Commentary: Institutions and Policies for Maintaining Financial Stability

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Robert Litan has written an excellent analysis of the challenges to maintaining financial stability and of alternative approaches to achieving this goal. Litan advocates largely abandoning the emphasis on the traditional "prevention-safety net" paradigm in which regulation attempts to shelter depository institutions from competition, restrict their activities, and provide implicit or explicit guarantees against losses through the lender of last resort and deposit insurance. This approach, Litan argues, is not only "being outmoded by market competition" but also "addictive and seductive." This type of regulation has undermined market discipline and has neither prevented banking crises nor provided safety to the financial system.

Litan offers the "competition-containment" approach as a means of improving financial regulation and financial stability. While this approach encompasses varied elements, the main thrust is to increase reliance on market discipline and to make regulation complementary to market forces in order to isolate problems before they propagate into systemwide troubles. While Litan's proposed redirection is quite sensible, I believe that reform should go much further in emphasizing the role of market forces in promoting stability and integrity of global banking and financial markets.

Many international financial transactions occur in a realm that is close to anarchy. While numerous committees and organizations

attempt to coordinate domestic regulatory policies and negotiate international standards, they have no enforcement powers. The Cayman Islands and Bermuda offer not only beautiful beaches but also harbors safe from most financial regulation and international agreements. In international financial transactions, where private contractual disputes would be litigated and what laws would apply are often highly ambiguous.

Yet, international financial markets and institutions have grown rapidly and have performed remarkably well. The unregulated euro market, in which securities issuers go to avoid domestic securities regulation, for example, has grown from nothing thirty years ago to a multi-trillion-dollar market without a major incident. In fact, the growth of many of the largest and most active international financial markets has been spurred by the avoidance of traditional government regulation. While frauds, mismanagement, and bankruptcies do occur—sometimes on a spectacular scale, as the collapse of BCCI and Barings illustrate—market forces have been highly effective regulators that have created order out of the apparent chaos of the international banking and financial markets.

The overall stability and integrity of these markets is due primarily to the role of private regulators, not public ones. To be successful in this anarchic but orderly realm, firms and markets must develop strategies that promote credibility and induce contractual performance, largely without recourse to traditional government-supplied legal devices. Striving for competitive advantage in these markets tends to generate the private regulation that then accounts for the success of international financial markets. My emphasis in this brief comment will be on how innovations in strategic organizational design and governance for financial institutions can handle international regulatory challenges more effectively than traditional public regulation.

Private strategic responses

The private strategic responses to concerns about stability and integrity take many forms. A traditional solution had been to create a members-only club, with high standards for membership. Clearing

houses and organized exchanges are the classic examples of this approach. Long before regulators were setting minimum capital and liquidity standards, bankers were policing each others' private note issuance through privately developed clearing systems during the so-called free banking eras in eighteenth and nineteenth century Scotland and early nineteenth century United States through the Suffolk System in New England (Kroszner, 1996a and 1997). Since the nineteenth century, the clearing house associations of the Chicago Board of Trade and Chicago Mercantile Exchanges have been monitoring the financial health of their members and providing a form of insurance against failure of the clearing members.

Most recent growth in the international markets, however, has been taking place outside traditional members-only institutions. Over-the-counter (OTC) derivatives trading, for example, has grown sharply during the last decade and, since 1994, has exploded. Much of the movement toward OTC markets is driven by the desire to avoid the domestic regulation that has been imposed over time on organized exchanges. Since OTC markets have no physical location, sovereign regulators have much difficulty in claiming that such activity falls within their jurisdictions.

In these effectively unregulated OTC markets, the strategic responses to the challenges of stability and integrity have taken a variety of forms. Independent credit-rating agencies play a key role in certifying the quality of potential counterparties to a transaction. These third-party monitors publicly grade the health of the major players. Contracts that involve long-term relationships often include clauses that permit early termination if a counterparty falls below a specified rating threshold. Some participants simply will not deal with others that do not meet a minimum rating. Private regulators have thus fulfilled the auditing, screening, and monitoring functions of the public regulators and have been quite effective even though they do not have the same legal powers to obtain information that public regulators do.

The emphasis on top ratings is a market-generated response to concerns about the risks of entering long-term contracts in the OTC

derivative market. As many institutions saw their ratings slip by the early 1990s, they began to face increasing costs of participating in these markets and were excluded entirely from some transactions. These firms then made the strategic decision to create new organizational forms to address the concerns about credit risk.

The innovation is a special purpose vehicle, called a derivative product company (DPC), that would be structured to garner a top rating. Less than high-grade institutions incorporated DPC subsidiaries, which have capital and governance structure distinct from the parent. A DPC can win a triple-A rating because its capital cannot be tapped by creditors of the parent company if the parent becomes bankrupt. Also, it may have credit enhancements that do not rely upon the health of the parent. Moody's and Standard & Poor's provide flexible definitions of DPC structures to allow firms to achieve triple-A status in a variety of ways. This strategic restructuring of the firm thereby improved the long-term stability and integrity of these derivative markets and the innovation was driven by market forces.

In addition to the rapid growth in derivatives, cross-border lending and international securities issues are at record highs. The role of banks in these activities raises another challenge for stability and integrity in the international markets, namely, the conflict of interest that can arise when underwriting and lending are combined. Consider a firm that suddenly experiences a shock that is likely to reduce its future profitability. A bank with a lending relationship to that firm may know before the market does that the firm's prospects have now dimmed. The bank's superior knowledge, however, is a double-edged sword. If the bank were free from conflicts, the bank would make an objective analysis of the firm's future and, if new securities were to be issued, reveal the information to the public. Alternatively, a rogue bank may try to take advantage of its superior knowledge by underwriting and distributing securities to an unsuspecting public and using the proceeds to repay the outstanding bank loan.

