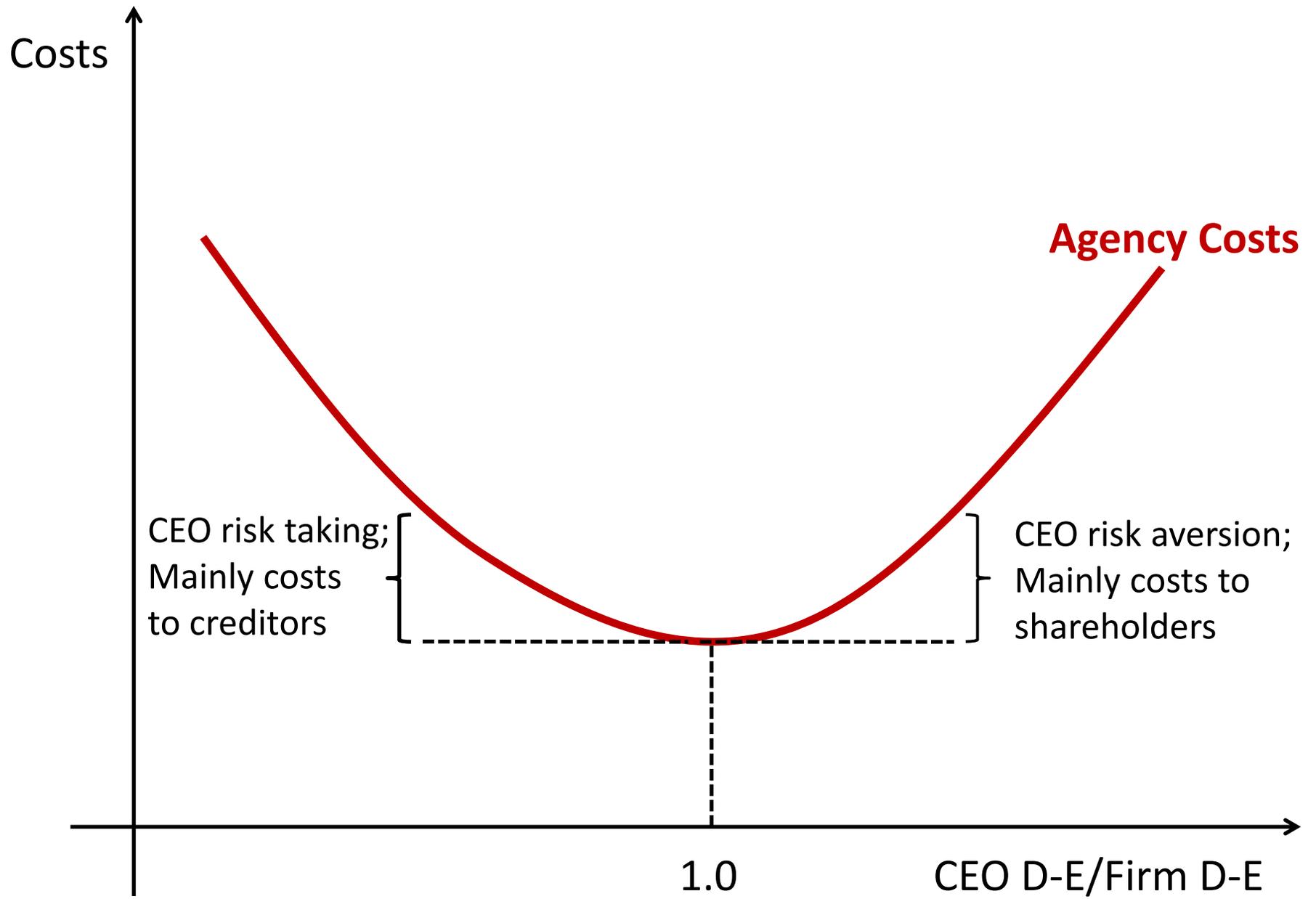
Discussion

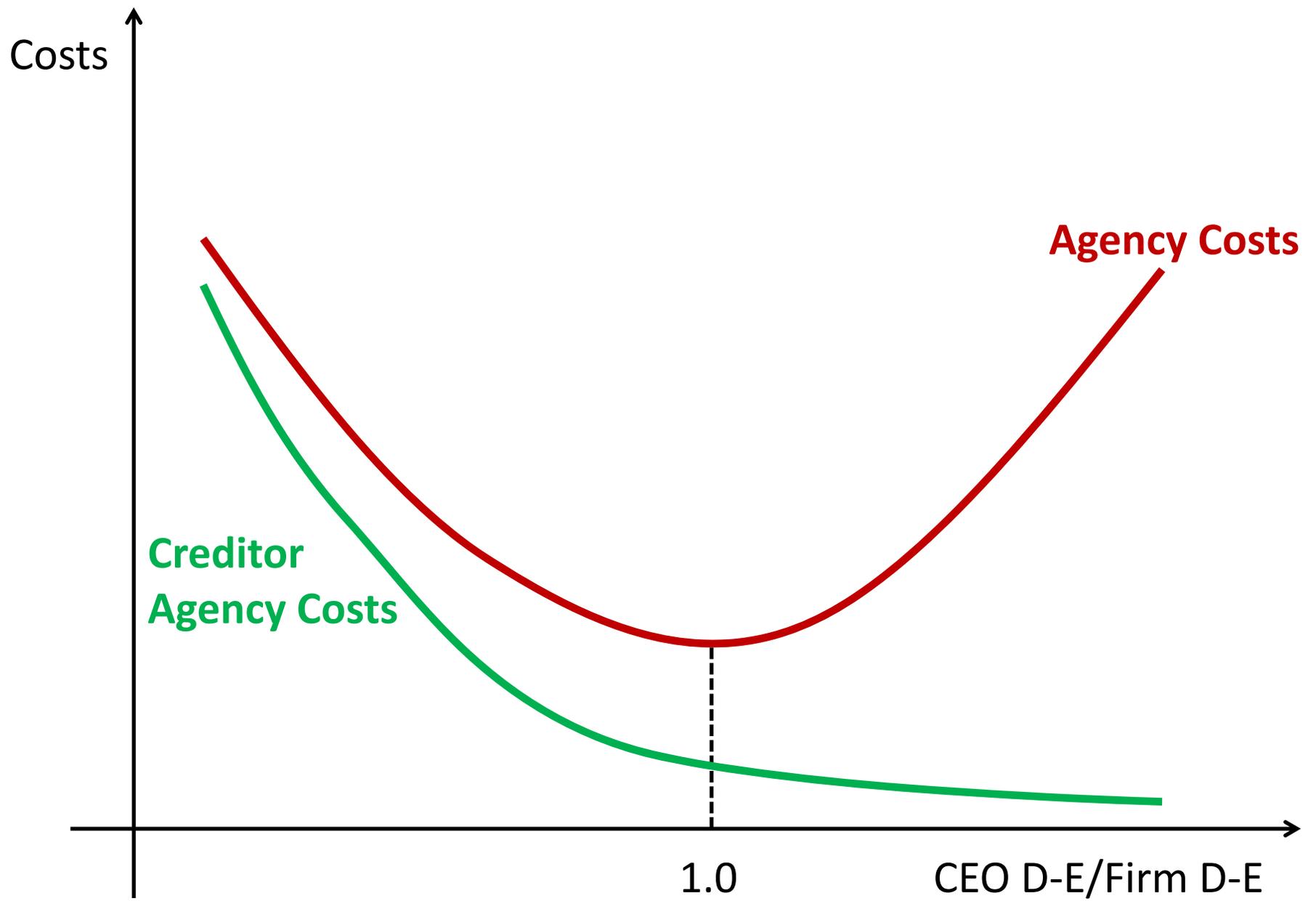
