

Protocol of the Discussion on «Market Structure, Monitoring and Capital Adequacy Rules» by THOMAS GEHRIG

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GEHRIG starts by indicating that there was not too much controversy. He agrees that he is assuming active core shareholders and emphasizing their role in a very special framework and that in a more general framework incentive effects would come up. By introducing capital requirements to broaden the shareholder base, shareholders would be less likely to be active shareholders.

He agrees that transparency issues and reputation building mechanisms are important in this context.

TERBERGER points out that GEHRIG showed that monitoring is lower under competition than under other market structures. She wonders whether monitoring is just «lower» or «too low», in other words, which the optimal level of monitoring is in this model world.

GEHRIG replies by stating that when you extend the model to allow for pre-entry, i.e., for an endogenous formation of the industry structure, the particular model used would suggest excessive entry. Then the free market outcome would actually imply too low an intensity of monitoring. GEHRIG acknowledges that the model is special in this respect and advocates a careful interpretation.

BLATTNER comments that GEHRIG's paper does not really model the market for corporate control and shareholder behaviour, but that GEHRIG is modelling monitoring within banks. He makes the point that applying the model to the question of capital adequacy regulation is a hazardous way of commenting on such an important issue. BLATTNER summarizes that the model predicts decreasing incentives for monitoring by the incumbent shareholders but that there are new shareholders as well, which might have some interest in additional monitoring. He suggests looking much more closely at the market for corporate control, which is of particular interest in banking because of the fact that there exists already capital adequacy regulation.

BOOT points out that the standard asset substitution argument in favour of capital regulation has been made in a lot of papers, but has always been made in isolation. According to him, emphasizing the often neglected effort aversion argument is quite important.

GEHRIG emphasizes that he does not want to make the point that internal control systems are unimportant, but that he was just mentioning a different and important type of moral hazard. To the extent that inside shareholders are doing the monitoring, they may be reluctant to issue new shares because that would dilute their ownership. Taking realistic banks, you observe shareholders and managers; how far could explicit contracts

actually make managers inclined to perfectly represent shareholders' interests? Basically, this can only be achieved by making the managers the residual claimants of the firm, what shareholders presumably do not want. Even if you could control managers at a high degree, who is going to monitor the shareholders? Basically, the argument is: The more concentrated the ownership structure, the better might be the monitoring such that the phenomenon per se would not disappear.

HELLWIG comes back to the phrase used by BOOT that «the theory is at a dead end». He agrees that theory provides very heterogeneous results, where the conclusions depend on model specification. He does not believe that introducing reputation effects will help, on the one hand because reputation effects are not always important, on the other hand because they enhance rather than reduce the heterogeneity of results that theory predicts.

Concerning the issue of the heterogeneity of conclusions the theory provides us with, one possibility is to say that theory is useless; the burden of proof, however, would then be on the person claiming this. Another possibility would be to say that maybe reality is heterogeneous. Then the question is: What is the point of having a homogeneous set of regulations imposed upon very heterogeneous institutions? He concludes that it is not enough to say that the heterogeneity of conclusions that we get from theory is troublesome, but that we have to go on and ask what this implies for our approach to banking regulation.

BOOT acknowledges that «dead end» was a wrongly chosen word and suggests the expression «stalemate» instead. He stresses that we have to ask what the next direction is and that he agrees with HELLWIG.