This concern was a key factor driving the passage of the 1933 Glass-Steagall Act in the United States, which forbids commercial

banks from underwriting and dealing in corporate securities (Kroszner, 1996b and Kroszner and Rajan, 1994). The fear that such conflicts can then lead to a destabilizing loss of confidence in public securities markets continues to be a major obstacle to permitting universal banking in the United States and plays an important role in the debate over financial reform in transition and emerging economies. The public regulatory solution generally involves mandating complete separation or strict "Chinese Walls" between lending and underwriting operations.

Market forces, however, have been able to provide the incentives for banks to reduce the potential for conflicts voluntarily through the strategic reorganization of the firm. Banks that lack credibility are penalized in the marketplace because purchasers will pay lower prices and demand higher yields from securities underwritten by institutions they cannot trust. Prior to the Glass-Steagall Act in the United States, banks organized their investment banking operations either as an internal securities department within the bank or as a separately incorporated and capitalized affiliate with its own board of directors.

In a study with Raghuram Rajan (1997), we found that the internal departments obtained lower prices than did the separate affiliates for otherwise similar issues they underwrote. The pricing penalty associated with the internal department is consistent with investors' discounting for the greater likelihood of conflicts problems when lending and underwriting are done within the same structure. We found that the pricing benefit for the separate affiliates increased with the number of affiliate board members who were independent of the parent bank. Banks thus can enhance their underwriting credibility and performance through a strategic reorganization which separates the lending and underwriting and uses independent board members as internal monitors. Consequently, we also found that U.S. banks increasingly adopted the separate affiliate structure in the decade prior to the passage of the Glass-Steagall Act.

German universal banks, which had traditionally underwritten through internal departments, have now been moving these opera-

tions out to separate affiliates in London. Until recently, the German securities markets had been relatively uncompetitive and dominated by the banks themselves, with relatively low participation by individuals or outsiders. In these circumstances, the major players would be equally well-informed so there would be little value in setting up a separate structure. To achieve credibility in an internationally competitive market, however, they have found it in their interest to separate these functions. Market competition thus propels banks voluntarily to adopt Chinese Wall structures without any regulatory requirements.

Public regulatory responses

Having examined the private strategic responses to promote stability and integrity in the anarchy of the international markets, let us now consider the roles and incentives of public regulators. Public regulators can and often do perform the same functions that the credit-rating agencies do by evaluating and rating the soundness of financial institutions. The incentives of the private and public regulators are quire different. The private rating agencies are rewarded for being the most effective and accurate monitor, particularly for being the first to spot a problem and warn the public about it. In contrast, distress that would trigger a downgrade is perceived as trouble not only for the institution but for the regulators as well. No one holds Standard & Poor's responsible when a firm experiences a shock that lowers its credit quality.

To avoid taking the blame, public regulators have an incentive to delay recognizing and publicly announcing problems, since there is a chance that a positive shock could eventually resolve the distress, and waiting could allow them to put the burden on future regulators or politicians. The poor record of U.S. regulators during the 1980s giving high grades to institutions whose failures were imminent and the consistently extreme official underreporting of the bad loan problem in Japan during the 1990s illustrate this tendency. In the U.S. savings and loan crisis, for example, the desire to put off the day of reckoning led regulators to undertake perverse policies that obscured problems in the short run—such as permitting economi-

cally insolvent institutions to pay dividends—but were extremely costly to taxpayers in the long run (see Kroszner and Strahan, 1996).

In addition, public regulators cannot be insulated from political and interest group pressures. In Chicago, the police cars are emblazoned with the phrase "we serve and protect" and often that phrase can be applied to public regulators. Rather than promote the public interest, the regulators may end up serving the private interest of the industry that they are regulating and protecting it from competition (see Stigler, 1988). The political pressures provide a background incentive different from that of the private regulators.

Finally, the public regulators have much greater difficulty accommodating the dynamic change of the market than do the private regulators. Moody's and Standard & Poor's can provide general guidelines for good practice and then exercise their judgment as innovations occur through time. Giving public regulators wide discretion is an invitation to political and interest group pressure.

Conclusions for regulatory reform

Consistent with Litan's "competition-containment" approach, the key lesson for regulatory reform is that public regulation should not be permitted to crowd out dynamic private regulation. Strategic organizational choices by financial institutions and third-party monitors such as credit-rating agencies have been quite successful in providing stability and integrity for the international financial markets. One of the proposals from the recent G-7 summit in Denver was to increase information sharing and coordination among the public regulators. If that information is also shared with the public, applying the regulators' advice to the markets for greater transparency to themselves, then this effort is to be applauded. Some, such as Henry Kaufmann, have gone further to suggest that an international superregulator be created to set common standards worldwide. A unified international regulator is likely to slow the engine that generates the innovations that have driven the spectacular growth of the international financial markets without any clear stability advantages.

To ensure that public regulation is effective at promoting stability, such regulations should be subject to a rough cost-benefit analysis. Litan and a number of other distinguished regulatory experts have jointly recommended that such a common-sense test be applied in health, safety, and the environment (Hahn and Litan, 1997). While certainly the quantification of the costs and benefits of many financial regulations is extremely difficult, the challenges would appear to be no greater in environment and safety areas where decisions are made about infrequent but highly costly events, much like financial crises. Emphasis on the costs and benefits of such regulation would greatly clarify the public debate and undoubtedly improve the nature of financial regulation.

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