Monitoring matters: debt seniority, market discipline and bank conduct

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Do debt holders monitor banks?

- **Method**: difference in difference - effect of exogenous change in debt priority law to establish causality as law affects only state-chartered bank (control group = nationally-chartered banks)
- **Results**:
  i) private debt holders react asymmetrically to change in priority claim order depending on direction of move in priority ladder
  ii) change of law has an economically significant impact of banks financial health (Z-score, non-preforming loans)
- **Contribution**: provides new evidence by making use of a new identification strategy and interpreting result *i*) as evidence of monitoring and result *ii*) as evidence of efficiency of monitoring

Motivation: Crucial for regulation design to empirically assess monitoring

1. Indirect assessment of deposit insurance negative effect

   If non-insured debt holders monitor and are efficient, we have a measure of risk-taking shifting induced by deposit insurance

2. Debt priority order: another regulation tool?

   If could identify type of debtors who monitor more efficiently (for a reasons exogenous to their place in priority ladder), conferring them a higher rank would reduce risk-taking

What is market discipline?

- Monitoring by a debt holder motivated by the fact that bank's behavior impacts its probability of default and therefore its own probability of being repaid
- If debt holder monitors, should react to any change in banks behavior that modifies its risk profile: different investment strategy etc.
- Reaction can take form of modification of price or of quantity of debt supplied
- By reacting, the debt holder has an impact on the banks' action: debt holds choice of debts enters the bank decision and modifies it

How to test for market discipline?

- Key: debtors should react to any **action of the bank** that modifies the probability of default
- Examples in the literature, try to identify relationship between:
  - withdrawal of uninsured deposits and imminence of failure (Goldberg Hudgins 2002)
  - financial condition and CD rate (Crane 1976, Cramer Rogowski 1985)
  - between subordinated debt rates and measures of bank performance (Avery *et al.* 1988)
  - rate on CDs and bank's riskiness (Baer Brewer 1986)
  - downgrade of debt by Moody's and reliance on insured deposits (Billet *et al.* 1998)

Interpretation of paper's results

1. Result *i* - Fact that cost for non-deposit funding increases (and quantity decreases) because of depositor preference law interpreted as evidence of monitoring
   - Could it be the reflect of higher risk independently of any monitoring?
2. Results *ii* - Fact that following announcement of law banks Z-scores increase and non-performing loans decrease (= better financial health) interpreted as evidence of efficiency of monitoring
   - Isn't set of results *ii* the relevant evidence to identify monitoring? Could interpret as banks anticipating a reinforced monitoring = market discipline

- Suggestion: interpret price effect as riskiness effect and quantity effect as (un)willingness to monitor?

Clarification - More details on why nationally chartered banks are not "treated"

- Exact definition of the two status?
- Could imagine an indirect effect of law on nationally-chartered banks (even if concerns only state-chartered banks) through an effect on market price of funding?
- Probably market share of state-chartered banks too small to make price move on markets where nationally-chartered banks find funding (international market?)
- So that no violation of Stable Unit Treatment Value Assumption?

Questions

- Parallel trend of controlled and treated groups shown unconditionally but variation exploited (in specification, controls and State*Quarter fixed effect) assumes parallel trend within each state: should redo t-test including controls and State*Quarter dummies?

- Could being nationally or state-chartered endogenous to policy (to avoid or benefit from the law)? Then maybe should not control for it? Do some banks change status during period studied?

- Successive adoption of law: start to move before in States where law adopted among the last? or checked by t-test on parallel trends?

Conclusion: a very nice paper with crucial implications!

- Very important paper for regulation design that sheds new light on the debate
- New identification strategy, very nice setting