A discussion of:

“Unnatural Section at Work: An Analysis of Bank-Firm relationships in Italy after Lehman”

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(*) Usual disclaimer applies

Praise

Database an achievement in itself

Good questions

Ambitious goals

Suggestive conclusions

High policy relevance

Outline

Summary of paper's goal and strategy

Looser ends and clarifications

Suggestions / alternatives routes

Quick reaction to "bonus material"

Conclusions

Aim of paper is twofold

- *"Our goal is to assess if the contraction of loan dynamics has been across the board or if it affected firms to a different extent.*
- *We also tried to verify if the borrower's selection has been characterise by the type of inefficiencies documented for Japan"*

Implicitly: two alternative hypothesis:

- (Myopic) forbearance lending (Peek and Rosengren 03)
- Flight to borrower quality by banks (BGG 96)

Summary of paper's strategy

- Identification scheme

"Our main identification scheme is built on the notion that, by its definition, 'unnatural selection' in credit allocation does not involve well-capitalised banks.

Therefore we first select the subsample of firms that borrow from at least one well-capitalised bank.

Then compute, for each of these firms, the growth of total credit received by the pool of well-capitalised banks,

and identify as 'impaired borrowers' those at the bottom tail of this distribution."

⇨ **Identification scheme selects "the worst risks among the best"**

- Interaction term: (Lower_capitalised)ij*(impaired_borr)ij

Looser ends and clarifications (1/3)

Theoretical underpinnings of paper need to be strengthened

- A range of models results is quoted: DeW-M(95), Be-Ro(97)

  which however model a very different type of 'soft budget constraints'

- **Main story**: (Japans') undercapitalised banks delay recognition of portfolio losses / by 'evergreening' loans to insolvent borrowers

  However in Japan the context was massive government intervention and close to zero rates for an extended period; Government ready to absorb losses

- For Italy 2008 H2, very different environment

  Role of government less clear, interest rates at 4.5% in September 08

  Banks dealing with "first round effects" of LB' demise (portfolio rebalancing + building liquidity buffers)

Looser ends and clarifications (2/3)

Identification strategy may be disputed

"…by its definition, 'unnatural selection' in credit allocation does not involve well-capitalised banks."

This part of the story could and should be checked / tested

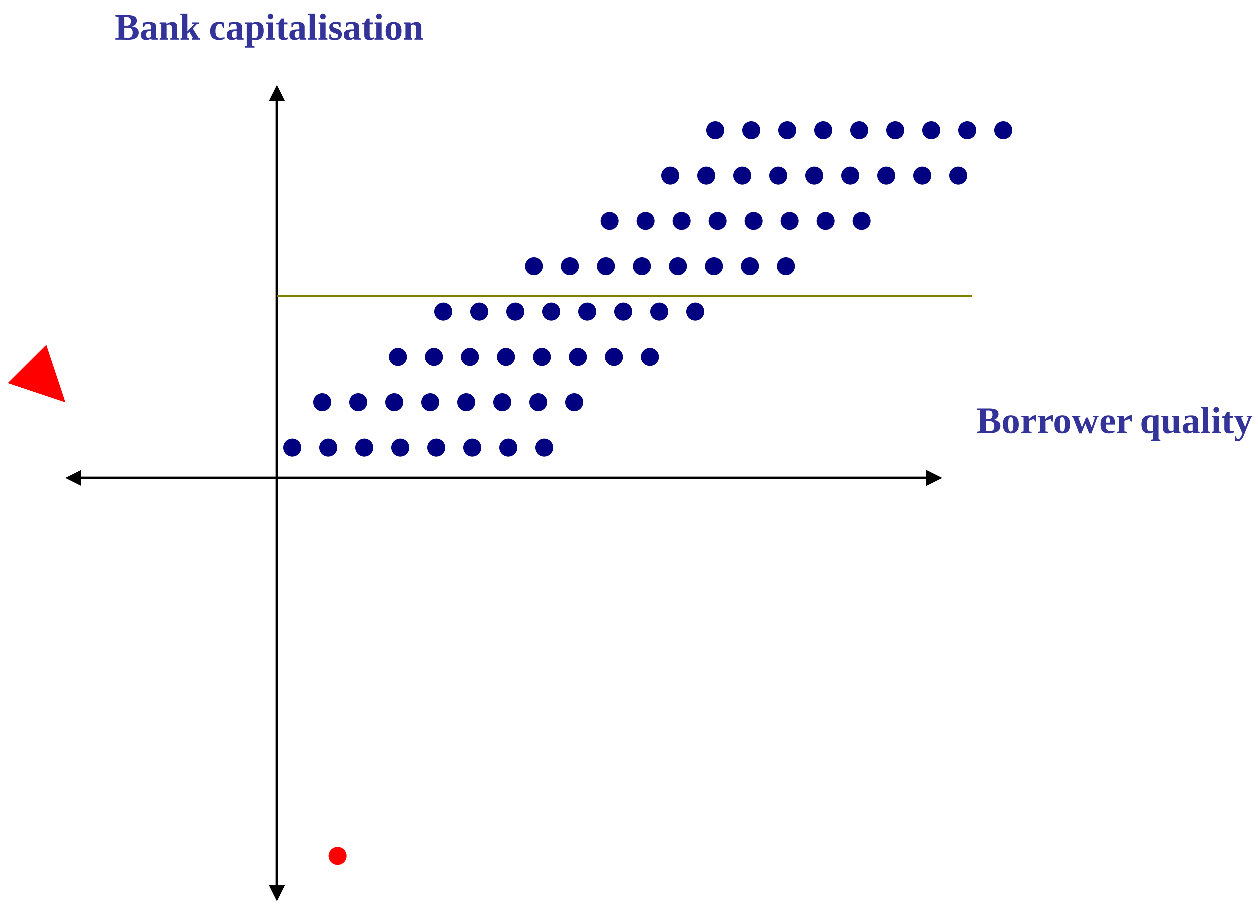
- "Worst among best risks" just that, not necessarily impaired

