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The emergence of market monitoring in Japanese banks: Evidence from the subordinated debt market

Masami Imai *

Wesleyan University, PAC123, 238 Church Street, Middletown, CT 06457-0007, USA

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Abstract

This paper uses a unique data set on the spreads of subordinated debts issued by Japanese banks to investigate the presence of market monitoring. The results show that subordinated debt investors punished weak banks by requiring higher interest rates. Moreover, I find that the spreads and the sensitivity of spreads to Moody's bank ratings both increased dramatically after the Japanese government allowed a large city bank, Hokkaido Takushoku Bank, to fail and passed the Financial Reform Act and the Rapid Revitalization Act in the late 1990s. These results suggest that the decline of conjectural guarantee led to the emergence of market monitoring. In addition, I find the relationship between spreads and accounting measures of bank risk to be quite fragile.
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1. Introduction

What is the best way to control the excessive risk-taking by banks? Although governments around the world traditionally rely on direct prudential supervision and regulation to achieve this goal, this approach has a poor track record. Barth et al. (2004) use

* Tel.: +1 860 685 2155; fax: +1 860 685 2301.
E-mail address: mimai@wesleyan.edu

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cross-country regression to show that prudential regulation focusing on capital adequacy requirement and restriction on banks' risk-taking activity does not necessarily lead to banking sector stability. That is, bank regulators have repeatedly failed to contain the moral hazard incentives of banks.

As a supplement to this regulatory discipline, some economists propose innovative strategies to keep banks' excessive risk-taking under control. One such proposal that has received a substantial amount of attention from policy-makers is a mandatory subordinated debt (MSD) requirement.[1] This proposal requires banks to frequently issue uninsured subordinated debts to put them under stringent market discipline on an ongoing basis. The MSD proposal is considered to be an attractive tool for bank regulators for various reasons.[2] In particular, the MSD proposal is expected to enhance direct market discipline: banks will internalize the costs of risk-taking every time they issue subordinated debts. Moreover, in so-called indirect market discipline, bank regulators can incorporate the credit spread of subordinated debt as a measure of bank risk when they undertake banking supervision that has become and will become increasingly complex.

Although the MSD proposal has great appeal from a theoretical viewpoint, governments around the world have been quite cautious about implementing it in practice. For example, although the joint report of the Board of Governors of the Federal Reserch System and the Secretary of the US Department of the Treasury (2000) recognizes the potential usefulness of the MSD proposal, it defers any recommendation of MSD policy in favor of "continuing research". Moreover, while the Basel Committee on Banking Supervision also finds market discipline to be an essential component of banking regulation in Basel II, it fails to recommend concrete measures to enhance it.[3] In fact, the Basel Committee of Banking Supervision (2003) surveyed the literature on bank subordinated debts and market discipline and found that all but one study, Sironi (2003), use US bank data. In their conclusion, they state: "there is considerable need for research on market discipline outside the United States".

In order to fill this gap in the literature, this paper investigates the presence of market monitoring in Japanese banks by empirically testing whether there is a positive relationship between subordinated debt spread and bank risk. This linkage between bank risk and spread is considered to be a necessary condition of, and the first test for the desirability of the MSD proposal.[4] There are three additional reasons for using Japanese banks as a case study. First and foremost, Japanese banks actively issue subordinated debts, which

[1] e.g. see Calomiris (1999) and Evanoff and Wall (2001).

[2] e.g. see US Shadow Financial Regulatory Committee (2000).

[3] Basel II recommends information disclosure and transparency to enhance market discipline, but many economists are critical of these measures since investors will have no incentive to make use of information to impose costs on risky banks unless they face a financial loss (see Benink and Wihlborg, 2002; US Shadow Financial Regulatory Committee, 2001).

[4] It is important to emphasize that the positive statistical relation between spreads and bank risk is merely a necessary condition for the success of the MSD proposal; it is also necessary that spreads be *accurate* measures of bank risk and that market indeed *influences* banks' risk-taking decision. This paper does not address these issues, but these issues need to be examined systematically in the future study of market discipline in Japanese banks. Several recent studies systematically examine these issues in the context of US banks (e.g. Hancock and Kwast, 2001; Bianchi et al., 2005; Bliss and Flannery, 2002; Ashcraft, 2006). Another important issue that is underresearched is whether market discipline banks via other non-price mechanisms such as quantity restriction and covenant (e.g. Covitz and Harrison, 2004; Goyal, 2005). To address this question, I attempted to obtain the data on covenants. I was not able to find these data.

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