BANKING AND CAPITAL MARKETS

New International Perspectives

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New International Perspectives

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INTRODUCTION AND OVERVIEW

H.A. Black, L.P. Blenman and E.J. Kane

This book organizes a series of papers that were presented at the Midwest Finance Association meeting in San Antonio, Texas. The collection emphasizes research on international financial markets, but most chapters develop results that are universal in scope and can be applied to national and regional settings as well. A theme that runs through almost all of the chapters is the importance of information asymmetries. Differences in who knows what and when inside information surfaces, constrain the role played by regulators and outside stakeholders in corporations, and the equity share that insiders are willing to retain.

This volume goes to press at a time when several central precepts of asset pricing and finance are under attack. The economic environment is one of the global crisis. Outsized losses have spilled across national boundaries. Most of these losses originated in financial services and real-estate markets, but produced large, but varied cross-sector and cross-country impacts. The difficulty of settling these losses onto particular institutions and taxpayers has spread crisis pressures widely. Each country's crisis traces to a mix of market and regulatory failures, including weaknesses in government supervision, in corporate governance practices, and in how financial risks are assessed and priced. Because this crisis has been both painful and widespread, it has intensified interest in identifying factors that trigger crises and in studying how hedging and risk management might better protect wealth in the future.

The volume covers financial institutions, banking markets, risk management, international investment, corporate governance and

their regulation. Much of the volume focuses on banks. Banks play a central role in crisis avoidance and control because they channel liquidity to transactions of all sorts. When banks fail, important payments chains are apt to be disrupted. This is why financial safety nets come into existence. Of course, the modern financial services industry also includes a number of near-banks. These corporations are also apt to be protected by implicit and explicit guarantees and other risk-sharing arrangements. Safety nets span deposit insurance, brokerage account protections and the screening of security issuers, investment banks and insurance companies. The degree of insolvency the world is experiencing underscores a need for safety net and information reform in the financial services industry. The size of bailout expenditures indicates how poorly many risks were accounted for and how pricing and employee compensation structures encouraged inappropriate risk taking.

Even where very flexible exchange rate schemes were in place, volatility spillovers occurred. Few national authorities were able to insulate themselves from harmful effects. In the face of a severe decline in asset prices, interconnection became a disadvantage. The highly touted benefits of globalization evaporated and revealed limitations of national monetary and fiscal policies that few had appreciated during good times.

Some chapters offer policy prescriptions: for averting crises, for upgrading prudential regulation and improving corporate governance. Some chapters develop empirical evidence on these same policy themes. Topics include the role of ownership structures in emerging markets. Other empirical chapters review international evidence on cross-listing, buyout activity and joint ventures.

The volume is divided into two parts. Part I covers Banking and International Finance and Part II covers Corporate Finance and Investments. The order of individual chapters was governed by an effort to establish a logical flow and closeness of fit. Obviously, strong arguments can be made for a different grouping. It should be equally obvious that too many problems beset the world's banking and capital markets to permit us to address them adequately in a single volume. We select writings for their ability to shed light on a subset of the problems that concern us.

The chapters in Part I analyze bank and exchange-rate regulation, paying special attention to the welfare losses that can be created by sub-optimal regulation. When bank supervision is inadequate, eventually safety net protections transfer losses to taxpayers. When supervision is too intrusive, too little lending is apt to occur, so that creditworthy customers find it more costly to carry out their plans. Some chapters in this section investigate the efficacy of value at risk (VaR) as a risk-management tool and whether the risks inherent in bank trading portfolios are properly priced. Maturity transformation strategies and their effectiveness in dealing with interest rate risk are also considered in these chapters. Other chapters deal with narrower topics: coordination failures in international lending, how introducing the euro affected various other asset markets, how variation in the country of origin might influence the success of international joint ventures and the pricing of risk in Latin American markets.

Part II deals with a number of important, but diverse, issues. These include identifying private benefits of control, reviewing corporate governance practices in Latin America and examining the usefulness of precious metals for hedging against inflation and equity risks. Chapter 9 examines whether and how non-standard ways of registering securities can reduce the cost of raising equity capital. Global loan syndication is treated in this part as well, but from a different perspective. Chapter 10 looks at how syndication might reduce underwriting quality because lenders would not coordinate or share adverse information about sovereign borrowers. It also examines how loan syndication affects the costs of borrowing in LBOs. The final two chapters deal with the benefits of cross-listing and the asymmetric impact that good and bad news have on stock return volatility.