Possibly less 'impaired' than those borrowers dealing with mainly with weakly capitalised banks

Looser ends and clarifications (2/3)

Assume instead:

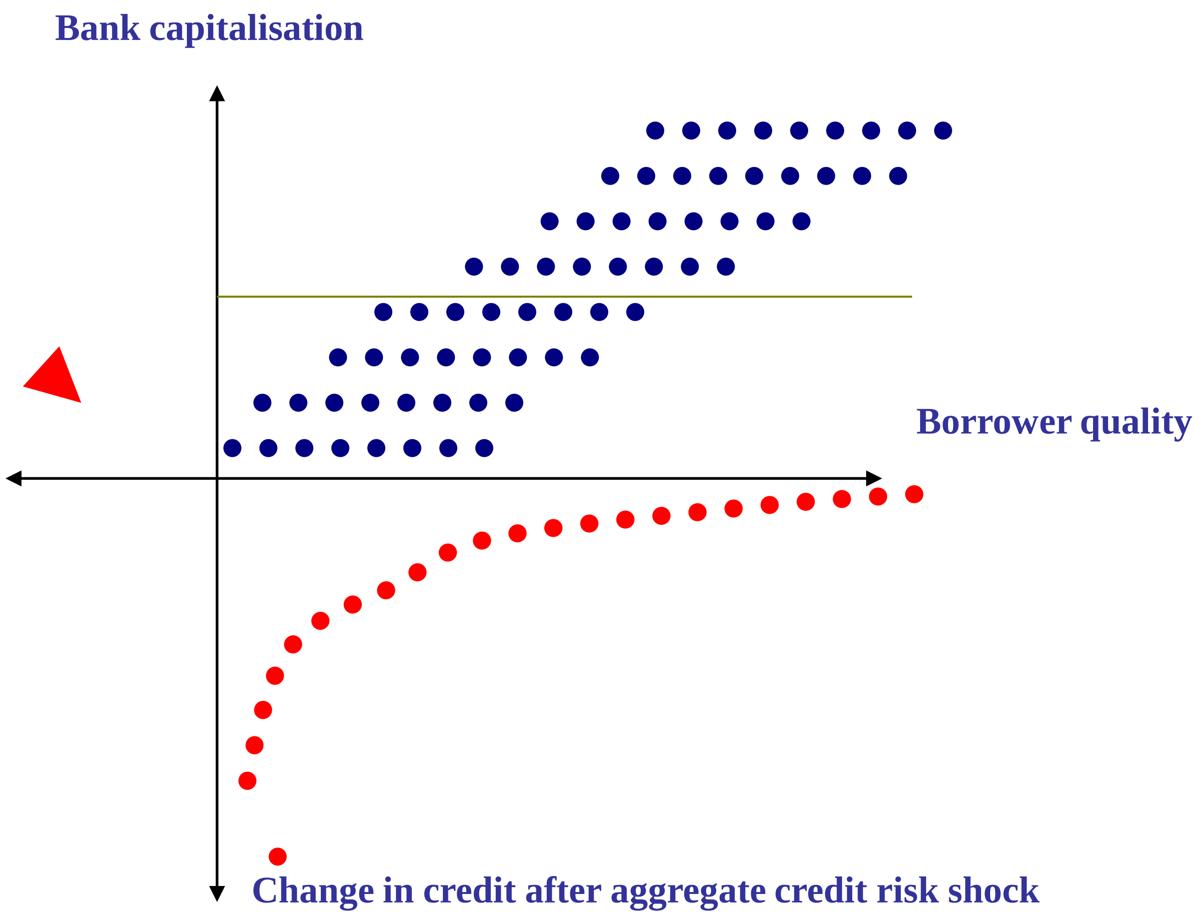
1. Pecking order in firm-bank relations



