How do Financial Crises Redistribute Risk?

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Discussion by Mark Carlson

The views in this presentation are those of the discussant and do not necessarily represent those of the Board of Governors of the Federal Reserve or its staff.

Overview

- This paper looks at how risk in the financial system was reshaped by mergers between 1929 and 1934.
- Construct two measures to assess risk.
  - One based on leverage and capital quality => likelihood of default
  - One based on interconnectivity => impact in the event default
- Give careful consideration to outcomes.
  - Survive
  - Exit: Merge (among equals) vs. "absorbed" (strong takes over weak) vs. fail
- Find that banks that acquired other banks increased their contribution to the risk in the financial system.

Impact of mergers is an important, but hard, question

- In the 1930s, a substantial number of banks ceased operations.
  - Mergers were a large part of that.
  - An important way of dealing with troubled banks.
- Impact of mergers during this turbulent period is understudied.
  - Difficult topic.
  - Applaud the efforts by the authors to tackle it.
  - Two particular issues where I think further work would be valuable.

Combining institutions

- Troubled banks have accumulated bad assets. Losses on those assets could be borne by:
  - Liquidation – current equity holders and depositors.
  - Merger – current equity holders and new equity holders.
- Key aspect of merger involves negotiations for how losses might be divided between the current and new shareholders.
  - Manifests in the price of the acquisition and the extent to which bad assets are written down at the time of the merger.
    - Surplus and undivided profits need not transfer.
    - Stock shares need not be swapped 1:1.
- Consequently, even if leverage increased, the continuing bank could be safer since the assets acquired were purged of bad quality assets.

An example of an absorption

	Auglaize National Bank of Wapakoneta, Ohio (1929)	People's National of Wapakoneta, Ohio (1929)	Combined entity People's National (1930)
Capital	$100,000	$100,000	$100,000
Surplus and undivided profits	$31,876	$97,246	$90,000
Loans	$671,556	$685,410	$1,129,452
Assets	$1,040,456	$1,012,713	$1,459,390
Net worth to assets	12.7%	19.5%	13.0%
R (risk measure)	14.2	7.4	9.1

Combining institutions (continued)

- It would be valuable to incorporate changes in capital, surplus, and undivided profits into the analysis.
  - That would tell us something about how troubled the acquired bank was.
- There were other risk mitigants as well.
  - Share-holders of the bank being absorbed might be responsible for losses associated with acquired assets for years afterward (Chapman 1934).
    - Especially the case if the price kept higher for reputational and confidence purposes.
  - It is admittedly impossible to get all the details of the acquisition.

Market structure

- There are important constraints related to acquisitions.
- There must be a viable acquirer
  - At least one other bank in the town (or vicinity).
  - Must be of at least comparable size and reasonable quality.
  - Authors need to control for this constraint in the analysis.
- For larger, more connected banks, likely only another large connected bank is a viable merger partner.
  - Almost inherent that this will increase the concentration of interconnectedness risk in the system. At least in the short run.

Thank you!

- Important, but understudied, topic and the paper provides thoughtful approach to investigating it.
- Look forward to seeing refined versions of the analysis.