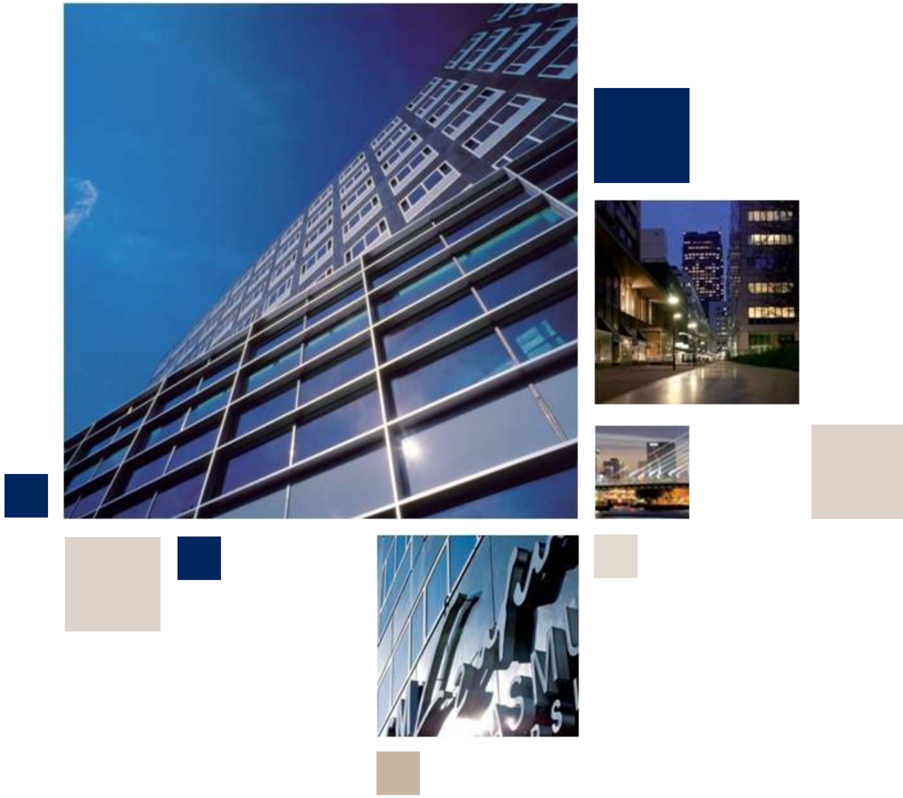
ROTTERDAM SCHOOL OF MANAGEMENT
ERASMUS UNIVERSITY

DEPARTMENT OF FINANCE

The Effect of Bank Supervision on Risk Taking: Evidence from a Natural Experiment



