2016 Banking and Financial Stability Meeting

Venue: **Allan Barton Forum, Level 2 Building 26C, ANU College of Business and Economics**

<u>Monday 15 August 2016</u>

12:00pm-1:00pm	**Welcome lunch and registration**
1:00pm-1:15pm	Opening remarks
1:15pm-2:00pm	**Title:** *Political connections and financial stability* **Presenter:** Kentaro Asai, Australian National University **Discussant:** Nadia Massoud, Melbourne Business School
2:00pm-2:45pm	**Title:** *Pension Deficits and the Design of Private Debt Contracts* **Presenter:** Van Vu, University of Newcastle **Discussant:** Nhan Le, Australian National University
2:45pm-3:00pm	**Afternoon tea**
3:00pm-4:15pm	**Title:** *CEO compensation and risk-taking at financial firms: Evidence from U.S. Federal loan assistance* **Presenter:** Amar Gande, Southern Methodist University **Discussant:** Meijun Qian, Australian National University
4:15pm-5:30pm	**Key Note Address:** George Pennacchi, University of Illinois **Title:** *Bank and Nonbank Competition for Retail Financial Services*
6:30pm	**Group Dinner @ Venue TBA**

<u>Tuesday 16 August 2016</u>

8:30am-9:00am	**Coffee**
9:00am-9:45am	**Title:** *On reaching for yield and the coexistence of bubbles and negative bubbles* **Presenter:** Hassan Naqvi, SKK Graduate School of Business **Discussant:** Guillaume Roger, University of Sydney
9:45am-10:30am	**Title:** *The Impact of the Australian Wholesale Funding Guarantee Scheme on Bank Funding Costs* **Presenter:** Eliza Wu, University of Sydney **Discussant:** Ding Ding, Australian National University
10:30am-10:45am	**Morning tea**
10:45am-11:30pm	**Title:** *Safe assets and dangerous liabilities: How bank level frictions explain bank seniority* **Presenter:** Will Gornall, University of British Columbia **Discussant:** Cagri Kumru, Australian National University
11:30am-12:15pm	**Title:** *Liquidity constraints, home equity and residential mortgage losses* **Presenter:** Harry Scheule, University of Technology Sydney **Discussant:** Antje Berndt, Australian National University
12:15pm-1:15pm	**Lunch and farewell**

Abstracts

Political connections and financial stability

Kentaro Asai (ANU)

Political connections distort ex-ante bank risk-taking incentives, but reduce bank stakeholders' beliefs about default as an equilibrium-selection device under the presence of government bailouts. Using a data set of U.S. banks, I verify the role of lobbying as a financial safety net and quantify the relative magnitude of the two channels. Using event-study approach, I reveal lobbying banks experienced greater reductions in credit default swap spreads than non-lobbying peers after bailout announcements in 2008. Using structural analysis, I find the equilibrium-selection channel has been dominant since 2008. These results suggest political connections reduce banks' risks ex post

On reaching for yield and the coexistence of bubbles and negative bubbles

Viral Acharya (NYU) and Hassan Naqvi (SKK GSB)

We develop a model of financial intermediation characterized by an inside agency problem such that asset managers, when they have access to high enough liquidity, "reach for yield" by overinvesting in risky assets and concurrently underinvesting in safer or medium-risk assets. The managers follow a pecking order whereby their first preference is to invest in risky assets; their second preference is to hoard liquid assets so as to provide a buffer against runs; and their last preference is to invest in medium-risk assets. This reaching-for-yield behavior of managers is conducive to the formation of bubbles in the market for risky assets and concurrently "negative bubbles" in the market for medium-risk assets. We show that loose monetary policy, by reducing the cost of liquidity shortfalls suffered by financial intermediaries, induces further "reach for yield" and amplifies the magnitude of bubbles and negative bubbles.

The Impact of the Australian Wholesale Funding Guarantee Scheme on Bank Funding Costs

Thi Mai Luong (UTS), Russell Pieters (UTS), Harald Scheule (UTS) and Eliza Wu (U. Sydney)

This study compares the effect of the introduction of the Australian Wholesale Funding Guarantee Scheme (WGS) on authorised deposit-taking institutions (ADIs). We evaluate this with respect to their funding costs and credit spreads. Furthermore, we assess the impact of this guarantee on the significance of a set of bank risk measures in determining banks' funding costs. We employ a difference-in-difference approach for a sample of 29 Australian banks, 15 building societies, and 196 credit unions over the period from March 2002 to December 2014. We find strong evidence to suggest that the guarantee helped Australian banks and credit unions to lower their funding costs and credit spreads. We confirm robustness by testing the fee-weighted WGS utilisation rate. The guarantee also weakened market discipline and reduced the sensitivity of funding costs and credit spreads to bank capital. Finally, we also find that the removal of the guarantee scheme had no effect on the funding costs and credit spreads of all types of ADIs.

