Financial Intermediaries and Markets at the Cross Roads: Economic and Legal Perspectives on Financial Stability, Liquidity and Corporate Control

Program

September 26-27, 2008
Hotel Hilton Royal Parc Soestduinen

Friday September 26, 2008

Session I Incentives within banks

Chair: Kee Hong Bae (Schulich School of Business)

9:00 - 9:45 ***Optimal Credit Risk Transfer, Monitored Finance, and Banks***
Gabriella Chiesa, University of Bologna

Abstract

We examine the implications of optimal credit risk transfer (CRT) for bank-loan monitoring, and the incentives for banks to engage in optimal CRT. In our model, properly designed CRT instruments allow banks to insure themselves against loan losses precisely in those states that signal monitoring. We find that optimal CRT enhances loan monitoring and expands financial intermediation, in contrast to the findings of the previous literature. Optimal CRT instruments are based on loan portfolios rather than individual loans and have credit enhancement guarantees, pretty much as banks do in practice. But the extent of credit enhancement needs to be precisely delimited. Above that exact level, monitoring incentives are undermined (loan quality deteriorates) and wealth is transferred from the bank's financiers to the bank. Properly designed risk-based capital requirements are shown to prevent such a wealth transfer and to provide banks with the incentive to engage in optimal CRT.

Discussant: Wolf Wagner (Tilburg University)

9:45 - 10:30 ***The Effect of CEO Stock Options on Bank Investment Choice, borrowing, and Capital***
Hamid Mehran (Federal Reserve Bank of New York)
Joshua Rosenberg (Federal Reserve Bank of New York)

Abstract

In this paper, we test the hypothesis that granting CEO stock options motivates CEOs of banking firms to undertake riskier projects. We also investigate whether CEO stock option holdings reduce the bank's incentive to borrow while inducing a build up of regulatory capital. Using a sample of 549 bank-years for publicly-traded banks from 1992-2002, we find evidence that equity volatility (total and residual) as well as asset volatility increases as CEO stock option holdings increase. In addition, it appears that grants of CEO stock options motivate banks to reduce their use of debt as evidenced by lower levels of interest expense and federal funds borrowing. Furthermore, we show that banking firms that grant more options to their CEOs build up more capital in future years.

Discussant: Riccardo Calcagno (VU University, Amsterdam)

10.30 - 10.45 Break

Session II Hedge Funds

Chair: Stefan Arping (University of Amsterdam)

10.45 - 11:30 ***Share Restrictions, Liquidity Premium and Offshore Hedge Funds***

Bing Liang (University of Massachusetts, Amherst)
Hyuna Park (Minnesota State University, Mankato)

Abstract

This paper examines liquidity premium in the hedge fund industry focusing on the difference between offshore and onshore hedge funds. Due to tax provisions and regulatory concerns, offshore and onshore hedge funds have different legal structures, which lead to differences in share restrictions such as a lockup provision. We find that offshore investors collect higher illiquidity premium when their investment has the same level of share illiquidity as the investment of onshore investors. Introducing a lockup provision increases the abnormal return by 4.4% per year for offshore funds compared with only 2.7% for onshore funds during the period of 1994-2005. We argue that the difference is explained by the stronger relationship between share illiquidity and asset illiquidity in offshore hedge funds. We also find that the benefit of offshore investors is maximized when they invest in offshore hedge funds that are not affected by onshore funds through a master-feeder structure.

Discussant: Casper de Vries (Erasmus University Rotterdam)

11:30 - 12:15 ***A Law and Finance Analysis of Hedge Funds***

Douglas Cumming (York University)

Abstract

This paper empirically analyzes the impact of hedge fund regulation on fund structure and performance using a cross-country dataset of 2137 hedge funds from 24 countries. The data indicate regulatory requirements in the form of restrictions on the location of key service providers and restrictions that enable distributions via wrappers tend to be associated with lower manipulation-proof performance measures, lower fund alphas, lower average monthly returns (as well as lower Sharpe ratios), higher fixed fees and lower performance fees. Also, the data show standard deviations of monthly returns are lower among jurisdictions with restrictions on the location of key service providers and higher minimum capitalization requirements.

Discussant: Donato Masciandro (Bocconi University)

12.15 - 13.45 Lunch

Session III Financial sector regulation

Chair: Joseph McCahery (University of Amsterdam)

13.45 - 14.30 ***Solvency Regulation and Credit Risk Transfer***

Vittoria Cerasi (Milano-Bicocca University)
Jean-Charles Rochet (Toulouse University)

Abstract

This paper analyzes the optimality of credit risk transfer (CRT) in banking. In a model where banks' main activity is to monitor loans, we show that a combination of CRT instruments, loan sales and credit derivatives, might be optimal to insure banks against shocks and to optimally redeploy capital when new investment opportunities arise, without impairing incentives. We derive implications for the optimal design of capital requirements.