Looser ends and clarifications (2/3)

Assume instead:

1. Pecking order in firm bank relationships
2. Flight to borrower quality upon shock



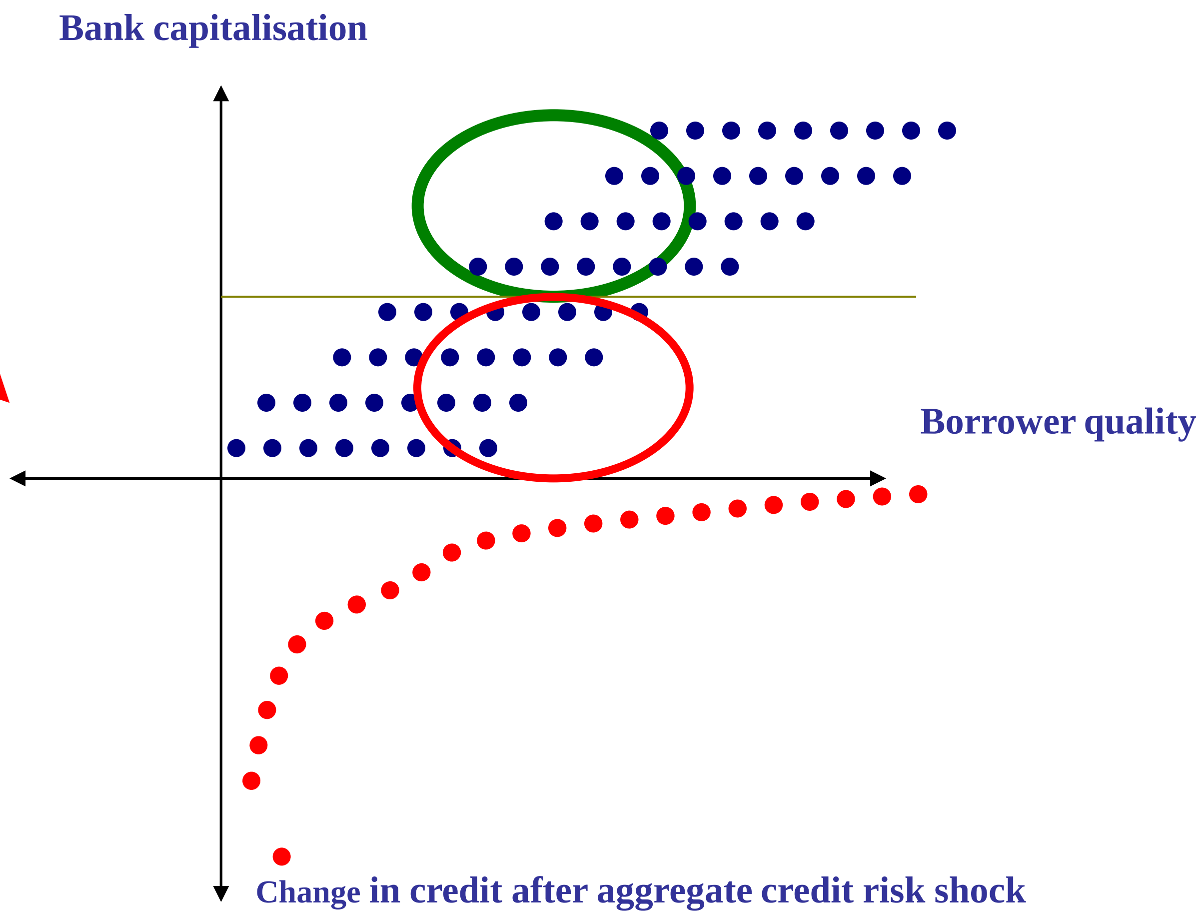
Looser ends and clarifications (2/3)

