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The wealth effects from a subordinated debt policy: evidence from passage of the Gramm–Leach–Bliley Act

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Abstract

Using an event study methodology which assumes that returns follow a GARCH (1,1) process, we estimate the wealth effects of a possible subordinated debt policy by examining the stock market reaction to the passage of the Gramm–Leach–Bliley (GLB) Act. A portfolio of banks with relatively high amounts of subordinated debt experienced positive and significant wealth effects associated with passage of the GLB. Portfolios made up of all banks, and those with no subordinated debt experience statistically insignificant wealth effects. We argue that these results suggest that policymakers should consider the use of subordinated debt as a way to enhance market discipline on banks.

JEL classification: G14; G21; G28

Keywords: Subordinated debt; GLB Act; Event study; Market discipline; GARCH

1. Introduction

In November 1999, Congress passed the Gramm–Leach–Bliley (GLB) Act, one of the most important pieces of banking legislation since the Great Depression. In addition to eliminating Glass–Steagall restrictions on commercial banks' affiliations with securities firms, the act also authorized

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[1] The views expressed are those of the authors and should not necessarily be attributed to the Federal Reserve Bank of Dallas, or the Federal Reserve System.

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banking organizations to offer insurance products and to engage in merchant banking activity. One of the likely consequences of the legislation is an acceleration of a trend evident in banking since the early 1980s—the consolidation of the industry. For example, in 1990, the 10 largest bank holding companies controlled 26% of all U.S. bank assets. By 2001, the top 10 organizations controlled almost 50% of industry assets.

As banking organizations become increasing large and complex, regulatory oversight can only provide a partial substitute for the corporate governance services provided by shareholders and creditors. As a result, a number of proposals have been formulated to increase the amount of market-imposed discipline on banks. Chief among these is the use of subordinated debt.[2] The GLB directed the Federal Reserve and the Treasury Department to study and report to Congress on the feasibility and appropriateness of requiring systemically important depository institutions and their holding companies to maintain some portion of their capital in the form of subordinated debt.[3] In the interim, the act requires that the 50 largest insured national banks have at least one issue of subordinated debt outstanding.

While subordinate debt is not the only bank liability capable of providing market discipline, the characteristics of such debt make it particularly attractive as a way of enhancing market discipline. Subordinated debt is not insured and, after equity, is likely to lose value first in the event of failure. The price of subordinated debt, then, should be closely correlated to the risks of the banking organization, and holders of this debt have incentives to demand greater disclosure.

What effects on the market value of the banking organization might a policy of mandatory subordinated debt produce? If requiring a certain amount of subordinated debt in banks' capital structure enhances market discipline, then shareholders might react in one of two ways. Bank stockholders might see moves to enhance market discipline as limiting the range of opportunities available to exploit the safety net. The well-known results from applying options-pricing theory to deposit insurance state that the value of equity is maximized by increasing asset risk. If so, then we might expect negative wealth effects from a policy of mandatory subordinated debt issuance.

On the other hand, enhanced market discipline might be viewed favorably by shareholders. Greater transparency and disclosure could result from a policy of mandatory subordinated debt issuance, which should be of value to shareholders. Moreover, several studies have shown that bank charter value can mitigate the risk-taking incentives from deposit insurance. If charter value is sufficiently large, value maximization can dictate protection of the charter, and, in this case, increases in leverage and asset risk would reduce, rather than enhance, shareholder wealth. If banks' charter value is high, then we would expect positive wealth effects to follow from attempts to implement greater market discipline on banks.

Assuming that returns follow a GARCH (1,1) process, we examine the wealth effects from issuing subordinated debt by estimating the stock market's response to events leading up to passage of the GLB.[4] We first analyze the industry-wide effects of the legislation by estimating wealth effects from a portfolio of all banks in our sample. Then, we compare the stock market's response based on a portfolio of banks with relatively high amounts of subordinated debt versus those banks with no subordinated debt in their portfolios. For all the banks in our sample, our results reveal that several of the event dates are statistically significant. However, the cumulative wealth effects associated with the GLB are statistically

[2] See Board of Governors of the Federal Reserve System (1999, Table 1) for a summary of these proposals.

[3] See Board of Governors of the Federal Reserve System and United States Department of the Treasury (2000).

[4] For an overview of the GARCH (1,1) procedure, see Engle (2001).