Financial fragility, uninsured deposits, and the cost of debt

Margot Quijano*

Department of Finance and Economics, McCoy College of Business Administration, Texas State University, United States

ABSTRACT

Using annual data from 1995 to 2009, I analyze the impact of banks' financial fragility on the costs of U.S. corporate bank loans. Diamond and Rajan (2001) hypothesize that financially fragile banks are able to raise funds at a lower cost and competition among banks result in some of these benefits being passed on to borrowers. My results provide broad support for this hypothesis, as I find that a one standard deviation increase in a bank's financial fragility lowers the cost of this bank's corporate loans by 7%. Since some types of regulation, such as deposit insurance, can decrease banks' financial fragility, this paper also contributes to the debate on the benefits and costs of bank regulation which can be helpful for policy-making.

© 2012 Elsevier Inc. All rights reserved.

1. Introduction

Banks as financial intermediaries stand between lenders and savers, and between borrowers and spenders, helping to transfer funds from one side to the other. However, these kinds of operations are not quite simple; this is evidenced by many bank failures happening in the past. Since bank stability is a major concern for any economy, several statements have been made about the fear of banks not having enough funding at the right moment:

"Many banks remain dependent on short-term funding to finance longer-term assets from counterparties that tend to flee at the first signs of distress" (Dudley, 2011).

The purpose of this paper is to analyze the impact of banks' financial fragility on U.S. corporate bank loan spreads. I follow the analysis of financial fragility in banks made by Diamond and Rajan (2001).

* Correspondence address: McCoy Hall 504, McCoy College of Business Administration, Texas State University, 601 University Ave., San Marcos, TX 78666, United States. Tel.: +1 512 245 9976; fax: +1 512 245 3089.
E-mail address: mq11@txstate.edu
They argue that banks finance illiquid assets with demand deposits, and demand deposits may increase banks’ fragility. When a bank is financially fragile, demand deposits become a source of market-based discipline. According to Berger (1991), market discipline in the banking sector can be described as a situation where banks’ stakeholders face costs that increase as banks undertake risks, and take action based on these costs. Diamond and Rajan (2001) further state that uninsured demand deposits discipline bankers because it exposes them to damaging runs by making their capital structure more fragile. Banks with the most fragile capital structure will be more committed to monitoring the loans granted to their clients, lowering the risk of calling back loans due to unexpected demand of deposits, and, in turn, lowering the chance of bank runs. If a bank run does happen, authorities may choose to bail out banks, but the costs of raising new funds increase as banks become more unreliable. If financial fragility increases, the chance of bank runs dissipates and the banks will have better access to cheaper sources of funding (i.e. more deposits). Diamond and Rajan (2001) also state that when financially fragile banks are able to raise funds at a lower cost, the competition among banks will result in some of these benefits being passed on to borrowers. Baer and Brewer (1986) corroborate that uninsured deposits are a source of market discipline, which means that as these become an important source of funding, banks are likely to manage their risks better. Park and Peristiani (1998) state that uninsured depositors would be the main monitors of banks since they are exposed to risky behavior from banks and may lose part of their deposits when banks fail.1

I test the implication of Diamond and Rajan (2001) that an increase in financial fragility lowers the cost of corporate loans. My proxy for financial fragility is the bank’s ratio of uninsured deposits to risk-weighted assets.

To test the impact of financial fragility on U.S. loan spreads, I use annual data, spanning from 1995 until 2006, on U.S. corporate bank loan prices and on uninsured deposits (normalized by risk-weighted assets) in U.S. banks. I include several variables in my tests to control for bank loan contracting specifics, firm characteristics, and macroeconomic conditions. I find that a one standard deviation increase in Uninsured Deposits decreases bank loan spreads by approximately 6.02–6.99%. Results imply that financial fragility will provide an incentive for banks to align their interests with those of investors and depositors. This gives banks an opportunity to access cheaper funding and to share such benefits with the borrowers. I also find that the stronger relationship between the borrower and the lender, the more will financial fragility matter in determining bank loan spreads.

It is plausible that the expected negative correlation between loan spreads and uninsured deposits, is due to the fact that the latter are simply deposits representing a source of liquidity to banks allowing them to offer lower prices in their loans; one of the valuable features of a bank charter is the ability to collect cheap and stable deposits to finance their operations. For robustness, I test the impact that insured and total deposits (both as ratios to risk-weighted assets) have on bank loan spreads in order to identify the effect that overall deposits have on loan spreads. The purpose of this robustness test is to discern if the expected negative impact on loan spreads is due to financial fragility created by uninsured deposits or due to cheap source of funding created by deposits in general. I find support for the notion that the negative impact on loan spreads is really due to the financial fragility created by uninsured deposits and not because of the cheap source of funding created by deposits in general.

Furthermore, a financially fragile bank may choose to lend only to low risk borrowers, thus a lower bank loan spread may be due to the bank’s specific selection of borrowers. As an additional robustness test, I determine if the negative impact that uninsured deposits have on loan spreads is due to the bank’s capital structure being financially frail and not because of their selection to lend to less risky borrowers. To do this, I estimate my main regression using nonperforming loans to control for risky borrowers. My main results still stand; financial fragility lowers the cost of bank debt, regardless of type of borrower.

Finally, I analyze the importance of uninsured deposits during the last financial crisis (from the years 2007 to 2009); in this particular event, several government responses to the crisis were made, such as increasing the deposit insurance ceiling, and injecting capital into banks’ balance sheets. It is

---

1 The importance of financial fragility is also recognized by formal regulators. Curry, Fissel, and Ramirez (2008) state that the instability of deposits is one of the factors considered in CAMEL ratings.
دریافت فوری متن کامل مقاله

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