Discussion of “Taxes and Bank Capital Structure” by Glenn Schepens

Juliane Begenau

Harvard Business School

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This paper

- Impact of relative tax-advantage of debt on banks' capital structure?
- Study of Belgium's 2006 change in tax legislation:
  - Notional interest deductability on equity
  - Reduction in taxable income = equity x average rate on 10-year government bonds
- Analysis:
  - DID with "treated" Belgian banks and "non-treated" EU banks
  - Matching of treated to non-treated banks based on similar trend in ETA
- Results:
  - ETA ratios increase by 1.03 percentage points
  - Increase in ETA not coming from reduction in assets or loans (controlling for demand)
  - Ex-ante less capitalized banks reduce risky corporate loans

Comments

1. Contribution
2. Taxes and competition
3. Economic significance
4. Open questions

Contribution

- Hard to establish the effect of taxes (Panier et al, 2013) on financing decisions because of
  - omitted vars in cross-sectional or cross-country studies
  - few tax reforms with significant changes in tax incentives
  - difficulty to control for time trends
- Quasi-natural experiment of the Belgium reform overcomes these issues
- Sample relatively small - but similar effects reported for larger sample of non-financial firms

Taxes and Competition

- Kashyap, Hanson, and Stein (2010):
  - competition in the banking sector
  - even a relatively small tax advantage of debt incentivizes banks to operate under high leverage
- Pennacchi (2014):
  - taxes and the competitive environment in loan and deposit markets determine bank capital structure
- Evidence for the KHS 2010 competition effect in Belgium?

Open Questions

- Matched banks mostly Italian and Spanish
  - Panier et al (2013) mostly used German, Dutch, and French banks?
  - Are Italian and Spanish banks similar enough?
- Risk-taking measured in terms of loan portfolio
  - Modern banks engage in many risk bearing activities, i.e. mortgages, securitization, risky government debt, interbank loans, trading activities, SIV
  - Effect of tax reform on these other activities?

Open Questions ctd

- What happens to the treated banks' ETA and total equity levels after 2007?
  - Effect lasting or perhaps even increasing?
  - Loans to less risky firms could result in less profitable loans
    Was that the case and how did banks adjust?
- How do "treated" and "non-treated" banks fared during the crisis?
  - Did Belgian banks outperform other banks because of higher capital cushions?

Economic Significance

- How relevant are tax incentives for bank capital structure decisions relative to other determinants?
- Why financial institutions operate at high leverage ratios is not explained by tax-advantage alone (e.g., compare to non-financials)
- Would the reform implied increase in capital ratios be enough to make banks safer?
  - What went wrong for Fortis and Dexia?

Conclusion

- Very interesting and relevant question carefully studied in a unique setting
- Quantifies relevant determinant of bank capital structure
- Raises important questions for bank regulation