Assume instead:

1. Pecking order infirm bank relationships
2. Flight to borrower quality upon shock

Then:

1. Identification selects worse among best



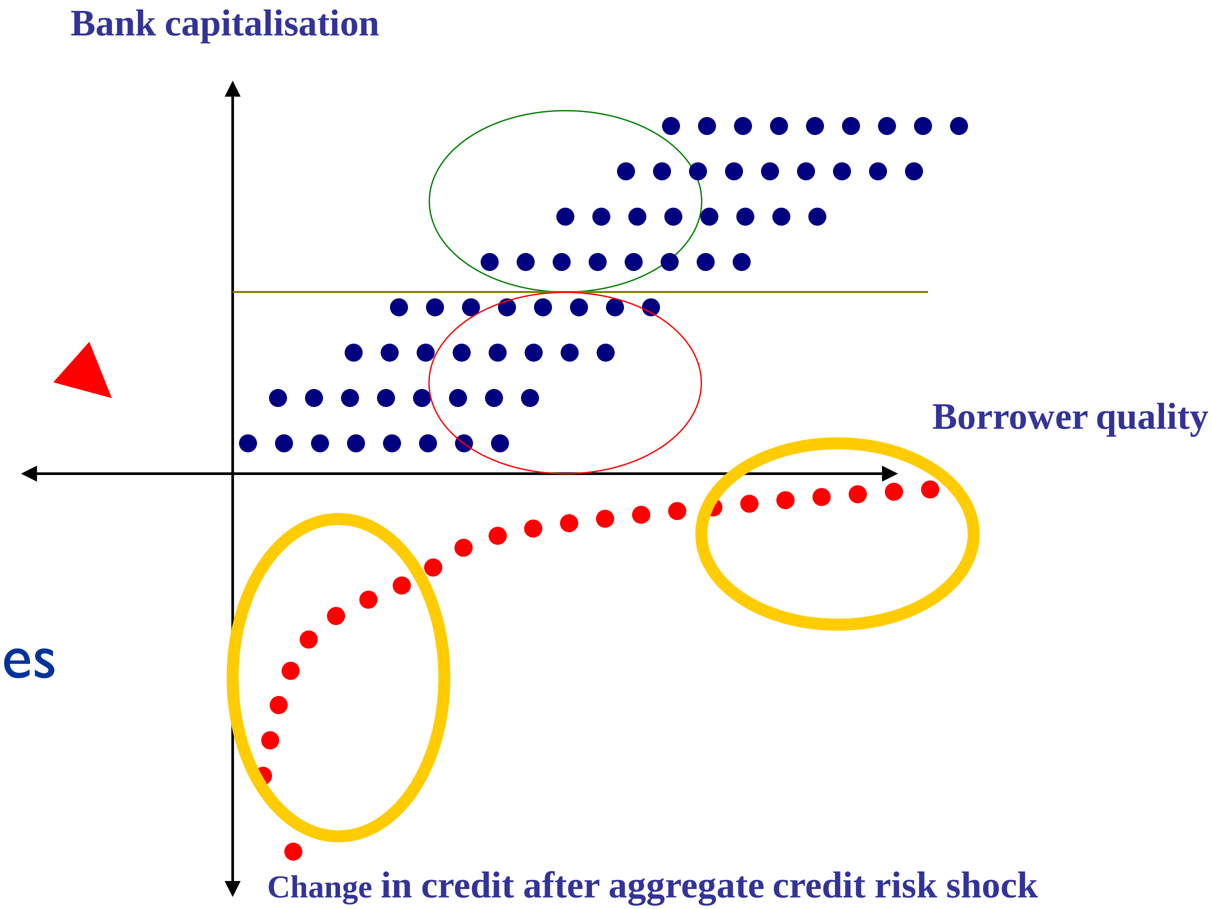
Looser ends and clarifications (2/3)

