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TITLE: Bank Risk and Bank Rents: The Franchise Value Hypothesis Reconsidered

ABSTRACT: The predictive relationship between banks' Tobin Q and a theory-based measure of bank risk of insolvency is highly non-linear. Using large samples of publicly quoted banks in the US, Europe, and Asia during 1985-2017, we find that higher values of Q predict lower bank risk of insolvency up to values of Q close to 1, but higher values of Q predict higher bank risk of insolvency when Q exceeds 1 and franchise value is priced. The franchise value hypothesis (FVH), postulating a negative relationship between bank rents and risk, is thus rejected in our samples. We then construct proxy measures of bank efficiency rents, loan and deposit pricing power rents, and rents due to government guarantees, and show that an increase of any of these rents is associated with higher franchise values. We provide a rationalization of the rejection of the FVH using a calibration of two standard financial models of the banking firm, and the qualitative implications of a simple industry model with agency costs and endogenous market structure.