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Testing for effective market supervision of New Zealand banks☆

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ABSTRACT

There is a considerable amount of research that seeks to determine the extent to which retail market participants exert market discipline on banks either through the price approach (the correlation of price to risk), or the quantity approach (the movement of funds in response to changes in risk). In this paper we propose and implement a third approach: the retail market conditions approach. We seek to determine if the prerequisites for the exertion of effective market discipline by stakeholder monitors, as set out in Llewellyn and Mayes (2003. The role of market discipline in handling problem banks. Bank of Finland Discussion Papers. <http://www.bof.fi/eng/7_tutkimus/index.stm> (retrieved 13.04.04)), prevail by directly examining conditions that prevail among retail market participants. We find little evidence to support the proposition that they are being met among New Zealand retail depositors.

1. Introduction

In addition to providing basic services, such as holding cash and effecting payments among economic agents, a banking system is often considered an important contributor to, or companion of,

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local economic development. For this reason, and because a safe repository for liquid assets to meet transaction or precautionary needs is widely considered desirable, a stable banking system is similarly considered desirable (cf. Levine, 1997).[1] How is this to be achieved? The Basel Committee on Banking Supervision (the "Basel Committee") goes a long way toward answering this question by resting its framework for banking supervision on three pillars: Minimum Capital Requirements; Supervisory Review Process; and Market Discipline (BCBS, 2005, p. 6). The last element can be sub-divided into discipline by wholesale markets and retail markets respectively.

The idea of market discipline as an effective moderator of bank behaviour is this: if a bank were to take on increasingly risky positions, market participants would become increasingly reluctant to finance it, leading to increasingly costly financing and possibly even a shortage of financing, for the relatively more risky bank. Faced with this, the bank would moderate its behaviour.

The idea of market discipline by wholesale markets is intuitively appealing. Ex ante, one would expect wholesale market participants to be relatively sophisticated providers of financing, able to both assess risk and price it. We would submit that market discipline by retail market participants is an entirely different matter. The potential gap in financial education and trading experience between wholesale and retail market participants calls into question the ability of retail market participants to collectively assess bank risk, and to properly charge for it. According to Birchler and Maechler (2002), depositors exert market discipline by withdrawing funds and re-depositing them in a preferred bank. Dewatripont and Tirole (1994), on the other hand, doubt that depositors have the ability to make a sensible risk assessment, especially if their deposit amounts are small, as they are imperfectly informed and face incentives to free ride.[2] There is a considerable amount of research that seeks to settle this debate by observing either the correlation of price to risk (the "price approach"), or the movement of funds in response to changes in risk (the "quantity approach").

Following the price approach, Ellis and Flannery (1992), Brewer and Mondschean (1994), and Cook and Spellman (1996) find a positive relationship between bank risk and the interest rate paid by American banks on large, uninsured deposits. Wilson et al. (2004) use Tier 1 capital[3] as a proxy for a bank's fundamental risk and examine the response of retail deposit interest rates to changes in New Zealand banks' Tier 1 capital. They find little support for the notion that retail depositors exert market discipline.

Using the quantity approach Birchler and Maechler (2002) study bank depositors in Switzerland and find that they tend to withdraw their deposits when a bank's fundamentals deteriorate. In similar studies, Goldberg and Hudgins (1996), Park and Peristiani (1998), Marino and Bennett (1999) and Jordan (2000) find decreases in uninsured deposits after a perceived increase in bank risk.

The purpose of this paper is to propose and implement a third approach: the direct assessment of whether or not the prerequisites for the exertion of effective market discipline by stakeholder monitors have been met. These prerequisites are presented in Llewellyn and Mayes (2003). This direct examination of conditions in the retail deposit market adds to the information available for assessing the likelihood that retail market participants exert discipline on banks. We conduct our assessment using retail market participants domiciled in New Zealand for the following reasons. The Reserve Bank of New Zealand (RBNZ) exercises a self-described "light-handed regulatory regime for banks, which relies on a combination of self, market and regulatory discipline" (RBNZ, 2004, p. 1). New Zealand is also one of only two OECD countries which does not operate deposit insurance or any other scheme for guaranteeing bank deposits. It applies a specific disclosure regime to support its reliance on market discipline, and this disclosure regime calls for the ready availability of two documents: the Key Information Summary (KIS) and the General Disclosure Statement (GDS). The RBNZ points to retail depositors as essential market participants with the potential to exert market discipline on banks, and appears to apply the model in Fig. 1.

[1] Llewellyn and Mayes (2003) and Goodhart et al. (1999) discuss various issues relating to the private and social costs of bank failures.

[2] An example would be in the case where they believe there is a regulator who is better informed than they are.

[3] Tier 1 capital is defined in BCBS (1988).