Assume instead:

1. Pecking order in firm bank relationships
2. Flight to borrower quality upon shock

Then:

1. Identification selects worse among best
2. Capitalisation dummies capture extremes



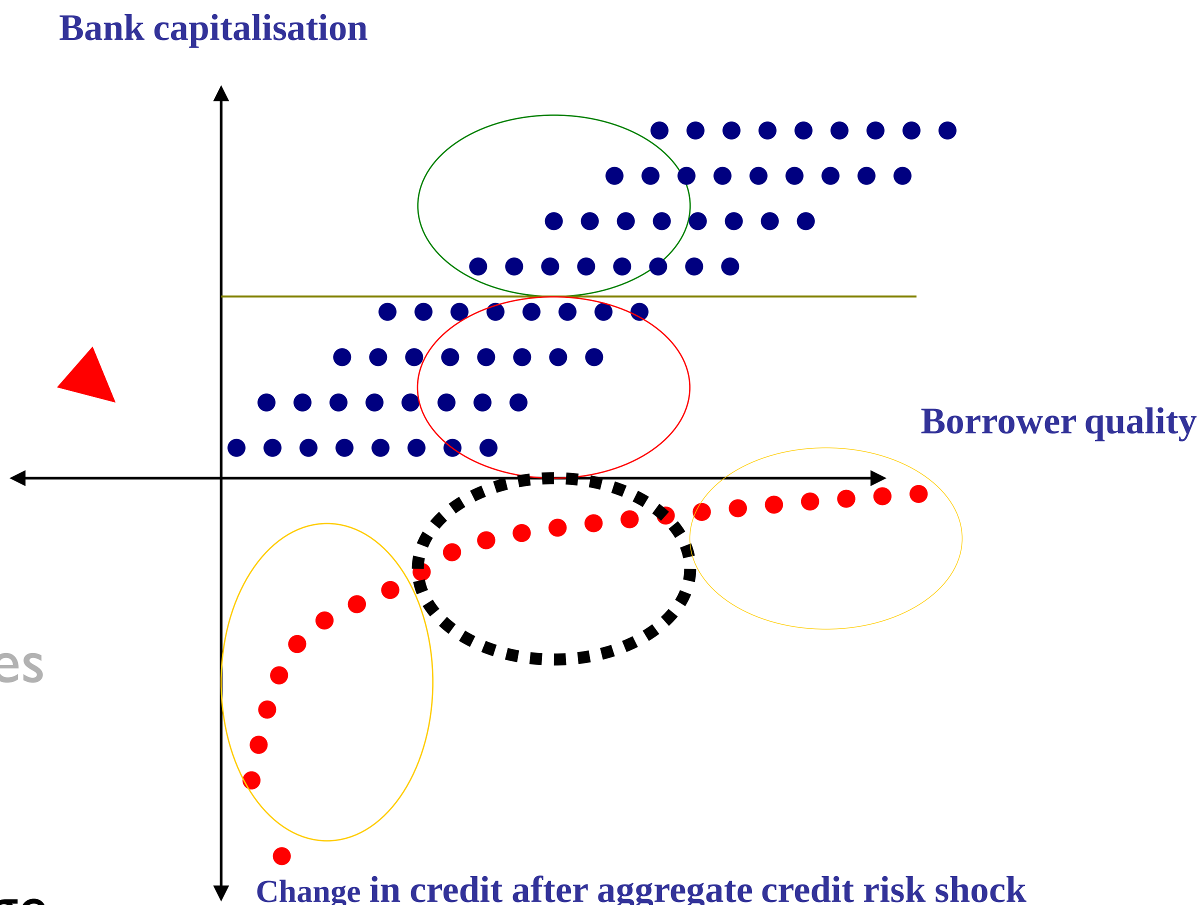
Looser ends and clarifications (2/3)

Assume instead:

