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Subordinated debt, market discipline, and banks' risk taking

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Abstract

The present paper demonstrates the ambiguous impact of subordinated debt on the risk-taking incentives of banks. It is shown that in comparison with full deposit insurance, subordinated debt reduces risk only if banks can credibly commit to a given level of risk. If, however, banks are not able to commit, subordinated debt leads to an increase in risk. This is because due to limited liability banks always have an incentive to increase their risk after the interest rate is contracted in order to reduce the expected costs of debt. Rational debt holders anticipate this behavior and accordingly require a higher risk premium ex ante. The higher interest rates in turn further aggravate the excessive risk-taking incentives of banks.

JEL classification: G21; G28

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1. Introduction

The recurring and severe banking crises during the last two decades made evident the high costs of extensive safety nets for banks. These costs comprise the substantial costs to taxpayers as well as the costs in terms of moral hazard and other market distortions created by the presence of the various safety nets. [1] Recognizing these facts, many economists and practitioners have begun to search for ways to reduce

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[1] See, e.g., Calomiris (1999) and Dow (2000) for an overview of the extent of moral hazard and the costs of safety nets in banking.

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the costs of the safety nets. The common consensus that has emerged from this search is that market discipline should be given a more prominent role. [2] The most popular proposals to improve market discipline and to reduce the costs of safety nets would require banks to issue a minimal amount of subordinated, uninsured debt. [3]

Underlying all the proposed subordinated debt requirements is the insight that subordinated debt holders are the first creditors to bear any losses resulting from risky investments by the banks. In contrast to shareholders, however, they do not participate in the upward gains from such risky activities. This gives subordinated debt holders a strong preference for low-risk investments by the banks and an incentive to monitor the behavior of banks because the banks' risk has a direct influence on subordinated debt holders' payoffs. Rational subordinated debt holders will require a higher risk premium, i.e., a higher interest rate, from riskier banks as a compensation for the higher risk they have to bear. As a consequence, market prices and interest rates should reflect individual banks' riskiness.

According to proponents of these proposals, the advantages of subordinated debt requirements are twofold. First, subordinated debt may provide indirect market discipline because rate spreads of subordinated debt contain information about banks' riskiness. Supervisors can infer that information from market data and improve their assessment of banks' riskiness based on accounting data. Furthermore, in contrast to accounting data, market data is more readily and frequently available. In principle, supervisory action could be linked to subordinated debt prices, such as prompt corrective action measures that have to be taken when debt spreads exceed certain threshold levels.

Second, and more importantly, subordinated debt may provide direct market discipline because investors directly influence the behavior of banks. [4] As pointed out already, subordinated debt holders will require a higher risk premium from riskier banks. Consequently, risky banks face higher debt financing costs. It is argued that these higher funding costs in turn induce banks to keep their risk at low levels. [5]

The present paper challenges this view that direct market discipline in the form of subordinated debt is an effective tool to reduce banks' risk-taking incentives. Under the plausible assumption that banks cannot commit to a level of risk, this paper suggests that subordinated debt may in fact lead to higher risks than in the absence of any market discipline, as under a complete deposit insurance scheme.

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[2] See, for instance, the newly proposed capital adequacy framework of the Basel Committee on Banking Supervision (2001). The framework explicitly includes market discipline as one of three pillars, in addition to a minimum capital requirement and a supervisory review process.

[3] For an example of a recent subordinated debt proposal, see Calomiris (1999). For a survey of various proposals, see Board of Governors (1999) and Lang and Robertson (2002).

[4] For an excellent overview of the various aspects of direct and indirect market discipline in general, see Flannery (2001).

[5] For instance, in Board of Governors (1999, p. 2) the view is expressed that 'the anticipation of higher funding costs provides an incentive ex ante for the banking organization to refrain from augmenting its risk'.