Discuss “Uneven Regulatory Playing Field and Bank Transparency Abroad”

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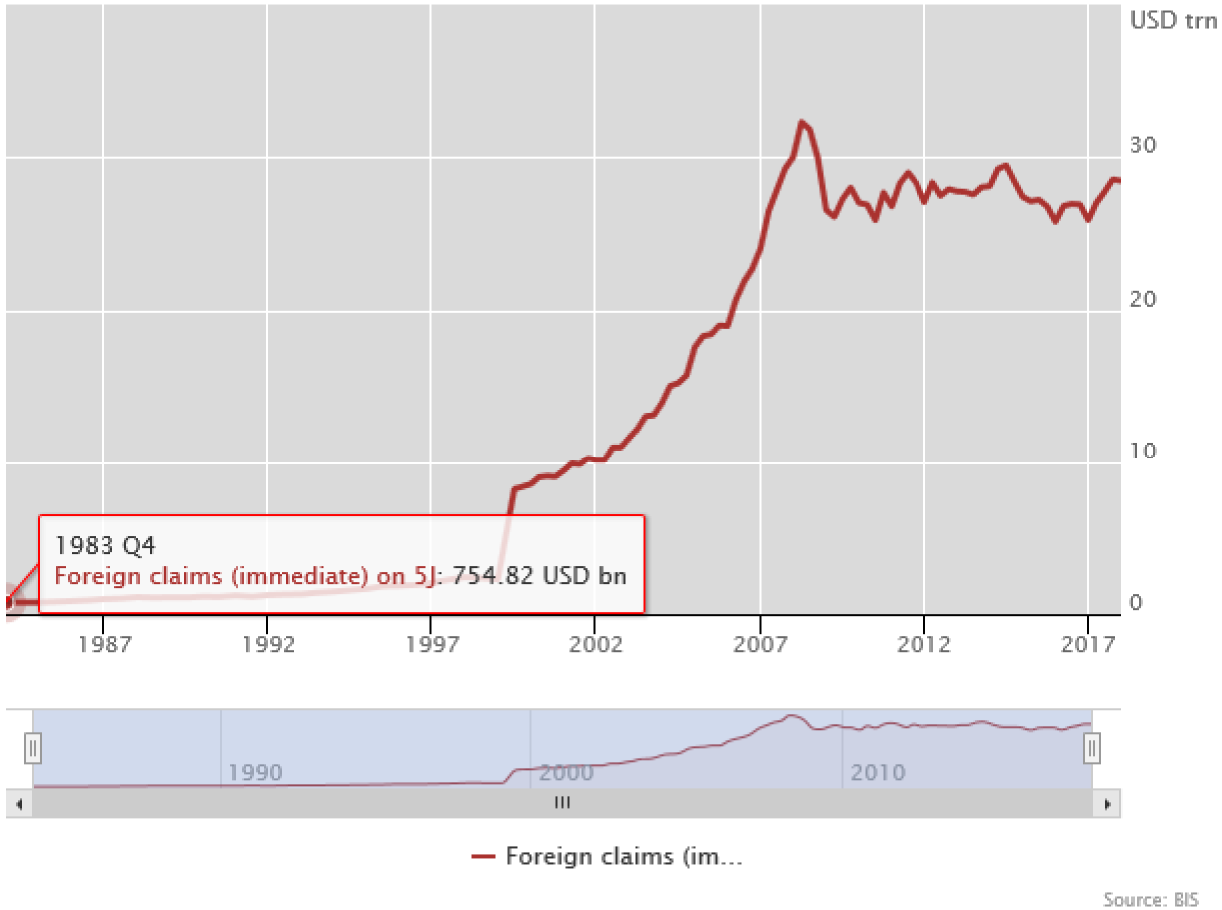
Why international banking?

