Monitoring market participants, externals and financial transactions in a global financial stability environment

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1. Introduction

The existing economic and financial literature has documented the importance of informed trades, volatility spreads and the stock market response to key financial events that can threaten domestic and global financial stability. After the Global Financial Crisis (GFC), the Dodd–Frank Wall Street Reform and Consumer Protection Act (DFA) were enacted in the United States to enhance financial stability and respond to widespread calls for changes to the financial regulatory system. This federal law overhauled financial regulation and made changes affecting every part of the US financial services industry. As discussed by Bernal et al. (2014), companies other than banks can also have a critical impact on the whole economy. This entails the need of investigating the potential impact of unexplored sources of risk on the entire financial system. This special issue provides a substantial contribution in this direction.

The GFC has also affected informed trading (Galariotis et al., 2015) and has highlighted, once again, the dynamic links between currency and banking crises. Informed trades are often associated with herding, which, in-turn, may trigger important informational inefficiencies to market participants, externals and financial transactions (Cipriani and Guarino, 2014), threatening the financial stability from different sources. Thus, it is of pivotal importance to understand whether informed trades affect also asset prices to deviate from their fundamental values. The papers included in this special issue attempt to answer some of the main research questions related to the role played by informed investors and the relationship between different types of crisis.

The International Finance and Banking Society (IFABS) Hangzhou Conference hosted by Zheijang University, China held on the 27th – 29th of June 2015 provided a forum for such debate, including papers on a wide range of financial issues. Eight papers presented at the IFABS Hangzhou Conference have been selected and published in this special issue. These papers represent a substantial contribution to key

debates of interest to regulators, supervisory authorities, central bankers and academia and can be classified into two main areas, namely: financial crises, stability and regulation; and, financial transactions.

We believe that the papers presented in this special issue strongly contribute to theoretical and empirical economic and financial studies already validated.

2. Financial crises, stability and regulation

Three highly linked themes underline the four articles included in this section. Two papers, Cumming et al., (2020) and Eijffinger and Karatas, (2020), focus on financial crisis and regulation; while Bernales et al. (2020) and Lei et al. (2020) investigate financial stability through behavioral effects of trading on information in the options market.

In June 2009, in response to the GFC, the Obama administration introduced the US DFA, which poses registration requirements and significantly higher disclosure of proprietary information for hedge funds. The goal of the paper of Cumming et al. (2020) is to analyze hedge fund performance, risk, and fund flows before and after the implementation of the DFA. The authors show that US hedge funds have lower alphas after the DFA implementation, compared to non-US hedge funds. Moreover, the DFA affects US hedge funds with more than USD150 million assets under management more than smaller funds, increasing fund outflow for certain US hedge fund strategies.

Eijffinger and Karatas (2020) provide an empirical analysis of the interrelationship between currency and banking crises. They use a panel approach for a sample of 21 developed and developing countries spanning the period between 1985 and 2010. Probit and bivariate probit estimations indicate that banking crises precede currency crises, and vice versa. Moreover, their findings show that external shocks, liberalized financial markets and/or highly leveraged banking sectors influence future banking crises. This study also confirms the theoretical links between current banking and currency crises.

In their contribution to this special issue, Bernales et al. (2020) extend the herding behavior literature to a previously unexplored field, namely option markets. They extend the original methodology developed by Chang et al. (2000), which has been mainly applied to equity markets, to option contracts. By investigating data spanning the option contracts traded in the US between 1996 and 2012, the authors document significant herding effects in option trading activity. The analysis is conditioned on a set of systematic factors related to periods of market stress, such as periods of high market volatility risk; dates of macroeconomic announcements characterizing the GFC; and, periods of large average dispersion of analysts' forecasts.

Finally, combining data from the Center for Research in Securities Prices, Compustat and Thomson Reuters Institutional Holdings database, Lei et al. (2020) examine volatility spreads and the stock market response to a broad sample of earnings announcements. Findings show a monotonic increase in the spread between call and put implied volatilities closer to the earnings announcement date, suggesting that informed traders are the driving force behind the option market activities prior to earnings announcements. After controlling for an array of firm announcement characteristics, findings show that

informed trading increases rather than decreases the stock market response to earnings announcements. These results support the notion that informed options trading immediately before earnings announcements helps alleviate stock market under-reaction to earnings announcements.

