DEUTSCHE BUNDESBANK
EUROSYSTEM

Workshop on

“The Costs and Benefits of International Banking”

Eltville, 18 October 2010

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Discussion of

“Financial Protectionism“

Discussion of
"Financial Protectionism: the First Tests"

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Workshop on "**The Costs and Benefits of International Banking**"
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Overview

Comments

1. Relevance
2. Identification Strategy
3. Data Issues
4. Interpretation of Results
5. Minor Issues

Conclusion

Overview

- Goal of the paper: Test whether there is any evidence of **financial protectionism** in the recent crisis
- What is financial protectionism?
  - Financial protectionism describes measures preventing efficient capital flows to other countries to the benefit of the domestic country
  - In this paper, it refers more narrowly to the prevention of efficient **cross-border bank lending**
- Hypothesis of the paper: After public interventions in the banking sector (esp. bank nationalizations), the government will try to direct the supported banks' lending towards **domestic** borrowers to foster the domestic economy

Overview

- Main findings:
  1. There is evidence of financial protectionism at **foreign banks** in the UK, but **not** at UK banks
  2. After public interventions, foreign banks substantially reduced the fraction of loans to British borrowers and raised interest rates on such loans
- Implication: In the recent crisis, financial protectionism of other countries hurt the British economy

Overall Assessment

- Topical paper, highly relevant for economic policy
- Nice disaggregated data set on UK-resident banks
- Interesting results
- But . . .

  . . . unclear identification strategy

  . . . low data transparency

  . . . interpretation of results unclear

  . . . a couple of minor issues

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1. Relevance

- Is there any anecdotal evidence of financial protectionism?

Relevance ✓

- Is there any anecdotal evidence of financial protectionism?
- Yes!
- **Political pressure** to lend to **domestic** (rather than foreign) borrowers:
  Vince Cable (Secretary of State for Business, Innovation and Skills): *"It's time the government stopped being a passive investor in the nationalised and semi-nationalised banks and ensured that they maintain lending to good British companies for the wider interest of the national economy." "Should banks lend to British companies or a Russian oligarch? The British taxpayer is underwriting the losses... we have to pick up the public interest."*
- **Support packages** (e. g. Commerzbank in Germany) were coupled with **lending programs** to (domestic) small- and medium-sized firms

2. Identification Strategy

- Dependent variable = "loan mix" = share of domestic loans in total loans
- Simplified version of estimated regression model:

$$
\begin{aligned}
\frac{\mathit{Domestic}_{it}}{\mathit{Domestic}_{it} + \mathit{Foreign}_{it}} &= \alpha_i + \beta_t \\
&+ \gamma \cdot \mathit{Nationalization}_{it} \\
&+ \gamma_{UK} \cdot \mathit{Nationalization}_{it}^{UK} + \epsilon_{it}
\end{aligned}
$$

Identification Strategy

- Expected values of different bank groups:

$$E(\frac{D_{it}}{D_{it}+F_{it}}|no\ nationalization) = \alpha_i + \beta_t$$

$$E(\frac{D_{it}}{D_{it}+F_{it}}|after\ nationalization, foreign) = \alpha_i + \beta_t - \gamma$$

$$E(\frac{D_{it}}{D_{it}+F_{it}}|after\ nationalization, UK) = \alpha_i + \beta_t + \gamma + \gamma_{UK}$$

- $-\gamma$ measures the effect of nationalizations of **foreign** banks (with a negative sign!), $\gamma + \gamma_{UK}$ is the effect of nationalizations of **UK** banks
- Interpretation of coefficients is made difficult by the model specification - use separate coefficients for UK and foreign banks to facilitate interpretation (as in the robustness checks)

Identification Strategy

- So far this is only descriptive statistics
- However, normally we are interested in identifying **causal effects**, and the interpretation in this paper clearly is a causal one
- If we want to interpret the γ parameters causally, we implicitly use banks that were never nationalized as a **control group**
- This amounts to assuming that nationalized banks - in the absence of treatment - would have evolved similarly to banks that were never nationalized

