2018 Banking and Financial Stability Meeting

Conference Schedule

Venue
QT Hotel, Ballroom 3
1 London Circuit, Canberra ACT 2601

Tuesday 7 August

11:30pm-12:30pm	Welcome and lunch
12:30pm-2:00pm	Session 1
2:00pm-2:30pm	Coffee break
2:30pm-4:00pm	Session 2
4:00pm-4:30pm	Afternoon tea
4:30m-5:30pm	Session 3
6:00pm	Drinks and dinner @ Monster Kitchen (The Mosaic Room), Hotel Hotel 25 Edinburgh Ave, Canberra ACT 2601

Wednesday 8 August

8:30am-9:00am	Coffee
9:00am-10:30am	Session 4
10:30am-11:00am	Morning tea
11:00am-12:30pm	Session 5
12:30pm-2:00pm	Lunch and farewell @ Capitol Bar & Grill, QT Hotel 1 London Circuit, Canberra ACT 2601

Conference Program

Tuesday 7 August

11:30pm-12:30pm	Welcome and lunch

Session 1

12:30pm-1:15pm	**Title:** Does securitization impair bank lending relationships? **Presenter:** Kelly Liu, ANU **Discussant:** Ying Xia, Monash, U.
1:15pm-2:00pm	**4-Slide Presentations** **Title:** Winning connections? Special interests and the sale of failed banks **Presenter:** Eden Zhang, Monash U. **Title:** Why do banks issue CoCo Bonds? **Presenter:** Jean-Pierre Fenech, Monash U. **Title:** Risk sharing, creditor diversity and bank regulation **Presenter:** Isaac Pan, ANU
2:00pm-2:30pm	Coffee break

Session 2

2:30pm-3:15pm	**Title:** Portfolio similarity and asset liquidation in the insurance industry **Presenter:** Stasnislova Nikolava, U. Nebraska **Discussant:** Kristle Cortes, UNSW
3:15pm-4:00pm	**Title:** Regulatory capital and internal capital targets: An examination of the Australian banking industry **Presenter:** James Cummings, Macquarie U. **Discussant:** Jean Helwege, UC Riverside
4:00pm-4:30pm	Afternoon tea break

Session 3

4:30pm-5:30pm	**Key Note Address:** Professor Robert Marquez, UC Davis **Title:** Government guarantees and bank portfolio risk
6:00pm	Drinks and dinner @ Monster Kitchen, Hotel Hotel

<u>Wednesday 8 August</u>

8:30am-9:00am Coffee

<u>Session 4</u>

9:00am-9:45am **Title:** Home advantage: the home bias in residential real estate
Presenter: Maria Yanotti, UTas
Discussant: Shams Pathan, UQ

9:45am-10:30am **4-Slide Presentations**

Title: Credit default swaps and debt overhang
Presenter: Jin Yu, Monash U.

Title: Bank activism and value creation
Presenter: Keke Song, MBS

Title: Military CEOs and bank loan contracts
Presenter: Huu Nhan Duong, Monash U.

10:30am-11:00am Morning tea break

<u>Session 5</u>

11:00am-11:45pm **Title:** Do lower returns on bank stocks suggest a lower cost of capital? An explanation for the low risk anomaly and the loan growth effect
Presenter: Mike Mao, Deakin U.
Discussant: Yichao Zhu, ANU

11:45am-12:30pm **Title:** Hurdle rate, zero lower bound and investors' active risk taking
Presenter: Zhongyan Zhu, Monash U.
Discussant: Chunhua Lan, UNSW

12:30pm-1:30pm Lunch and farewell

Abstracts

Does securitization impair bank lending relationships?

Kelly Liu (ANU), Yupeng Lin (NUS), and YiHui Wang (Fordham U.)

We study whether and how corporate loan securitization through collateralized loan obligations (CLOs) has changed the nature of bank lending relationship. We use a large dataset of CLO collaterals to identify securitized loans and the relationship lenders. We show that even if a relationship lender securitizes a past loan, it continues to gain future lending business from the same borrower. The new loans from this securitization-funded relationship lender, when compared to loans from a traditional relationship lender, have fewer covenants, smaller amount of revolvers at higher costs, and larger amount of institutional term loans at lower costs. In addition, the new loans from these lenders are also more likely to be securitized. Our results suggest that lending relationship is impaired as securitization weakens monitoring efforts and reduces the information advantage of relationship banks. Yet, these lenders seem to be able to keep their relationship borrowers with their access to structured credit markets. Overall, our findings indicate that benefits of securitization coexist with its costs in relationship lending.