Bank and Nonbank Competition for Retail Financial Services

George Pennacchi (U. Illinois)

I consider banks' choice of capital structure and the interest rates on retail loans and deposits when financial services markets are characterized by economies of scope, corporate taxes, and competition from nonbanks (shadow banks). In markets with rich retail lending opportunities but limited retail savings, banks may choose high equity capital (low leverage) when they are not subject to corporate income taxes. When banks are taxed, equity capital declines and retail borrowers bear the tax burden. For the opposite case of markets with few lending opportunities but plentiful retail savings, banks minimize capital and the tax burden falls on depositors. When banks face greater nonbank competition for retail savings, equilibrium loan rates increase, encouraging entry from nonbank lenders. The model's predictions are consistent with U.S. banks over the last two centuries. Recent empirical research on how taxes affect bank behavior also supports the model

Pension Deficits and the Design of Private Debt Contracts

Balasingham Balachandran (U. La Trobe) , Huu Nhan Duong (U. Monash) and
Van Hoang Vu (U. Newcastle)

We examine how the funding status of defined benefit pension plans affects the design of bank loans. We find a positive relation between the amount of pension deficits and the cost of bank loans. Borrowers with larger pension deficits are also more likely to be imposed collateral requirement, and are subject to more covenant restrictions. In addition, they have a higher likelihood of violating loan covenants. Collectively, these findings indicate that pension deficits represent an additional source of risk that is priced by creditors. Further analyses reveal that the effect of pension deficits on the cost of borrowing is linked to the degree of financial constraints and information asymmetry problems

Safe assets and dangerous liabilities: How bank level frictions explain bank seniority

Will Gornall (UBC)

This paper uses bank fragility to explain why bank loans are senior in firm capital structure. High leverage makes banks more vulnerable to financial distress than the typical bond investor, and thus makes banks willing to pay for seniority. Bank seniority emerges even when banks need skin in the game, as bank effort has more impact on a large senior loan than on a smaller junior claim with the same systematic risk. Adding deposit insurance or bailouts adds a subsidy to tail risk, which makes large senior claims even more attractive to banks. Empirically, this model explains why procyclical firms avoid bank loans and provides a host of debt structure predictions.

CEO compensation and risk-taking at financial firms: Evidence from U.S. Federal loan assistance

Amar Gande (SMU) and Swaminathan Kalpathy (Texas Christian U.)

We examine whether risk-taking among the largest financial firms in the U.S. is related to CEO equity incentives before the 2008 financial crisis. Using data on U.S. Federal Reserve emergency loans provided to these firms, we find that the amount of emergency loans and total days the loans are outstanding are increasing in pre-crisis CEO risk-taking incentives – "vega". Our results are robust to accounting for endogeneity in CEO equity incentives and selection of financial firms into emergency loan programs. We also rule out the possibility that our results are driven by a financial firm's funding base, its complexity, or CEO overconfidence. We conclude that equity incentives (vega) embedded in CEO compensation contracts were positively associated with risk-taking in financial firms which resulted in potential solvency problems. We also find some evidence, although somewhat weaker, that higher incentive alignment ("delta") mitigated such problems in those financial firms.

Liquidity constraints, home equity and residential mortgage losses

Hung Xuan Do (UTS), Daniel Rosch (U. Regensburg), and Harry Scheule (UTS)

This paper analyses how borrower liquidity constraints and home equity relate to the realized loss given default (LGD) using the quarterly U.S. residential mortgage loan-level data observed from Q2 2005 to Q1 2015. We define defaulted loans with zero-LGD as cure loans and those with non-zero LGD as non-cure loans. We find robust evidence that the borrower liquidity constraints and positive equity are explaining cure, while negative equity explains non-zero loss. However, a relationship between borrower liquidity constraints and the nonzero LGD is not economically meaningful. Our findings support to separate cure and noncure loans in mortgage loss risk models.