ANNUAL REVIEW OF FINANCIAL ECONOMICS (/CONTENT/JOURNALS/FINANCIAL) Volume 3, 2011 (/content/journals/financial/3/1)

Financial Intermediary Balance Sheet Management

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Vol. 3:289-307 (Volume publication date December 2011)

First published as a Review in Advance on September 09, 2011

Conventional discussions of balance sheet management by nonfinancial firms take the set of positive net present value (NPV) projects as given, which in turn determines the size of the assets of the firm. The focus is on the composition of equity and debt in funding such assets. In contrast, the balance sheet management of financial intermediaries reveals that it is equity that behaves like the predetermined variable, and the asset size of the bank or financial intermediary is determined by the degree of leverage that is permitted by market conditions. The relative stickiness of equity reveals possible non-pecuniary benefits to bank owners so that they are reluctant to raise new equity, even during boom periods when equity raising is associated with less stigma, and hence smaller discounts. We explore the empirical evidence for both market-based financial intermediaries such as the Wall Street investment banks, as well as the commercial bank subsidiaries of the large U.S. bank holding companies (BHCs). We further explore the aggregate consequences of such behavior by the banking sector for the propagation of the financial cycle and securitization.

Keyword(s): capital (/search?value1=%22capital%22&option1=pub_keyword), debt (/search?value1=%22debt%22&option1=pub_keyword), leverage (/search?value1=%22leverage%22&option1=pub_keyword), procyclicality (/search?value1=%22procyclicality%22&option1=pub_keyword)

Vol. 4 (2012), pp. 339–360

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Vol. 13 (2021), pp. 15–36

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Vol. 6 (2014), pp. 419–441

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Vol. 4 (2012), pp. 255–296

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Vol. 2 (2010), pp. 75–102

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