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Bank management and market discipline

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Abstract

In recent years, market discipline has attracted interest as a mechanism to augment or replace government regulation of the financial sector and, especially, depository institutions.

The ability to substitute market discipline for bank regulation is of much interest and we use a theoretical model to examine it. In a stylized comprehensive model, we incorporate the characteristics of the regulatory structure and examine the effects of different parameters on the optimal decisions of the bank. These parameters include changes in risk, deposit-insurance coverage, and degree of market discipline. Interesting results include the following: (1) an increase in competition should result in less equity financing, higher deposit interest rates, and higher risk premiums (spreads); (2) exogenous shocks, such as an increase in oil prices, will result in more equity financing; (3) the sensitivity of the two types of deposits will react to a change in market discipline in opposite ways. Our theoretical results are consistent with empirical evidence in recent studies.
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1. Introduction

Stakeholders in a firm can monitor and control the firm's behavior using market mechanisms. The ability of stakeholders, including debt holders and stockholders, to influence the cost and quantity of funds available to the firm and the valuation of its assets provides a market-based structure for corporate governance (market discipline). Market discipline is considered optimal

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for corporate governance, as is evident in unregulated industries. However, this paradigm of governance, particularly when employed by debt holders, may not apply to financial institutions and, especially, to highly regulated depository institutions. Since most liabilities of smaller or medium depository institutions are deposits or privately held debt that are not traded in the market, debt holders lack opportunities to examine the performance of managers and, therefore, cannot exercise market discipline. This information asymmetry is a particular problem for depository institutions, since bank managers practice the opaque business of making confidential bank loans. Moreover, the same government that does much to govern these institutions by means of regulatory and supervisory mechanisms also guarantees a large part of the depositories' liabilities. Wherever deposit insurance is in effect, depositors have no incentive to monitor the bank. The information asymmetry and lack of incentive to monitor have been widely noted, prompting many observers to ask how market discipline can be applied to financial institutions.

Depository institutions are highly regulated to protect against the disruption of the unique services they provide and to avoid the social costs (negative externalities) that such a disruption would impose on the economy.[1] In recent decades, many countries have experienced an upturn in financial instability in the form of financial crises, including banking and currency crises.[2] Further, financial institutions have become more complex in recent years due to financial innovations and the widening of their scope of activities. It has become apparent that traditional regulatory and monitoring mechanisms are either poorly applied or intrinsically inadequate. Indeed, Demirguc-Kunt and Detragiache (2002) find that deposit insurance is detrimental to bank stability.[3] Because of these developments, market discipline has attracted the interest of academics, regulators, and bankers as a mechanism that may be used to augment or, to a certain degree, replace government oversight of the financial sector. Indeed, the Basel II Capital Accord is about increased disclosure and market discipline. Its author, the Basel Committee on Banking Supervision, "emphasizes the potential for market discipline to reinforce capital regulation and other supervisory efforts in promoting safety and soundness in banks and the financial system."[4]

The literature on market discipline in banking focuses on policy issues and discusses various proposals, such as mandatory subordinated debt (Crocket, 2002). The empirical literature looks at the effect of bank risk on several available market measures.[5] The theoretical literature is quite limited; most of it argues that the best way to improve market discipline and reduce costs of deposit insurance is to require banks to issue subordinated or other uninsured debt (Calomiris and Kahn, 1999). More recently, Blum (2002) demonstrates the ambiguous effect of subordinated debt on risk taking by the bank. A related area of research, both theoretical and empirical, is

[1] See Paroush (1988) on the domino effect and the need for supervision in banking.

[2] See Williamson (2001) for a review of reports on financial crises, including banking and currency crises, in *Currency Crises* (Krugman, Paul, ed), NBER Conference Report series. University of Chicago Press, 2000.

[3] In the US, the 1980s savings-and-loan crisis demonstrated how a supervisor's forbearance could increase the cost of a crisis. As a result, the 1991 FDICIA mandated least-cost resolution of failing banks and prompt corrective action by the FDIC.

[4] The first two pillars of Basel II are adequate bank capital and supervisory review. Market discipline, to be facilitated by disclosure of meaningful information by banks, is supposed to augment regulatory discipline. See Basel Committee on Banking Supervision (2003).

[5] Sundaresan (2001) examines the desirability of incorporating market discipline in bank supervision and regulation and explores the use of equity prices as signals of bank credit risk. Saunders (2001) criticizes the use of bond spread yields, as they reflect not only default probability but also recovery rates and advocates the use of the more liquid equity-market data instead of debt-market data. More generally, equity holders can influence bank behavior by taking corporate governance measures. For a review of US empirical evidence, see Flannery (1998).

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