

Comment on CHARLES GOODHART, «Some Regulatory Concerns» and «An Incentive Structure for Financial Regulation»

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When the BLATTNER-HELLWIG research project on bank capital regulation which led to this and last year's conferences started two years ago, my own evaluation of our state of knowledge in the area of bank regulation was that we have quite a bit of partial knowledge about specific aspects of regulation but that in the absence of a well-established, authoritative and general theory of financial regulation, we still know very little about what constitutes an *optimal* regulatory framework.¹ My conclusion from this was that we ought to be modest in our claims, careful with respect to international harmonisation of regulation, and leave sufficient room for competition among regulatory systems.

I had modest hopes that after two years of additional research on the subject, we would be in a much better position. Now, I feel that we have indeed learned a lot in these two years. But we have learned especially that we still know very little and that we still have to be modest in our claims. Having said this, I believe that the spirit of CHARLES GOODHART's recommendations in the two papers I have to discuss here is precisely the right one.

In the centre of this conference is the subject of capital adequacy regulation (CAR) for banks. The papers by GOODHART take a more sweeping view of banking and financial regulation, though. This is a sensible perspective, as a discussion of CAR must necessarily take place in the more general context of overall banking regulation. CAR represents just one possible type of regulation, and we must ask ourselves whether there are other, possibly superior types of regulation.

Before raising that question, it is customary, and necessary indeed, to ask for the fundamental reasons why we need *any* kind of regulation at all. What goes wrong in the absence of regulation, in a completely unregulated system? This (obvious) question is the one with which GOODHART begins.

The traditional motives for banking regulation are those of customer protection and systemic stability. Both have to do intrinsically with bank safety, of course. These are the arguments stressed by GOODHART, too. In the forefront are external effects resulting from information asymmetries concerning asset qualities, asset values and risk exposure, interbank linkages, contagion effects and systemic risk, and adverse incentive effects of excessive government guarantees and (improperly priced) deposit insurance. GOODHART gives an intelligent discussion of these traditional justifications of regulation, with which I largely agree. He takes both motivations for regulation, customer protection

1. See, e.g., BALTENSPERGER 1989/90, p. 1.

and systemic stability, seriously to some extent. This leads him to suggest two separate branches, or arms, of a regulatory authority, (a) an investor protection arm and (b) a systemic stability arm. His justification for setting up two separate bodies is that he sees the aim of both as quite separate and different. Here, I am not so sure that I fully agree with him. I would contend that it is in most cases *not* the customer loss *as such* which provides the real basis of concern, but the related worry that such losses could lead to disturbances and shocks assuming an economy-wide significance (as illustrated by the «too big to fail» problem), thus affecting the stability of the system in one way or another. Thus, in a sense, behind the customer protection argument lies always also a worry about systemic stability. Therefore, I would not want to exaggerate the difference between the two motivations; rather, I see them as very much related.

This is also reflected by the fact that deposit insurance – the major instrument, apart from general supervision and enforcement of sound auditing and accounting procedures, envisioned by GOODHART for the investor protection arm – as traditionally seen is very much an instrument of systemic stability, and not just of depositor protection for its own sake (e.g., DIAMOND and DYBVIK 1983). As to the uniqueness of the financial sector with regard to the potential for misuse and fraud which is stressed by GOODHART (p. 10), I feel that this is an aspect which financial services share with a fairly large number of other, non-financial types of «experience goods» ranging from a multitude of food and household products to, e.g., auto repairs and health services.

Of course, there may be an argument for having more than one separate authority in terms of «checks and balances» for the regulators, i.e. as an instrument to limit regulatory power. But this would be an entirely different argument.

The worry about adverse effects of system-wide importance is also what is behind governments' inclination to implicitly or explicitly extend guarantees and insurance to bank customers. The factual existence of such guarantees, in turn, is a major justification of bank capital regulation, even to those like BENSTON and KAUFMAN who are, in principle, against any kind of government intervention at all.²

Another argument for regulation, recently stressed by DEWATRIPONT and TIROLE 1994, but not so much by GOODHART in this paper, sees banking regulation, especially CAR, as a tool for improving shareholder incentives to monitor bank management, thereby indirectly protecting depositors. My difficulty with this argument is that I fail to see what is specific to banks in this, justifying a *specific banking* regulation. Also, while it is true that requirements for more bank capital *increase* the stake of shareholders in the bank, the accompanying increase in the level of regulatory supervision and scrutiny may *reduce* the need for shareholder monitoring.

