Discussion: The Winner's Curse: Evidence on the Danger of aggressive Credit Growth in Banking (T. Kick, T. Pausch, B. Ruprecht)

Mira LAMRIBEN*

4th EBA Research Workshop - London

** The views expressed are those of the discussant and do not necessarily reflect the official position of the EBA*

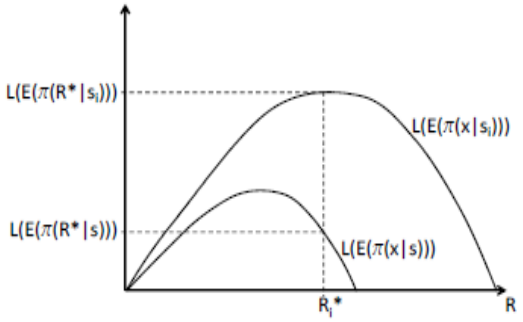
1. Objectives and scope of the study

- Four areas of investigation :
  - Why do banks engage in excessive credit growth? (Theoretical analysis)
  - How to characterise/identify excessive credit growth (*vs* adequate credit growth) before a bank fails ? (Empirical analysis)
  - Do banks engaging in excessive credit growth experience higher write-offs than other institutions? (Empirical analysis)
  - Are they more vulnerable (i.e. more likely to default)? (Empirical analysis)
- Policy objective :
  - To suggest a new approach to identify, *ex ante,* institutions which are likely to :
    - incur abnormal write-offs
    - be subject to capital surcharge.
- Scope :
  - The analysis focuses on banking sector in Germany and on the evolution of German domestic loan portfolios during 1999-2013.

2. Methodology

- Theoretical analysis
  - Demonstrate that the loan supply function L (E(∏(RIs))) is a "backward bending" and how this function is affected by bank's perception of risk.
  - Based on literature on auction theory (Williamson 1987) and calculus.

Figure 1: Loan Supply with $s_i < s$



L, Loan supply
E(∏), expected profit
R, nominal repayment of loan by borrowers
s, risk

- Empirical analysis
  - Measures of (excessive) credit growth

	Explanatory variables	Description	Further explanation/objective
Standard measures	Credit growth	Δ ln credit (∈ [0, ∞])	Look at the magnitude of the positive change in lending
	Dummy large credit growth	Δ lending > 2 SD above mean of banking sector	
New measures	Gap excessive credit growth	% positive deviation from the bank's long term lending trend (derived from the HP filter)	Look at the cyclical deviation from the long-term lending trend
	Rel. gap excessive credit growth	% positive deviation from the banking sector's long term lending trend (derived from the HP filter)	

- Impact of credit growth on loan write-offs

  LWO = f (CG,BS,C,ME, u) (OLS + Tobit models)

- Impact of credit growth on bank risk (bank stability)

  ZSCORE= f (CG,BS,C,ME, u) (OLS model)
  DISTRESS = f (CG,BS,C,ME, u) (Probit model)
  DEFAULT = f (CG,BS,C,ME, u) (Probit model)

Dependent variable *: LWO, Loan Write-offs* (loss rate deviation to overall loss rate (OLS) / write-offs to total credit (Tobit model)
Main explanatory variable: *CG,* Credit Growth ("Credit growth" / "Dummy large credit growth"/ "Gap excessive credit growth"/ "Rel. gap excessive credit growth"
Control variables *BS,* Bank-specific control variables; *C,* market competition control variables; *ME*, macro economic control variables; *u*, error term

3. Results and conclusions

- Main results
  - Uncertainty regarding the actual risk level => overoptimistic banks behaviour (i.e. underestimation of risk) => Excessive loan growth.
  - Standard measures of excessive loan growth do not capture loan loss risk and bank ‘s vulnerability.
  - However, excessive loan growth measured as cyclical deviation of bank’s long-term lending trend has:
    - a positive and statistically significant impact on loss rate,
    - a negative and statistically significant impact on bank’s stability.
- Conclusions
  - Measures of excessive loan growth derived from the HP filter have a predictive power in identifying vulnerable banks.
  - Such an approach could be used as a supervisory tool to identify institutions which may need capital surcharge under SREP.

4. Comments

- Very detailed and clear study which encompasses most of the supervisory concerns regarding excessive lending growth and implications for the banking sector.
- Strong empirical analysis:
  - Benefit from a very granular and adequate database
  - Adequately built econometric model (e.g. lagged values, Lerner index)
  - Display robust results
- Suggested approach regarding the identification of excessive lending growth provides added value to the literature and new insights to supervisors.

5. Suggested improvements and extension

- Suggested improvements in the paper
  - Clarification in the definition used for the dependant variable *LWOs* (e.g. treatment of provisioning?).
  - Further explanation/clarification of the reason why standard measures of credit growth do not capture loss risk, especially as contra to literature.
  - Interpretation of the magnitude of the impact of excessive growth loan on loss rate and bank stability.
- Suggested extension for the empirical study
  - "Risk adjusted" parameters (explanatory variables): decomposition of total lending growth by portfolio (sovereign, real estate…) to capture estimates in relation to risk level and identify more precisely portfolios that are more risky to excessively increase.

6. Policy implications

- Can the suggested new measures of excessive loan growth be used as a supervisory tool, at microeconomic level, to assess banks' robustness and to determine potential capital surcharge?
  - The measure requires a large set of data to capture long term lending trend => availability of the data needed by NCAs at bank level?
  - The measure is not risk sensitive i.e. affects total bank lending and not only the most risky portfolios => excessive credit growth should be primarily analysed at portfolio level?
  - The measure does not account for loss provisioning policy and may overestimate *ex ante* the negative impact of loan growth on bank's robustness => could be completed by other risk indicators (e.g. coverage, provisioning rate).

EUROPEAN BANKING AUTHORITY

Floor 46, One Canada Square, London E14 5AA

Tel: +44 207 382 1776
Fax: +44 207 382 1771

E-mail: info@eba.europa.eu
http://www.eba.europa.eu