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ScienceDirect
Journal of Banking & Finance 31 (2007) 769–786
Journal of BANKING & FINANCE Applied Section
www.elsevier.com/locate/jbf

Market price accounting and depositor discipline: The case of Japanese regional banks

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Received 29 November 2004; accepted 5 May 2006
Available online 1 August 2006

Abstract

We examine the determinants of Japanese regional bank pricing-to-market decisions and their impact on the intensity of depositor discipline, in the form of the sensitivity of deposit growth to bank financial conditions. To obtain consistent estimates, we first model and estimate the bank pricing-to-market decision and then estimate the intensity of depositor discipline after conditioning for that decision. We find that banks were less likely to adopt market price accounting the larger were their unrealized securities losses. We also find statistically significant evidence of depositor discipline among banks that elected to price to market. Our results indicate that depositor discipline was more intense for the subset of banks that adopted market price accounting.

JEL classification: G18; G21

Keywords: Disclosure; Japanese banking; Market discipline

1. Introduction

Private depositors and investors may discipline financial institutions for falling into precarious capital positions, either by requiring higher expected returns for their assets or removing their assets entirely. Such market discipline enhances the financial regulatory

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0378-4266/$ - see front matter
doi:10.1016/j.jbankfin.2006.05.015

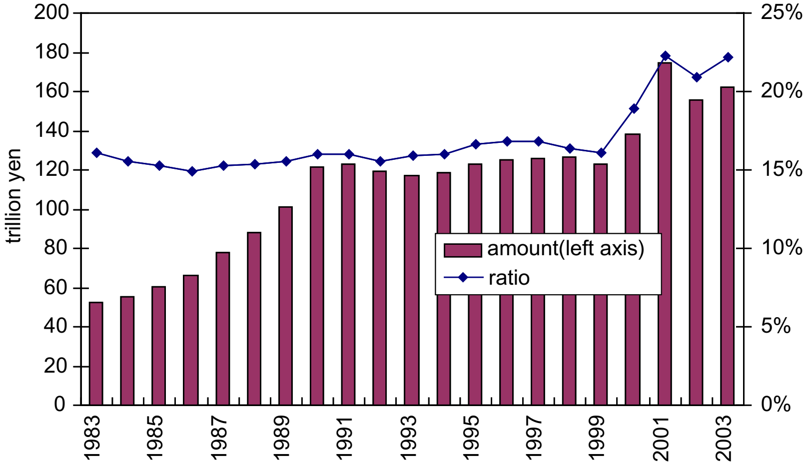

Fig. 1. Securities holdings by Japanese banks. (*Notes*: Reported figures are measured at the end of March. Securities include national government bonds, corporate bonds, and equities. Ratio is defined as Securities divided by total assets. Sample includes all domestically licensed banks since 1994. Before 1994, trust banks that are subsidiaries of security companies and foreign banks are excluded. Source – Bank of Japan.)

environment by increasing bank incentives to maintain adequate capital positions and avoid excessive risk (e.g., Flannery, 1998). There is ample evidence that such market discipline exists among bank bond holders (e.g., Flannery and Sorescu, 1996; Morgan and Stiroh, 2001). Moreover, a number of studies have documented market discipline among uninsured depositors in the United States. Goldberg and Hudgins (2002) find that the share of uninsured deposits declines among failed institutions in the proximity of their failure date. Park and Peristiani (1998) find that holders of large certificates of deposit discipline problem thrifts by moving their assets to other banks or demanding higher interest rates from their troubled bank.

However, the existence of deposit insurance reduces insured depositor incentives to discipline problem banks. Jordan et al. (2000) find that equity holders respond immediately to news concerning enforcement actions, but found only modest declines in deposits. Gilbert and Vaughan (2001) fail to find any evidence of unusual deposit withdrawals or increases in bank interest rate as a result of enforcement announcements. Moreover, Billett et al. (1998) and Jordan (2000) find that banks can mitigate the response that does take place by switching from uninsured to insured deposits.

In this paper, we examine the extent of depositor discipline on Japanese banks in 2001. Japanese equity values fell dramatically during the 2000 fiscal year, as the Nikkei 225 declined 36% from the end of March 2000 through end-March 2001. At the same time, Japanese banks' equity and bond holdings actually increased, both in absolute value and as a share of total assets (Fig. 1). This increase was primarily due to increased holdings of government bonds, which rose from 46 trillion yen in March 2000 to 73 trillion yen in March 2001. Equity holdings changed little over the period, falling from 46 trillion yen to 44 trillion yen.[1]

[1] The other security component, foreign securities, increased from 13 trillion yen to 23 trillion yen.