

Asymmetric Information, Bank Failures, and the Rationale for Harmonizing Banking Regulation

A Rejoinder on Comments of Ernst Baltensperger and Peter Spencer

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I am grateful for the two critical comments by Ernst Baltensperger and Peter Spencer, which have added to the debate on an important issue. My rejoinder is as follows.

When the Basel Committee developed rules for harmonized banking supervision, they did not believe that systems competition would itself be able to ensure an efficient system of prudence regulation in the various countries. Harmonization is the opposite of systems competition, and those who advocate harmonization mistrust the forces of systems competition. This includes the EU, which has already declared that it will adopt the Basel II rules that are currently being developed, as well as all the other countries that are likely to adopt the new Basel rules.

When Rudi Dornbusch (2003) gave his Munich Lectures in 1998, he argued that financial fragility was the reason for the vulnerability of the Asian economies and a prerequisite for the Asian crisis of 1997. He attributed the financial fragility of the Asian countries to a “deliberate lack of regulation, supervision and transparency,” which induced financial agents to neglect the value at risk and to take gambles. Dornbusch argued that the IMF should, in future, act as an international supervisory authority making its loans dependent on countries’ sticking to common guidelines for effective prudence regulation, and he poked fun at the “liberation theologians” who believe in laissez-faire solutions for government actions.

Given these demands for collective supervisory and harmonizing activities, my question simply was what the possible rationale for such demands might be. If systems competition among bank regulators worked, there would be no need for collective actions. Thus my task was to isolate possible causes of inefficiency in systems competition and not to find conditions under which systems competition would work.

My critics do not find this task legitimate. They simply deny that there is a problem. As there is no problem, no solution needs to be sought, and

my article is superfluous. Systems competition works because financial investors are well informed and are able to distinguish between the regulatory systems of single countries. A country has no scope to neglect its regulatory tasks behind the back of the investors. Yes, admittedly, there was an Asian crisis, but it resulted from bad IMF policies rather than a failure of systems competition – a view strongly objected to by Dornbusch, by the way.

I find this kind of reasoning frustrating, because it discourages theoretical papers on problems before their empirical validity has been ultimately decided. For me a prior suspicion is enough justification to design a theory that can then be tested. Dornbusch, the Basel Committee, and the EU, for that matter, believe there is a problem with systems competition; they justified my suspicion. This is enough motivation even if Baltensperger and Spencer see no problem.

In fact, I do not share their optimism, because I find it absurd to assume that savers, even financial investors, can *fully* monitor country-specific regulatory systems. Understanding one's own national regulatory system is a burdensome task in itself, given that regulation consists not only of fixing a minimum equity requirement, as set up in the simple model, but of specifying many detailed supervisory rules for alternative kinds of banking business. How much more complicated is it to overlook a large number of far distant countries that have encoded their laws in foreign languages, that act according to unwritten cultural laws, and that differ in particular in the degree of strictness with which they implement the written laws! How small must the windows in one's ivory tower be for one to believe that there is no asymmetric information in the "market" for regulatory constraints!

The European mortgage-backed securities market is a good example of the ignorance that prevails in practice. The market is dominated by the German *Pfandbrief*, which covers three-quarters of the total. The *Pfandbrief* is a nearly perfectly safe asset, because German regulation is extremely strict, backing its value with first-rate real estate collateral priced at about 40% below the market values. Since the introduction of the euro, the *Pfandbrief* has been facing the competition of many incomplete imitations from other countries, which definitely incur higher risks without having to offer higher rates of return for the investors. In view of the market's ignorance of the true risks involved, the pressure on the German supervisory agencies has been increasing to also allow the German banks to carry out more risky and profitable investment with the funds they received, and the public debate about how to widen the scope of international investment activities has already begun. I fail to see another reason for this alarming process than the competition of laxity that I have modeled.

Spencer argues that experience rating would be a realistic opportunity to assess the country-specific differences in regulation. As investors can observe

country-specific frequencies of bank failure, they know about the quality of regulation. Baltensperger adds that monitoring is easy because there are specialists doing it and because country-specific regulatory rules do not change frequently. These arguments are unconvincing in that if they were true, the Asian crisis could never have happened. At least, the crisis could not have resulted from financial fragility and a deliberate neglect of financial regulation, as Dornbusch and many other observers have claimed.

