

Wishful Thinking or Effective Threat? Tightening Bank Resolution Regimens and Bank Risk-Taking

Magdalena Ignatowski (Goethe University Frankfurt)
Josef Korte (Goethe University Frankfurt)

Discussion by Esteban Prieto (Deutsche Bundesbank)

Scope

- Did changes in bank regulation after/during the financial crisis reduce risk-taking behavior of banks?
- Approach:
 - Difference-and-Difference estimation using Dodd-Frank Act as 'natural experiment'
 - Exploits information at the holding level, bank level and loan level
 - Categorize banks as 'affected'/'non-affected' by OLA based on the share of assets previously not regulated by FDIA

Contributions/ general assessment/ results

- Effects of 'Dodd-Frank-Act' on the (risk-taking) behavior of banks is of utmost relevance to policymakers and vividly debated among economists
- So far, empirical evidence on this issue is principally non-existing
- Innovative approach to identify the effect of OLA on bank risk-taking
- Careful analysis, robustness checks, reasonable modeling choices
- Interesting results:
 - OLA significantly decrease risk-taking of affected banks
 - Banks shift their new mortgage lending towards less risk
 - However, this effect does not hold for the largest and most important financial institutions, suggesting a 'too-big-to-fail' problematic

Comments overview

- Identifying assumptions
- Policy/treatment endogeneity
- The empirical setup
- Minor comments

Identifying assumptions I

- Dodd-Frank (OLA) affected some banks and others not
- Dodd-Frank reforms the entire regulatory landscape in the US:
 - Limits on proprietary trading: 'Volcker Rule'
 - Changes in bank capital regulation
 - Regulation of hedge funds
 - Regulation of (part of the) insurance industry
 - Regulation of over the counter trading
- Why should OLA be driving the results? Can you control for the effects of other regulatory changes, especially 'Volcker Rule' and changes in capital regulation?

Identifying assumptions II

- BHC with (large) non-FDIA regulated activities will be subject to new resolution regulation
- Excerpt from Dodd-Frank Act:

(b) DETERMINATION BY THE SECRETARY.—Notwithstanding any other provision of Federal or State law, the Secretary shall take action in accordance with section 202(a)(1)(A), if, upon the written recommendation under subsection (a), the Secretary (in consultation with the President) determines that—

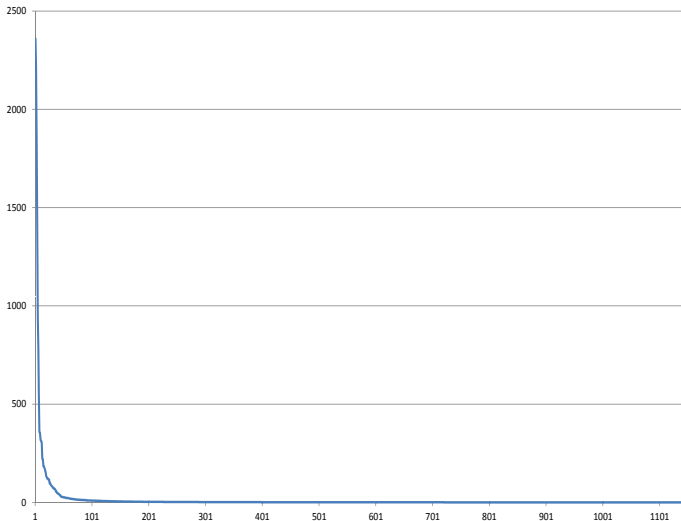
(1) the financial company is in default or in danger of default;

(2) the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States;

(3) no viable private sector alternative is available to prevent the default of the financial company;

