Competition of Bank Regulators: A More Optimistic View

A Comment on the Paper by Hans-Werner Sinn

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1. Introduction

The main objective of Hans-Werner Sinn's contribution (Sinn 2003) is to analyze system competition in bank regulation. He presents a very pessimistic view of such competition, arguing that it cannot work properly and will result in a level of regulation that is too lax relative to what would be socially desirable (a "race to the bottom"). Sinn's analysis is based on a model of credit and banking with asymmetric information and limited liability. The first half of his paper presents a formal restatement of a result well known from the literature, namely that limited liability and asymmetric information distort banks' risk choices, providing an incentive for banks to finance overly risky investments and choose too little equity capital (the *gamble-for-resurrection* argument). Sinn (1980) himself had extensively analyzed the gamble-for-resurrection argument in his book on economic decisions under uncertainty. The imposition of capital requirements by national governments is a well-known remedy for dealing with this problem. However, Sinn argues, these regulations will not survive in a globalized economy under system competition. A national solvency regulation is said to create a positive international policy externality on foreign lenders of domestic banks, inducing national regulators to choose a level of regulation that is too low (an undersupply of regulation).

By trying to model system competition in the context of bank regulation, Sinn takes up a highly topical and interesting issue, and he is to be commended for this. Indeed, analysis of system competition in bank regulation so far has mostly been restricted to verbal discussions,[1] with a formal treatment of the issue still lacking. Regretfully, I find Sinn's analysis of the issue quite unconvincing.

1 See, e.g. Kane (1991), pp. 334–336, Baltensperger and Behrends (1994), pp. 296–298, or Gehrig (1995), pp. 753–554.

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2. Observation of Differences in National Regulations

Sinn argues that the same mechanisms that lead to excessive risktaking in the national context will also prevent competition among national regulatory authorities from working properly. This hinges, as in the national context, on the lack of ability on the part of bank lenders to differentiate between different bank product qualities. But, while in the national context this refers to lenders' ability to differentiate between activity structures and risk profiles of individual banks, which is difficult indeed, in the case of international system competition it refers to the ability to differentiate between different national regulatory regimes. It seems to me that differences in national standards in banking regulation are difficult to hide and can fairly easily be revealed to bank lenders by financial specialists, rating agencies, and the financial press.

In its most general form, Sinn's argument says that, since governments tend to engage in those activities that cannot be handled satisfactorily by competitive markets (his "selection principle"; see Sinn 1997), we cannot expect that reintroducing a market through system competition will work. Rather, he argues, system competition will bring about the same kind of market failure that justified government intervention in the first place. In my view, this argument suggests a questionable and unconvincing analogy and is not applicable to the present case. Asymmetric information as a basis of an externality and allocative inefficiency may be convincing at the national or individual-bank level. Monitoring activity structures and risk profiles of individual banks is very difficult, given today's importance of off-balance-sheet activities and availability of market instruments allowing bank portfolio adjustments at a moment's notice. (Still, the benefits of enhanced transparency and disclosure rules should not be totally discounted.) At the international level, though, the issue is a completely different one. Public laws and regulations cannot be hidden, nor do they change very frequently in an unforeseeable way. Their degree of enforcement can be monitored by interested specialists. Admittedly, attempts to exploit legal formulations and corresponding evasion and circumvention activities may occur and develop over time. But resulting patterns can be observed and do not change overnight. So an alleged externality would have to have another source, one that is not revealed by Sinn.

Thus, I find it rather difficult to believe that markets should not be able to price such risk differentials more or less adequately. It is true that international lenders and markets did not appropriately discriminate among banks and countries in the 1990s. But this has, in all likelihood, much more to do with expectations that national authorities and the international community (e.g., through the IMF) would come to help and bail out ailing borrowers in case of imminent danger than with lack of information (an alternative, and

basically equally important reason for adverse risk incentives, which makes no appearance in Sinn's discussion).

If we allow for the possibility that regulation (up to a point) has benefits, and that these benefits are, at least to a certain extent, recognizable to bank lenders, there is no obvious reason why the winner in a deregulation race will be the country with the most relaxed standard.

There can be little doubt that reputations for tough, or weak, regulatory standards can be established over time. Succumbing to the temptation to exploit the advantage resulting from a low regulatory standard may have high long-run costs in terms of reputation. This may explain why a country like Switzerland, which according to Sinn's analysis should probably have a low level of regulation, exhibits one of the internationally toughest standards in capital adequacy regulation. By simply not allowing for this possibility, Sinn's analysis takes a biased view of regulatory-system competition. So, while I find his analysis to be technically correct, I find it economically unconvincing in its central point.

3. Regulatory Competition as a Process of Search

There is another aspect of Sinn's reasoning that, in my view, introduces a bias for solutions with coordinated regulatory action and against system competition. Sinn's analysis of regulation is limited by the supposition that all necessary ingredients to quantitatively determine the socially optimal capital requirement are known. Furthermore, it assumes that this is the level of regulation actually chosen by governments, at least in the national context and under international cooperation.

In reality, however, the optimal capital adequacy requirement may be quite difficult to determine. Beyond this, public-choice considerations may explain why actual regulatory decisions may deviate from socially optimal ones. If only for this reason, we should not dismiss the idea of system competition lightly.