Discussant: Stefan Arping (University of Amsterdam)

14:30 -15:15 ***The Procyclical Effects of Basel II***

Rafael Repullo (Centro de Estudios Monetarios y Financieros (CEMFI))
Javier Suarez (Centro de Estudios Monetarios y Financieros (CEMFI))

Abstract

We analyze the cyclical effects of moving from risk-insensitive (Basel I) to risk-sensitive (Basel II) capital requirements in the context of a dynamic equilibrium model of relationship lending in which banks are unable to access the equity markets every period. Banks anticipate that shocks to their earnings as well as the cyclical position of the economy can impair

their capacity to lend in the future and, as a precaution, hold capital buffers. We find that the new regulation changes the behavior of these buffers from countercyclical to procyclical. Yet, the higher buffers maintained in expansions are insufficient to prevent a significant contraction in the supply of credit at the arrival of a recession. We show that cyclical adjustments in the confidence level behind Basel II can reduce its procyclical effects without compromising banks' long-run solvency.

Discussant: Lev Ratnovski (International Monetary Fund)

15.15 - 15.30 Break

Session IV Arranger Certification

Chair: Douglas Cumming (Schulich School of Business)

15.30 - 16.15 ***Arranger Certification in Project Finance***

Stefano Gatti (Bocconi University)
Stefanie Kleimeier (Maastricht University)
William Megginson (Thew University of Oklahoma)
Alessandro Steffanoni (Interbanca)

Abstract

Though highly plausible, empirical research has yielded ambiguous evidence of third-party certification in capital market financings, due to confounding influences and multiple impacts. We examine certification by lead arrangers of project finance (PF) syndicated loans, because PF vehicle companies are stand-alone entities, created for a single purpose, with all valuation impacts contained in the project financing package. Using a sample of 4,122 project finance loans, worth $769 billion, arranged between 1991 and 2005, we show that certification by prestigious lead arranging banks creates economic value by reducing overall loan spreads compared to loans arranged by less prestigious arrangers, and by allowing larger and more highly leveraged PF deals to be funded. Banks participating in these loan syndicates, rather than the project sponsors, are the parties that pay for certification, and do so by allowing top-tier arrangers to keep larger fractions of the up-front arranging fees.

Discussant: Nadia Massoud (Schulich School of Business)

16:15 -17:00 ***Bank Reputation in the Private Debt Market***

Joseph McCahery (University of Amsterdam)
Armin Schwienbacher (University of Amsterdam and Université catholique de Louvain)

We examine the impact of lead arranger's reputation on the design of loan contracts such as spread, fees and the inclusion of restrictive covenants. We evidence that the loan market differs from the public bond market in many ways. Among other things, it seems to be much more concentrated, in particular the last few years. Controlling for the non-randomness of the lender-borrower match (self-selection bias), we find that reputation of top tier arrangers leads to higher spreads, and that top tier arrangers retain larger fractions of their loans in the syndicate. These larger spreads are especially pronounced for borrowers without credit rating that have most to gain from top tier arranger certification. Top tier arrangers are able to select the best deals and thereby sell smaller portions of their loans to junior banks by negotiating better terms with borrowers. This is consistent with the market power hypothesis for more established banks, but not the signaling hypothesis for which empirical support has been found in public markets (Fang, 2005). Interestingly, the effect is strongest for transactions done after changes in banking regulations (including the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994) that led to significant consolidations in the banking industry, also among the largest commercial banks. Consistent with the overall results on spreads, top tier arrangers offer lower arranger fees only to borrowers with credit ratings that have little need for additional certification by lenders.

Discussants: Kee Hong Bae (Schulich School of Business)

17:00 Drinks followed by dinner

Saturday September 27, 2008

Session V Corporate governance

Chair: Armin Schwienbacher (University of Amsterdam)

9:00 – 9:35 ***Corporate Governance and Innovation: Theory and Evidence***

Haresh Sapra (University of Chicago)
Ajay Subramanian (Georgia State University)
Krishnamurthy Subramanian (Emory University)

Abstract

We develop a theory of the effects of external corporate governance mechanisms such as takeover pressure and internal mechanisms such as compensation contracts and monitoring intensity on innovation by firms. Our model generates three testable predictions: (i) innovation varies non-monotonically in a U-shaped manner with takeover pressure; (ii) innovation increases as monitoring intensity increases, and (iii) the sensitivity of innovation to changes in takeover pressure declines with monitoring intensity. We show strong empirical support for these predictions using both ex ante and ex post measures of innovative activity. In our empirical analysis, we use difference-in-difference tests, which exploit the natural source of exogenous variation created by the passage of state level antitakeover laws, to identify the effects of governance mechanisms on innovation. The prediction of a U-shaped relation between innovation and takeover pressure suggests that innovation is fostered by either strong anti-takeover laws that significantly deter takeovers or an unhindered market for corporate control. Monitoring is most effective in enhancing innovation at intermediate levels of takeover pressure. Effective shareholder monitoring not only enhances innovation, but also reduces the sensitivity of innovation to variations in external takeover pressure created by the passage of anti-takeover statutes.