- International banking system is a very important conduit for the capital transfers across countries

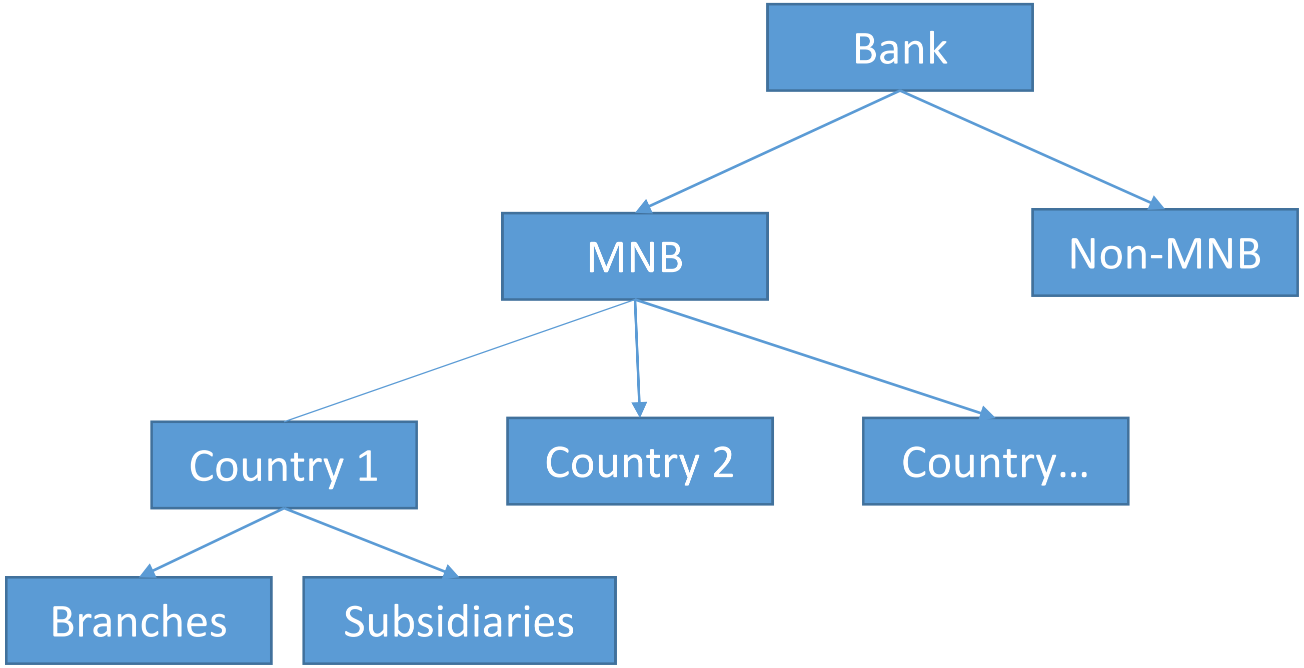


Important but controversial

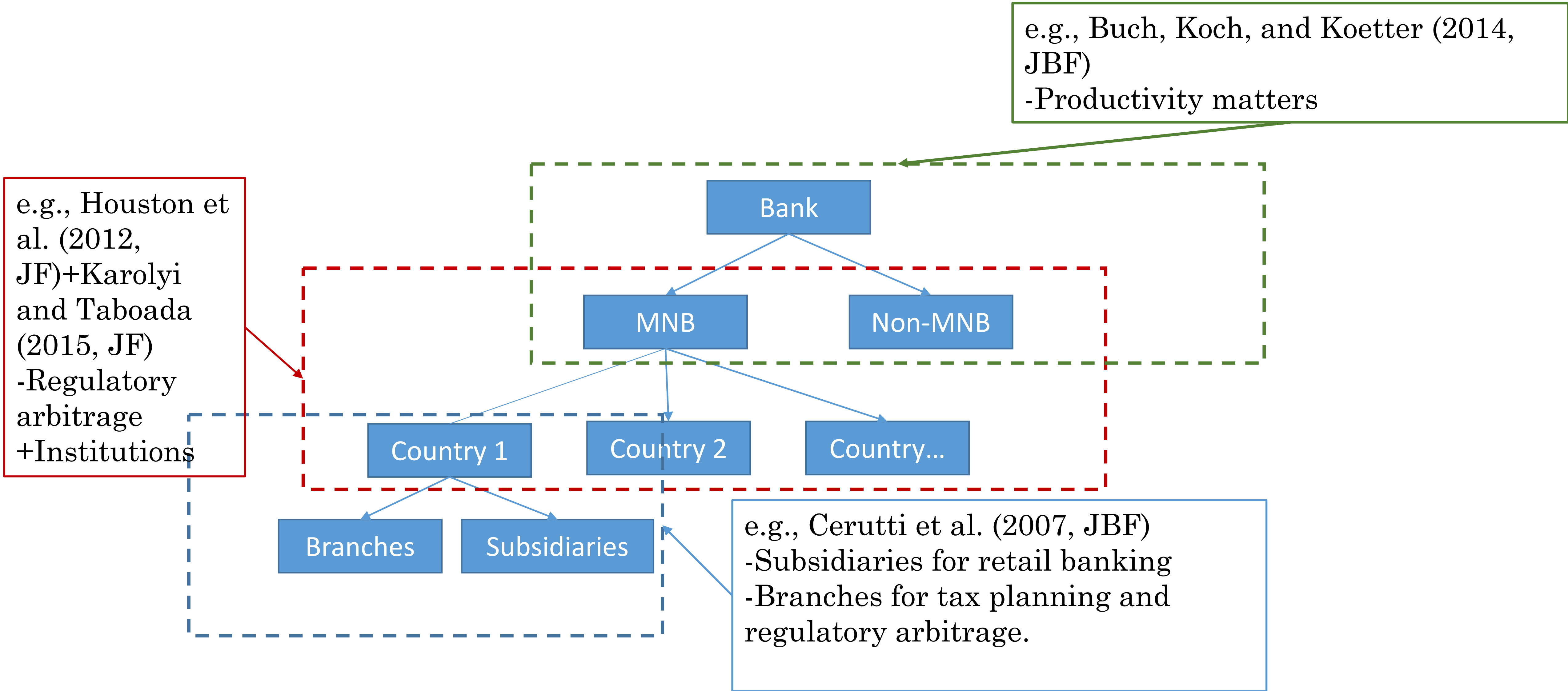
- The reasons for existence of multinational banks (MNB) are complex (e.g., Gray and Gray, 1981; Williams, 1997)
    - Theory 1:Imperfections in local lending market (e.g., over-regulation; funds, and informational capital)
    - Theory 2:Economies of internal operation
    - Theory 3:Entry into a high-growth market
    - Theory 4:Overcome the market entry-barriers
    - Theory 5:Multinational wholesale banking theory
        - Currency clientele effect
    - …

