Discussion

FDIC-JFSR Conference

Intermediation and the Real Economy

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Three Papers

- Berger and Roman:
  - Banks receiving government funds via TARP generated positive effect on local real economies.
- Khan and Ozel:
  - Information in bank loans has predictive power for performance of local economy.
- Neuhann and Saidi:
  - Universal banking enables banks to finance riskier firms leading to gains in productivity and value.

Common Theme

- Banks are an important source of capital for firms.
- They play an important role in the local economy.
- Relationships between banks and firms are important.
- Soft information based on proximity/relationships plays an important role.

HENCE:

  - Providing capital to banks can have positive real effects.
  - Banks' information is useful in predicting economic outcomes.
  - Financial deregulation enabling banks to take more risk benefits firms.

Alternative Views

- Banks, and especially relationship banking, are not that important anymore.
  - Increasing role of financial markets and other forms of financing.
  - Within banking, more standardization; less of a role for soft information and relationships.
- Banks take excessive risks and make bad loans when they have the resources to do so.
  - Agency problems due to insurance/guarantees.
  - Hence, need to restrict/regulate banks.
- Overall, the collective evidence in these papers point in a different direction.

Berger and Roman

- Analyze the effect of banks' reliance on TARP on the economic variables in the states where these banks operate.
  - Main economic variables: Job Creation, Hiring Establishments, Business Bankruptcies, Personal Bankruptcies.
- Analysis based on Diff-in-Diff logic: changes in economic variables in banks that received a lot of TARP money after TARP.
- All economic variables with the exception of Business Bankruptcies point to a positive effect of TARP on real economic activity.

Berger and Roman – Cont'd

- Key challenge in interpreting the results is identification:
  - Is there causality between TARP and economic conditions?
  - Why do some banks get a lot of TARP money and others don't?
  - Alternative story: Banks in states that had the potential to grow applied to get more resources.
- Authors conduct some analysis using IV, e.g., political connections at the state or bank level helped securing more TARP money.
  - But, question remains: is this exogenous or unrelated to economic changes?

Berger and Roman – Cont'd

- Another challenge is that evidence is rather indirect:
  - Test effects on employment, bankruptcies, etc., but no direct evidence on what banks/firms did.
- Other studies suggest mixed evidence on the effect of TARP on lending.
- It may be interesting to look more directly at what firms who borrow from banks did.
- Differentiate between different types of firms and different types of banks to get a sense whether effect is likely to be a result of TARP.

Khan and Ozel

- Authors use information in bank loans and show it has predictive power for economic conditions in states where banks operate.
  - Information in bank loans includes provisions for loan and lease losses, changes in nonperforming loans, risk premium on loans, and loans growth.
  - Economic activity measured by the state coincident index published by Philadelphia Fed.
- Show that some predictive power remains even after controlling for other variables that reflect information about local economy:
  - State leading index and value-weighted stock return of publicly traded firms headquartered in a given state.

Khan and Ozel – Cont'd

- Paper does not ask a question about causality:
  - Do banks have superior information about local economy? Or, do banks' conditions/views affect the real economy?
  - Such a question would be interesting to look at.
- Paper needs to establish more strongly what are the key implications of the results.
  - Correlation between banks' expectations and local conditions are not very surprising.
- Can we use the information as a real-time measure for future economic activity?

Khan and Ozel – Cont'd

- Is the information available in real time?
- What can we do with the information?
- Is it useful in predicting future changes?
  - Predictive power decreases significantly once we try to look a bit ahead.
  - Provisions for losses remains as main informative variable. Why?
- Another potential key insight: Banks have information that no one else has in the economy.
  - But, again, predictive power decreases when we include other variables.
  - Also, I would have liked to see more thorough examination of other sources of information and whether banks' information is still valuable:
    - Media, analysts, bond ratings, etc.

Neuhann and Saidi

- Glass Steagall act of 1933 did not allow banks to engage in commercial banking and investment banking activities at the same time.
- A change in 1989 allowed banks to combine both activities, but with strong firewalls between them.
- Firewalls were largely removed in 1996, enabling information flows across products and provision of loans and investment bank services to the same firms.
- Paper attempts very careful identification:

Neuhann and Saidi– Cont'd

- Compare firms that benefited from universal banking in 1996 with those that could not benefit from it for arguably exogenous reasons:
  - They engaged with another investment bank just prior to the 1996 change.
- But, is this really exogenous and unrelated to other firms' variables?
- Who are the firms that started working with investment banks around that time?
- Paper shows that firms that benefited from the universal banking exhibit more risk (sales volatility, implied volatility from options, etc.)
- But, maybe this is related to the characteristics of those firms relative to those that already worked with another investment bank in 1996?

Neuhann and Saidi– Cont’d

- Overall, identification exercise is not the most intuitive and may not capture most important effects.
  - Note that the results are also quite weak and not very statistically significant.
- The paper highlights positive effects of risk taking: greater productivity and valuation.
  - What about negative side of risk taking?
  - It is surprising that there are no results on defaults and other negative outcomes.

Conclusion

- All three papers provide very interesting angles on the role of banks in the real economy, suggesting the importance of bank financing and relationship banking.
- More work can be done to sharpen the interpretation and convince readers more strongly of key economic messages.
- I look forward to reading future versions!