Banking Regulation and Supervision: Paper Discussion by Stijn Van Nieuwerburgh

Regulatory Changes and the Cost of Capital for Banks\(^1\)
The Value of Regulators as Monitors: Evidence from Banking\(^2\)

\(^1\)Anna Kovner and Peter Van Tassel

\(^2\)Emilio Bisetti

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Kovner and Van Tassel

- Computes cost of equity capital for banks
- High in crisis, much lower after Dodd-Frank Act, especially for largest banks
- Intuition: Dodd-Frank Act lowered bank risk-taking, making bank equity safer
- However, they also find a higher WACC for banks after Dodd-Frank Act passage, including for the largest banks
- Consistent with implications of model with tighter regulatory capital constraints post Dodd-Frank Act (Elenev, Landvoigt, Van Nieuwerburgh)

\[ WACC = \mathbb{E}(Return^{Equity}) \times \frac{E}{A} + \mathbb{E}(Return^{Debt}) \times \frac{D}{A} \]

- But, lower cost of equity capital doesn’t always mean higher welfare! Tighter capital requirements also imply:
  - Lower output and capital investment
  - Higher macro-economic volatility due to lower risk absorption capacity of financial sector
There are well known difficulties with computing expected equity returns
Particularly pronounced over short windows (e.g., Financial crisis or SCAP period)
Robustness to other factor models is a good start
Also explore factor models where factors are based on bank stock returns only
More promising: use options data to compute both equity risk premium and individual betas (Martin 2007, Martin and Wagner 2017, Buss and Vilkov 2012)
Banks between $150-500 million in assets are exempted from onerous financial filings requirement

Assumption: Fed is devoting fewer resources to supervise them. Would be nice to provide direct evidence on this

Finds that market-to-book ratio of assets decreases 1% and market-to-book ratio of equity falls 7% relative to those (just) above threshold

Intuition: Shareholders now need to spend more resources on auditing/consulting to prevent rent extraction by management, especially in riskier banks

Like the experiment and the supporting direct evidence
Fed is spending large amount of resources on supervision

It thereby provides a valuable public good

Do bank shareholders pay high enough fees for supervisory services they "consume"? Only BHCs with $50 billion in assets are charged a supervisory fee by the Fed

Source: Eisenbach, Lucca, and Townsend 2017
Suggestions for both papers

- Post hoc ergo propter hoc
  - This is a period with major changes in regulatory capital rules (Basel III) that interact with changes in supervision. Is Bistetti paper just picking up supervisory changes?
  - The period also had major cyclical fluctuations (eg: housing boom and bust). This makes it difficult to cleanly estimate cost of capital and isolate effect of capital regulation (Kovner and Van Tassel)
- Use later changes to regulatory and supervisory framework as out-of-sample tests
  - 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act
    - FR Y-9C threshold changed from $500 million to $1 billion, and from $1 billion to $3 billion effective March 2015 and September 2018, respectively
- Papers show that tighter capital regulation and stricter supervision are good for banks’ shareholders, especially for large banks
  - Could these results reflect comparative advantage in regulatory compliance (economies of scale) for large banks?
Conclusion

- Macro-economic burden of regulation not captured
- Coffey, McLaughlin, and Peretto 2016 estimate the cumulative cost of federal regulation has dampened economic growth by approximately 0.8 percent per year since 1980
- Suggests we need a macro-economic framework/general equilibrium analysis to study all parties affected by regulation and supervision including
  - Financial Intermediaries
  - Their borrowers (Firms and households)
  - Their lenders (Depositors and debt holders)
  - Government (Explicit and implicit bailout guarantees)