Monitoring and Controlling Bank Risk: Does Risky Debt Help?

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ABSTRACT: We examine whether mandating banks to issue subordinated debt would enhance market monitoring and control risk taking. To evaluate whether subordinated debt enhances risk monitoring, we extract the credit-spread curve for each banking firm in our sample and examine whether changes in credit spreads reflect changes in bank risk variables, after controlling for changes in market and liquidity variables. We do not find strong and consistent evidence that they do. To evaluate whether subordinated debt controls risk taking, we examine whether the first issue of subordinated debt changes the risk-taking behavior of a bank. We find that it does not.