J. Finan. Intermediation 24 (2015) 411–440

Contents lists available at ScienceDirect

J. Finan. Intermediation

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

Market discipline and conflicts of interest between banks and pension funds

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ARTICLE INFO

Article history:
Received 17 April 2012
Available online 18 April 2014

Keywords:
Conflicts of interest
Institutional investors
Pension funds
Banks
Market discipline
Argentina

ABSTRACT

We study the behavior of private pension funds as large depositors in a banking system. Using panel data analysis, we examine whether, and if so how, pension funds influence market discipline in Argentina in the period 1998–2001. We find that the disciplining role of pension funds depends on whether or not banks are connected to the pension fund industry through ownership of pension fund management companies. We find evidence that pension funds exert market discipline on unconnected banks but not on connected ones. On balance, pension funds undermine market discipline in the banking system as a result of conflicts of interest. We conclude that regulations aimed at averting these conflicts can enhance market discipline.

1. Introduction

In the last three decades, a surge in the frequency and intensity of banking crises has destabilized economies worldwide, motivating research aimed at explaining their causes. A common view holds that government guarantees of bank liabilities weaken depositors' response to changes in bank-specific fundamentals ("market discipline") and result in excessive risk taking which ineffective regulation and supervision are unable to tame.[1] An important unanswered question is whether large depositors enhance market discipline.

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[1] For a database documenting the high frequency and intensity of systemic banking crises in the period 1970–2007, see Laeven and Valencia (2012). On the connection between government guarantees and market discipline, see for example Demirguc-Kunt and Huizinga (2004) and Demirguc-Kunt and Detragiache (2002).

http://dx.doi.org/10.1016/j.jfi.2014.04.002

Private pension funds are large depositors in many Latin American and Central and Eastern European countries which implemented pension reforms from pay-as-you-go to fully funded systems over the last three decades. In these countries, pension funds therefore could exert influence on market discipline.

This paper studies the behavior of private pension funds as large depositors in Argentina in the period 1998–2001. Argentina provides an excellent case study, as it introduced a funded pension scheme in 1994 and suffered a dramatic banking panic episode 7 years later, in 2001.

We define market discipline as a situation in which depositors withdraw (increase) deposits in response to increases (declines) in banks' risks as measured by a deterioration (improvement) in bank fundamentals.[2] In theory, pension funds can influence market discipline in banking systems through different channels. On the positive side, in contrast to individuals, pension funds are *sophisticated*, *large*, and *long-term* depositors. Pension funds' advantage in monitoring implies that they could enhance market discipline, penalizing banks for fundamental weaknesses or excessive risk-taking by withdrawing deposits. On the negative side, pension fund behavior could be affected by *conflicts of interest* in relation to banks. Pension funds could favor connected banks, undermining instead of enhancing market discipline. In Argentina, banks' ownership of Pension Fund Management Companies raises the possibility that conflicts could have influenced the deposit allocation of pension funds.

For these reasons, the case of Argentina is of particular interest. We conduct panel data analysis over the period 1998–2001[3] to address the questions whether, and if so how, pension funds influence market discipline in a banking system.

The first question that we address is, "do pension funds *exert* market discipline on banks?"

We find that the disciplining role of pension funds depends on whether or not banks are connected to the pension fund industry through ownership of pension fund management companies. We find evidence that pension funds exert limited market discipline on unconnected banks but not on connected ones. Regarding unconnected banks, we obtain the following two results. First, pension funds exert discipline with respect to two CAMEL-type fundamentals: capital adequacy and the non-performing loans ratio—an asset quality indicator. We find no evidence that pension funds exert discipline with respect to changes in bank profitability, exposure to the government, liquidity, or the bank fundamental indicator *z*-score—a distance-to-insolvency measure. Second, the discipline exerted by pension funds strengthens as the share of pension fund deposits in a bank rises; this suggests that a larger presence of pension funds in a bank's deposit base improves their disciplining incentives.

Regarding connected banks, however, we find that the disciplining behavior of pension funds is tainted by *conflicts of interest*. Pension funds undermine overall market discipline by shifting deposits toward connected banks with weakening fundamentals. In sharp contrast to unconnected banks, connected banks gain pension fund deposits as their capitalization and *z*-score measures decline.

The second question that we address is, "do pension funds *enhance* market discipline?" In other words, "does the presence of pension funds affect the disciplining behavior of other depositors?" We find evidence that other (non-pension fund) depositors exert discipline with respect to some CAMEL-type fundamentals—capital adequacy and exposure to the government[4]—and the *z*-score when the share of pension fund deposits is small. As the share of pension fund deposits rises, however, the discipline exerted by non-pension fund depositors vanishes—possibly due to a crowding out effect whereby a larger presence of pension funds in a bank's deposit base reduces the incentives for other depositors to exert market discipline.

[2] A broader definition would also include situations where depositors demand higher interest rates in response to a deterioration in fundamentals—see Berger (1991) and Martínez Pería and Schmukler (2001). Our goal is to compare the disciplining behavior of pension funds and other depositors, but we have no data discriminating the interest rates earned by type of depositor.

[3] This study period is limited by data availability; although bank-specific as well as macroeconomic information is available for a longer time period, 1998–2001 is the longest period for which the deposit allocation of pension funds across individual banks is available.

[4] Exposure to the government sector is a highly relevant bank fundamental in the case of Argentina. The study period includes a banking crisis and a protracted sovereign debt crisis. Thus, we interpret high provision of government financing by a bank as a fundamental weakness—a high exposure to sovereign default risk.