



National bank window dressing and the call loan market, 1865–1872



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ABSTRACT

After the American Civil War, market observers attributed increases in interest rates around quarterly reporting dates to window dressing by national banks. Window dressing is a temporary change in portfolio designed to produce a more appealing report to regulators or to the public. This paper tests for increases in interest rates at quarter end under a natural experiment, a change in the reporting law. Using daily data on the call loan interest rate in New York City, we find no evidence of systematic increases in the call loan rate just before the quarterly reporting dates of national banks.

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1. Introduction

Banks and other financial institutions submit data about their condition to regulators on specific dates. To fulfill regulatory obligations or to impress shareholders or counterparties, banks might be motivated to appear larger or more financially stable in these reports. In particular, banks could engage in transactions around the reporting date that temporarily improve the financial condition of the bank. This behavior is known as window dressing, a temporary change in portfolio designed to produce a more appealing report to regulators or to the public.

Window dressing decreases the accuracy of reported information. Both academic economists and government regulators use historical data on balance sheet information to test hypotheses about the bank industry and to prescribe policy. In the presence of window dressing, bank statistics submitted to regulatory authorities systematically mismeasure benchmark portfolios, so subsequent academic work that relies on self-reported bank data could overestimate benchmark series. In particular, [Friedman and Schwartz \(1970, p. 212–213\)](#) state that window dressing may cause academic economists to overestimate historical banking reserves, thus leading to inaccurate measures of the money supply. Studies of banking crises rely on reports that are vulnerable to

window dressing. Further, investors in financial intermediaries may be less able to discipline firms by monitoring when management manipulates reports.

Modern bank regulators show concern about window dressing. Due to potential window dressing that occurred before and during the most recent financial crisis, the SEC recently considered proposals that would decrease the ability of public companies to window dress balance sheets ([SEC, 2010](#)). Over the past several years, large financial companies have shed short-term borrowing on quarterly reporting dates ([Kelly, McGinty, & Fitzpatrick, 2010](#)). [Owens and Wu \(2011\)](#) provide evidence that large bank holding companies decreased short-term borrowing around the reporting date to appear less levered. In addition, the Repo 105 transaction by Lehman Brothers temporarily decreases borrowing on the balance sheet ([Chang, Duke, & Hsieh, 2011](#)). The SEC has considered reinstating a requirement that public companies record average levels of borrowing between quarters.

Modern academic research investigates window dressing by banks. [Johnson \(1969\)](#) describes tactics taken by commercial banks in the 1960s. After presenting a brief theory and outlining potential motivations for window dressing, [Allen and Saunders \(1992\)](#) highlight window dressing assets upwards. Allen and Saunders document a quarter-end increase in asset levels (specifically federal funds and repos) by banks from 1978 to 1986 as well as a corresponding increase in the federal funds rate of about 22 basis points before the reporting dates. Allen and Saunders claim that banks increased assets so as to appear larger. For example, bank officers

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may obtain higher salaries from managing larger, more prestigious banks. [Yang and Shaffer \(2010\)](#) update the results of Allen and Saunders for the post-2000 period and observe that large banks continue to upward window dress total assets. Using individual bank transactions, [Furfine \(2004\)](#) shows foreign banks pay higher interest rates to lend to U.S. commercial banks around year end reporting dates in order to display a safer lending portfolio. Window dressing could take place in other money markets as well. For example, [Musto \(1997\)](#) argues that discount yields increase on commercial paper maturing across the turn of the year due to window dressing by portfolio managers.

However, other authors point to alternate hypotheses that could explain increases in interest rates around the reporting dates. [Kotomin and Winters \(2006\)](#) argue that a preferred habitat for liquidity explains increases in the interest rate at quarter end. In the preferred habitat theory, corporations (clients of the banks) require demand deposits at the turn of the quarter to fulfill transactions, such as payroll, dividend payments, or corporate debt service. The additional demand for cash decreases the price of financial assets and increases the interest rate. Since bank reporting requirements are roughly coincident with the beginning of the quarter, an increase in interest rates at the end of the quarter could also be explained by the preferred habitat theory. Kotomin and Winters model the federal funds rate from 1994 to 2002 and find that interest rates rise 34 basis points at the end of the quarter and then fall over the first two days of the quarter. They argue that it should not take two days for the federal funds rate to return to normal levels at the start of the new quarter because banks should quickly reverse window dressing transactions. Similarly, [Griffiths and Winters \(2005\)](#) find that yields on one-month instruments such as CDs and eurodollar deposits increase before the end of the year when firms or investors would rather hold cash, but that the premium falls to zero just before year end. Turning to weekly balance sheets, [Kotomin and Winters \(2006\)](#) also describe how reducing an increase in transactions deposits on bank balance sheets at the quarter end may take as long as a week, which is inconsistent with window dressing as a temporary change in portfolio that should be reversed immediately after the turn of the quarter. Kotomin and Winters suggest that a preferred habitat better explains the longer duration of changes around quarter end dates than bank window dressing.