But the financial fragility was there, and even the international supervisory agencies like Moody's and Standard & Poor's had not been able to warn the investors in time of the meltdown that happened, just as they had proved unable to warn the investors of the savings & loan debacles or the failure of WorldCom and Enron. This indeed suggests that there was a substantial scope for unobservable policy actions. Monitoring banks and financial institutions is extremely difficult even for experts. True, investors were able to observe the previous performance of Asian banks, but that would not have helped them detect weaknesses in the national regulatory systems with regard to systemic, correlated risks, whose implications are rarely observable. The meltdown of national banking systems that occurred around 1989 was not a repetitive event in a country's history whose observation would have allowed the assessment of probabilities on the basis of actual frequencies. There will be no further meltdown in the Asian tiger countries for the time being, but banking crises will continue to pop up at other, unforeseen places in the world, as they used to do in the past.

The year 2002 is the year of the most severe crisis of financial capitalism in the postwar period in the U.S. and Western Europe. This crisis, too, has not been prevented by Moody's and Standard & Poor's, and we can only hope that it will not develop into something like the Asian crisis on a larger scale.

Spencer argues that if there were a monitoring problem of the kind I describe, then banks would help themselves. International banks would try to monitor their unsound fellows closely and would exclude them from the international banking markets if their respective national regulation were not tight enough. This is the well-known Panglossian view of the world. God designed the nose optimally, and it cannot be improved by a surgeon. If this analogy were true in the market economy, we would not need national food agencies to monitor and control hazardous ingredients because firms would help themselves by banning their reckless competitors from the market, and we would not need a national banking regulation because the banks would regulate themselves. What about the transaction costs of doing so? Regulatory activities that avoid the gamble for resurrection are public goods that are not easily provided by private agents. Only centralized, collective actions are able to internalize the externalities, but it is very difficult to bring such actions about.

Setting up the Basel Committee and implementing its recommendations via directives from Brussels and via national laws is such a centralized action. True, it was the banks themselves that wanted the Basel II rules to increase their profits, as I explained in the paper, and they contributed to their formulation. However, the Basel II rules would be useless without being enforced by government actions. Anyone who welcomes the Basel II rules must implicitly assume that unbridled systems competition would be a problem.

I am willing to admit, of course, that financial investors have *some* possibilities to monitor regulatory systems; they are not completely ignorant. Reality is between two theoretical extremes:

- (i) investors cannot observe any differences between the countries; and
- (ii) investors can perfectly observe the differences between the countries.

Clearly, the relationship between some countries is closer to case (i), and that between others is closer to case (ii). My critics come from London and Switzerland. Undoubtedly, these places have been successful players in systems competition, even able to build up brand names based on tough national regulation. There was a reward for these countries, in interest rates, for establishing the reputation of being tough. I fail to see, however, why this observation should imply that financial investors were able to distinguish between Thailand and Malaysia, or Indonesia, Korea, and Japan, and I doubt that they will be able to distinguish between Botswana, Sri Lanka, and Colombia, to pick three countries that have not been in the center of interest so far. My example of the European mortgage-backed securities market suggested that financial investors were even unable to distinguish between various European countries. The fact that there are products with brand names does not logically or practically exclude the possibility that there is a lemon competition between no-name products. The producers of brand names of course do not like the idea that their competitors will use regulatory measures to improve the quality of their products.

Baltensperger unfortunately gives the impression that I treat only case (i) in the paper. He accuses me of “simply not allowing for (the) possibility” that savers or financial investors could monitor national regulatory policies. However, this is not true (and was not true in earlier versions of my paper). On p. 321 I also deal explicitly with case (ii) and devote one paragraph to showing that competition works perfectly in this case. I did not make this case a proposition, since I found it intellectually uninteresting, not contributing to explaining the frequent financial crises we have seen in recent years. Nevertheless, to ensure that it can no longer be overlooked, let me now state the case more explicitly:

Proposition 4a Suppose international investors can perfectly monitor national regulatory rules and correctly infer what they mean for the risktaking of national banks. Then countries will implement the efficient solvency rules, and the invisible hand of systems competition works well.