Discussion by Thomas Lambert

EFA 2018 – Warsaw

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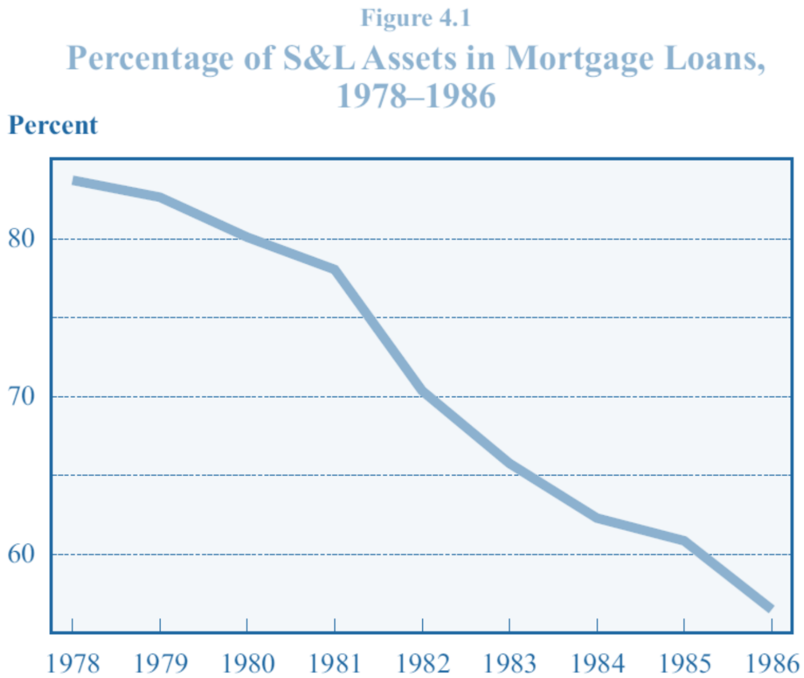
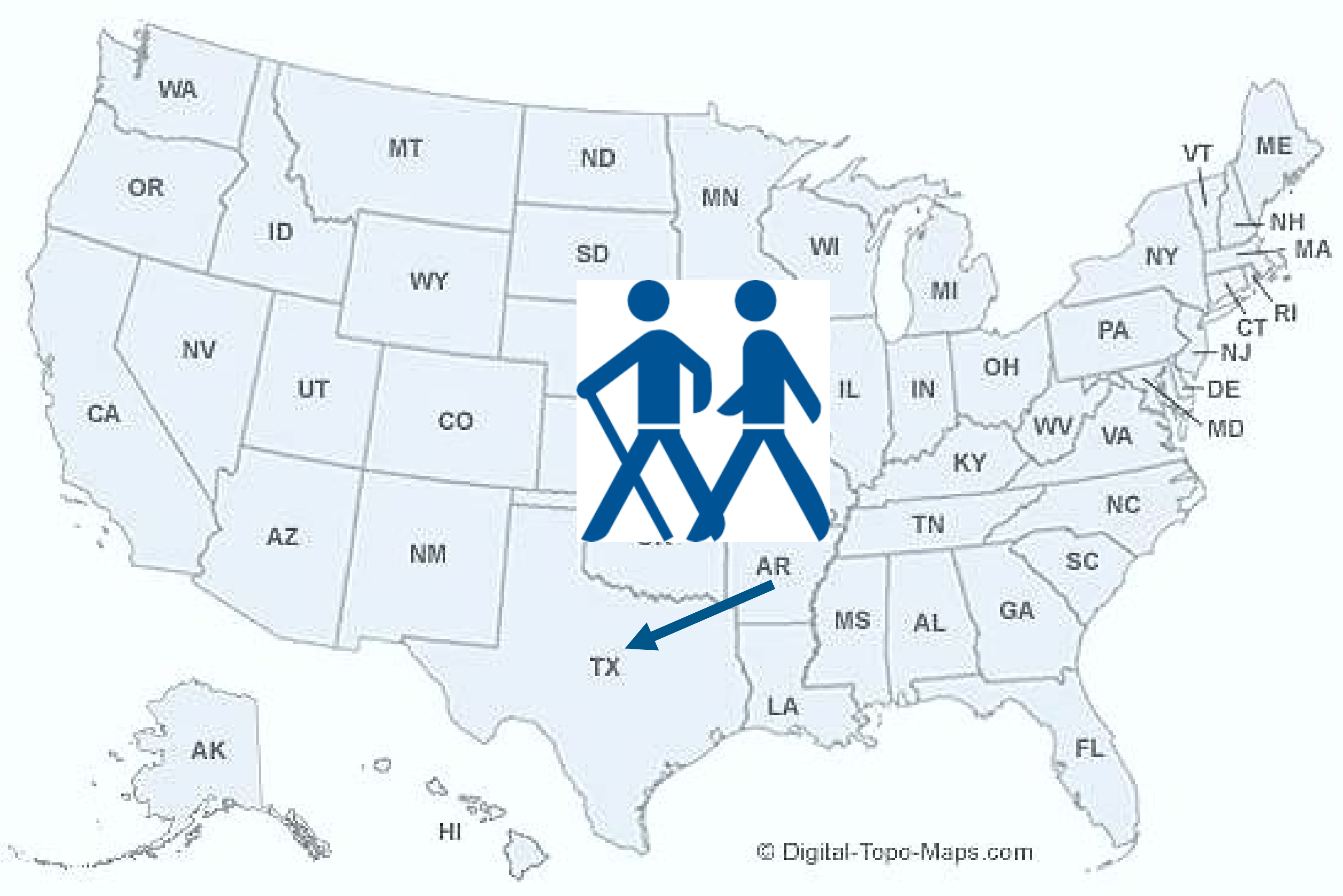
AUTHORS POSE AN IMPORTANT QUESTION

