NORTH-HOLLAND

Journal of Economics and Business 53 (2001) 313–324

Journal of Economics & Business

Market discipline prior to bank failure

Julapa Jagtiani*, Catharine Lemieux

Federal Reserve Bank of Chicago, Supervision and Regulation Department, 230 South LaSalle Street, Chicago, IL 60604-1413, USA

Received 14 September 1999; received in revised form 14 November 2000; accepted 29 November 2000

Abstract

This paper examines pricing behavior for bonds issued by bank holding companies in the period prior to failure of their bank subsidiaries. The results indicate that bond prices are related to the financial condition of the issuing bank holding companies, and that bond spreads start rising as early as six quarters prior to failure as the issuing firm's financial condition and credit rating deteriorate. Strong market discipline exists during this critical period—bond spreads for troubled banking organizations are many times those of healthy ones. Our results suggest that bond spreads could potentially be useful to bank supervisors as a warning signal from the financial markets. In addition, our finding implies that the proposals to require bank holding companies to issue publicly traded debt in a greater volume and frequency will likely enhance market discipline in the banking system when it is most needed. © 2001 Elsevier Science Inc. All rights reserved.

JEL classification: G21; G28; G20

Keywords: Market discipline; Bank failure; Subordinated debt proposal

1. Introduction

Banking deregulation or reregulation has been an ongoing process since the 1970s. Many of the restrictions placed on banking as a result of banking panics in the 1920s have been either lifted or modified. Geographic barriers and many product restrictions have been eased. Financial market globalization, product innovations, new technologies, and consolidation, along with regulatory changes, are causing banks and bank supervisors to reconsider how

* Corresponding author. Tel.: +1-312-322-5798; fax: +1-312-322-5894.
E-mail address: julapa.a.jagtiani@chi.frb.org (J. Jagtiani).

0148-6195/01/$ – see front matter © 2001 Elsevier Science Inc. All rights reserved.
PII: S0148-6195(00)00046-1

they do business. Supervisors must balance their need for information with the burden imposed on the regulated entities. The objective is to minimize regulatory burden without compromising the safety and soundness of the banking organization. This can be achieved by increasing market discipline and the use of market information. Market discipline may be enhanced by increasing the incentives for debt holders to monitor bank management—thus complimenting the work of bank supervision. Debt holders can provide bank management with incentives to limit their risky activities by demanding a larger risk premium on bond spreads. In addition, the use of market information in bank supervision can potentially allow bank supervisors to spend less of their scarce resources collecting information from bank management.

Previous studies have examined the role of debt holders in disciplining bank management and have shown that pricing in the debt market is sensitive to the risk profile of the issuing banking firms (Flannery & Sorescu, 1996 and Jagtiani, Kaufman, & Lemieux, 2000). However, the literature sheds little light on whether debt holders can effectively monitor banking firms during the period prior to bank failure. Since the federal safety net subsidy is most critical and market discipline is most needed during the period prior to failure, we focus on the pricing of bank bonds during the twelve quarters prior to failure. Understanding the pricing behavior of banking firms' publicly traded debt during the period prior to failure is a critical element of maintaining the stability of the financial system.

This paper may be considered an extension of two earlier studies by Jagtiani, Kaufman, and Lemieux (2000) and Flannery and Sorescu (1996), which examine the pricing of bank holding company (BHC) bonds during the post-FDICIA period (1992–1997) and pre-FDICIA period (1986–1991), respectively. Both studies find some degree of market discipline in the market for bonds issued by BHCs. However, there has been no study that investigates pricing behavior when banking organizations are facing financial difficulties—our paper fills this gap in the literature. Our results provide implications for proposals that 1) attempt to utilize debt holders to compliment bank supervision, 2) advocate the use of bond spreads in the supervisory process, and 3) advocate increased disclosure to enhance market discipline [see Evanoff (1993) and Haubrich (1998)]. The rest of the paper is organized as follows. Section 2 describes the data and presents summary statistics of the data. Section 3 discusses the empirical methodology. Section 4 presents the empirical results, and Section 5 concludes.

2. The data

Our sample consists of banks that failed during the period 1980 to 1995, whose parent bank holding company had publicly traded bonds outstanding during the recent quarters prior to failure. We started with 185 failed banks (104 BHCs) during the sample period. Several of the failed banks were associated with the same BHCs.[1] Most of the banks on our initial list were eliminated because of the lack of bond data. None of the banks in our sample had outstanding publicly-traded debt, and the parent BHCs of only five of these failed banks did. Our final sample includes those five failed banks whose parent BHCs had outstanding bonds as of their fail date. These banks are Continental Bank, MBank, Southeast Bank N.A., Bank

دریافت فوری ← متن کامل مقاله

ISIArticles
مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات