"Believe me, it will be enough": Governmental guarantees and banks' risk taking in the fair value portfolio

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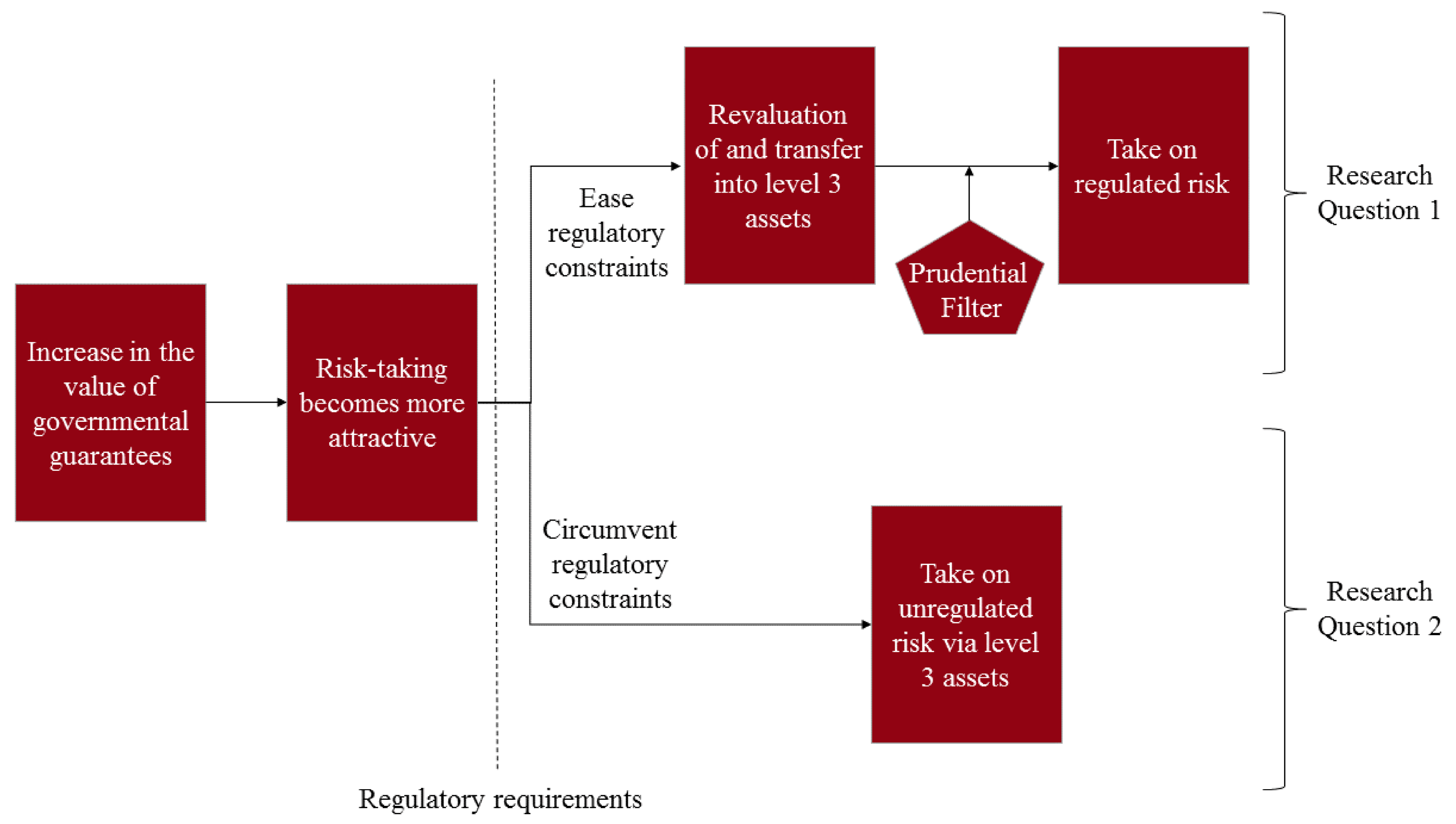
Motivation

- **(Implicit) guarantees and deposit insurances during the financial crisis**
  - 5.1 trillion Euro of approved states aid for financial institutions between October 2008-2012 (OECD, 2014)
  - Stabilizing banking system and preventing bank runs
- **Governmental guarantees might distort banking behavior**
  - Risk-taking becomes potentially more attractive (e.g., Hovakimian and Kane, JF 2000)
  - Substantial moral hazard effect (Gropp et al., ROF 2014)

→ Incentives to ease or circumvent regulatory requirements via Level 3 assets (Bushman, EPR 2016; Beatty and Liao, JAE 2014)



Research Questions

Consequences of governmental guarantees on two distinct aspects of banks fair value portfolios closely tied to risk taking

1. Have banks used level 3 asset revaluations to artificially boost their regulatory capital?

   H_{1a}: Banks in countries with a lower prudential filter for their fair value revaluation will report higher fair value gains in (or more transfers into) their Level 3 portfolio compared to high filter countries.

   H_{1b}: The effect will be stronger when the increase in the governmental guarantees' value is larger.

2. Have banks invested in level 3 assets to increase their (unregulated) risk?

   H_2: Banks will buy more Level 3 assets on the capital market if their governmental guarantees become more valuable.

Research Design

1. Panel regression: Country-specific moderator variables
   → Prudential filter
   → Value of governmental guarantee
2. Difference-in-Differences
   - Sharp increase in the value of governmental guarantees of distressed Euro countries in 2012
   → DD: Distressed vs. non-distressed Euro countries
3. Event study: Capital market reaction to "Draghi-Put"

Data

European Setting

- Strong harmonization with respect to political stability, rule-of-law and banking regulation
- Sufficient variation across the impact of prudential filters and reliability of governmental guarantees
- Draghi-Put in 2012 for European Euro countries

Current Sample

- Hand-collected data from annual reports 2009 to 2014
- Data for 60 banks (from ~ 120) from 10 countries collected

Descriptive Statistics

Treatment	Banks	Countries	Fair Value Assets % of total	Level 3 Assets % of FVA
0	35	5	20.04%	1.35%
1	25	5	20.59%	6.21%
Total	60	10	20.27%	3.37%

Preliminary Results

Dependent Variable: Purchase Level 3	(1)	(2)
VARIABLES		
PostDraghi*Treatment	**0.326***	**0.347***
Size		1.517
Tier1Ratio		-0.559
ShareL3A		-0.719
LoanToAssets		-0.268
ShareDeposits		-0.679
RoE		-0.002
Fixed Effects	B&Y	B&Y
Observations	240	191
R-squared	0.543	0.570

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

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