Bank Cost of Equity and Loan Supply

Mattia Girotti and Guillaume Horny (Banque de France)

Abstract

We study how bank cost of equity affects loan supply. We exploit unique quarterly balance sheet information on Euro-area banks from 2010 to 2019, matched with each bank's stock prices. Building on standard valuation methods, we take the stock price as an inversely related proxy for the bank's cost of equity. We address endogeneity concerns by using an instrumental variable derived from the liquidity of each stock. Our findings indicate that an increase in a bank's stock price of 10% --hence a decrease in its cost of equity-- translates into an increase of its corporate lending of about 250 millions for an average bank annually. We document that this is because the bank benefits from a cheaper access to capital and issues new equity. Our results highlight a direct link between banks' stock market value and loan supply.