Winning connections? Special interests and the sale of failed banks

Deniz Igan (IMF), Thomas Lambert (Erasmas U.), Wolf Wagner (Erasmas U.), and Eden Zhang (Monash U.)

We study how lobbying affects the resolution of failed banks, using a sample of FDIC auctions between 2007 and 2014. We show that bidding banks that lobby regulators have a higher probability of winning an auction. In addition, the FDIC incurs higher costs in such auctions, amounting to 16.4 percent of the total resolution losses. We also find that lobbying winners have worse operating and stock market performance than their non-lobbying counterparts, suggesting that lobbying results in a less efficient allocation of failed banks. Our results provide new insights into the bank resolution process and the role of special interests.

Why do banks issue CoCo Bonds?

Jean-Pierre Fenech (Monash U.), Barry Williams (Monash U.), and Sonny Tan (Monash U.)

This study investigates why banks issue Contingent Convertible Bonds (CoCos). We find that a bank's systemic risk level is a possible reason for CoCo issuance. Contrary to the pecking order theory, earnings management practices play a lesser role, and there is no evidence of banks becoming riskier after issuing CoCos. However, we find systemically riskier banks are more likely to issue CoCos. Thus, riskier banks may be utilising CoCo loss absorption mechanisms to partially internalise the costs of future loan losses. If banks are issuing such instruments without regulatory prompting, then an issuance may signal the need to provide greater oversight. Conversely, if such issuances do result from regulatory prompting, then banks may be engaging in risk management strategies, minimising their cost of equity issuance.

Risk sharing, creditor diversity and bank regulation

Kentaro Asai (ANU), and Guangqian Pan (ANU)

Can creditor diversity mitigate bank fragility like asset diversification? We argue that a capitalized bank, which can produce safe securities enough to compensate for severely risk-averse creditors, is unlikely to experience financial panic if it is funded by creditors with diverse attitudes toward risk. In the presence of such diversity, the bank matches the riskiness of securities to the risk tolerance of creditors in order to reduce financing cost. Indeed, our theory and evidence suggest that capital regulation eliminates the potential for financial fragility, conditional on the presence of creditors with heterogeneous attitudes toward risk.

Portfolio similarity and asset liquidation in the insurance industry

Mila Getmansky (U. Mass), Giolio Girardi (SEC), Kathleen Weiss Hanley (Lehigh U.) Stanisava Nikolova (U. Nebraska), and Loriana Pelizzon (Goethe U. Frankfurt)

Certain large insurers have been designated as Systemically Important Financial Institutions (SIFI) under the assumption that the forced liquidation of their common holdings could lead to systemic risk. We construct a measure of commonality in portfolio holdings using cosine similarity, and confirm that insurers with more similar portfolios have larger common sales regardless of their size. We also document that during the financial crisis, potential SIFIs with greater portfolio similarity of illiquid and downgraded securities have greater sales commonality. Our measure is easily implementable and can be used by regulators to identify insurers who may contribute to asset liquidation channel vulnerabilities.

Regulatory capital and internal capital targets: An examination of the Australian banking industry

James Cummings (Macquarie U.), and Kassim Durrani (Macquarie U.)

Using a unique but confidential database, this study examines the capital management practices of Australian banks under the Basel regulatory framework. We find evidence that banks respond to pre-defined internal targets when managing their capital positions. We find evidence of a significantly negative relationship between the internally targeted capital buffers of banks and recent economic growth. These findings support the view that the capital conservation buffer and countercyclical capital buffer under the Basel III rules are necessary reforms to address the tendency of banks to manage their capital buffers in a pro-cyclical fashion. However, we also find evidence of forward-looking behaviour by bank managers that is likely to dampen the impact of fluctuations in credit market conditions on their lending activities: Banks set higher capital targets when the outlook for future economic activity is improving and the demand for loanable funds is increasing.

Home advantage: the home bias in residential real estate

Mardi Dungey (UTas), and Danika Wright (U. Sydney), Maria Yanotti (UTas)

Do home-biased residential real estate investors purchase and perform differently than those investors who look for opportunities further away? We identify a large sample of investors in the property market and measure the proximity of their purchase from their existing residential location. It is hypothesised that, in line with the results of home bias in other investment markets such as equities, there is a preference among residential real estate investors to buy nearby and that this bias affects their returns. The home bias can be used to optimise housing market lending criteria and to inform housing investment policy. It should also be considered in household portfolio allocation decisions and has broad implications for how psychology affects financial decision-making.

