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# Public disclosures and calendar-related movements in risk premiums: evidence from interbank lending<sup>☆</sup>

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## Abstract

This paper finds that risk premiums on overnight interbank loans increase dramatically at year-end. Further, cross-sectional variation in prices reflects, in part, differences in public disclosure requirements across institutions, suggesting a significant influence of window dressing on behavior in this market. © 2002 Elsevier B.V. All rights reserved.

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## 1. Introduction

Extensive research has examined the behavior of financial markets around calendar events. This paper carries forward previous work by studying calendar-related changes to the pricing of federal funds transactions. These transactions represent unsecured overnight loans between financial institutions. Relative to other financial markets, the funds market offers two key advantages in understanding the impact of the calendar on financial market pricing. First, this market is an overnight

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market.<sup>1</sup> Thus, any anomalous year-end effects, for example, would show up on a single day, December 31. Similarly, any quarter-end effects occur precisely at quarter-end. Second, the federal funds market contains institutions with notably different disclosure requirements regarding their federal funds market activity. This cross-sectional variation can be exploited to test whether window dressing plays a role in any calendar-related movement in risk premiums.

An examination of unique data identifying individual federal funds transactions delivers two main empirical results. The first is that the relationship between the rate paid on overnight borrowing and borrower risk changes dramatically at year-end and at quarter-end. More precisely, the spread between the rates paid by risky and safe institutions to borrow in the funds market is much higher at year-end than on a normal business day. Smaller, but still significant increases in risk premiums are found at quarter-end.

The second key finding exploits the fact that only branches and agencies of foreign banks are required to disclose even limited information regarding the composition of their federal funds portfolios. It is shown that lending by foreign banks to US commercial banks on disclosure dates is done at a notably lower rate of interest than foreign bank lending to other institutions. This suggests that foreign banks willingly accept a lower rate of interest in order to show a portfolio tilted towards US borrowers. That this change in risk premiums is associated with a flight from risk is confirmed by an analysis of the interbank loan portfolios of foreign and US banks around the year-end.

The rest of the paper is organized as follows. Section 2 briefly reviews the previous literature on calendar-related movements in financial markets. Section 3 discusses the federal funds market, particularly the role played by the Federal Reserve in determining prices. Section 4 demonstrates that risk premiums in the funds market rise at year-end and at quarter-end. Section 5 documents the relationship between disclosure requirements, the repricing of risk, and the time variation in the composition of interbank loan portfolios. Section 6 provides evidence suggesting that the year-end changes to risk premiums and interbank loan portfolios documented in Sections 4 and 5 cannot solely be driven by calendar-related increases to the level of risk. Section 7 concludes.

## **2. Previous research**

Much of the interest in calendar anomalies stems from Keim (1983), who finds that stock returns of small firms outperform those of large firms in January, a finding that has become known as the “January effect”. Although a complete understanding of Keim’s finding has not yet been reached, two competing hypotheses have attracted the most attention in the literature: tax-loss selling and window dressing.<sup>2</sup>

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<sup>1</sup> According to a Federal Reserve Bank of New York (1987) survey, 96% of federal funds loans were for an overnight maturity.

<sup>2</sup> A third possibility, suggested by Glosten and Milgrom (1985), is that above average returns in January represent compensation for the possibility that insider traders possess more non-public information at year-end. Seyhun (1988), however, does not find empirical support for this hypothesis.

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