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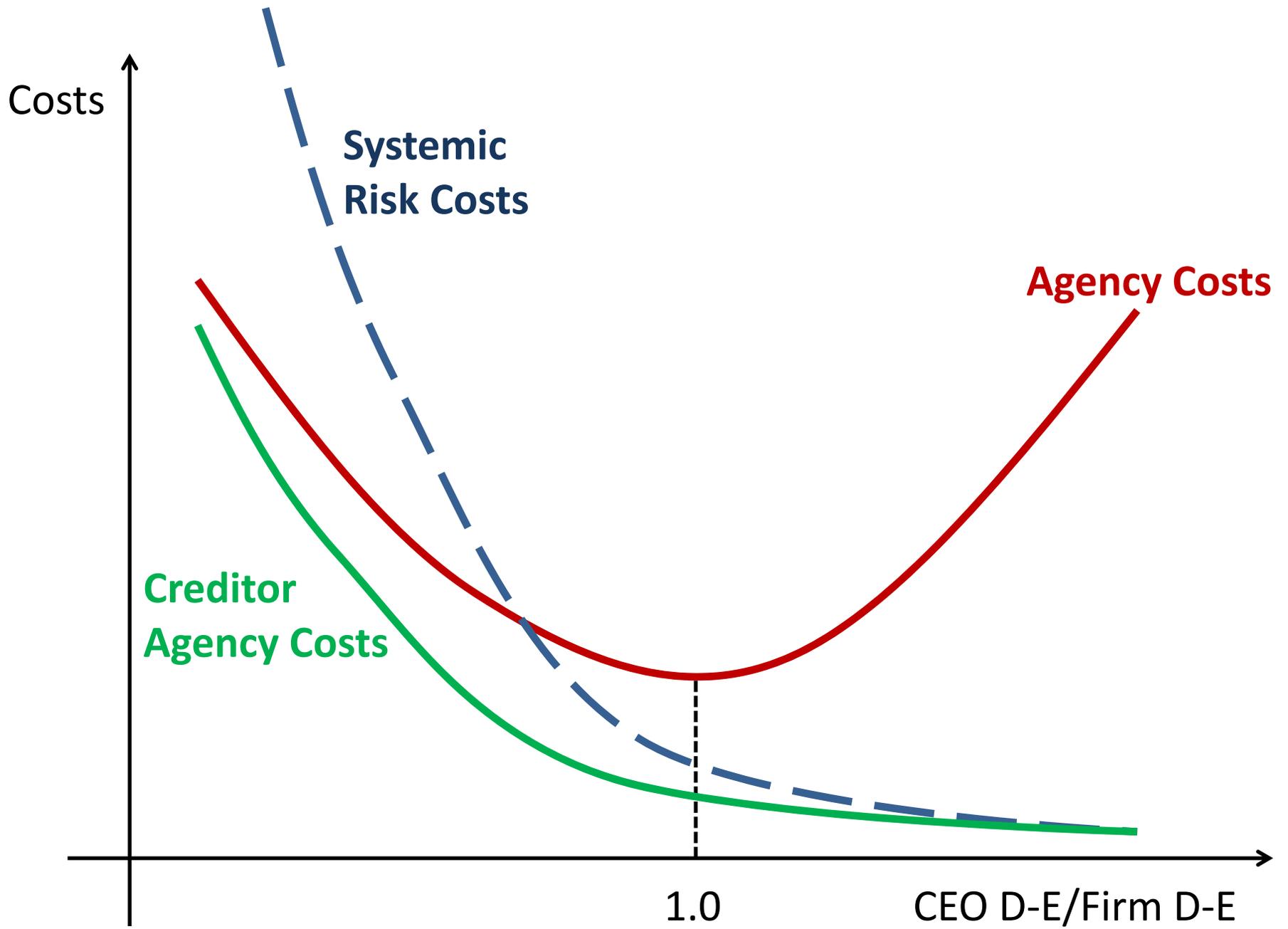
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Is Jensen & Meckling framework appropriate?