Credit default swaps and debt overhang

Tak-Yuen Wong (Shanghai U. of Finance and Economics), and Jin Yu (Monash U.)

We analyze the impact of credit default swaps (CDS) trading on firm investment and financing in a dynamic contingent claims model. Through the empty creditor channel, our model not only features a trade-off between debt capacity and costly bankruptcy but also shows that creditors' CDS protection allows a firm to capture a larger tax benefit at the expense of increasing agency cost. We quantify the agency cost of CDS as the loss in firm value induced by debt overhang. More precisely, CDS protection transfers firm future cash flows from shareholders to creditors, thereby discouraging the former from undertaking value-increasing investment projects. For firms with grim growth prospects, high business risk, or more tangible assets, the agency cost can be substantial. Moreover, we argue that debt overhang decreases with creditors' bargaining power, renegotiation frictions, and the debt's commitment to socially optimal credit insurance. The model yields a novel empirical implication that tests of the real impact of CDS trading need to account for times of debt issuance or refinancing.

Bank activism and value creation

Kee-Hong Bae (York U.); Keke Song (MBS), Jun Wang (U. Western Ontario)

This study investigates the impact of bank activism on target firms' debtholders and shareholders by examining the abnormal bond and stock returns around shareholder activism events. We find that debtholders rather than shareholders benefit when shareholder activists are banks. We also find that relative to other activists, bank activists are more likely to target larger financial firms with higher leverage and lower credit quality and that bank activism target firms experience greater reduction in leverage ratio and improvement in credit quality. Additionally, the positive abnormal bond returns associated with bank activism only exist in the subsample of bank activism events where bank shareholder activists are also current lenders of the same target firms. We interpret these findings as follows: bank activists gain control rights through delegation of their trust business clients; the separation of cash rights and control rights associated with banks' proxy holdings may cause a conflict of interests problem if bank activists also hold loan stake in the same target firms.

Military CEOs and bank loan contracts

Huu Nhan Duong (Monash U.), Harvey Nguyen (Massey U.), Mia Pham (Monash U.), and Van Vu, (U. Newcastle)

We show that bank charge lower loan costs for firms run by CEOs with military background. Our findings are robust to controlling for other CEO characteristics and addressing endogeneity issues using propensity score matching and instrumental variable analysis. Firms with military CEOs are also subject to lower collateral requirements and covenant restrictions. Further results suggest that the effect of military CEOs on bank loans arises as a result of the role of military CEOs in improving firm information environment and reducing firm risk. Overall, our findings highlight the importance of CEO military experience in shaping the costs and designs of private debt contracts.

Do lower returns on bank stocks suggest a lower cost of capital? An explanation for the low risk anomaly and the loan growth effect

Mike Mao (Deakin U.), and John Wei (HKUST)

Banks with higher equity risk and faster loan growth have lower abnormal stock returns. By disentangling *ex ante* cost of capital from cash flow and discount rate news in bank stock returns, we show that the lower returns do not suggest lower cost of capital. The underperformance of banks with higher equity risk is explained by the poorer cash flow news. The underperformance of banks with faster loan growth is due to both the cash flow and the discount rate news components. Overall, the evidence points to the nontrivial role of investors' inefficient forecasts of expected bank risk and fundamentals.

Hurdle rate, zero lower bound and investors' active risk taking

Woon Sau Leung (U. Cardiff), and Zhongyan Zhu (Monash U.)

We propose a searching model with hurdle rate to understand fund-flow decisions made by investors of fixed income mutual funds. The hurdle rate is inelastic and heterogeneous and could change the searching criterion of some investors. Investors with positive hurdle rates may switch between two motivations. One is to actively take risk and the other is to follow relative fund performance. Investors with a zero hurdle rate would, however, always search and choose from their neighboring mutual funds following relative performance. The regime of zero federal fund rate could motivate investors with positive hurdle rates to switch from following relative performance to active risk-taking. The empirical results support this prediction. Since 2009, there is a significant difference on fund flows on fixed income mutual funds. Although the evidence of significant fund outflows from fixed income mutual funds following the safe benchmark during the taper tantrum period is consistent with anecdote evidence, we have also documented significant fund inflows to fixed income mutual funds following the risky benchmark.