2. See, e.g., BENSTON and KAUFMAN, 1996. Note that, when evaluating CAR, it makes a marked difference whether we use as a standard of reference (a) a system without any kind of regulation, or (b) one without CAR, but with other types of intervention, including especially an effective safety net of government guarantees, already in place.

All this said, I find myself much in agreement with the thrust of GOODHART's arguments. It would seem difficult to entirely dismiss all the arguments explaining the *possible* occurrence of problems under a regime without any regulation. What is much less clear, however, is how to evaluate the practical and quantitative importance of these potential problems and their relation to the *costs* of regulation. Are the regulations worth their price? This is a very important question which is asked too seldomly and which needs to be addressed more directly and systematically, as GOODHART reminds us. His insistence on this point is well taken. Awareness of the costs of regulation also furthers awareness of the limited possibilities of regulation and helps to shift attention to the importance of public disclosure and of control procedures internal to the financial institutions. In his second paper, GOODHART proposes and discusses a number of mechanisms which intend to help improving incentive structures encouraging an efficient internal management:

One is setting up efficient internal (and external) auditing procedures with appropriate sanctions for bad management.

Another is the establishment of pay-off structures which make it worthwhile for agents in the firm to follow established control procedures and rules. GOODHART points to the fact that existing pay-off structures may encourage «gambling for resurrection», much like limited liability rules. This is a valid and interesting point. Of course, it raises the more general question of what the appropriate objective of devices like limited liability or of given pay-off schemes are and what the *optimum* level of risk exposure to aim for by the firm and its management is. Clearly, minimization of risk cannot be the overriding objective. A bank management which is not willing to assume any risk would not be a good bank management. But GOODHART is certainly right in suggesting that it is worthwhile to investigate the behavioral consequences, including the implications for risk taking, of alternative pay-off systems.

A further mechanism favored by GOODHART is that of a clearly defined and credibly announced gradual response to declining bank capital, with the aim of avoiding time inconsistency problems and forcing banks to correct shortage situations while the cost of doing so are still manageable.

An interesting issue raised by GOODHART in this context is whether regulators' responses and sanctions should be made conditional on general market conditions or not. The motivation for such a conditionality obviously is the desire to avoid reinforcing an already bad economic situation by tightening conditions in the market for bank capital in a recession. GOODHART argues for *not* making regulatory actions and sanctions dependent on general business conditions, however. He points to the dangers of such conditionalities. In a way, he here reemphasizes the point that moral hazard type problems and the role of government as a guarantor of banks and bank customers is at the heart of the distortions we are facing and discussing. If banks know in advance that in crises times prudential standards will be relaxed, they will be less careful and take fewer precautions to begin with, in comparison to a situation where they know that strict standards will remain in place also in hard times.

I think that this is just one example reflecting a frequent dilemma we are facing in this field, caused by our insufficient knowledge of the practical weight and importance of the effects and costs of various types of regulation and of nonregulation: There is a widespread notion and belief that an entirely unregulated system *can* lead to occasional problems and disruptions. But all regulatory answers carry their costs, too. We simply do not know enough about the balance between benefits and costs. Therefore, evaluations of financial regulation are typically marked by a certain indecision. Nevertheless, I feel that the basic thrust of GOODHART's papers, and of much of the more recent discussion of regulation, suggesting a shift towards *less* formal, rigorous and complex regulatory solutions, towards simpler rules and more reliance on internal control mechanisms and on disclosure requirements, is well taken. Ideas like requiring institutions to pre-commit themselves to restrain losses within a given limit over a specified time period appear as a sensible approach in this perspective. Financial institutions and industries have a great self-interest in setting sound standards and avoiding problems of instability and disruption. This should be exploited to the greatest possible extent by public regulation. At all cost, public regulation should avoid solutions which effectively weaken this self-interest, rather than strengthening it (such as, e.g., public safety nets of all sorts).

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