Proof. Already given in Sinn (2003a, p. 321).

Admittedly, I did not formally treat the intermediate case where some monitoring, albeit not perfect, is possible. But this was for the sake of simplicity only, and it does not affect the conclusions. Unless *perfect* monitoring is possible, there is at least some scope for country gains by choosing overly lax regulation and imposing a negative policy externality on other countries, and hence the conclusion that systems competition will be too lax if banks are owned by domestic residents while foreigners are among the lenders remains valid. This is, in fact, a robust conclusion that should survive quite a number of model variations, including the ones that Baltensperger suggests. Actually, he admits that himself in his first paragraph, which deals with the formal aspects of the model.

Interestingly enough, Baltensperger argues that the benefits of tough regulation will be “at least to a certain extent recognizable to bank lenders” and that the winner in a deregulation race will therefore not be the country with the most relaxed standard. I am surprised at his saying this, because it suggests that my model implies a race to the bottom and that his assumption implies efficient regulatory competition. The truth is that my model generates an interior solution in the realistic case where there are both foreign bank owners and foreign lenders. Thus, the country with the most relaxed standard does not, in fact, win out, but nevertheless there is underregulation in systems competition. This feature will definitely remain true if we assume that the benefits of tough regulation are only to a certain extent recognizable to bank lenders. As long as the benefits are only partially recognizable, as Baltensperger seems to admit, there is the international policy externality resulting from asymmetric information that distorts the equilibrium in systems competition towards excessive laxity.

I should mention that the conclusion also emerges when my model is interpreted in terms of a time-consistency story. Suppose there is no asymmetric information, but loan contracts are long-run, while both banks and regulatory agents are able to change their risktaking behavior and equity choices after the contracts have been made. Savers or financial investors perfectly anticipate the banks’ and the regulators’ behavior, but the impossibility of renegotiating implies that changes in the banks’ risktaking with limited liability will nevertheless impose a marginal externality on savers. This would be an extension of the approach chosen by Jensen and Meckling (1976), a remark that I made in the first version of the paper submitted

but deleted to satisfy the space limitations imposed by the editor. As was shown in a comment by Dominique Demougin at the annual meetings of the Verein für Socialpolitik, all equations and all conclusions would go through in this case, when the equilibrium conditions are interpreted as applying to the *ex ante* phase where the contracts are made, and the other marginal conditions to the *ex post* optimization of banks and governments. In particular, there would again be a competition in laxity of the kind I described. I chose not to emphasize this possibility because I found that the repeated nature of loan contracting that characterizes reality places more emphasis on the asymmetric-information interpretation. Still, this interpretation is an important one that should be taken into account.

I agree with what Ernst Baltensperger says on the general possibility that collective agencies such as governments – or Basel committees, for that matter – may themselves make mistakes. We have all sung this tune many times. I see no point in repeating it whenever I write on systems competition, and I can only refer my readers to chapter 1 of my book on systems competition, where such issues are discussed at length (Sinn 2003). The failure of systems competition is, of course, not a sufficient condition for government actions. However, it is a necessary one.

Both commentators make a couple of constructive remarks on technical aspects of the model. I appreciate these remarks and certainly agree that richer banking models could be constructed that incorporate the other aspects of bank decisions, in particular those that would explain the useful functions of bank equity capital. However, richer models are more complicated and burden the reader with more mathematics. It is my understanding of good theorizing that one keeps models as simple as possible to capture the effect one wants to study, rather than aiming for completeness. With a higher formal density, I could easily produce an interior equity choice even without regulation by introducing bankruptcy costs, derive the equilibrium with banks that diversify over a certain number of clients (instead of only one per bank), or allow for the volume of funds being optimized in addition to risktaking. All my assumptions here are innocuous, aiming at simplicity only. As the ingredients I chose are sufficient to produce an interior solution in systems competition (which the critics overlook), I did not need more complicated assumptions than the ones I chose. Nevertheless I would of course welcome extensions of the kind the commentators suggest.

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