Journal of Economics and Business 63 (2011) 1–22

Contents lists available at ScienceDirect

Journal of Economics and Business

Enhancing market discipline in banking: The role of subordinated debt in financial regulatory reform☆

Douglas D. Evanoff[a], Julapa A. Jagtiani[b,*], Taisuke Nakata[c]

[a] Federal Reserve Bank of Chicago, Chicago, IL 60604, United States
[b] Federal Reserve Bank of Philadelphia, Philadelphia, PA 19106, United States
[c] Department of Economics, New York University, New York, NY 10012, United States

ARTICLE INFO

Article history:
Received 13 April 2010
Received in revised form 17 May 2010
Accepted 18 July 2010

JEL classification:
G21
G38
G28
L51

Keywords:
Regulatory reform
Market discipline
Subordinated debt
Bank capital
Financial regulation

ABSTRACT

The increasing complexity of large financial firms has led to consideration of alternative regulatory structures. This has intensified recently because of the worldwide turmoil in financial markets. One important consideration has been to increase reliance on market discipline—most notably, increased reliance on subordinated debt (sub-debt) in the bank capital structure to discipline banks' risk taking. This proposal, however, has been subject to criticism related to the quality of the signal generated in current sub-debt markets. We argue that previous studies evaluating the potential usefulness of sub-debt proposals have evaluated sub-debt spreads in a very different environment from that characterized by a fully implemented sub-debt program, where the market will become deeper, issuance will be more frequent, debt will be viewed as a more viable means to raise capital, bond dealers will be less reluctant to publicly disclose more details on debt transactions, and generally, the market will be more closely followed. As a test to see how the quality of the signal may change, we evaluate the risk-spread relationship—accounting for the enhanced liquidity and market transparency surrounding *new* debt issues. Our empirical

☆ The authors acknowledge helpful comments on earlier drafts from an anonymous referee, Dan Covitz, Ray DeGennaro, Fred Furlong, Joel Houston, Simon Kwan, Jose Lopez, Mitchell Petersen, Larry Wall, and participants at the FDIC's conference on "Risk Transfer and Governance in the Financial System," the Financial Management Association European conference in Zurich, Switzerland, the Federal Reserve System Committee on Financial Structure Meeting, and the Western Economic Association conference. We also thank Carlos Gutierres, Loretta Kujawa, Lauren Gaudino and George Simler for dedicated research assistance. The views expressed are those of the authors and may not be shared by others including the Federal Reserve Bank of Chicago, the Federal Reserve Bank of Philadelphia, the Federal Reserve System, or any of the above-mentioned reviewers.

* Corresponding author. Tel.: +1 215 574 7284.
E-mail address: Julapa.Jagtiani@phil.frb.org (J.A. Jagtiani).

0148-6195/$ – see front matter © 2010 Published by Elsevier Inc.
doi:10.1016/j.jeconbus.2010.07.001

results indicate a superior risk-spread relationship surrounding the period of new debt issuance due, we posit, to greater liquidity and transparency. Our results overall suggest that the degree of market discipline would be significantly enhanced by a mandatory sub-debt program, thus suggesting a potential role for sub-debt in the banking regulatory reform.

© 2010 Published by Elsevier Inc.

1. Introduction

> "When pursuing regulatory objectives through the application of market discipline, regulators must consider the nature of the incentives faced by different types of stakeholders... equity holders may "gamble for resurrection" by encouraging rather than discouraging excessive risk-taking... holders of uninsured debt don't benefit if the bank's stock price rises when undue risk-taking pays off. Consequently, they focus on what bank managers are doing to avoid default... The incentive to monitor risk-taking is particularly keen for holders of subordinated debt, as they are last in line in the event of failure. Because debt holders are sensitive to changes in the probability of financial distress, risk-taking by a bank raises its cost of funding in credit markets, and that connection creates an incentive for banks to control risks. Moreover, the price of a bank's debt provides useful information about the bank's riskiness. With that information, the bank's counterparties and supervisors can take steps of their own to ensure that the bank is operating safely..." [Bernanke, 2007].

With the turmoil in current financial markets, there have been calls for significant modifications to bank regulation.[1] Risk management and supervision appear to have failed in recent years and numerous reform proposals have been offered to prevent similar incidents in the future [see Congressional Oversight Panel, 2009; Larosiere, 2009; Litan and Baily, 2009]. However, the calls for reform are not new, as there has been a growing awareness that increased reliance on alternative oversight forces has become necessary as the banking industry has become increasingly complex.[2] For this reason, market discipline was one of the three pillars supporting safety and soundness of the banking system in the Basel Capital Accord (Basel II) framework. In establishing a more effective market discipline in banking, it has been argued that subordinated debt (sub-debt) could potentially play a vital role as a component of required capital—especially at large and complex banking organizations (LCBOs). Indeed, there is evidence that debt yields do vary with the riskiness of firms and there was information embedded in sub-debt spreads for certain financial institutions prior to the market meltdown in the fall of 2008. Recently there have also been proposals to introduce contingent capital to supplement equity capital. This usually takes the form of subordinated debt that automatically converts to equity when a conversion event occurs, thus helping to replenish the bank's equity base; see Flannery (2009) and Hancock and Passmore (in press).

The financial crisis that started in August 2007 has demonstrated that there was insufficient market discipline in the banking industry and banks were not constrained from taking excessive risk. Bernanke (2007) points out that neither market discipline nor regulatory oversight alone is completely adequate for keeping the banking system safe and sound and that the value of a hybrid system, where direct regulation and market discipline supplements one another, has been increasingly appreciated. We argue that mandating sub-debt issuance, whether convertible or not, would force the bank to continually "pass the test of the market" and provide signals to market participants and regulators about the condition of the bank. Banks would be required to regularly approach the market and would not be able

[1] As in many industries, there is the typical search for optimal regulation that constrains financial firm behavior with limited distortion to operations. For example, see Evanoff (1988), Evanoff, Israilevich, and Merris (1990), and Freixas and Gabillon (1999).

[2] See Greenspan (2000), Ferguson (1999), Meyer (1999, 2000), Bank for International Settlement (1999) and Parkinson (in press).

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