Discussant: Enrico Perotti (University of Amsterdam)

9:35 – 10:10 ***Evaluating the Effects of Mergers and Acquisitions on Employees: Evidence from Matched Employer-Employee Data***

Don Siegel (SUNY Albany)
Ken Simons (RPI)

Abstract

The unit of analysis in empirical studies of the employment and wage effects of mergers and acquisitions is typically the plant or firm. In contrast, the unit of observation in this study is the individual worker, which allows us to provide direct, systematic empirical evidence on the effects of different types of mergers and acquisitions on employees. Specifically, we analyze linked employer-employee data for the entire population of Swedish workers and over 19,000 manufacturing plants for the period 1985-1998. For each worker, we have data on gender, age, national origin, level of education, type of education, location, industrial sector, annual earnings, as well as each employee's complete work history both before and after a merger or acquisition. We can also identify whether the plant was involved in a full or partial acquisition or divestiture, as well as a related or unrelated acquisition. The empirical evidence suggests that employee outcomes are more favorable when only part of the company is bought or sold or when the firm engages in an unrelated acquisition.

Discussant: Abe de Jong (Erasmus University Rotterdam)

10:10 – 11:00 ***Empty Voting and Efficiency***

Alon Brav (Duke University)
Richmond Mathews (Duke University)

Abstract

We study how the possibility of separating voting interests from economic ownership ("empty voting") affects the efficiency of corporate governance. In our model, an informed strategic trader (such as a hedge fund) observes that a management proposal is up for a vote, and can establish separate positions in the firm's shares and votes on the record date. The trader accomplishes the separation between votes and shares by, for example, borrowing shares on the record date or hedging its economic exposure. It can then trade shares in a noisy stock market between the record and voting dates. We find that the strategic trader's presence can improve overall efficiency despite the fact that it will sometimes sell short after the record date and then vote to decrease firm value. We also document cases where this logic is overturned, and provide comparative statics with respect to market liquidity and the cost of separating votes from share ownership.

Discussant: Zacharias Sautner (University of Amsterdam)

11.00 -11.15 Break

Session VI Financial sector risk, regulation and innovation

Chair: Arnoud Boot (University of Amsterdam)

11.15 - 12.00 **_Using Price Information as an Instrument of Market Discipline in Regulating Bank Risk_**

Alfred Lehar (University of Calgary)
Duane Seppi (Carnegie Mellon University)
Günter Strobl (University of North Carolina at Chapel Hill)

Abstract

An important trend in bank regulation is greater reliance on market discipline. In particular, information impounded in securities prices is increasingly used to complement supervisory activities of regulators with limited resources. The goal of this paper is to analyze the theoretical foundations of market-based bank regulation. We find that price information only improves the efficiency of the regulator's monitoring function if the banks' risk-shifting incentives are not too large. Further, if the regulator cannot commit to an ex ante suboptimal auditing policy, market-based bank regulation can lead to more risk taking in equilibrium, increasing the expected payments by the deposit insurance agency. Finally, we show that the regulatory use of market information can decrease the investors'incentives to acquire costly information, thereby reducing the informativeness of stock prices.

Discussant: Hans Degryse (Tilburg University)

12:00 – 12: 45 ***The Effects of Bank Market Structure and Organizational Form on Entrepreneurial Incentives***

Kose John (New York University)
David Gaddis Ross (Columbia University)

Abstract

We study a model where economic agents must exert costly effort to develop entrepreneurial projects, and agents benefit from the entrepreneurial efforts of other agents. Agents rationally anticipate each other's actions but cannot coordinate them. The equilibrium of the resultant "global game" is characterized by a "tipping point." Only when an economic state variable is above this point does a functioning economy arise. We then show that a noncompetitive or inefficient banking system raises the tipping point, potentially severely retarding economic development. A further implication is that small economic shocks and subtle changes in the structure of the financial system may have a large systemic impact on the economy, even in the absence of direct contagion among financial intermediaries. Our results include a prescription for an organizational form of the financial intermediary that ameliorates the effects associated with bank market power, namely that of the cooperative financial institution ("CFI"), which is owned by its borrowers and savers instead of a third party. In an extension of our basic model, we also study "redlining" and show that it can arise as an equilibrium phenomenon

Discussant: Enrique Schroth (University of Amsterdam)

12.45 - 14.00 Lunch

14.30 Trip to Amsterdam, with canal tour and dinner