1. Pecking order in firm bank relationships
2. Flight to borrower quality upon shock

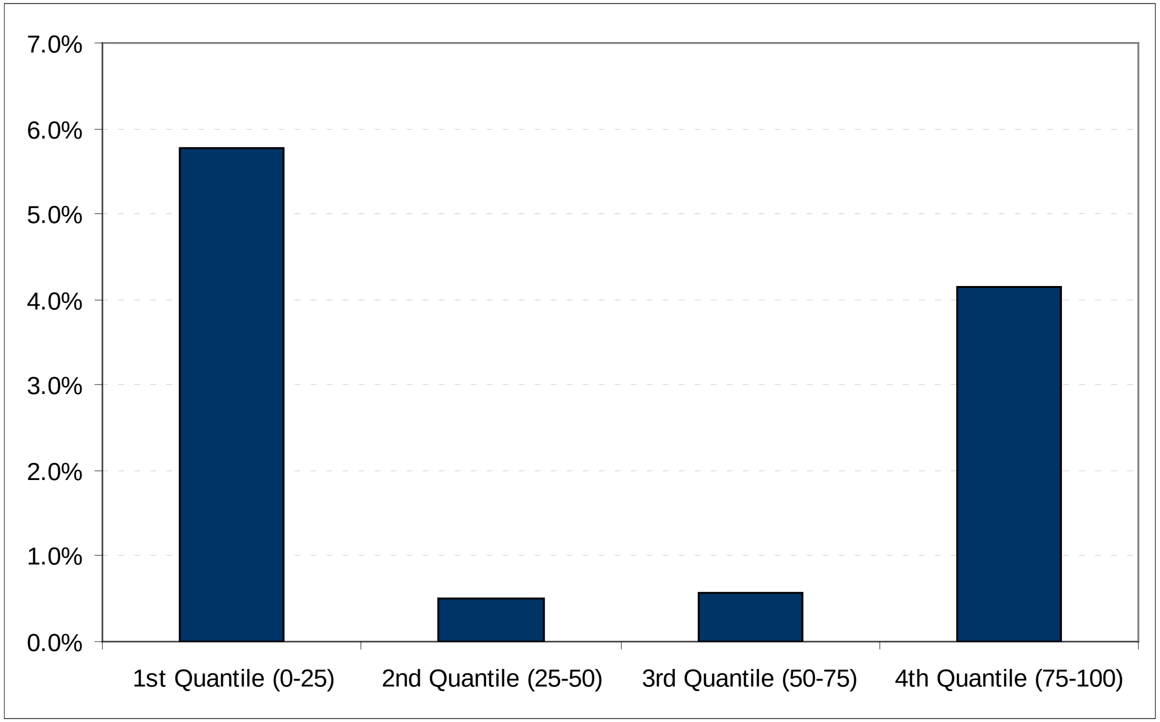
Then:

1. Identification selects worse among best
2. Capitalisation dummies capture extremes
3. And interaction term just captures mid range risks



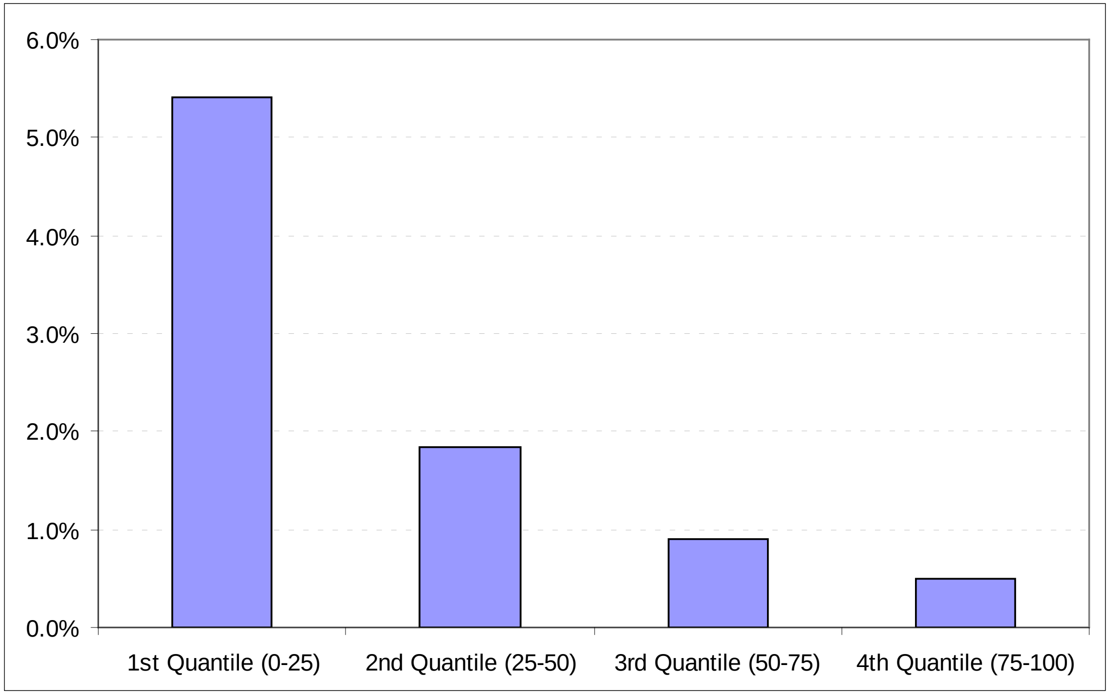
Looser ends and clarifications (3/3)
Nonetheless, is the story plausible?

