

Economics focus Markets as watchmen

The new international regime for regulating banks ought to give a bigger role to market discipline through subordinated debt

EXPERTS all acknowledge that the world still lacks a system of financial oversight that makes banking a safe and stable business. Given that deposit-taking banks are inherently risky enterprises (they borrow short-term, promise to repay in full on demand, and then lend the proceeds long-term), there may be no such system—short of a radical rethink of what banks are for. Still, in the meantime, regulators ought to be able to improve on the present approach.

The apparently endless efforts to craft Basel 2, a new capital-adequacy standard for banks, are intended to remedy known defects in the existing rules, which were laid down in the first Basel accord and adopted in 1988. Everybody agrees that the new rules must strike a better balance between regulation (with incentives for effective self-monitoring), supervision and market discipline. The signs are that Basel 2 will rightly put more emphasis on the third of these than did Basel 1—but still not as much as it should.

Disclosure of information is one way to help markets keep an eye on what banks are getting up to. Basel 2 will be all for more disclosure. But more information is not enough by itself. Markets also need an incentive to use it. Bank shareholders cannot be relied on to control the risks their bank may be taking: it can make sense for a bank (and its owners) to take a chance on risky lending, in return for high profits. Depositors are equally unreliable as supervisors: deposit insurance (necessary to lessen the danger of a

run on the banks) assures a steady inflow of deposits until it is too late. What is needed for effective discipline is creditors who stand to lose if the bank gets reckless, and who have no stake in the profitable upside from unduly risky lending.

The answer, some economists argue*, is simple. Insist that banks issue, in proportion to their deposits, a slice of subordinated debt—that is, debt which will not be repaid in full if the bank defaults. The owners of this debt (unlike shareholders) receive an interest rate determined by the market, rather than a share of the bank's profits; and, unlike depositors, their exposure is uninsured. So the incentives are properly aligned for effective monitoring. The price of this debt in the market ought therefore to reflect the riskiness of the bank's operations. If the bank has to pay a high yield to attract buyers for its subordinated debt, that is an ominous sign.

Strong versions of the subordinated-debt proposal would link regulatory action to trigger-levels of the risk premium implied by this yield. Mild versions would merely have regulators keep an eye on the risk premium as one more indicator they keep under review.

Basel 2 is unlikely to include even the mild version of the idea. The draft proposals rely mainly on encouraging banks to develop their own risk-rating systems. This addresses a big weakness of the current one-size-fits-all approach, but one drawback is obvious: adventurous banks may tweak their systems so that they systematically underestimate risk, leading to

a lighter capital requirement. Supervisors will watch out for this, but that may not be enough. Why the reluctance, then, to supplement supervision with market discipline by means of subordinated debt?

Perhaps because regulators think they are better at gathering and interpreting information than markets. The confidence seems misplaced. One recent study suggests that supervisors are better at gathering some kinds of information, markets better at others. Why not use both? Certainly, market discipline puts a lot more people to work on the problem.

Some sceptics question whether the yields on subordinated debt would actually tell you very much. Studies of systems where some banks voluntarily issue subordinated debt suggest that the yields do adjust to the riskiness of the banks' operations. Another problem is that small banks may issue too little debt to support a liquid market, so that trading is infrequent and the yields correspondingly uninformative. One way to get round this would be to require the bank to auction small tranches of debt each month; another would be to exempt small banks from the requirement. A third worry is that the yields would be open to manipulation by insiders. This is a real concern. Supervisors would have to guard against it by keeping an eye on who was buying what in the market for subordinated debt.

These and other drawbacks argue, for now, against adopting a strong version of the subordinated-debt proposal, under which automatic regulatory consequences would flow from fluctuations in yields. It is difficult to see how they weaken the case for the mild version. One could start with a modest requirement, calling only on large banks to issue subordinated debt equivalent to, say, 2% of their total assets. (Many banks would already comply.) Regulators would need to enshrine in an international agreement the principle that holders of this debt would not be bailed out even if depositors and other stakeholders were. Examination of the risk premium could then be integrated in the supervisory "pillar" of Basel 2. Only if this proved useful need regulators think about a stronger version. It is worth a try. ■

* See "The New Basel Capital Accord: Making It Effective With Stronger Market Discipline", by Harald Benink and Clas Wihlborg, forthcoming in *European Financial Management*, March 2002. The version of this column on our website provides a link to a conference draft.

