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Market discipline across bank governance models: Empirical evidence from German depositors☆

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ABSTRACT

German savers are renowned for preferring safe, long-term investments, thus providing patient capital, with bank deposits playing an important role. Based on a unique data set for the period 2003–2012, thus covering the financial crisis, our empirical findings do not confirm this hypothesis but reveal instead that market discipline is prevalent throughout the entire period of observation. Hence, the financial crisis did not provoke major behavioral changes. Moreover, depositors' alertness was not silenced by a government guarantee of all deposits issued after the Lehman collapse. However, the strength and type of market discipline vary across governance structures, with savings banks' and cooperative banks' depositors significantly more active than depositors with commercial banks.

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1. Introduction

The role of market discipline has been receiving increasing attention from researchers and policymakers alike in the light of the recent financial crisis. Market discipline constitutes a form of self-regulation exercised by purchasers of financial services in order to punish the behavior of sellers that impose a cost on the buyers for which they have not been compensated (Berger, 1991). Following Rochet (2008), Flannery (2001), and Kwast et al. (1999), the value of market discipline exercised by banks' creditors results from its disciplining management decisions toward choosing lower-risk projects. Notably, current research on the role of and outlook for market discipline focuses on well-informed financial investors rather ignoring small savers among which depositors are an important group. One possible explanation points to existing deposit insurance schemes which might be taken by depositors as a welcome relief from performing otherwise necessary but cumbersome monitoring tasks (Dewatripont & Tirole, 1994). As has also been shown, however, deposit insurance schemes may incentivize bank managers to take excessive risks, which if exercised on a large scale might pose a serious threat to the stability of the entire banking system (Kim & Santomero, 1988). Deposit insurance schemes, however, are not prepared to provide sufficient protection from losses once systemic risks have materialized. As will be described in more detail in Section 2, empirical studies exist which confirm market discipline irrespective of existing deposit insurance schemes for a considerable number of countries. However, to the best of our knowledge no such study exists for Germany. The German financial system has a tradition of bank orientation characterized by stable relationships between depositors and their "housebanks".[1] Prior transportation of the European directive[2] into German law in 1998, deposit insurance in Germany rested by and large on informal guarantees given by the banks themselves but leaving a depositor

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[1] In Germany, a bank with which a depositor has a close relationship (for instance it transacts with this bank) is called housebank.

[2] 94/19/EC: CELEXNo. 394L0019; 97/9EC: CELEX No. 397L0009; 2009/14/EC: CELEX No. 309L0014.

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without any formal and judicially enforceable claim in the event of a bank failure. This lack of legal entitlements notwithstanding, German depositors have come to be regarded as "lazy" managers of their wealth (Größl, von Lüde, & Fleck, 2013), providing large amounts of patient capital to their housebanks. Whether the outbreak of the financial crisis in 2008 put a limit to this patience is difficult to tell because German Chancellor Angela Merkel and her then-Finance Minister Peer Steinbrück reacted promptly to the Lehman Brothers failure by proclaiming an unlimited government guarantee of all deposits ("Merkel–Steinbrück guarantee"). On the whole, however, it must be recognized that the concept of German depositors as lazy managers of their wealth remains a hypothesis which still has to be proved empirically. Not only in the face of the financial crisis but also amid ongoing changes within the German banking system in a globalizing financial world, a comprehensive study of the behavior of German depositors appears overdue. Evidence on this point is important above all because, inasmuch as German savers have never been that lazy or have become more sensitive at least in the aftermath of the financial crisis, they too would contribute to the self-regulation of the banking system.

Before we embark on an empirical investigation into the existence of market discipline among German depositors, we need to take into account a key feature of the German banking system, namely the parallel existence of different bank governance models based on different ownership structures which, in turn, are closely related to the existence of three pillars. Whereas in particular large banks belonging to the group of credit banks[3] are organized as stockholding companies, cooperative banks are owned by their members and hence by their depositors. Savings banks and Landesbanken have multiple obligations: they operate under public law, giving priority to the economic well-being of the region in which they are based, and are also fully liable for their debt. [4]