Median growth in credit risk **exposure** by capital buffer quantiles
(Q2 2008 to Q4 2008; Source: TFICF data)



Looser ends and clarifications (3/3)
Nonetheless, is the story plausible?

Median growth in **RWA** by capital buffer quantiles
(Q2 2008 to Q4 2008; Source: TFICF data)



Some evidence of different risk management of banks under higher balance sheet stress

Suggestions / alternative routes (1/2)

Modelling front:

- Ideally, provide a <u>simple</u> theory of bank stress and myopia
  - Probably you want to include management concern for turnover
  - Role of government role (e.g. guarantees) likely important
- Clearly distinguish between:
  - Incentives to fund negative PDV projects and risk taking
  - Bank behaviour under stress and soft budget constraints
- Could risk weights for assets in MRC calculations (Basle II) discourage forbearance
- [Take into account optimal debt structure issues]

Suggestions / alternative routes (2/2)

Empirical front:

- Worry about power of test (currently low)
- Explicitly allow also for and distinguish from '**flight to quality**'
- Inspect directly if
  - More polarisation after LB in firms links with banks?
  - Non-linear relation between degree of stress and forbearance?
- Do "differences in differences" as a more robust test
  - Estimate propensity to lend for bank classes, before and after LB and for different types of firms/risks
  - Compare to Puri, Rocholl and Steffen (2009): similar study on German firm bank relationships **that reports no evidence of "unnatural selection"**

Quick reaction to “bonus material”

- Indeed useful to strengthen longitudinal dimension (F&S)
- Important to control for corporate governance issues
  - Could you proxy for quality of corporate governance of banks and see it crowds out other regressors?

- Can you distinguish /condition on degree of LB’s impact?
  - Akin to Peek’s control for Japanese banks operating in US?
- Can you use information on market value of capital and/or capital target instead of book value (or at least banks’ ratings or risk scores?)