3. Financial transactions

Financial transactions may affect firms' value, the direction of corporate investments and access to financing sources through different channels. This may be due to market participants performing financial transactions, like in the case of financial advisors processing M&A deals; banks that control access to financing sources, as with mortgages applications; or, connections between external and market participants, which may "drive" corporate investments. The four papers included in this section investigate these three research areas characterizing financial transactions. In particular, Guo et al. (2020) investigate the relationship between financial advisors and acquirers; and Chen et al. (2020) between guarantors and firms issuing guaranteed bonds. The linkages between politics and corporate investment in China is analyzed by Pan and Tian (2020); while Bai and Lu (2020) study the applicant profiles for mortgage applications.

Via analyzing 3420 US deals during 1990 – 2012, Guo et al. (2020) examine whether top-tier M&A financial advisors create value for acquirers with different financial conditions in both the short and long term. Deals are classified into three groups, namely constrained, neutral and unconstrained firms, depending on the acquirer financially constrained-acquisitions. Their results show that top-tier advisors improve performance for constrained acquirers rather than neutral, and unconstrained acquirers. In particular, top-tier financial advisors improve the performance of constrained acquirers in both short and long terms by 1.45% and 24.27%, respectively. For deals with investment banker involvement, constrained acquirers advised by top-tier financial advisors have the lowest deal completion rate, and pay the lowest bid premiums; in opposition to unconstrained acquirers. The authors conclude by stating that constrained acquirers tend to retain top-tier financial advisors to gain superior synergy, while unconstrained acquirers do it to ensure deal completion.

Chen et al. (2020) explore the potential determinants of corporate guaranteed debt issuance. In particular, corporates often use affiliated firms as guarantors when issuing guaranteed bonds, combining external financing with internal credit enhancements. Their results empirically show that mainly firms with fewer tangible assets, lower credit ratings, more pronounced debt overhang and/or greater managerial agency problems, issue guaranteed bonds. Moreover, alternative motives of firms for guarantee use are captured by guaranteed-bond prices at issuance, with a bonds' rating at issuance largely explained by the issuers' rating.

Aggarwal et al. (2015) argued that, in China, given that the state plays both the role of regulator and market participant, this in turn could threaten the interests of investors. The paper by Pan and Tian (2020) investigates the relationship between political connections and corporate investments in China through the model developed by Chen et al. (2011). In particular by analyzing the ongoing corruption scandals and the recent anti-corruption campaign initiated in China, they construct a natural experiment that identifies

the bribery and personal connections between the ousting of corrupt politicians and related firms. Their findings show that the investment expenditure of event firms declines significantly after the ousting of politicians compared with that of non-event firms, especially for non-state-owned enterprises (SOE). While, after the ousting of politicians, the investment efficiency improves for event SOEs, but declines for event non-SOEs, compared with their non-event counterparts. Finally, they document that the ousting of the politicians influences firm investment decisions more after the recent anti-corruption campaign.

The paper of Bai and Lu (2020) uses HMDA data, which covers about 90% of mortgages issued in the United States, to analyze the mechanism of adverse selection in the credit market. The authors consider mortgage applications that are approved by lenders but rejected by applicants and find that a low-risk applicant is more likely to reject a loan offer, except when the offer is made by an informed lender. Moreover, using lender-year specific loan acceptance rate and jumbo mortgage investment as proxies for lenders' information advantage, the findings show that lenders with a lower likelihood of being rejected are indeed better informed than others.

4. Current and future key challenges

This special issue highlighted four key messages about the future of financial stability and markets: i) financial markets, instruments and transactions need continuous monitoring activity and investigation. For example, it would be interesting to extend the model of Chang et al. (2000) to the European option markets to see whether the main assumptions behind this model still hold for markets less liquid than the US. ii) Market participants other than banks also play a pivotal role for financial stability; thus, a further empirical investigation examining how regulation affects these entities is required. iii) Financial crises may be due to different sources, which often are highly correlated as in the case of banking and currency crises. Finally, iv) as also demonstrated by Baker et al. (2016), political connections may affect the wider economy; this requires assessing the interrelationship between politics and finance, especially in developing countries.

While this special issue represents a significant contribution to the existing economic and financial literature, we believe that more investigation on themes related to the ones included in this special issue is needed to fill open gaps in the literature.

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