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Mark J. Flannery

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By MARK J. FLANNERY *

Levered firms operate with distorted investment incentives: they will fail to implement some investment projects with positive net present value (NPV) and may undertake negative-NPV projects which sufficiently increase their portfolio risk.[1] These investment distortions reduce firm value, and in efficient financial markets firm shareholders fully bear the costs of inappropriate investments. Accordingly, shareholders employ debt-contracting mechanisms that reduce their investment distortions. Several contracting devices are commonly employed: restrictive covenants (Clifford W. Smith, Jr., and Jerold B. Warner, 1979), secured debt (René M. Stulz and Herb Johnson, 1985; Elazar Berkovitch and E. Han Kim, 1990), short-term debt (Steward C. Myers, 1977), and operating with low leverage. The optimal structure for a firm's financial liabilities maximizes its net benefits of leverage and should depend importantly on the nature of the firm's business endeavors.

This paper examines the capital structure of financial intermediary firms which finance relatively illiquid, informationally intensive securities. These firms include commercial banks, thrifts, finance companies, and some insurance companies. Financial firms' investment incentives are influenced by debt in the same way as any other firm's, yet they operate with unusually high leverage. For example, at year-end 1990, commercial-bank equity comprised approximately 6.5 percent of their total assets. The corresponding capital ratio was 2.9 percent for Savings Association Insurance Fund (SAIF)-insured thrifts, and 8.1 percent for domestic finance companies. By contrast, the average U.S. nonfinancial firm's capital ratio was about 55 percent. In addition to their high leverage, many financial firms issue liabilities with shorter maturity than their assets. Since many financial-firm assets are illiquid, this short funding exposes them to substantial liquidity risk (Charles Goodhart, 1988). Some writers (e.g., John H. Kareken, 1985) suggest that bank maturity-mismatching occurs only because the existing federal "safety net" subsidizes liquidity risk-taking. Though government regulation has surely exacerbated banks' exposure to illiquidity risk, this risk appears to be an intrinsic feature of banking-firm operations. For example, Gary Gorton (1984 p. 5) reports that 12 substantial banking panics erupted in the United States between 1800 and 1915, causing problems for "even solvent banks" which "could [not] meet the demands of large numbers of depositors trying to withdraw funds at one time." Banking trade publications from the early

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[1] The stockholder–bondholder conflict has been analyzed by Stewart C. Myers (1977), Clifford W. Smith,

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