Research in International Business and Finance 24 (2010) 315–328

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Market discipline and the evaluation of Euro financial bonds—An empirical analysis

Klaus-Michael Menz *

Fixed Income Portfolio Management, HSBC Global Asset Management (Deutschland) GmbH, Königsallee 21/23, 40212 Düsseldorf, Germany

ARTICLE INFO

Article history:
Received 27 April 2008
Received in revised form 10 February 2010
Accepted 13 February 2010
Available online 19 February 2010

JEL classification:
G28
G33

Keywords:
Euro financial bonds
Market discipline
Financial stability
Bond evaluation
Subordinated debt policy

ABSTRACT

Within the context of the increasing discussion on a shift in financial regulatory philosophy from the currently prevailing rules-based approach to a more incentive-based supervisory procedure in which market discipline should play a decisive role in overcoming several moral hazard and efficiency problems of the financial system, the question regarding the evaluation of financial bonds has gained an important dimension. Such a disciplining market influence could namely be exercised if financial institutions were obliged to issue subordinated bonds on a regular basis (mandatory subordinated debt policy). However, the influence of market discipline will only be effective if the evaluation of different subordinated (and other) bonds occurs in a differentiated manner and dependent on the inherent risks. This study provides findings, on the basis of which this requirement for the Euro financial bond market can be regarded as fulfilled.

1. Introduction

The new capital requirements for credit institutions (Basle II) represent the most significant changes in bank supervisory laws since the implementation of the Basle Accord in 1988 (Deutsche Bundesbank, 2004). The main component of the new ruling system are the modified minimum capital requirements, which are to bring necessary regulatory capital more in line with the factual risk profile of the banks (Pillar I).

A further element of the extensive new supervisory system which is not so much in the focus of public discussion, is represented in Pillar III, which aims to activate market forces by increasing dis-

* Tel.: +49 211 910 3973; fax: +49 211 910 1373.
E-mail address: klaus-michael.menz@hsbctrinkaus.de.

0275-5319/$ – see front matter
doi:10.1016/j.ribaf.2010.02.002

closure requirements and transparency standards for banks. This goal of integrating market discipline as an important pillar in regulation will be further pursued via a planned reform of the EU supervisory laws for insurances (Solvency II).[1] According to Lane (1993), market discipline in this context means that market participants send out signals which force financial institutions to adopt solvency consistent behavior.

A possible concrete instrument which utilizes this disciplining market force for the aim of financial supervision is the regulatory obligation to issue subordinated bonds on a regular basis (so-called mandatory subordinated debt policy) (see e.g. Board of Governers of the Federal Reserve System, 1999; Calomiris, 1999). Such an obligation could have an intentional influence on the incentive structure of financial institutions, since an aggressive firm policy or deterioration of the credit quality could lead to higher return claims by the bondholders, which in turn would suggest a substantial rise of the refinancing costs. Overall, the disciplining market influence would then be effective if the evaluation of subordinated (and other) bonds is carried out in a differentiated manner and dependent on the inherent risks. Whether this implicit assumption is justified will be empirically examined in this paper for the Euro financial bond market.

A further motivation for this study is the fact that in the past, empirical examinations on the valuation of bonds were predominantly focused on financial instruments of industrial firms (see Foerster and Sapp, 2005, p. 1). In contrast, shares or bonds of financial institutions were frequently excluded from analysis.[2] Therefore, this paper will enable a direct comparison between the evaluation of Euro industrial and financial bonds by using the research design (period and analytical methods) of the study conducted by Nelles and Menz (2007), who exclusively investigated the Euro industrial bond market.

This paper provides the following results. Firstly, issue specific and fundamental-systematic factors explain the largest part of the observed credit spread variation. Secondly, analyses of the factor coefficients document significant risk sensitivity over time, which substantially increases particularly during turbulent market phases. However, we also find signs of insufficient risk anticipation by investors. Thirdly, comparisons with Euro industrial bonds demonstrate that individual credit quality is significantly more important for financial bonds.

The structure of the paper is as follows. In Section 2, the concept of market discipline will be discussed and the instruments for the utilization of this supplementary regulatory pillar will be presented. In Section 3, the relevant issue characteristics of financial bonds will be described. Further fundamental-systematic determinants are the topic of discussion in Section 4. Subsequently, the study design will be elucidated and an empirical analysis conducted (Section 5). A critical appraisal and summary of the findings will be presented in Section 6.

2. Market discipline: concept, implementation vehicles and empirical evidence

Banks in particular are subject to intensive regulatory supervision and control by public institutions due to the central economic importance and "Run"-risk[3] with possible concomitant contagious effects which is attributed to them. In extreme cases, an individual solvency crisis of a single financial institution could cause an undesired destabilization of the whole banking sector, endangering the solvency of the entire financial system. However, in order to protect their central role in an economy as a provider of protection against ambiguous financial risks at all times, insurances are also comprehensibly regulated.[4] For these reasons supervisory institutions aim to influence the behaviour of

[1] The planned European Union directive is expected to be adopted by the end of 2008 and implemented starting from 2010, coming into force in 2012 (Maglanoc, 2008).

[2] Thus, also in the influential work of Fama and French (1992), shares of financial institutions are explicitly excluded from the investigation. A similar procedure can also be observed in empirical bond studies (e.g. Yu, 2005).

[3] A "Run" usually means an inrush on a bank, in times of effective or expected problems of solvency, in which the customers try to rescue their deposits in cash (Diamond and Dybvig, 1983).

[4] Policy-holders claims are only met if the insurance company has sufficient solvency at any time. This is especially important as many contingent liabilities are of a very long-term nature.