Optimal regulatory solutions are difficult to establish even in theory. They depend on how we view banks and their role in the economy, and how we model the external effects on society that are possibly associated with their activities. Sinn's analysis is based on one particular example of such a view. In his model, if we take it literally, the optimal capital requirement is such that it "prevents the limited liability constraint from becoming operative" (Sinn 2003, equation 13 and subsequent discussion). Thus, equity has to be large enough to cover the bank's outstanding debt obligations under all possible realizations of investment returns. This implies a very high level of capital, an implication that lets Sinn himself argue that "such a strict interpretation

of the model would make little sense" (Sinn 2003, footnote 18) and leads him to accept more generous solutions. But which ones precisely? Sinn is silent on this. So we are left with a very unclear answer as to the best level of capital requirement, even by Sinn in the context of his own model.

If we allow for alternative models, the answer becomes even more difficult. Gehrig (1995), a paper that is approvingly quoted by Sinn, actually emphasizes the ambiguous nature of the effects of bank capital requirements and the difficulty in evaluating their desirability.

This uncertainty about the theoretically correct level of regulation, along with considerations of public choice, creates vast potentials for divergences between actual regulation and (socially) optimal regulation. This, if nothing else, is a solid reason for making regulatory regimes contestable by allowing a certain amount of regulatory competition. This is reinforced by the fact that a particular regulation, even if it is optimal at one time, may cease to remain optimal over time in a dynamic industry like the financial one.

Of course, these arguments in defense of competition in regulation do not imply that no inefficiencies could arise under a purely competitive approach. Such inefficiencies, if clearly perceived, might lead us to accept a certain amount of cooperation and minimal harmonization, e.g., as implied by the Basel Accords. My concern here is that relying too exclusively on cooperation and harmonization could result in even greater weaknesses.[2]

4. Modeling the Credit and Bank Intermediation Market

Finally, let me make a few remarks on Sinn's formal model of the bank intermediation market. I find some aspects of the particular model formulation chosen by him peculiar. I mention this last, though, because I believe that the central behavioral feature Sinn wants to obtain from his model – the tendency towards excessive risktaking under limited liability and asymmetric information – is robust and would hold up under alternative model formulations as well. Nevertheless, I think that Sinn's model is limited by these features.

A first point concerns the economic role of banks in the model. According to Sinn, this role is that of a "delegated monitor" for business investments (reflecting the presence of prohibitive costs of direct lending). This is basi-

2 As Kane has reminded us, one possible way of looking at a system relying excessively on cooperation and harmonization is to interpret it as an attempt at the formation of an international cartel among regulators, with the purpose of protecting them from the unpleasant effects of international mobility of financial firms and their customers. The difficulty of arranging durable patterns of international regulatory cooperation then may reflect, above all, the usual difficulties inherent in forming and maintaining a worldwide cartel in any product (Kane 1991, p. 335).

cally as in Diamond (1984), but with the difference that the friction behind this delegation is not explicitly captured by the model, but just asserted, in contrast to Diamond. In another respect, however, Sinn's model is entirely different from Diamond's. In the latter, the consolidation of investment risks by the bank plays a central role, allowing the bank to offer risk consolidation services to its lenders, driving down the "delegation costs" implied by the indirect lending through banks to a level that makes intermediated lending feasible and attractive to all participants. In Sinn (2003), in contrast, banks do not diversify their lending across independent borrowers. Instead, each bank specializes in just one (type of) borrower. This means that the bank does not offer diversification services; rather, bank lenders (households) are assumed to produce these themselves by diversifying across the debt instruments issued by the various banks. What kind of banks are these? Sinn calls them "investment banks." But I am not sure that this captures what real-world investment banks do. I am also not convinced that the German *Hausbank* "comes close to this ideal" (Sinn 2003, p. 312). In terms of transactions and portfolio management costs, this credit-market arrangement would seem to amount to a highly complicated and costly one for lenders or households.

Secondly, it is worth pointing out that Sinn's capital requirement is not just that, but at the same time an asset allocation (or "liquidity") requirement, since his model allows the bank to invest equity capital in the safe asset only. This is different from real-world capital regulations, which typically just require the bank to finance a certain proportion of its risky assets with non-borrowed (equity) funds, without stipulating a particular form of investment for these funds.

Also, I see no reason why equity capital has to be introduced from the beginning in the form of a regulatory constraint. The special feature of his model that has probably led Sinn to employ such a formulation is that in his model, without the regulatory constraint, the bank would choose to hold no capital. This reflects the fact that in this model bank capital plays no positive role perceived by the banks themselves. In my view, this is an unattractive model feature. Models could be formulated that allowed for a positive role of bank capital recognized by banks themselves, be it as a signal of sound behavior, or be it as insurance against the potential costs of reorganization and restructuring associated with bankruptcy or imminent bankruptcy (Baltensperger 1972, 1980; Baltensperger and Milde 1987). Recent market developments have painfully demonstrated the beneficial effects of a high level of capital to the shareholders and managers of many firms, including in particular financial firms, suffering sorely from excessive levels of debt and low equity capital buffers. Well-capitalized firms with conservative debt exposures have stood up much better to the recent financial storms and the capital erosion resulting from declining asset values than firms with high debt

and low capital. A model that assigns a more meaningful economic role to bank capital would be more attractive, in my view, without changing the central behavioral results Sinn is looking for in order to conduct his subsequent analysis of system competition.

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