Discussion of:
“Government Guarantees and Bank Risk Taking Incentives”

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Overview

- **Overall topic:** The effect of guarantees on banks’ risk taking
- **Research question:** How does the removal of explicit guarantees affect risk taking of banks?
- **Setting:** (Announcement of) removal of “Gewährträgerhaftung” (explicit guarantee) for German Landesbanken
- **Identification strategy:** Exploit differential treatment of Landesbanken and Non-Landesbanken
Summary

The setting
- **2001:** Announcement of removal of (explicit) government guarantees for German Landesbanken
- **2005:** Removal becomes active
- **Inbetween:** Possibility to issue bonds still explicitly guaranteed

Theoretical predictions
- **Franchise value effect:** Increase in expected refinancing costs decreases “franchise value” and increases risk-taking
- **Market discipline effect:** Reduction of guarantees increases market discipline which decreases risk-taking
- **Transition period:** only the franchise value effect can already unfold
Summary

Main findings

▶ Prior to 2001:
  Lower borrower risks for Landesbanken, no differences in loanspreads

▶ After 2001 (before 2005):
  Increased borrower risk for Landesbanken, increased loanspreads for Non-Landesbanken

▶ Relative risks of Landesbanken increase, relative spreads decrease
▶ Stronger effect for banks with higher expected downgrades

Interpretation: Results support the franchise value hypothesis

▶ Higher risk-taking as a reaction to reduced franchise value
▶ Reduction in franchise value particularly strong for banks with higher downgrades
Overall assessment

Praise
- Topic highly relevant for economic policy
- Well written paper, clear structure
- Robust results
- Interesting and rich setting, already relevant in itself

Discussion
- Are results fully consistent with the interpretation?
- Isn’t there a competing explanation that is even more plausible?
- Does the institutional setting correspond to the theoretical framework?
Are results fully consistent with the interpretation?

**Franchise value effect:**
- Loss of guarantees should increase refinancing costs after 2005
- Discounted profits are thereby reduced
- Bank has “less-to-lose” which increases risk-taking incentives
- Effect the stronger the larger the reduction in franchise value

**Risk-taking incentives?**
- Increased risk-taking: higher “upside” at the cost of higher default rates
- Predictions for loans: **increase** in spreads and borrower risk
- However, the results indicate that loan spreads even **decreased**
- Thus, Landesbanken took on **worse** risks with **lower** spreads
- No additional upside as compared to loans previously granted
- Results not fully reflect the notion of the franchise value effect
 Isn’t there another explanation?

**Landesbanken before 2001:**
- Competitive edge in the market for loans due to cheaper funding

**Landesbanken after 2001:**
- Incentive to issue bonds to optimally exploit remaining guarantees
- Anticipation of cost increase after 2005

**Potential effects**
- Anticipated cost increase reduces competitiveness in the loan market
- Loss of “Good projects”: Increase in risk, decrease in loanspreads
- Invest additionally raised funds: increase in lending quantity
- These projects should have worse risk-return trade-offs

**Prediction:** Bond issuance and risk increases, loanspreads decrease
Does the institutional setting correspond to the theoretical framework?

- Franchise value mechanism implicitly assumes banks to behave as if maximizing franchise value
- ‘A bank” is not a single decision maker, but an organization
- Franchise value should matter for equity holders as it reflects their wealth

- Private banks: Governance and control mechanisms incentivizing bank managers to maximize franchise value
- Do owners of Landesbanken have incentives to maximize franchise value?
- Owner of Landesbanken and the guarantor are approximately similar
Further comments

- Additional insights from a deeper discussion on the differential effects **before and after 2005**
- Sample splits based on **ex ante** measures? (Reverse causality of borrower risk and shadow ratings)
- Can we really rule out a **market discipline effect**? (Refinancing of longterm loans)
- Aren’t there **spillovers due to competition effects**?
- How representative are syndicated loans? Is **other lending behavior** an important omitted factor?
- **Clustered standard errors** should be reported in baseline results. Can you do twoway-clustering?