Accepted Manuscript

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Leonard I. Nakamura, Kasper Roszbach

PII: S1042-9573(17)30068-2
DOI: 10.1016/j.jfi.2017.11.001
Reference: YJFIN 769

To appear in: *Journal of Financial Intermediation*

Please cite this article as: Leonard I. Nakamura, Kasper Roszbach, Credit Ratings, Private Information, and Bank Monitoring Ability, *Journal of Financial Intermediation* (2017), doi: 10.1016/j.jfi.2017.11.001

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Credit Ratings, Private Information, and Bank Monitoring Ability [*,†]

Leonard I. Nakamura
Federal Reserve Bank of Philadelphia

Kasper Roszbach
Norges Bank and University of Groningen

November 24, 2017

Abstract

In this paper, we use credit rating data from two large Swedish banks to elicit evidence on banks' loan monitoring ability. For these banks, our tests reveal that banks' internal credit ratings indeed include valuable private information from monitoring, as theory suggests. Banks' private information increases with the size of loans.

However, our tests also reveal that publicly available information from a credit bureau is not efficiently impounded in the bank ratings: credit bureau ratings predict future movements in bank ratings and improve forecasts of both bankruptcy and loan default.

The inefficiency of bank ratings is greater for smaller loans. We investigate possible explanations for these findings. Our results are consistent with bank loan officers placing too much weight on their private information, a form of overconfidence. Risk analyses of the loan portfolios in our data could thus be improved by combining the bank credit ratings with public credit bureau ratings.

The methods we use represent a new basket of straightforward techniques that enable both financial institutions and regulators to assess the performance of credit rating systems.

Keywords: *monitoring, banks, credit bureau, private information, public information,ratings, regulation, supervision, overconfidence.*

JEL codes: D82, G18, G21, G24, G32, G33

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1 Introduction

How can bank managers, investors, bank regulators, and other stakeholders know whether a bank is a good monitor? This question has become more important since the 2008-2009 financial crisis, during

[*]We are indebted to Elif Sen, Fuyuo Nagayama, Gustav Alfelt, and Ethan Haswell for providing outstanding research assistance and grateful for comments from three anonymous referees, the editor, Bo Becker, Sreedhar Bharath, Martin Brown, Mikael Carlsson, Sonja Daltung, Evren Damar, Hans Degryse, Mark Flannery, Mark Flood, Tor Jacobson, Elizabeth Kiser, William Lang, Steven Ongena, Jose-Luis Peydro, Harvey Rosenblum, Frank Schorfheide, Norman Schürhoff, Daniele Terlizzeze and seminar participants at the University of Zurich, Federal Reserve Bank of Philadelphia, Riksbank, Finansinspektionen, Svenska Handelsbanken, the National Bank of Serbia, the 2008 EEA annual meeting, the Probanker symposium in Maastricht, the Tor Vergata Conference on Banking and Finance, the Federal Reserve System Committee Meeting on Banking, the 2009 ASSA meetings, the 2009 FMA, the 3rd Swiss Winter Conference on Financial Intermediation, the 2010 Chicago Bank Structure conference, the CEPR-EIEF conference on Transparency, Disclosure and Market Disciplines in Banking Regulation, the 2011 Econometric Society European meeting, and the Banque de France Panel Data conference 2012. The views expressed in this paper are solely the responsibility of the authors and should not be interpreted as reflecting the views of Norges Bank, the Executive Board of Sveriges Riksbank, the Federal Reserve Bank of Philadelphia, or the Federal Reserve System. Earlier versions of this paper were titled "Credit Ratings and Bank Monitoring Ability." This paper is available free of charge at www.philadelphiafed.org/research-and-data/publications/working-papers and www.ssrn.com.

[†]Nakamura: Research Department, Federal Reserve Bank of Philadelphia; e-mail: leonard.nakamura@phil.frb.org. Roszbach (on leave from Sveriges Riksbank): Research Department, Norges Bank and Faculty of Business and Economics, University of Groningen; e-mail: kasper.roszbach@norges-bank.no, Roszbach: Research Department, Norges Bank, Oslo, Norway University of Groningen, Faculty of Business and Economics, Groningen, The Netherlands E-mail: kasper.roszbach@norges-bank.no

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