



Market discipline, disclosure and moral hazard in banking[☆]

Erlend Nier^{*}, Ursel Baumann

Bank of England, Threadneedle Street, London EC2R 8AH, UK

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Abstract

This paper examines empirically the hypothesis that market discipline is effective in providing incentives for banks to limit their risk of default, by holding capital buffers against adverse outcomes in portfolio risk. We have constructed a large cross-country panel data set consisting of observations on 729 individual banks from 32 different countries over the years 1993 to 2000. Theory implies that the strength of market discipline ought to be related to the extent of the government safety net, the observability of bank risk choices and to the proportion of uninsured liabilities in the bank's balance sheet. Using panel data techniques, we test whether these factors provide incentives for banks to hold larger capital buffers against adverse outcomes in portfolio risk. Our results suggest that government safety nets result in lower capital buffers and that stronger market discipline resulting from uninsured liabilities and disclosure results in larger capital buffers, all else equal. While our results therefore point to the effectiveness of market discipline mechanisms in general, we also find that the effect of disclosure and uninsured funding is reduced when banks enjoy a high degree of government support. Our results finally suggest that while competition leads to greater risk taking incentives, market discipline is more effective in curbing these incentives in countries where competition among banks is strong.

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^{*} Corresponding author.
E-mail address: erlend.nier@bankofengland.co.uk (E. Nier).

1. Introduction

In recent years considerable attention has been paid to the topic of market discipline in banking. Market discipline refers to a market-based incentive scheme in which investors in bank liabilities, such as subordinated debt or uninsured deposits, “punish” banks for greater risk-taking by demanding higher yields on those liabilities. The reason market discipline is needed is that banks are prone to engage in moral hazard behaviour. Banks collect deposits and invest these funds in risky assets (loans). To safeguard against insolvency, banks hold capital buffers against adverse outcomes in their investments in risky assets (loan default). But the bank’s private solvency target may not take into account the interests of depositors, nor of society as a whole. Market discipline is a mechanism that can potentially curb the incentive to take excessive risk, by making risk-taking more costly.

A number of recent policy initiatives recognise the importance of market discipline in safeguarding financial stability. These include initiatives to create internationally accepted accounting standards (IAS) and proposals to make it mandatory for banks to issue subordinated debt, see [Evanoff and Wall \(2000a\)](#). Moreover, the Basel Committee on Banking Supervision¹ (BCBS) has taken the view that enhancing market discipline is increasingly important in a world where banking activities are becoming more and more complex. This view is reflected in Pillar 3 of the proposed revised capital framework (Basel 2), which encourages greater bank disclosure to strengthen market discipline. In particular, the hope is that greater disclosure of a bank’s risk profile will provide banks with incentives to hold capital commensurate with the risks they take.

In view of these policy initiatives, it is important to ascertain whether market discipline can be effective, but also to assess under what conditions it might not be. However, as has been emphasised by [Berger \(1991\)](#), [Bliss and Flannery \(2002\)](#) and [Hamalainen et al \(2001\)](#), the “previous literature has concentrated primarily on whether the market prices [of bank liabilities] react adversely to information about risk” ([Berger, 1991](#)).² But this does not reveal the degree to which market discipline is effective as an incentive scheme, i.e. to what degree does the existence of market discipline actually influence bank behaviour? This paper seeks to address this question and examines empirically the hypothesis that market discipline is effective in providing incentives for banks to limit their risk of default, by holding capital buffers against adverse outcomes in portfolio risk.

For market discipline to be effective three conditions need to be satisfied. First, investors in bank liabilities need to consider themselves at risk of loss if the bank defaults. Second, market responses to changes in the bank’s risk profile need to have cost implications for the bank and its managers. Third, the market must have adequate information to gauge the riskiness of the

¹ See Basel Committee on Banking Supervision (2003).

² [Flannery \(1998\)](#) and [Hamalainen et al. \(2001\)](#) provide extensive surveys of this literature. In addition, a small literature examines the extent to which banks respond to changes in the yield of their subordinated debt. [Bliss and Flannery \(2002\)](#) fail to find any evidence that following a change in yield spreads managers respond with changes in balance sheet allocations. As pointed out by [Evanoff and Wall \(2000b\)](#), this “study is attempting to capture one aspect of discipline imposed by the debt market—ex post discipline. [That is,] do managers change their behaviour following a change in yield spreads? Another form of discipline, and that most typically associated with sub debt proposals, [refers to how banks may change their behaviour] in an attempt to *avoid* having the market impose costs through increased spreads. This *ex ante* discipline encourages firms to prudently manage risk” (emphasis added). Moreover, [Covitz et al. \(2004\)](#) provide evidence that banks’ decision to issue additional sub debt is influenced by yield spreads. They show that increases in yield are associated with a reduction of new issues of debt. In contrast to both these studies, our study is an attempt to examine the effectiveness of ex ante discipline.

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