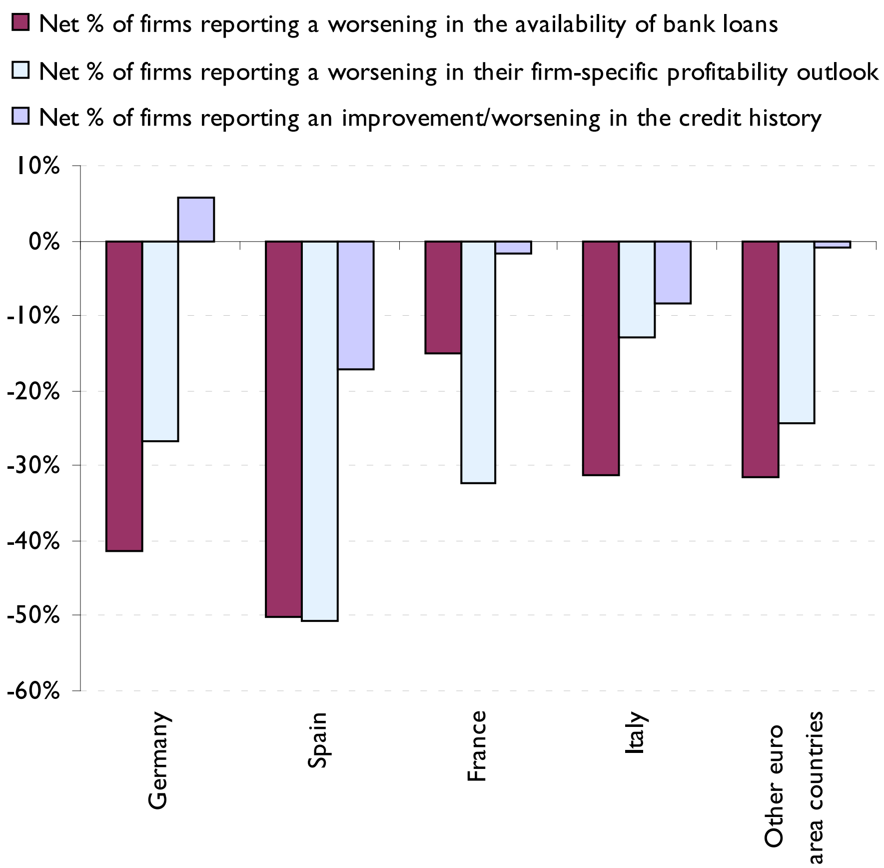
Conclusions

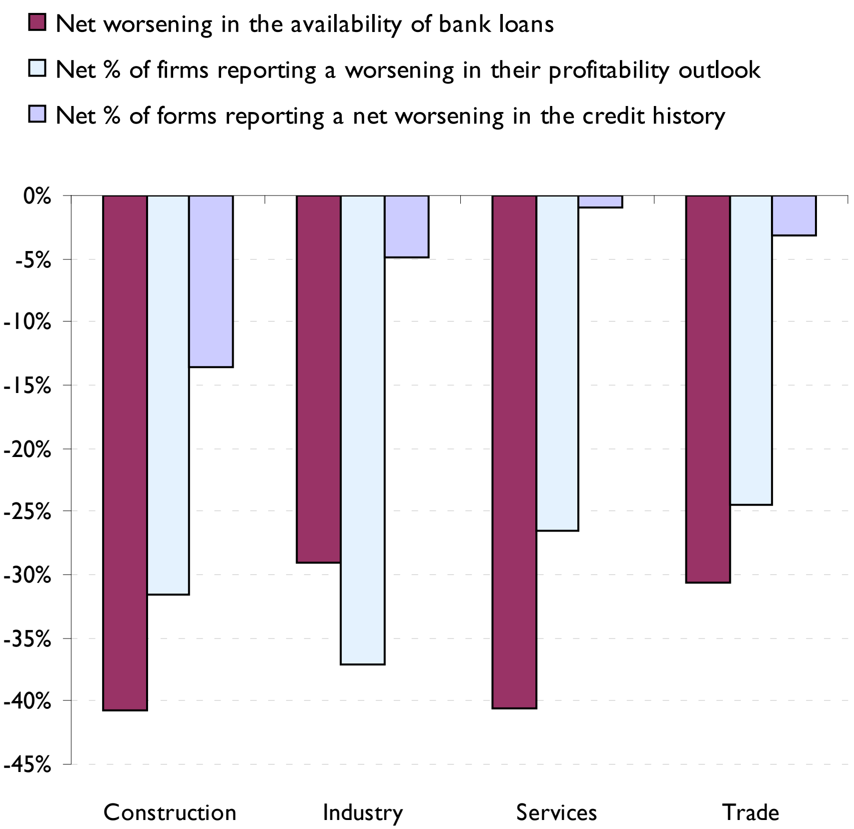
1. Very interesting and promising, yet to be refined
2. Tackles a highly policy relevant topic that has tended to be unduly ignored during the crisis period
3. If confirmed, should make us think more deeply about analysing credit developments
4. In any case, strongly supports the case for greater use of micro data to shed light in policy discussions

Kiitos

BACKGROUND SLIDES

Evidence from euro area firms' survey on access to finance





Net % of firms reporting an increase/decrease in terms and conditions of bank loans in 2009H1