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How to get banks to take less risk and disclose bad news [☆]



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ABSTRACT

There is wide agreement that before the recent financial crisis, financial institutions took excessive risk in their investment strategies. At the same time, regulators complained that banks did not reveal the extent of their difficulties in a timely fashion thus reducing the effectiveness of government intervention to prevent or mitigate the deleterious effects of the financial crisis. The purpose of this paper is to investigate how regulators can best use certain tools at their disposal to motivate banks to take less risk and to provide adverse information to regulators early. We argue that two tools, namely (i) allowing bank payouts to equity holders even when banks report they are in trouble and (ii) constraining banks' future investment strategy when they are in trouble can achieve both goals. We show that, in some cases, it is optimal to use both of these tools in combination. That is, in such cases it is optimal to allow equity payouts when banks report they are in trouble, even though such payouts increase the incentive for banks to take excessive risk and even though these payments are financed by taxpayers. We also show that the more socially costly is constraining the bank's portfolio selection or the more complex are the bank's assets, the more likely it is that allowing larger payouts and fewer constraints is optimal. Finally we discuss how changes

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in bank capital requirements interact with inducing disclosure and preventing excessive risk taking.

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1. Introduction

It has been widely claimed that the recent financial crisis was caused, or at least exacerbated, by excessive risk-taking by banks and that the financial crisis contributed to the subsequent recession. Banks were taking excessive risk, the argument goes, because by increasing risk banks could increase the value to their stockholders of implicit government guarantees. Essentially, this is a version of the well-known asset substitution problem. When housing prices fell, banks became financially distressed. The government, fearing a cascade of defaults by banks, indeed stepped in and rescued banks that were thought to be “too big to fail,” i.e., those that were large enough for such defaults to have systemic consequences.

These events naturally led to a reexamination of existing regulatory systems that did not prevent the crisis. One result was the Dodd-Frank Wall Street Reform and Consumer Protection Act, one of whose goals is to curtail risk taking by banks. At the same time, regulators complained that banks did not reveal the extent of their difficulties in a timely fashion thus reducing the effectiveness of government intervention to prevent or mitigate the deleterious effects of the financial crisis. For example, early intervention by regulators may prevent bank runs and mitigate systemic losses caused by the refusal of banks to lend.¹

The purpose of this paper is to investigate how regulators can best use certain tools at their disposal to motivate banks to take less risk and to provide adverse information to regulators early. The regulatory tools we consider are (i) allowing bank payouts to equity holders even when banks report they are in trouble (the “carrot”) and (ii) constraining banks’ future investment strategy when they are in trouble (the “stick”).² We choose these tools for two reasons. First, they are relatively unexplored in formal analyses. Second, to the extent that allowing equity payouts has been discussed in the public policy debate, it has been widely condemned.³

Obviously, our model must include an incentive for banks to take excessive risk, a reason for the regulator to want to prevent this behavior and the ability to reduce it, private information on the part of banks about future solvency, a reason why banks are reluctant to disclose bad news, and a social benefit from early disclosure by banks when they are in trouble. We include these elements in a simple model that includes a bank and a regulator. Each period, the bank chooses an investment portfolio strategy. The bank’s equity holders have an incentive to choose an excessively risky strategy due to leverage, i.e., asset substitution. The regulator wants to prevent such risk taking, because there are social costs of bank failure. These are due partly to the inefficiency of excessive risk taking and partly to the increased risk of bank default that may cause a cascade of counterparty defaults resulting in financial crises of the sort just witnessed. The social benefit from early disclosure is that it enables the regulator to prevent payouts to equity holders when the bank is in trouble.⁴ This, however, gives

¹ It is clear from personal communication with regulators that they believe that banks did not reveal information in their possession in a timely fashion and that, had the banks done so, regulatory intervention would have been more effective. Some empirical evidence that banks had information that they did not disclose is provided by [Ryan et al. \(2013\)](#) which shows that there was an unusually high volume of bank-insider sales in late 2006 and that this activity was positively associated with banks’ write-down of securitization-related assets after the onset of the crisis. Evidence that more timely corrective regulatory action improves its effectiveness is provided by [Agarwal et al. \(2012\)](#).

² Although a full analysis of optimal regulation is beyond the scope of this paper, we comment on some other tools below.

³ For example, after the recent loss of several billion dollars by J.P. Morgan Chase, Simon Johnson said “I would be shocked [if the Fed does not stop the capital payouts],” referring to the billions of dollars the Fed allowed Chase to pay to equity holders as a result of passing an earlier stress test (see “SEC Opens Review of J.P. Morgan,” [WSJ.com](#), May 11, 2012).

⁴ In earlier versions of the paper, we also assumed that early disclosure enabled the regulator to reduce the social cost of bank failure, but this additional element does not add much to the results. It has been dropped in the current version to simplify the exposition.

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