Important but controversial

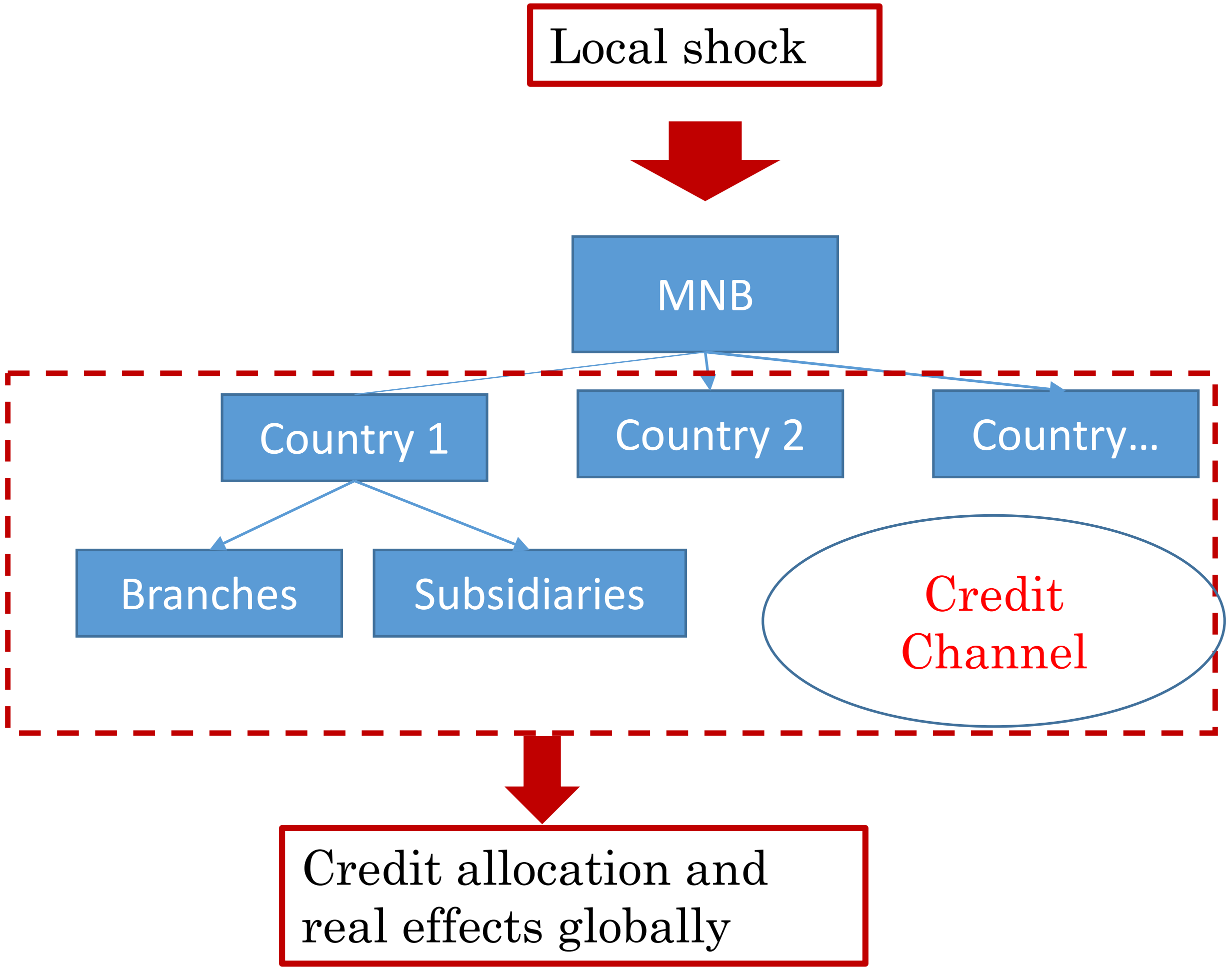
- Identification is a big challenge
- Complex nested Logit model