The fact that ownership structures have a significant impact on a firm's governance model has been confirmed by a large body of literature,[5] with firms' risk tolerance and risk management receiving the most attention. Hence we would expect that the existence as well as the type of market discipline will depend on the governance model of the chosen housebank. Furthermore, it is likely that deposit insurance would translate into different risk attitudes and risk management strategies depending on the specific governance structure. We would also, for example, expect depositors of banks with a higher risk tolerance to also display greater willingness to punish their banks for bad behavior. It is noteworthy in this respect that the three banking groups briefly introduced above differ in their activities to ensure the safety of deposits beyond risk management on the individual bank level. For the group of credit banks, what stands out is that deposit insurance is organized as a cooperative institutional arrangement among otherwise competing banks. By contrast, both the group of savings banks as well as cooperative banks represent risk-sharing networks among non-competing credit institutions with the aim to ensure the existence of each member bank as well as the sustainability of the network as a whole. Hence deposit insurance here constitutes only one element of ensuring the safety of deposits alongside a complex net of measures meant to avoid member banks' failures while avoiding moral hazard. Concerning the group of savings banks public ownership adds a further safeguard, and the prompt rescue of failing Landesbanken by their respective owners might have blurred the abandonment of a state liability in the eyes of depositors. Taking all this together, we would expect to find that market discipline is more pronounced for the group of depositors of credit banks than of cooperative and savings banks. We would furthermore expect greater market discipline among depositors of cooperative banks than among depositors of savings banks.

The purpose of this paper is to investigate, using an empirical study, to what extent German depositors exercise market discipline in the first place, and if so, whether the specific governance structures have a visible impact which explains differences between banking groups in terms of depositors' behavior. Our particular interest lies in the role of the financial crisis. As examples of disciplining measures exercised by depositors intended to incentivize managers to switch to lower-risk projects, we examine whether depositors switch to deposits with shorter maturities and/or claim higher interest rates as a consequence of their bank's increased risk-taking. In order to answer these questions, we conduct an empirical analysis by applying panel regression techniques to empirically examine the German banking system; here, we use a unique data set provided by the Deutsche Bundesbank which combines MFI interest rate statistics, balance sheet statistics, and the supervisory database.

Our paper aims to contribute to the literature on market discipline by depositors and on the relationship between banks' risk-taking behavior and governance structures. By and large, the existing literature concentrates on the role of deposit insurance for market discipline while broadly ignoring the impact of governance models. On the other hand, papers dealing with the impact of governance on risk-taking largely disregard market discipline by depositors.[6] The main contribution of our paper relates to examining the interaction between market discipline, regulation, and bank governance conducting an empirical analysis of the German banking sector which appears as particularly suitable to study a variety of bank governance models.

The remainder of the paper is organized as follows. Section 2 reviews the theoretical and empirical literature. Section 3 presents the major characteristics of the German banking system relating to depositors' safety and Section 4 describes the applied data set. Section 5 is dedicated to the presentation of the empirical analysis. Section 6 concludes the paper.

2. Literature review

Though representing a debtor–creditor relationship, a standard deposit contract differs from what we define as a standard debt contract (Diamond, 1984; Williamson, 1986). Firstly, depositors have the right to exit at negligible or no cost. Secondly, prevailing deposit insurance schemes signal that the safety of the depositor's claim is at least partly separated from the respective bank's risk behavior. Whether depositors consider these features as a relief of any obligation to monitor and punish their banks for bad behavior, has been the topic of numerous empirical investigations.

Concerning the behavior of US depositors market discipline was found for uninsured deposits (Baer & Brewer, 1986; Calomiris & Wilson, 1998; Ellis & Flannery, 1992; Goldberg & Hudgins, 1996; Hannan & Hanweck, 1988; Hosono, 2004) as well as for insured deposits (Baer & Brewer, 1986; Cook & Spellman, 1994; Maechler & McDill, 2006; Park & Peristiani, 1998). Crabbe and Post (1994) show that the intensity of punishments turns out to be less severe if deposits are insured. Sanctioning mechanisms encompassed higher interest rates, deposit withdrawals, restructurings towards insured deposits as well as distressed banks' difficulties in attracting new

[3] We use the terms "credit banks" and "commercial banks" interchangeably.

[4] Full liability is a direct consequence of the Brussels Concordance of 2002 which restricts public ownership in these banks to the binding of their objectives to public interests.

[5] For basic contributions see Jensen and Meckling (1976) and Shleifer and Vishny (1997). A more recent survey is provided by Singh and Davidson (2003).

[6] Hughes and Mester (2012) discuss market discipline in the context of the market for corporate control.

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