Part I: Banking and International Finance

Jason Ball and Victor Fang on “Value-at-Risk Disclosures and the Implications on Bank Shareholders” is a study of how VaR disclosures for the trading portfolio impact this class of stakeholder. Even though disclosures are reported with a lag, the authors show that incorporating this information in their analysis improves estimates

of betas and forecasts of next period's realized return. The chapter makes the case that even though VaR has been used to report trading risk faced by banks and that risk has to be priced by the market, shareholders are not adequately compensated for that risk. This implies that the risk is either mismeasured or mispriced. Putting aside more technical objections to the use of VaR, this has serious implications for investment banking as previously practiced. The authors suggest that equity investors would be better off holding stakes in banks without large trading portfolios. The finding that bond returns are positively related to VaR positions, is somewhat puzzling, unless size of positions proxies for bank profitability. This is because shareholders face a moral hazard problem and are asymmetrically compensated. They share in few of the benefits from increased profits but are susceptible to bank failures.

Arup Daripa and **Simone Varotto** in "Ex-Ante Versus Ex-Post Regulation of Bank Capital" ask a very important question: What is the optimal form of capital regulation for banks? Information asymmetries ensure that either ex-ante or ex-post regulation is usually dominant in any specific situation, given banks' private information, the reputation and risk aversion profiles of bank managers. However, the authors show that a combination of both regimes is superior to either the ex-ante or the ex-post approach taken in isolation if banks have superior information about the underlying risk of their assets. The authors underline their new approach by modeling a trade-off between "safety loss" and "overprotection loss". In their framework, the bank regulator sets the optimal capital level by minimizing an objective function that is a linear combination of these two elements. The weights set on each element depend on the immediate priority of the regulator, but the authors show that in combination with appropriately regressive penalties, regulators can prescribe for well-capitalized banks, regardless of whether their goal is reducing solvency risk or reducing overprotection losses. Regulatory forbearance and the possibility of banks taking cosmetic measures to reduce perceived risk leave open the question of whether this policy prescription might ultimately be successful.

Erhan Uluceviz and **Levent Yildiran**, in their study “Effects of International Interbank Loans on Twin Crises”, address the issue of whether international banks contribute to the development of banking and financial crises by failing to coordinate their lending policies. Evidence presented in the chapter importantly suggests that such coordination failures are more likely to trigger crises in developing countries than in developed countries. Low institutional quality in the former countries establishes preconditions for crisis to the extent that there already exist budgetary deficits, high real rates of interest and low foreign exchange reserves. Relatively more developed economies tend to be less exposed to the advent of crises because they are protected by the quality of the institutional structures in place. The authors make the key point that international flows of funds to some developing countries have had the perverse effect of destabilizing the recipient. Better oversight is needed. In many ways, some of the themes of the previous study resonate here also.

Lucía Morales in her work, “International Transmission Effects of Volatility between Financial Markets in the G-7 since the Introduction of the Euro”, looks at the effects on first- and second-order moments of return in asset and exchange markets from introducing the euro. Volatility increased at the announcement, but somewhat-reduced levels of volatility emerged as markets matured. This pattern of response is typical of markets for a new product. The innovation here is that the study is done both within region bilateral rates as well as with the cross rates of the euro currencies with those of prime currencies such as the dollar, pound and yen. Volatility persistence is observed in both currency and stock markets. The evidence seems to show that the effect of volatility in stock returns on the volatility of exchange rates is larger than the influence that runs in the reverse direction. The effects of adopting the euro differ greatly across countries. An unresolved question is why.

Usha R. Mittoo, **Dennis Chung** and **Zhou Zhang**, in “Country-of-Origin Determinants of Value Creation in International Joint Ventures: A Comparison of Hong Kong and U.S. Investments in China”, develop a series of insights about what characteristics lead to a

successful joint venture. They explore the role of market size, partner size and nationality factors in sourcing foreign direct investment into China from potential Hong Kong and US joint venture partners. “Home country bias” and cultural distance factors would tend to give an advantage to Hong Kong firms, but market size and partner size are countervailing factors. The evidence suggests that for culturally distant firms, there is a learning effect from previous investments in China but no such effect for Hong Kong firms. Several country-of-origin factors prove important in creating wealth in new joint ventures. However, the task of disentangling the precise causative roles of the individual factors is still a work in progress. It turns out that firm size has opposite effects for US and Hong Kong firms in determining a venture’s success. Making progress on this problem is rendered especially difficult because of the likelihood that numerous hidden factors are important for investors that wish to engage themselves in this major, but still largely planned economy.

