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Impact of bank size on CDS spreads:

International evidence before and during the financial crisis[†]

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Abstract

This paper studies the drivers of the bank CDS spread, taken as a measure of credit risk, by considering the impact of the housing market along with a number of potential bank level determinants, such as regulatory capital, leverage, size, liquidity, asset quality and operations income ratio. We build upon a unique dataset consisting of 115 banks over the period 2004-2011, headquartered in 30 countries from both developed and emerging countries. The sample period we have allows us to study the determinants of the CDS spread covering the period of financial crisis. Results suggest that the CDS spread is driven by asset quality, liquidity and operations income ratio. Bank size is found to have a non-monotonic impact on the CDS spread. If the bank is small, an increase in size reduces the average credit risk. If the bank is large enough, an increase in size raises the latter. From our results we derive the level of bank size that minimizes the CDS spreads. Financial institutions growing beyond this threshold are subject to higher credit risk, implying that smaller and medium sized banks are safer than large banks.

Keywords: Bank CDS spread, leverage, capital requirements, liquidity, asset quality, bank size, too-big-to-fail financial institutions, financial crisis.

JEL Classification: G01, G21, G32.

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