To account for alternate explanations of window dressing, we take advantage of a change in the reporting procedure. Regulators and newspaper columnists accused national banks of window dressing just after the American Civil War. Under the National Bank Act of 1864, all national banks submitted balance sheets to the Comptroller of the Currency on the first Monday of each quarter. Since banks knew when their balance sheets would be inspected, banks could accumulate additional reserves or curtail lending to appear more financially sound on the reporting days. Just as with modern institutions, banks faced similar incentives to improve balance sheets temporarily around the reporting dates. Using balance sheet data, [Hoag \(2015\)](#) suggests that banks did window dress their balance sheets in the 1860s by increasing reserves by about 6% in the aggregate in one U.S. city, Philadelphia. To prevent window dressing, Congress changed the way national banks reported their balance sheets to regulators in March 1869. The 1869 amendment directed the Comptroller of the Currency to call five times a year for reports of previous dates of his choice. Congress intended that the new reporting procedure would eliminate the incentive for banks to window dress their balance sheets. If banks did not know when the Comptroller would call for reports, then the banks could not temporarily improve their balance sheets.

The change in the reporting law allows a natural experiment. Before the change in the law, banks reported their balance sheets on the first Monday of the quarter. These reports could involve both

window dressing and the preferred habitat for liquidity. After the change in the law, reporting dates no longer fell on fixed quarter end dates. But we can examine counterfactual quarter end dates when the reports would have fallen after the change in the law if the reporting procedure had remained constant. Interest rates on these quarterly dates after the change in the law would no longer be subject to window dressing, but still could be related to preferred habitat behavior. Therefore, we can compare the interest rate before the change in the law to the interest rate after the change in the law on dates when the quarterly reports would have occurred under the old law. If window dressing was a problem, we would expect higher interest rates before the change in the law, even after controlling for preferred habitat.

The historical episode is relevant to the modern inquiry into window dressing. The nineteenth century data possess the advantage that the experimental design controls for preferred habitat behavior. The cleaner test merits interest from modern scholars. Even in a circumstance where preferred habitat cannot mask window dressing behavior, we still do not see any effect of window dressing on the money market. According to economic theory, financial institutions, both then and now, have an incentive to improve their appearance on the reporting dates. In fact, the literature review above suggests that scholars have identified possible evidence for window dressing behavior in every decade from the 1960s onward. Even though bank regulation has become more complicated and sophisticated, the basic motivation to present improved reports has not changed. In particular, since national banks were not protected by deposit insurance in the late 1860s, national banks had an incentive to convince depositors of their soundness by manufacturing safer or more fiscally conservative reports.

We investigate the money market just after the American Civil War for evidence of window dressing. We focus on a particularly liquid money market, the call loan market in New York City. Call loans are demand loans on collateral security. If banks accumulated reserves or slowed lending around fixed reporting dates to improve financial stability, this action would contract the money supply. Therefore, bank window dressing would lead to an increase in interest rates around the reporting dates before the change in the law. The window dressing motivation to increase interest rates around the beginning of the quarter would be absent after the change in the law. Using data on the call loan market in New York City during the period 1865–1872, we find no evidence that interest rates increased two days before quarterly reporting days. That is, the data do not reveal systematic increases in interest rates two days before the reporting date. In addition, market participants experience a slight preferred habitat for liquidity during this period.

The remainder of the paper is organized as follows. Section 2 documents historical descriptions of bank window dressing. Section 3 outlines the advantages of the historical natural experiment. Section 4 describes the data. Section 5 outlines the test that will be performed. Section 6 details the econometric results. Section 7 concludes.

2. History

The chief regulator of the national banks noted the tendency of national banks to window dress their balances sheets. The Comptroller of the Currency, H. R. Hulburd, who was responsible for oversight of the National Banking System, stated in his 1867 Report that ([Office of the Comptroller of the Currency, 1867](#), p. vii):

... It is known, understood, and anticipated, by all who have dealings with the banks, that they are in the habit of preparing systematically for making creditable exhibits on quarter day.

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