- **Srivastav, et al. use J&M-style ratio as main test variable:**
 - CEO debt-to-equity / Firm debt-to equity
 - J&M-style ratio is explicit in this methodology
- **Bennet, et al. separate the CEO and Firm ratios:**
 - Simple CEO debt-to-equity ratio is main test variable
 - Firm debt-to equity is included as control variable
 - J&M-style ratio not used, but it is implicit in this methodology
- **Is this the appropriate framework for their tests?**
 - Is CEO inside leverage meaningful only in relation to Firm leverage?
 - Does the J&M “ratio of ratios” = 1.0 have meaning in these papers?







Is Jensen & Meckling framework appropriate?

- **Both of these studies focus on default risk.**
 - Bennet, et al.: Main dependent variable is Expected Default Frequency.
 - Srivastav, et el.: Main dependent variable is Distance to Default.
- **Default risk is the only risk that matters for creditors.**
- **Default risk is the major and ultimate risk that matters for bank supervisors.**
 - Indeed, Bennet, et al. use CAMELS (safety and soundness) ratings in place of default risk in robustness testing.
- **The J&M “ratio of ratios” = 1.0 has no special meaning for either creditor wealth or supervisor utility.**
 - Neither paper tests for differences in default sensitivity around 1.0.
 - Srivastav, et al: Are results similar if you substituted the simple “CEO ratio” in place of the J&M “ratio of ratios” ?

Raw CEO inside debt/CEO inside equity

		mean	median	std. dev.
Wei and Yermack	299 US non-financials	0.22	0.15	0.24
Bennet, et al.	371 US BHCs	0.37	0.09	1.35
Srivastav, et al.	117 US acquiring BHCs	1.15	0.39	2.23

- **Why are Srivastav, et al. values so high?**
 - In their first-stage probits, they show that higher CEO inside debt makes acquisition less likely.
- **Srivastav, et al.: What about internal growth?**
 - Does inside debt shift growth from external channel to internal channel?
Or does it simply staunch growth altogether?
- **Both papers: Were CEO inside debt levels persistent before, during and after the crisis?**
 - A time series from 2007-2013 would be interesting.

Returns to CEO inside debt

- **Srivastav, et al: Acquisitions by high inside debt banks are risk-reducing.**
 - Research into other bank policy decisions a natural complement/check.
- **Bennett, et al: Inside debt reduces default risk and increases ROE, ROA and excess returns.**
 - Is inside debt really this powerful? Risk↓ and Returns↑ ?
 - We need to see both studies repeated using data from across an entire business cycle.
 - Example: Capitol Federal Bank.
- **Bennett, et al. argue that inside debit may be a “signal” to investors that the bank will be strong during uncertain times.**
 - I would expect the coefficients on their inside debt ratios to have smaller coefficients during “normal times” when all banks are far from default.

Vega, Delta, Inside Debt and Endogeneity

- **Delta and vega are theoretically and/or arithmetically related to various CEO inside debt measures.**
- **Delta and vega are used as r.h.s. controls in both papers:**
 - In all Srivastav, et al. models.
 - In Table 8 robustness tests in Bennett, et al.
- **The estimated marginal effect of inside debt—holding delta or vega constant—is difficult to interpret.**
- **A bank's delta, vega and inside debt are all likely endogenous to a bank's default risk.**
 - Srivastav, et al. instrument for inside debt—only in Table 6—but do not instrument for their vega/delta variable.
 - Bennet, et al. do not attempt to treat endogeneity of CEO compensation incentives.

Economic magnitudes

- The two papers use different models and specifications.

		A one standard deviation increase in:	Is associated with:
Bennet, et al.	Table 2(1)	Inside Debt Ratio	1/12 th std dev reduction in EDF
Bennet, et al.	Table 2(5)	Inside Debt Ratio	1/20 th std dev increase in DD
Srivastav, et al.	Table 5(5)	CEO Relative D/E Ratio (Wei and Yermack's "CEO relative incentive ratio")	1/6 th std dev increase in DD from acquisition
Srivastav, et al.	Table 5(6)	CEO Relative D/E Ratio (Wei and Yermack's "CEO relative incentive ratio")	1/4 th std dev increase in DD from acquisition

- Are these economically significant effects?
- Can the Bennet, et al. result be expressed as "increase in CEO inside debt needed to reduce EDF to acceptable supervisory level" ?

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