Short-Selling Bans and Bank Stability:

Evidence from two Crises

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Abstract

Most stock exchange regulators around the world reacted to the financial crisis of 2008-09 by imposing bans or constraints on short sales. These hurried interventions, which varied considerably in intensity, scope, and duration, were presented as measures to restore the orderly functioning of securities markets and limit unwarranted drops in securities prices, capable of exacerbating the crisis. More recently, during the Eurozone sovereign debt crisis in 2011, stock exchange regulators in some European countries like Belgium, France, Greece, Italy and Spain have imposed similar restrictions on short-selling with the aim of stabilizing the volatile evolution of bank stock prices. The large majority of these bans have targeted financial stocks, the regulators' rationale being that in times of market stress, sharp drops in banks' stock prices caused by short-selling activity could have severe consequences for the stability of the banking system. The economic mechanism linking stock price drops to bank's insolvency is rarely spelled out in detail. The closest theoretical arguments are the violation of a leverage constraint, as argued in Brunnermeier and Oehmke (2008) and the increased price volatility that makes creditors' runs more likely, as argued by Liu (2013). Although these arguments are appealing and reasonable, no supporting empirical evidence exists so far. Our paper aims to fill this gap. We investigate the effect of short-selling bans on the stability of financial institutions around the world by canvassing the evidence produced by the two most recent episodes of short-selling restrictions, the 2008-09 credit crisis and the European sovereign debt crisis in 2010-12. More specifically, we examine whether ban enactments shielded the subjected banks during the two different crises by supporting their prices and by reducing their volatility and probability of default. In contrast to the predictions of Brunnermeier and Oehmk (2013) and Liu (2013), we find that none of the regulators stated objectives were achieved. We observe that banned financial institutions had worse excess returns, higher volatility, and higher probability of default compared to ex-ante equal financial institutions. The detrimental effects of short-selling bans seem to be even worse for weaker financial institutions that were thought to benefit the most from short selling restrictions.

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