Important but controversial



Important but controversial

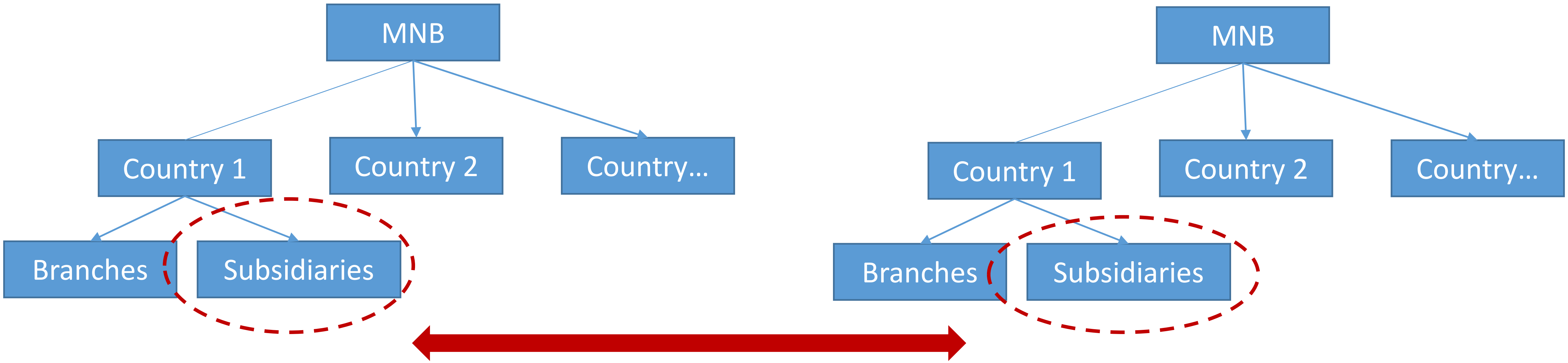


Adv: 1)Smart and clean identification;
2) economically important effect.
(e.g., Peek and Rosengren 2000 AER, 2005 AER, Ivashina et al. 2015 QJE, Cetorelli et al. 2012 AER, Chava and Purnanandam, 2011 JFE, Philipp, 2012 JF, Giannetti and Laeven, 2012, JFE)

The current paper

Parent bank facing tight regulation

Parent bank facing lax regulation



From a perspective of disclosure

Disclosure is important since 1) It is a reflection of lending activities (Jiang et al, 2016 RFS; Lin, 2016) 2) It can have a feedback effect on lending (Beatty and Liao, 2011 JAE)

Findings:

- Foreign subsidiaries' transparency decreases when their home countries have tighter activity restrictions (than host countries).

  Redundant

  - $Dis = a_0 + a_1(\text{home index} - \boxed{\text{host index}}) + \text{other control} + \text{host} \times \text{year} + \varepsilon$
- The above effect is driven by weak supervision power of host countries.
- The findings are best explained by risk-takings stemming from regulatory arbitrage.

Comment 1 A better interpretation of current empirical results.

- The current story provides direct theoretical prediction for the first layer (risk shifting).
- The theoretical prediction for the second layer (opacity) is weak.
- An increase in risk-takings needs not lead to an increase in opacity.
- The demand of opacity in facilitating risk-takings is weak when the regulations of host countries are lax.

Comment 1(Cont.)

What are the alternative theories?

1) Optimal level of opacity (positive view of regulatory arbitrage)

- Improve coordination efficiency (e.g., Morris and Shin, 2002 AER)
- Improve the liquidity of money-like instruments (Gorton and Pennacchi, 1990 JME)
- Reduce competitive harm (a vast of accounting literature)

2) Lax regulations allow banks to move toward an optimal level of opacity.

3) Need not to be associated with a higher risk

Comment 1 (Cont.)

2) Export poor information environment to the host country.

- Spillover effect of home country institutions to the host country via Cross-border M&As (Bris, Brisley, and Cabolis, 2008; Antràs, Desai, and Foley, 2009; Chari, Ouimet, and Tesar, 2010; Erel, Liao, and Weisbach, 2012)

3) Alternatively, it is not just about tighter regulations, but about poorer institutions

- Poorer institutions ⇒ tighter regulation.
- Poorer institutions ⇒ opaque information environment.

