Unlocking the Dynamics of Scope Transformation in US Banks, 1992 – 2006

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- A Discussion

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1.00 Summary

1.01 Research question:

- US Bank Holding Companies (BHCs) have become increasingly diversified
- More than 50% of income for US BHCs comes from activities considered non-core for the banking sector (i.e. not deposit-taking or lending)

Goal of paper: How has this diversification impacted performance of US BHCs?

1.02 Literature:

- Large literature on diversification by US banks and its consequences
- Much more than I can review here:
  - Laeven and Levine (JFE, 2007)
  - Brunnermeier, Dong, Palia (Working paper, Princeton University, 2017)
  - Stiroh (JMCB 2004, JBF 2006)
  - Gandhi, Keifer, Plazzi (Working paper, University of Notre Dame, 2018)
  - Many more …….

1.03 What's novel:

- Most existing research uses ***same*** measure of bank diversification:
  - Ratio of interest to non-interest (or fee) income
  - Some variation thereof
- First to look at actual activities:
  - Actual primary / secondary activities reported by each subsidiary of each BHC
  - Activities classified by NAICS codes

  You should make a bigger deal of this than you currently do in the paper!!

1.04 Key variables and tests:

- Key explanatory variable:

  Scope = Number of unique NAICS reported as primary or secondary businesses by all subsidiaries of a BHC

- Key dependent variable:

  Performance = Book value of Return on Equity (ROE)

- Key test:

$$Performance_t = \alpha + \beta Scope_{t-1} + Controls_{t-1} + \epsilon_t$$

1.05 Key result:

- Lots of interesting results in the paper
- You already saw them in the presentation

$$Performance_t = \alpha + \beta Scope_{t-1} + Controls_{t-1} + \epsilon_t$$

$$\beta < 0$$

2.00 Comments

2.01 General comments:

- Excellent paper!
- Unique dataset – and authors exploit this to the maximum
- Very well written and executed
- Recommend everyone to read it!
- My comments:
  - Just a few more things to think about
  - Some additional tests that could be possibly run

2.02 Comment 1: Are scope expansions negative NPV:

- Not necessarily – A new activity takes time to become profitable
- At HSBC:
  - A new branch (not necessarily new activity) takes time to turn profitable
  - On average new branches / activities became profitable only by 5-7 years
- To their credit, authors realize this:
  - Run specification $Performance_t = \alpha + \beta Cum\ Scope_{t-1} + \epsilon_t$
  - $Cum\ Scope_{t-1} = Sum\ of\ new\ activities\ in\ last\ 1\ -5\ years$
- Not sure if this fixes the problem:
  - For one, shouldn't we be looking at cumulative cash flows (ROE) from a new activity
- Feel more could be done!

2.03 Comment 2: Market reaction:

- Why not look at stock markets reaction when a BHC announces a new business activity
- This may not be perfectly possible in all cases:
  - Announcement dates are not (exactly) available
  - Not all banks are publicly traded
- Still even if you could do this for a small subset:
  - Much more convincing that new (unrelated, non-modal) activities destroy BHC value and markets pick this up

2.04 Comment 3: Scope measurement:

- *Scope* increases when **<u>existing subsidiary</u>** adds a **<u>new</u>** primary or secondary business activity (as classified by NAICS)
- Also increases when BHC adds a **<u>new subsidiary</u>** with a **<u>new</u>** primary or secondary activity
- But what if existing subsidiaries add (drop) 3rd, 4th… activities (not reported in the database) – these are missed cases of scope expansions / contractions
- Probably do not affect main results– but how important are they?
- Do banks always create new subsidiaries for a new activity?

2.05 Comment 4: More controls:

- Cheap shot: Its always easy to ask for more controls
- Not clear if specifications control for lagged ROE
- Important:
  - As ROE is persistent
  - ROE may influence decision to expand in the first place
  - More profitable banks have the resources to expand

2.06 Comment 5: Other minor things:

- Split the sample – show results before and after repeal of Glass-Steagall:
  - Are results due to deregulation of banks / activities they can engage in?
- Summary statistics for scope and its cross-section distribution:
  - How often do banks contract scope –not clear from graph
  - Banks are different from non-financial firms

Overall Conclusion:

- Again – An excellent paper!
- Very intriguing and unique dataset and interesting results!
- Recommend everyone to read it!