Bank Scope and Regulation: A Discussion of Korinek and Kreamer; Cunat, Cvijanovic, and Yuan; King, Massoud and Song

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Perspectives on Regulation

- Two elements of bank regulation: capital & scope
- Can focus on capital and ignore portfolio:
  - Allow banks to do whatever they want as long as they remain solvent. If a bank is in danger of going under, force recapitalization(PCA). Shut down banks with insufficient capital.
  - Justification for deregulation in 1980s and 1990s
- Can reduce risk to FDIC and society by narrowing the scope of bank assets
  - Deposits should not be used to fund risky activities
  - More pragmatic approach if bank capital is not easily observed or regulators are unable/unwilling to enforce rules

Perspectives on Regulation

- Pros and cons of focus on Capital:
  - Pro: Innovation (and therefore efficiency) is not stifled
  - Con: Difficult to enforce capital regs
    - Assets are opaque and hard to value, hence equity unknown
    - Incentives for overvaluation of reported equity in bad times and undervaluation in good times
    - Even when insolvency is apparent, TBTF and other forbearance policies are chosen over PCA
- Pros and cons of focus on Scope:

  Pro: low volatility of assets so low probability of failure

  Cons:
    - Underinvestment problem in the economy
    - Increases the probability of a slow decline in bank profitability and an increase in the concentration of assets, both of which could ultimately lead to a large number of failures (cannot be in business with zero risk)

Korinek and Kreamer

- Bank risk-taking is bad for the economy because it involves an externality that is not priced
  - Externality is lower production by nonfinancial firms whenever bank risk-taking activity has a negative realization
- In their model, there is no upside to bank risking for the economy as a whole, only for the banks
  - No role for credit allocation in their economy, as all production is valuable and riskless.
  - Banks are not in the business of evaluating the credit risk of borrowers and giving loans to businesses that are likely to repay them

Korinek and Kreamer

- Bank profit is unrelated to the profitability of firms
  - A decline in bank lending cannot occur because the number of positive NPV projects has decreased but only from a shortage of equity
  - Shortage of equity arises when risk works out poorly
- Bank capital has externalities when it falls but none when it rises
  - Externalities owe to fact that deposits are low and they are low due to contracting problems
- Banks face a risk return trade-off but firms do not
  - Welfare would be increased if banks did not exist and workers invested in their firms directly. They cannot do so by assumption.

Korinek and Kreamer

- Letting banks do whatever they want as long as they have enough capital is not a choice by assumption
  - Bank capital is limited by previous period risk taking
- Upside of letting banks do whatever they want is that riskier projects get funded.
  - Since riskier projects have a higher return on average, letting banks do whatever they want makes the return higher on average
    - In their model, the upside to risky projects has no benefit to society

Cunat, Cvijanovic, and Yuan

- Impact of RE shocks on bank capital and lending
  - Nice strategy for identifying local RE shocks
  - Very confused/confusing discussion about supply shocks and demand shocks (of housing or loans?)
- How do banks react to shocks?
  - Boyson, Jindra and Helwege (2013) say that they issue equity, rely more on deposits, sell off assets that have done ok (not toxic assets), cut dividends, shrink
  - Results here are largely consistent with BJH
- RE shocks are a big deal (see also Cole and White (forthcoming JFSR)
  - So, regulate banks to have less RE?
- Odd that sample banks have almost no C&I loans – more likely that RE will matter?

Cunat, Cvijanovic, and Yuan

- Split sample and look closely at large banks with low capital and small banks with high capital
  - More useful to look at banks with high fraction of RE in bank assets?
- Goal is to identify shocks to capital that affect lending
  - Even if identification of shocks to capital ok, still want to know how banks recapitalize
    - Equity issuance to public (SEOs), private placements, dividend cuts, repurchase program changes, cherry picking (asset sales with positive realized gains), toxic asset sales
- Maybe a second goal should be to identify reduction in lending due to decreased demand for real estate loans, which is another source of systemic risk and spillovers.

Cunat, Cvijanovic, and Yuan

- Data are from 2005-2010 using only housing prices
  - Would be interesting to compare effects of last crisis with that of Texas in mid 1980s
- I like that focus of paper is on real estate because as Cole and White point out, most banking crises stem from real estate losses
  - MBS should be a better way for banks to engage in residential RE lending:
    - geographic diversification,
    - senior tranche vs. whole loans,
    - market pricing allows more precise measure of capital
    - What is impact of RE shock on capital via MBS valuations?
  - If paper is serious, conclusion is that regulations should limit exposure to real estate, especially residential housing.

King, Massoud and Song

- Motivated by Volcker Rule, authors examine trading assets and their impact on risk, profitability and stock returns.
- Trading assets could help banks diversify but could simply increase probability of default.
  - Similar question to 2nd paper in session, except that the culprit is trading assets rather than RE.
- Authors find that trading assets are associated with higher risk and lower profits and lower returns, and higher systemic risk.
  - Systemic risk is defined as tail risk so odds are high that higher bank risk means higher systemic risk.
  - Cannot be an equilibrium result:

    Higher risk = lower profits

King, Massoud and Song

- Similar question to Avery and Berger (1991)
  - Asset assigned lower risk weights associated with relatively “better” bank performance
  - Call report data from 82-89 show that risk-weighting is sometimes off but overall makes the likelihood of failure decline
  - More of a “what if?” approach that would allow comparisons that take into account the capital changes that arise with risk restrictions
- Z-score variable strikes me as a poor idea
- Why look at trading assets as a source of risk?
  - Trading on interest rates or buy and hold strategies with sovereign debt could be as troublesome
  - MBS are safer than whole mortgage portfolios

Conclusion

- Three papers start with the assumption that greater risk is bad for the banking system and therefore the economy
  - Consider the positive elements of risk taking and the role of banks in credit allocation to positive NPV projects
- Two empirical papers examine risky assets in isolation – trading assets and RE are treated separately - counterfactual is not a riskless bank
- Negative outcomes in bank risk-taking lead to changes in bank capital, so don’t consider bank risk in isolation from capital structure choice
  - Equity issuance, cherry picking, deposit growth, divestitures and overall shrinking strategy