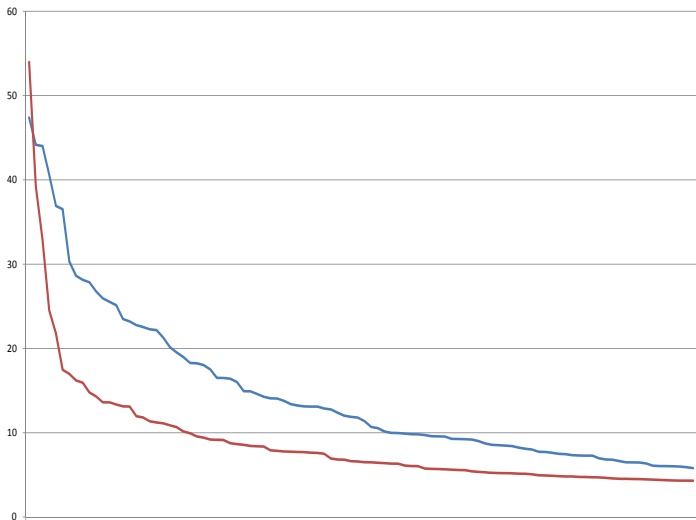
Identifying assumptions II

- Size distribution of BHC in the US



Identifying assumptions II

- Size distribution of top 40-140 BHC and top 100 German Savings Banks



Identifying assumptions II

- Standard bankruptcy law will apply to institutions not affecting financial stability of the US
- Not clear that smaller BHCs change risk-taking behavior because of the potential of being systemically important

Identifying assumptions III

- For diff-in-diff estimation the groups' composition must remain the same over the pre-and post treatment period
- OLA might have changed which banks fall into treatment/non-treatment group
- Related: how do you deal with mergers, failures etc...over this time period

Policy/treatment endogeneity

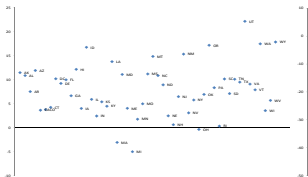
- A crucial assumption in diff-in-diff is the exogeneity of the treatment
- Is the empirical setup immune to policy endogeneity?
- Exogeneity is violated if the treatment (*afterOLA* \times *Affected*) depends on past realization of the outcome variable (*Risk*)
- Dodd-Frank Act was a response to high levels of bank risk!
- Bank risk at the micro level does not influence policy making \rightarrow valid if sufficient variation in bank level risk \rightarrow Might be worth discussing in the paper
- Whether a bank is affected by the policy could depends on past risk realization!
- Larger problem (?): instrumental variable approach? Use past information (from 04-07 period) to compute *Affected*?

The empirical setup

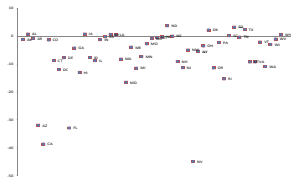
- Pre-treatment period from 2007-Q2 to 2009-Q2; post-treatment period from 2010-Q3 to 2012-Q2
- Interim period excluded from the analysis
- Parameter measuring treatment effect contains all shocks between 2009Q2 and 2010Q3:
bank-level, regional, national/global shocks
- Implicit assumption: homogeneous reaction of treatment/non-treatment group to all shocks other than Dodd-Frank between 2009Q2 and 2010Q3
- Not sure if very convincing
- Choose one quarter (say 2009Q3) as treatment period; fixed-effects for all other periods will capture the remaining shocks
- Side effect: Volcker Rule first endorsed only on January 2010

The empirical setup II

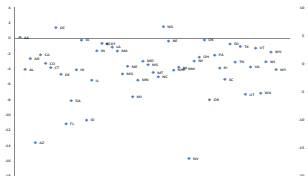
- Crisis was not a felt homogeneously: State-level house price growth



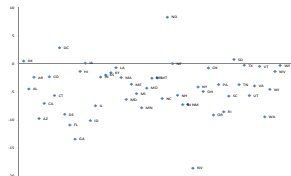
(a) 2005Q3 - 2007Q2



(b) 2007Q3 - 2009Q2



(c) 2009Q3 - 2010Q2



(d) 2010Q3 - 2012Q2

- Suggests including region-time effects in the models

Minor Comments

- A table of descriptive statistics of the treatment/non-treatment group pre-/post treatment would help set up the story
- A robustness test with standard errors clustered at the bank level is mentioned
→ Should be used in all regressions (see Bertrand, Duflo, Mullainathan 2006; QJE)

Final assessment

- Great paper!
- Well written and very interesting
- Addresses a topical and highly relevant issue
- Some open issues which can be fixed

Thanks