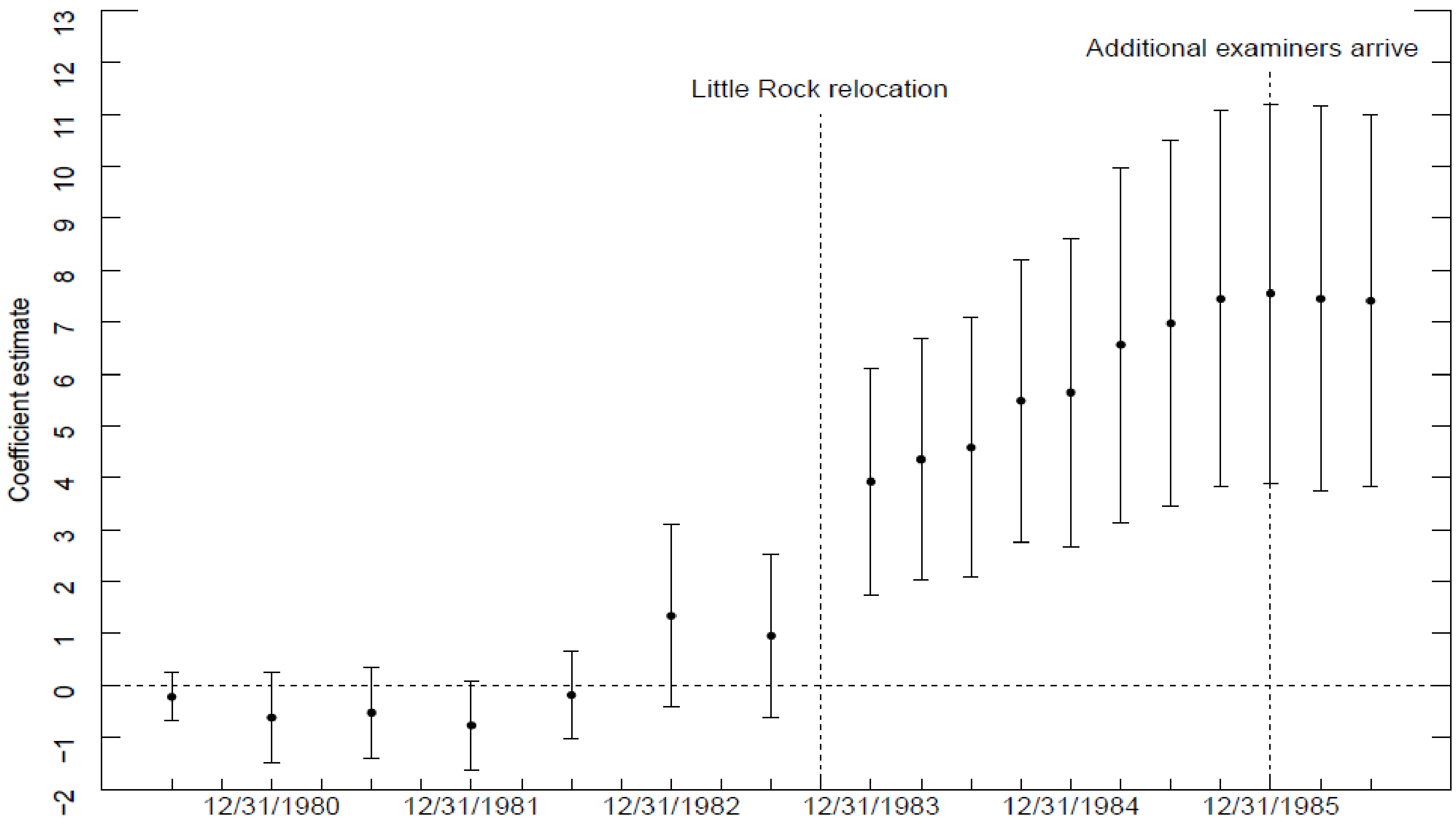
- Causal identification of supervisory oversight on risk taking
- Question by nature fundamentally hard to study:
  - Disentangling regulation from supervision: A major change resulting from deregulation was that, in 1982, S&L investment portfolios rapidly shifted away from traditional home mortgage financing and into new activities



THE MOVE TO DALLAS WENT BADLY



AFFECTED THRIFTS ARE RISKIER…



Effect not found for commercial banks

… WHICH LEADS TO COSTLIER FAILURES

Savings & Loans

FHLB District	Rank	Resolution Costs/Assets (%)
Dallas	1	80.7
Topeka	2	35.7
Des Moines	3	21.8
Atlanta	4	19.8
New York	5	18.4
Chicago	6	18.1
Boston	7	15.8
Cincinnati	8	13.5
Indianapolis	9	12.6
Seattle	10	10.4
Pittsburgh	11	9.9
San Francisco	12	9.3