Hendrik Scholz, Stephan Simon and Marco Wilkens, in their work “Maturity Transformation Strategies and Interest Rate Risk of Financial Institutions: Evidence from the German Market”, assess the risk posed to financial institutions by interest rate risk. The risk posed by changes in interest rate is typically assessed by utilizing duration data for both assets and liabilities. In the absence of such data, a two-factor model of a firm’s stock returns can be used instead. Regressing firm equity returns on the market portfolio and a bond index over a designated period of investment is another method of assessing the risk. The authors develop what they call maturity transformation factors, derived by orthogonalizing a standard interest rate factor and market rate of return. These factors also enable them to estimate the extent of maturity transformation undertaken by the firms and thereby infer differences in the effective maturities of aggregate assets and liabilities. The new factors are compared with standard interest rate factors in terms of their effectiveness in explaining the exposure of different kinds of financial institutions including banks, life insurance companies and real-estate firms, whose operating results are very interest-rate sensitive. Using industry-level data, the

authors present evidence that these two new factors, called “extra-market interest rate sensitivity” and “total interest rate sensitivity”, perform better in a two-factor model explaining the sensitivity of returns to interest rate changes, than do other more traditional interest rate factors.

Gökçe Soydemir, Rahul Verma and Jose Moreno, in “Asymmetries in the Market Price of Risk: Evidence from Latin America”, examine how spillovers in risk premiums are transmitted across international markets. In many respects, this chapter explores the same themes as the study by Morales. Whereas Morales examined volatility spillovers across stock and exchange markets, these authors analyze how the Sharpe ratio reacts across markets. They present evidence that the risk-adjusted returns in Latin American markets are higher than those in the U.S. market. In fact, they prove significantly higher than comparable benchmark returns. The evidence also suggests that Latin American markets respond more sharply to negative surprises than to positive surprises. The effects of negative surprises also persist longer. In summary, after showing that Latin American markets move in sympathy with U.S. markets, they paint a picture in which relatively integrated markets each price risk asymmetrically.

Part II: Corporate Finance and Investments

Angelo Baglioni, in “Corporate Governance Institutions as Signaling and Commitment Devices”, presents a policy blueprint for dealing with agency costs faced by investors in corporate equities. To the basic problem of moral hazard with managers, entrepreneurs and/or dominant shareholders who have control, he adds a lemon problem. Owing to information asymmetry, investors have no way to distinguish how much scope entrepreneurs in different firms have to extract private benefits. Good managers, shareholders and entrepreneurs do not try to extract private benefits, but so-called bad ones do. When good and bad entrepreneurs sell partial equity stakes in their firms, Baglioni shows that cross-subsidization is implicit in the equilibrium price of sold equity. Good entrepreneurs pay part of the cost extracted by bad entrepreneurs in the form of private

benefits, even if third-party governance regulations strive to limit the extraction of such benefits. He shows that self-regulation on the part of all firms raising equity dominates the third-party regulatory strategy. With self-regulation, a separating equilibrium can develop that dictates different strategies for good and bad entrepreneurial types and eliminates the cross-subsidization. The study stresses the advantage of self-regulation.

Jennifer E. Bethel and **Laurie Krigman**, in “Managing the Costs of Issuing Common Equity: The Role of Registration Choice”, discuss the costs of raising equity in U.S. capital markets. The choice discussed is that between traditional registrations and shelf registration. Shelf registration unequivocally lowers the costs of raising funds for low-information asymmetry firms, but can substantially raise costs for high-information asymmetry firms that release little information. These opaque firms suffer from costs associated with market overhang. Nevertheless, the authors posit that the main driver behind the use of shelf registrations is *not* cost minimization but risk minimization. Shelf registration offers firms the flexibility to be able to raise funds quickly in the event that their finances warrant it or if fortuitous circumstances arise. However, the authors uncover no evidence that firms have successfully timed the market in raising funds via shelf registrations. Traditional registration generates less ambiguity and information asymmetry than the shelf registration method. Consequently, the costs associated with market overhang are lower for both types of issuers when they use the traditional method.

