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# Strengthening banks' market discipline and leveling the playing field: Are the two compatible?

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**Abstract**

This paper examines whether the supervisory objective of strengthening market discipline is compatible with the one of enhancing competitive equality for internationally active banks. This issue is empirically investigated by comparing the determinants of major US and European banks' subordinated notes and debentures (SND) spreads. Three main results emerge. First, the spread/rating relationship is both statistically significant and very similar for US and European banks' bonds. Second, US banks tend to pay a higher average spread on their SND issues because of a poorer average rating. This is due to the presence of European public sector banks, i.e. banks which are either government owned or benefit from explicit government guarantees. In fact, US banks have slightly better Moody's bank financial strength and FitchIBCA individual average ratings, which omit the influence of government and other external support on risk borne by investors. Finally, controlling for the issuing banks' default risk, US banks pay a statistically significant lower average spread on their SND issues. This result is attributed to the higher liquidity of the US market for banks' bonds. © 2002 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

During the last 15 years, an increasing attention has been devoted by bank supervisors and regulatory economists to the issue of market discipline. While different

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opinions exist on the best way to achieve it, most observers agree that bank supervisors should increasingly rely on market forces to supplement their traditional supervisory methods. As recently outlined by the General Manager of the Bank of International Settlements and Chairman of the Financial Stability Forum: [1]

> "... the thinking behind prudential policies experienced a paradigm shift. This has been crystallized in increasing efforts to work with, rather than against, the grain of market forces ... As a result, market discipline has come to play a greater role in ensuring financial stability ... more can and should be done to strengthen market discipline."

There are two interdependent reasons for this emphasis on market discipline. First, the activities of major international banks have become increasingly complex. As a consequence, the task of controlling their risk taking behaviors has become an increasingly difficult one. Second, a trend towards a stronger regulatory reliance on banks' own internal risk management systems has emerged. In its 1996 Capital Accord amendment proposal, [2] the Basel Committee on Banking Supervision endorsed the use of banks' own market risks models, contingent on important qualitative and quantitative standards. More recently, in an effort to reduce the incentive for regulatory capital arbitrage transactions, prompted by the widening gap between banks' and regulators' definitions of credit risk capital, the Basel Committee has proposed to introduce an internal ratings based (IRB) approach to capital requirements. [3] This proposal is in turn considered by many as a first step towards the use of full portfolio credit risk models to set regulatory capital. A future capital adequacy regime based on banks' internal risk measurement models poses a major threat for bank supervisors. Given the shareholders' option-like payoff profile, banks experiencing significant unexpected losses and getting closer to their default point could find it convenient to adopt gaming behaviors by artificially reducing the internally produced risk measures while increasing their risk taking activities in an effort to replenish their equity capital. The growing independence of bank management in determining their capital adequacy must therefore be accompanied by an increasing role of market forces in monitoring banks' risk profiles and influencing banks' management decisions.

The relevance of this role to be played by private investors has been recognized by the Basel Committee itself. The Committee's recent proposals to reform capital adequacy are based on three main "pillars". While the first two pillars focus on credit risk capital requirements and on the future role of national supervisors, the third pillar is aimed at strengthening the role of market discipline through an improvement in banks' disclosure (Basel Committee on Banking Supervision, 2001a).

A second relevant feature of the Committee's recent proposals to reform the capital adequacy framework concerns its main objectives. The ostensible purpose of the 1988 Basel Accord was to strengthen the safety and soundness of the international

[1] Crockett (2002).
[2] Basel Committee on Banking Supervision (1996).
[3] Basel Committee on Banking Supervision (2001a).