Identification Strategy

- This is quite implausible!
- Banks were "treated" (nationalized) because they were **insolvent**
- Nationalization typically goes along with a fundamental **restructuring**, e. g. foundation of an asset management company (bad bank), a break-up of international holdings (see Dexia), divestment of certain activities (especially foreign ones), leading to a dramatic **shrinkage of banks' balance sheets** (80 percent for Northern Rock, 85 percent for Hypo Real Estate)
- This is not captured by bank fixed effects
- Hence, identifying assumption is doubtful
- Adding **controls** solves the problem only partly (Note the insignificance of results when control variables measuring bank performance are included, Tables 4b, 5)

3. Data Issues

- The paper is based on an impressive, very detailed data set
- But: Very **little information** about the data in the paper
  - No descriptive statistics
  - No graphs showing the **evolution** of the loan mix **over time** for different bank groups → This would also be useful to justify identification assumptions in a diffs-in-diffs framework
  - No information about banks included in the sample (what type of banks? from which countries? size of banks?)
  - Describe the **business models** of the large number of foreign banks (431 out of 487) in the UK
  - Regarding nationalization, one would like to see a table with detailed information about each nationalized bank (name, date of nationalization, type of restructuring etc.)
  - Exploit information on the **sectoral composition** of lending (businesses, households etc.)
  - Distinguish foreign **subsidiaries** and **branches**

4. Interpretation of Results

- Main results:
  - For nationalizations, there is strong evidence of financial protectionism for **foreign** banks, but **not** for UK banks
  - For "unusual loans/liquidity", there is evidence of financial protectionism for **both** types of banks
  - For capital injections, there is an **inverse** effect for both types of banks
  - For privatizations, there is evidence of financial protectionism for **foreign** banks (and no data for UK banks)
  - Results also show up in interest rate regressions (but in a much smaller sample)
- Some results are not entirely robust: Financial protectionism is found also for **UK** banks when foreign lending is measured in a different way; main result disappears when **controls** on the **performance** of banks are included

4. Interpretation of Results

- Interpretation of UK banks is rather straightforward because the distinction between foreign and domestic lending comes out of the data
- The same is not true for **foreign banks**
  - For them British lending is foreign lending
  - But non-UK lending includes lending to its home country and to other countries
  - A shift of lending by a German bank from the UK to France would be interpreted as financial protectionism in this paper

Interpretation of Results

- The loan mix may change due to changes in the exchange rate even if the composition of the loan portfolio remains unchanged (**valuation effects**)
- **Locational** statistics $\rightarrow$ no consolidation of international bank groups (hence, intra-group loans are included)
- What about **demand-side** effects?

Interpretation of Results

- There is evidence that banks **generally** withdraw from foreign markets in reaction to a negative wealth shock ("**flight home effect**", Giannetti/Laeven 2011, "**great retrenchment**", Milesi-Ferretti/Tille 2011)
  - Effect is not only found for nationalized banks, but is much more general
  - Possible explanations: Withdrawal from riskier or less profitable activities, concentration on core business, behavioral biases
  - These alternative explanations are **not** related to bank ownership
- Foreign lending may generally be **more volatile** because it is to a lesser degree based on **relationships**

Interpretation of Results

- Several results require explanation
  - Why does financial protectionism only appear in foreign banks? This seems to contradict anecdotic evidence.
  - Why is there an **inverse** effect of capital injections?
  - Why is there an **inverse** effect of British nationalization when control variables are included?
- Some theory may be useful...

5. Minor Issues

- Critical assumptions should be discussed in the paper, not only in footnotes
- Signs on “foreign privatization” in Tables 3/4/5 should be switched (some confusion of signs also in the interpretation)
- Controls should generally be added **jointly**, not one by one
- The word “domestic” should be replaced by “British” to avoid confusion regarding foreign banks
- “Unusual access to liquidity” is defined very vaguely
- Use **clustering by country** of origin
- Tobit is not appropriate to model fractions, use **fractional response model** suggested by Papke/Wooldridge (1996)

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Conclusion

- Interesting topic and results
- **Identification strategy** should be reconsidered
- **Rich data set** should be presented in more detail and exploited for identification
- Financial protectionism should be clearly distinguished from **alternative interpretations**
- Paper should try to **explain** observed asymmetries and surprising results, based on theoretical considerations

Thank you very much for your attention!