Stock Liquidity Shocks and Banks' Risk-Taking Behaviour

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Summary

This paper investigates whether stock market liquidity has an impact on banks' risk-taking behaviour. Using the Tick Size Pilot Program of the Securities and Exchanges Commission (SEC) to identify liquidity shocks, I show that banks with less liquid stocks take more risk, as reflected in lower Z-scores, higher earnings volatility and non-performing loan ratios, and lower capital adequacy ratios. I examine the two mechanisms through which reduced stock liquidity increases banks' risk-taking: dampening the governance effect of discipline trading by stockholders and reducing the price informativeness for managers to obtain feedback on investment decisions. The result suggests the governance channel has greater explanatory power than the feedback channel.