Country	Activity restrictions	External audit	Accounting practices	Transparenc
Argentina	7.25	6.25	0.00	5.25
Australia	7.25	5.75	1.00	5.50
Austria	4.50	6.75	0.50	4.25
Bahrain	7.50	6.75	1.00	6.00
Belgium	6.00	7.00	0.00	5.00
Botswana	8.50	6.00	1.00	4.75
Brazil	6.25	6.00	0.67	5.00
Canada	5.25	5.50	0.50	5.50
Cayman Islands	6.33	4.22	1.00	3.65
Chile	9.25	5.75	0.25	5.25
China	10.63	4.69	0.25	4.70
Croatia	6.00	7.00	1.00	5.50
Czech Republic	7.67	5.33	1.00	4.67
Denmark	6.50	6.75	0.50	5.50
Egypt	8.00	7.00	1.00	5.75
Estonia	5.25	7.00	1.00	5.50
France	5.75	6.00	0.25	4.75
Germany	4.33	6.25	0.33	4.25
Greece	6.75	6.00	0.50	5.00
Hong Kong	3.25	5.71	1.00	5.50
Hungary	7.00	7.00	0.67	4.75
Indonesia	9.67	6.50	1.00	5.25
Ireland	5.00	6.25	1.00	5.50
Israel	9.75	5.00	0.67	6.00
Italy	7.75	4.75	0.50	5.25
Japan	8.67	4.33	0.50	4.67
Jordan	8.00	6.50	1.00	5.25

Comment 1 (Cont.)

3) Competition and opacity

- Foreign banks lack soft information and face comparative disadvantages.
  - Particularly severer for foreign banks from countries with stricter regulations on banking activities.
  - It is not related to regulatory arbitrage.
- Higher proprietary cost of disclosure
- Alternatively, parent banks have to rely more on internal market to support subsidiaries expansion (Haas and Lelveld, 2010).
  - Relying on internal market ⇒ higher opacity.

Comment 1 (Cont.)

What are the alternative tests for the story of risk-shifting (risk-taking)?

- I prefer a more neutral term of "risk taking".

1) Allocation of credit
   - e.g., Wang and Xia (2014) ; Benmelech et al. (2011)
2) Volatility of subsidiary EBITDA
   - Borrow the idea from corporate finance literature (e.g. Yeung et al., 2008)
3) Capital structure of subsidiaries (e.g., leverage)
   - Duchin and Sosyura (2012)

Comment 2 Identification

M&A is not a valid identification strategy.

- The bank's choice of target subsidiary is endogenous.
    - The M&A decision per se is an important research question (e.g., Karolyi and Taboada, 2015, JF)

    - The banks decide to acquire a subsidiary from a restricted country and the banks decide to acquire a subsidiary from an unrestricted country could be different on some dimensions that correlated with the disclosure outcome. In that case, causality is not established.

Comment 2 (Cont.)

Exogenous change of home country's restriction policies.

- Utilize some exogenous policy changes of the home country's banking restriction policies.

- Participation in GATT/WTO
    - Member countries need to open the banking market to the foreign investors and therefore lead to deregulations in general.
    - Use the post-participation period as an IV.
    - Or check the detailed agreement and come up with a finer IV.

Comment 2 (Cont.)

Less disclosure, higher banking instability?

BUT: Disclosure is an endogenous decision which may be correlated with other factors that determines the banking stability.

- One bank (A) has a lot of NPLs and choose not to disclose as to hide the losses.
- Another bank (B) which does not have much NPLs, does not need to disclose NPLs explicitly (for example, having more investment banking business).
- Subsequently, we observe bank A failed but bank B did not. However, this is due to more non performing asset from bank A not the disclosure standard they chose to take.

Comment 3 Measurement

What does the y variable really capture?

- A score based measure capturing important missing items in financial reporting

Who need (have) this information?

1) Regulators
   - Banks have to disclose the NPLs and banking activities to regulators.
2) Shareholders
   - Similarly, shareholders should have this information according to the reporting regulations.

Can’t be used to test the risk shifting argument.

Comment 3 (Cont.)

Who need(have) this information?

3) Competitors (or counterparties)

- This information is available for the regulator and shareholders but not the competitors or the counterparty
  - The measure is valid for testing the proprietary cost hypothesis or coordination efficiency hypothesis.

Need to discuss

1) Whether the data quality of BankScope is equal for different countries
2) If some items are disclosed through other information channels (e.g. footnote) rather than the financial statement, can such information be captured by BankScope?

Overall

- This is a very ambitious paper.
- The research question is important.
- But, by nature, it needs to overcome numbers of empirical obstacles.
- Good luck with the publication.