Kenneth Daniels and **Irwin Morgan**, in “The Impact of Arrangers and Buyout Sponsors on Loan Pricing in LBOs: A Cross Border Study”, represent a further exploration of the costs of raising funds in different ways. Here the market is the debt market and the instrument is the syndicated loan. The authors examine in detail the structure of the syndicated loan market and find that arrangers of syndicated loans help to mitigate information asymmetries and help to certify the quality of the debt. In this market, small deal sizes are typically associated with single arrangers. Costs are higher in small deals with single arranger structures because the creditworthiness of small issuers is

typically opaque. Sponsored deals also have significantly higher all-in spreads even after controlling for the number of arrangers in the deal. It seems that sponsored deals are highly complex ones that are riskier than the average deal. Hence, the higher yield reflects the additional risks of the deal. The authors also show that all-in spreads on U.S. LBOs are higher than those for comparable European deals. They attribute this cross-country spread to the higher degree of leverage employed in U.S. deals.

Lawrence Kryzanowski and Arturo Rubalcava, in their study “Ownership Control and Valuation Changes for Earnings Announcements around U.S. Cross-Listings by Canadian Firms”, analyze the factors that drive the benefits of cross-listing on U.S. exchanges. They ask whether the changes that are observed the result of the behavior of non-insiders who hold float shares. They try to disentangle any pure listing effects from effects that are purely earnings-related. The authors find no evidence that when changes in float shares are conditioned on earnings surprises, they play any role in explaining the changes in firm value that occur either in the pre-listing or post-listing periods. However, when they consider the entire listing period (i.e., combining the pre-listing, announcement and post-listing intervals), they find that, conditioned on negative earning surprises, float shares help to explain declines in firm value. They also find evidence of reduced ordering costs in terms of lower bid-asked spreads, but greater risk because price volatility increases. Surprisingly they show that the incidence of insider ownership increases after a U.S. listing. This is contrary to what would be expected *a priori*.

James R. McCown and John R. Zimmerman, in their study, “Analysis of the Investment Potential and Inflation-Hedging Ability of Precious Metals”, analyze the long- and short-term hedging abilities of gold and silver. The evidence shows that as an investor’s time horizon increases from one month to five years, the correlations between inflation and returns from holding positions in both metals increase and are positive. The increase in the correlations with the length of one’s investment horizon is monotonic for gold but not so for silver. For stocks, the evidence shows that the returns on stocks are

negatively correlated with returns on positions in both gold and silver. These patterns prove robust to splitting the sample period in two subperiods, in which returns on stocks are strikingly different. Simply taking long positions in either could achieve the goal of hedging, but gold is a demonstrably better hedge against rising inflation. The correlations between the returns on the metals and the stock markets are somewhat weaker. At short time intervals, they are close to zero but becoming increasingly negative over longer horizons. The authors show that the ability of gold and silver to hedge against stock market returns is tied primarily to their ability to hedge against inflation.

Diego Cueto, in his paper “Corporate Governance and Ownership Structure in Emerging Markets: Evidence from Latin America”, is also concerned with the problem with the private benefits of control. However, unlike Baglioni’s contribution, this is not a policy chapter. It is a cross-country study of the discrepancy between cash-flow rights and voting rights and of the possibility for asset diversion. He provides evidence of a negative effect on firm value when a dominant shareholder exists. Dominant shareholders exert influence within a firm that is disproportionate with their actual voting rights in emerging Latin American markets. In this study, all named shareholders are assigned a unique voting status: either stand alone, member of a business group, member of a blockholder group etc. The panel data analysis shows that investors have negative perceptions about large ownership concentration. Firm value decreases with the percentage of voting rights held by the dominant shareholder, the excess gap between cash-flow rights and voting rights. However, if large ownership concentration is in fact present, investors prefer that the blockholder be a corporation or a family business group.

Joon-Young Song, in “Asymmetric Impact of News on Stock Return Volatility”, continues the line of investigation pursued by Morales (Chap. 4) and Gökçe Soydemir, Rahul Verma and Jose Moreno (Chap. 7). Whereas other chapters focused on the asymmetric impact of spillovers across international markets and on the pricing of risk, Song is concerned with whether the volatility spillover is a factor that should formally be captured in an asset-pricing model. He confirms

this hypothesis, finding evidence that a stable dynamic relationship exists between movements in the returns of small firms and large firms when a news event occurs. He also finds that small firm stock returns are significantly affected by news about large firms. The returns on large firm stocks are not significantly affected by good news on small firms. Even after sorting portfolios by size, industry affiliation and markets, the asymmetric response persists. The asymmetry in effect is not a factor only of size. However, Song acknowledges that size might be the dominant explanatory factor.

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