IDENTIFICATION: MUTUAL-TO-STOCK CONVERSIONS

- The period coincided with liberalizations permitted by the Garn-St Germain Act enacted end-of-year 1982

- The act permitted, among others, federal stock charters and allowed the conversion of mutuals to stockholder ownership (Kroszner and Strahan JF 1996)

Number of Newly Chartered FSLIC-Insured S&Ls, 1980–1986

Year	State-Chartered	Federally Chartered	Total
1980	63	5	68
1981	21	4	25
1982	23	3	26
1983	36	11	47
1984	68	65	133
1985	45	43	88
1986	13	14	27
TOTAL	348	144	492

Source: Lawrence White, *The S&L Debacle*, 106.

- Both the ownership status and the conversion itself may have affected the propensity of thrifts to take risks that, on average, led to considerable losses
  – Managers of mutuals are more risk averse as their income and wealth is concentrated in their job position (Benston, Carhill and Olasov 1991)

IDENTIFICATION: CONTROL GROUPS

- Growth among thrifts was particularly strong in the Sunbelt and in states whose economies were energy related and booming in the early 1980s. Texas S&Ls were among the most aggressive growers.

- Benston, Carhill and Olasov (1991, page 322) *The Failure and Survival of Thrifts: Evidence from the Southeast* (NBER).

The Southeast refers to the area supervised and served by the Federal Home Loan Bank of Atlanta (district 4). It includes Alabama, the District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, and Virginia. The area is quite diverse in that it encompasses rural and urban communities and states with stable, growing, and declining economies. As such, it represents a good cross-section of the United States, with the notable exception of the boom and bust southwestern states of Texas, Louisiana, Colorado, and Arizona, where a very large part of the losses imposed on the FSLIC (and later on its successors, the FDIC and taxpayers) occurred. Hence, although the findings reported likely are not representative of the southwestern states, they probably provide a good picture of the rest of the nation. In this study, we analyze data from the 517 FSLIC-insured thrifts in operation at year-end

SUGGESTIONS

- Control for mutual-to-stock conversions
  - Time-varying → bank FE not sufficient

- Impose at least the following matching criteria:
  - Asset growth
  - Sunbelt region

- Complete the picture on interest-rate risk and credit risk
  - Look at the interest-rate risk as an alternative risk measure
    - A vast number of insolvencies of S&L associations in the early 1980s was predictable because of the interest-rate mismatch of the institutions balance sheets.
  - Look at NPL
    - Particularly low prior to the shock in the 9th district (cf. Table 2)!

CONTRIBUTION

- Recent supporting evidence that lenient supervision leads to excess risk taking, e.g.:
  - Granja and Leuz (2018) exploit the extinction of the OTS to show that stricter supervision increases small business lending and business activities. This increase stems primarily from well-capitalized banks and those more affected by the new regime
  - Delis et al. (MS 2017) show that supervisory enforcement actions reduce risk taking
  - Lambert (MS 2018) shows that lax supervision due to capture tends to increase risk-taking behaviors
  - Kisin and Manela (2017) show that banks and thrifts paying higher fees are subject to more lenient regulation and have more loans defaulting

- Similar point for the determinants of the costs of forbearance:
  - Cole and White (JBF 2017) and references therein

IMPLICATIONS: EXPLORE THE CHANNEL

- **Staff**
  - Further exploit the supervisory blitz that occurred in 1986 – perhaps not as exogenous though (FHLBB saw the storm coming)
- **Distance from supervisors office**
  - Estimate a triple interaction specification with distance from office before/after the relocation to Dallas
- **Supervisors' experience and training**
  - Look at e.g. average age of staff, background, banking job experience
- **More acute conflict between examiners and supervisors and potential for capture**
  - Regional Banks were owned by the institutions they supervised, the potential for conflicts of interest was quite strong
- **Budgetary restrictions/Supervisory fees paid**
  - Reagan administration called for a reduction in the size of the federal government
- **Distracted supervisory agents**
  - Due to relocation efforts or new job search

CONCLUSION

- Important paper, nice experiment
- Better position the paper and discuss the implications for today's supervision of thrifts
- Strengthen identification, also on resolution costs (look at the probability of failing at the bank level)
- Good luck with the paper!

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