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Short Communication

Size and support ratings of US banks[☆]



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ABSTRACT

We examine whether Fitch support ratings of US banks depend on bank size. Using quarterly data for the period 2004:Q4 to 2012:Q4 and controlling for several factors that make large and small banks different, we find that bank size is positively related to support ratings. However, the effect is non-linear in line with the ‘too-big-to-rescue’ hypothesis. After the failure of Lehman Brothers and the passing of Dodd-Frank the relation between size and potential support has become stronger.

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1. Introduction

We examine whether Fitch support ratings of US banks depend on bank size. According to the Fitch website, external support ratings “do not assess the intrinsic credit quality of a bank. Rather they communicate the agency’s judgment on whether the bank would receive support should this become necessary. These ratings are exclusively the expression of Fitch Ratings’ opinion even though the principles underlying them may have been discussed with the relevant supervisory authorities and/or owners.”¹

Fitch does not provide details about their rating methodology, but it seems likely that size plays a crucial role. As pointed out by [Boyd and Runkle \(1993\)](#), failure of a large bank is supposedly more feared by supervisors than failure of a small bank, due to possible macroeconomic externalities. Therefore,

[☆] The views expressed in this paper are those of the authors and do not necessarily reflect the official positions of the IMF or De Nederlandsche Bank.

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¹ See: https://www.fitchratings.com/jsp/general/RatingsDefinitions.faces?context=5&detail=505&context_In=5&detail_In=500.

it is more likely that large banks will receive government support if needed. Banks that are ‘too-big-to-fail’ (TBTF) receive a *de facto* government guarantee, which will be reflected in their riskiness as perceived by creditors (see Strahan, 2013 and Kroszner, 2013 for reviews of the TBTF literature). In addition, TBTF financial institutions can attract deposits at rates that do not reflect the risks otherwise inherent in their operations (Jacewitz & Pogach, 2014). However, some recent studies have pointed out that banks may also be ‘too-big-to-be-rescued’. Demirgüç-Kunt and Huizinga (2013) report that banks’ CDS spreads are negatively related to the fiscal balance of the government in the banks’ home country. Arguably, countries with sound public finances can spend more on bank bailouts resulting in lower losses on bank liabilities (hence lower CDS spreads). Similarly, Correa, Lee, Sapriza, and Suarez (2014) report that sovereign rating changes have a significant, non-linear and robust impact on bank excess stock returns. This effect is stronger for sovereign downgrades than for upgrades. Their results suggest that banks with more government support before the rating event tend to experience a significantly larger fall in excess stock returns. In view of these studies, we test for a non-linear relationship between bank size and external support ratings.

According to Kroszner (2013) and Strahan (2013), perceptions of government support have varied considerably over time. We therefore examine whether the impact of size on external support ratings has changed since the failure of Lehman Brothers² and the passing of the Dodd-Frank law, which has set in motion reforms that may have ended TBTF expectations.

The paper that comes closest to our analysis is Ueda and Weder di Mauro (2013) who estimate the value of the TBTF subsidy using expectations of government support embedded in credit ratings. Their results suggest that, on average, banks in major industrial countries enjoyed credit rating bonuses of 1.8–3.4 in 2007 and 2.5–4.2 in 2009. These uplifts in credit ratings can be translated into a funding cost advantage of some 60–80 bp. Our paper differs from this study as we focus on US banks, and examine whether the relationship between bank size and external support ratings is (1) non-linear in view of the ‘too-big-to-rescue’ argument, and (2) time-varying in view of attempts to end TBTF expectations.

The remainder of the paper is structured as follows. The next section discusses related literature. Section 3 outlines our methodology and Section 4 describes our data. Section 5 discusses our results. The final section concludes.

2. Related literature

Our paper is related to three strands of literature. This section outlines the main issues in these studies and explains how our paper contributes.

First, several studies have examined the impact of bank size on bank risk. Arguably, larger banks are better diversified. However, Demsetz and Strahan (1997) report that large bank holding companies are not less risky than small bank holding companies, as large banks use their diversification advantage to work with lower capital ratios and to pursue riskier strategies. In line with this argument, DeYoung and Roland (2001) report that fee-based activities are associated with increased earnings volatility. Also Stiroh (2004, 2006b) and de Haan and Poghosyan (2012) find that a greater reliance on non-interest income is associated with more volatile returns. As pointed out by Stiroh (2006a), a shift into new activities affects the portfolio variance by changing the weights on the components and by introducing a diversifying covariance. Apparently, the higher reliance on relatively volatile non-interest activities outweighs the diversification benefits. Motivated by this line of research, we include leverage, several proxies for risk, and diversification (proxied by the share of non-interest income in total income of banks) as controls in our regressions.

Second, several papers have examined the importance of economies of scale. Arguably, banks can benefit from scale economies because the credit risk of their loans and financial services and the liquidity risk of their deposits become better diversified, thereby reducing the cost of managing these risks and allowing banks to conserve equity capital as well as reserves and liquid assets. Furthermore,

² On the one hand, the fact that US authorities were not willing to rescue Lehman Brothers may have led to a downward re-assessment of the link between size and external support ratings. On the other hand, the failure of Lehman Brothers has also made it clear that it is very costly to let a large bank fail, due to its interconnectedness (Strahan, 2013). This experience may have reinforced the impact of size on external support ratings.

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