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What determines bank-specific variations in bank stock returns? Global evidence

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ABSTRACT

This paper examines how bank regulation and supervision measures affect the synchronicity of bank stock returns, a measure that is negatively related to variations in bank-specific fundamentals and stock price informativeness. Using data from World Bank surveys in 35 countries, we find that bank stock returns are less synchronous in countries with more stringent capital regulations, more supervision that emphasizes private monitoring, and less government bank ownership. On the other hand, direct government control of bank activities, as well as direct government monitoring and disciplining, do not reduce stock return synchronicity.

1. Introduction

The recent financial crises in the U.S. and other economies demonstrate the inadequate dissemination of bank-specific information to public investors, which degrades the banking system's functionality and its possible contributions to economic growth (Barth et al., 2012b). The crises have spawned

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[1] Part of the work was done when song was a visiting scholar at University of Limoges and an assistant professor of accounting at Michigan Technological University.

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a growing global debate and an academic literature focused on the effective and efficient regulation and supervision of financial firms (e.g., Ivashina and Scharfstein, 2010). A central unresolved issue in the literature on bank regulation and supervision, however, is a sound understanding of the factors that contribute to informational transparency (Barth et al., 2001, 2004a,b, 2006, 2008, 2012b). There is also the question of whether banks ought to pursue more nuanced, firm-specific activities to serve the purpose of allocating capital, which reduces the likelihood of high systematic risks and can also cater to economic dynamism.[2]

In this study, we contribute to this burgeoning literature by empirically investigating which bank regulation and supervision measures affect bank-specific variations in bank stock returns. The premises are that firm-specific stock return variations reflect both firm-specific variations in fundamentals resulting from firms pursuing idiosyncratic strategies (Chun et al., 2008) and price recovery of firm value based on informed risk arbitrage (Grossman and Stiglitz, 1980; Morck et al., 2000; Morck et al., 2013a,b). Bank regulation and supervision may restrict the intrinsic variations of bank activities across banks. In addition, bank regulation and supervision may affect the stability, corporate governance standards, and information transparency of the banking system, which all affect investors' cost-benefit balance of collecting bank-specific information (Ferreira and Laux, 2007; Jin and Myers, 2006; Morck et al., 2000).

We therefore explore the relationship between several bank regulation and supervision measures and asynchronous bank stock returns. These bank regulation and supervision measures are broadly classified into two types. The first type comprises direct controls, which include activity restrictions, direct monitoring and disciplining from supervisory agents, and state ownership. The second type comprises market empowering and protecting measures, which include capital stringency and supervisory approaches that encourage private monitoring of banks. We obtain bank regulation and supervision data for 35 countries from World Bank surveys released in 2001, 2003, 2007, and 2011, which perhaps accurately reflect the situation for each country at the end of 1999, 2002, 2005, and 2010 (Barth et al., 2008, 2012a,b). We use these variables to explain bank stock return synchronicity based on 2000, 2003, 2006, and 2011 data.

Our empirical work sheds light on the differential effect of these two broad approaches on bank-specific stock return variations. For direct controls, we do not find regulatory restrictions on bank activities and direct supervisory power significantly affect bank stock return synchronicity. Indeed, higher government direct ownership is even associated with subsequent greater synchronicity. However, market empowering measures (stringent capital regulations and empowering of private monitoring power) are associated less synchronized bank stock returns.

These results may suggest that direct government controls, like restrictions on bank activities and high government supervisory power, confine banks to follow similar behavior and act according to macroeconomic conditions. Thus, bank stock returns do not exhibit lower level of synchronicity. Direct government involvement in banking in the form of state ownership raises the synchronicity in a bank's stock return suggests that government-owned banks have more agency and information asymmetry problems, which reduce investors' incentives to collect private information and conduct informed risk arbitrage. In addition, these results may suggest that banks are following government macroeconomic policies more closely (Morck et al., 2013a,b). The consequence is less firm-level variations in bank fundamentals and thus their stocks' returns.

On the other hand, market empowering measures increase corporate governance in banks, which increases the benefits investors obtain from collecting and incorporating bank-specific information into bank stock prices. In addition, because of heightened market discipline, managers may be less likely to enjoy a quiet life and more likely to undertake firm specific innovations. This leads to more bank-specific variations in fundamentals. Also, high level of market protecting measures induces investors' confidence in the banking system (Berger et al., 1995) and thus induces them to conduct more informed risk arbitrage on banks.[3] All these lead to high level of firm specific stock returns.

[2] On firm specific activities and capital allocation, see Morck et al. (2013a,b).

[3] Investors would not want to conduct informed risk arbitrage in a market in which fundamentals are too volatile because fundamental values may change unfavorably while the investors are waiting to sell.