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Market discipline in international banking regulation: Keeping the playing field level

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Abstract

The focus of this article is the debt market as a powerful disciplinarian source for large and complex banking organizations around the world. We empirically study the interactions between reinforcing banks' market discipline and preserving a level playing field in international banking. Our approach consists of conducting cross-country comparisons of the *secondary* market prices sensitivity to market measures of bank risk (traditional and financial strength ratings). The results are generally consistent with the market discipline paradigm. However, much progress still needs to be made (especially in Japan and certain European countries) in order to make the level playing field principle compatible with the reinforcement of market discipline on an international level.

JEL classification: G15; G21; G28

Keywords: International banking regulation; Basel II; Market discipline; Subordinated debt; Credit spreads

> "If the banks are bad, they will certainly continue bad and will probably become worse if the Government sustains and encourages them. The cardinal maxim is, that any aid to a present bad Bank is the surest mode of preventing the establishment of a future good Bank."
>
> W. Bagehot, *Lombard Street*, IV§4

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1. Introduction

Recently, the international authorities have reserved a unique place for market discipline in the reform proposals of banking regulation and supervision around the world. For instance, the third Pillar of the new Basel Capital Accord (Basel II) explicitly highlights the potential benefits from integrating the market forces in the traditional safety nets (see the revised framework, BIS, 2004). The Basel Committee approach consists of strengthening market discipline by proposing a set of requirements and recommendations concerning the public disclosure practices for internationally active banks. However, even if transparency is in fact a necessary condition for effective market discipline, nothing can guarantee that it is also a sufficient one. The requirements set up in the third Pillar of Basel II would have the expected positive impact on bank soundness, only if the market participants act in a manner consistent with financial stability. Unfortunately, in most cases, such a behavior is not spontaneous. The exclusive focus of the Basel Committee on transparency issues renders the concept of market discipline very ambiguous.[1] This partial picture of market discipline makes the third Pillar the most fragile of the three key elements of Basel II. The mutual reinforcement, as well as the rebalance of the three pillars, becomes under these circumstances all the more problematic.

A straightforward method to enhance market discipline in banking, as it has been discussed in the US since the early 1980s, is the *Mandatory Subordinated Debt Policy* (henceforth MSDP).[2] This proposal suggests a *modus operandi* of market discipline based on two main channels (BGFRS, 1999): (1) a *direct* channel activated *via* the cost of issue, which theoretically should be sensitive to the risk profile of bank issuers and (2) an *indirect* channel, effective so long as the supervisor and other private counterparts impose constraints based on the prices formed in the *secondary* market. In this respect, triggering Prompt Corrective Actions, setting risk-sensitive deposit insurance premia, and adjusting the frequency of *on site* examinations in function of market signals represent several possible configurations of the indirect channel. Given the respectable intellectual roots of the MSDP, it is surprising to note that this kind of reform proposal has never been included on the regulatory agenda of the promoters of Basel II.

Evanoff and Wall (2000a,b), fervent partisans of the MSDP, presented a credible gradual plan, to be adopted in several stages, as soon as the American Congress officially approves this project. In their opinion, a broad consensus around the application of the MSDP at international level is desirable, but the lack of coordination at this level should not prevent the implementation of the plan in the US.[3] However, we consider that a unilateral modification of the *status quo* in

[1] In the same vein, Flannery (2001) considers that a more appropriate name for the third Pillar of Basel II should be "Mandatory Disclosure," and not "Market Discipline." Rosengren (1999) and Jordan et al. (2000) note that transparency does not go hand-in-hand with the special nature of banking activity. Indeed, the credit decision is based on narrow long-term relationships with borrowers and the investment projects features are private information. Furthermore, as shown by Rochet and Vives (2004), if the market faces coordination problems, too much disclosure may impair financial stability. Rochet (2004) also criticizes the ambiguity of Basel Committee as regards the precise methods to enhance market discipline.

[2] The most fervent advocates of MSDP are Calomiris (1999), Evanoff and Wall (2000a,b), Flannery (2001), and Herring (2004). For an overview on various MSDP proposals, the reader can refer to BGFRS (1999, pp. 6–12), BGFRS&SDT (2000, pp. 58–65), or Evanoff and Wall (2000a, p. 67 *et passim*).

[3] This point of view is also emphasized by the Fed's Board of Governors and the US Treasury: "*If additional evidence suggests that legislation requiring issuance of subordinated debt by certain institutions is appropriate*, *the Secretary* [of the Treasury] *and the Board* [of Governors of the Federal Reserve System] *may recommend such a policy to Congress*" (BGFRS&SDT, 2000, p. iv).