13th Annual FDIC/JFSR Bank Research Conference

Regulation and Bank Cost of Capital

Discussion by

Robert Hauswald

Kogod School of Business, AU

KOGOD SCHOOL *of* BUSINESS
AMERICAN UNIVERSITY • WASHINGTON, DC

The Message

The end of market discipline

is near because investors expect

The shadow cost of bank capital

to be really low in the presence of

Deposit rate advantages at the largest banks

- Three papers providing a refreshing look at the cost of capital: deposits, bonds, equity
  - Size matters for banks' cost of capital, but why?
  - Suggests a merger: meta-study of bank WACC

Acharya, Anginer, Warburton

- Credit spreads unresponsive to risk for larger banks; not so for small and medium-sized ones
  - Implicit guarantees worth 28 bps: 120 in 2009
  - Gains to bank shareholders from M&A: size premium is primarily a ‘too big to fail’ rent
- But why protect bondholders? No clear case
  - EU discussion on bail-ins shows political push-back
- Identification as always an issue in such studies
  - TBTF, information advantages, or economies of scale

Questions

- Sample: banks, but why broker-dealers, exchanges, and insurance companies?
  - Analyze subsamples: nested specifications using slope dummies to gauge differential effects
- Trade data: really – no matrix or stale quotes?
- Clever use of Merton (1974) and DD; but
  - Why not KMV data outright?
  - Problem: if bondholders price the subsidy so might shareholders - how does it affect results?

Robustness

- Why not run at least 2SLS?
  - Fitch variables as instruments
- Arellano-Bover/Blundell-Bond: construct a panel and use dynamic panel estimation: diagnostics
- Not sure about Fitch variables: subjective
  - why not use their support rating, too?
- Bear Stearns and Lehman failures might not be exogenous shocks – at least needs an argument
  - Do you really need this part of the analysis? If so,
  - Why not difference-in-difference estimation?

Jacewitz and Pogach

- Investigate how size affects deposit rates
  - After a look at bond pricing and the cost of equity the third ingredient in bank WACC
  - Focus: uninsured deposits
- Large banks enjoy a 15 to 40 bps lower risk premium on uninsured deposits
  - Like in Acharya et al., implicit guarantees are at work: but what is the economic mechanism? Politics?
- Use regulatory shock to identify effects: EESA 2008 raises insurance limit to 250K
  - Clever identification strategy: again, truly exogenous?

Observations

- Analysis relies on cross-sectional regression
  – Why not difference-in-difference approach?
- Panel analysis: spread in deposit rates between large and all other banks
  – What is large? Robustness to size definition?
  – Why not dynamic panel methods to address joint endogeneities: Arellano-Bover/Blundell-Bond
- What is the economic question?
  – Policy implications?

Kisin and Manela

- Disconnect between academe and industry:
  - Very different estimates of cost of bank equity
  - Matters for regulation: regulators in the middle
- Cost of requiring additional capital seems really low: 142m on average – Admati et al.
  - Flies in the face of what we teach MBAs and the
  - kicking and screaming of the industry
- Clever way to estimate shadow cost: CAPM?
  - Did not think I would ever see a Lagrangean

Bank Real Cost of Capital: King (2009), BIS Quarterly

	Zimmer and McCauley (1991)	Maccario et al (2002)	This study	
Method	Real return on equity	Inverse of P/E ratio	CAPM	
	1984–90	1993–2001	1993–2001	2002–09
Canada	10.3	12.0	10.7	5.4
France	...	7.7	10.6	7.3
Germany	6.9	7.0	11.4	9.0
Japan	3.1	2.8	12.0	11.2
United Kingdom	9.8	8.9	9.5	6.6
United States	11.9	8.8	10.4	7.2

Sources: Maccario et al (2002); Zimmer and McCauley (1991); author's estimates. Table 1

Concerns

- Lagrangean analysis only make sense for capital constrained banks: exogenous identification?
  - How to identify such banks the is the key issue
- Selectivity issue: one needs a conduit but
  - Capital-constrained banks without conduits?
  - Conduit assets are not homogeneous: spread varies
- Loopholes are by definition an oversight
  - If they become pervasive oversight is corrected: begs the question how representative the results are

Lessons

- Bank capital seems to be much cheaper than anybody thinks: CAPM-centric view? If so,
- Require banks to hold much more capital
  – Regulatory menu: activities ⇔ K-structure
- Implicit guarantees: TBTF not the right view
  – TITF: Too Important to Fail – Acharya et al.
  – TBTR: Too Big to Rescue
  – TCTR: Too Complex/Costly to Regulate/Review
  – TDTT: Too Dangerous to Touch