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Banks' Equity Stakes and Lending:

Evidence from a Tax Reform

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Abstract

We study how a bank's equity stake in a borrowing firm affects lending to that firm. Similar to prior papers, we find a positive association between a bank's equity stake in a borrowing firm and lending to that firm. While such a positive cross-sectional correlation may be due to equity stakes benefiting lending, it may also be driven by endogeneity. To distinguish the two explanations, we study a German tax reform that permitted banks to sell their equity stakes tax-free. After the reform, many banks sold their equity stakes, but did not reduce lending to the firms. This observation is robust to several alternative model specifications, control groups, and time windows. Our findings suggest that banks' equity stakes may be less important for lending than previously thought.

JEL classification: G21

Keywords: Relationship banking, Ownership, Monitoring

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