Financial Regulation and Market Forces

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In the popular mind, regulatory discipline and market discipline are alternative ways for society to allocate and distribute valuable resources. Regulation is thought to command outcomes that are politically more desirable than those likely to be brought about by the unfettered play of market forces.

My research emphasizes that this distinction is a false one. It cannot be pushed very far without breaking down. Market forces lead regulated parties to adapt to reduce the net burdens that regulation seeks to impose on them (KANE, 1981). Equally important, decisions made by regulators are themselves affected by incentives that are established by the interplay of market forces in political, bureaucratic, and economic environments (KANE, 1984, 1988).

This market-oriented perspective makes us view the shape and ultimate effects of regulation as endogenous economic variables. It also requires us to jettison comforting assumptions about why financial regulation exists and how its form and effects are shaped. It tells us that, except occasionally and by accident, regulators cannot straightforwardly get their way. Nor can their performance as agents for society be reliably monitored by potential principals. This means that regulators cannot be blindly relied upon to serve faithfully and effectively any particular set of societal interests.

Those who portray regulation as if it were exogenous assume away two problems: the need for regulation to adapt in response to regulatee avoidance opportunities and the conflicts that obviously exist between the public good and the narrow political, bureaucratic, and economic self-interest of official decisionmakers. For example, textbook presentations of how fiscal and monetary stabilization policies are formulated ignore tax-avoidance activity and treat policymakers as tireless, selfless, and relatively fully informed.

This naive perspective conflicts with the motive force that economic analysis ordinarily assigns to agents’ self-interest. Logical consistency requires economists to analyze in particular the specific political and bureaucratic goals and constraints under which government officials operate. Taking such a focus led STIGLER (1971) to a theory of regulatory “capture.” This theory maintains the assumption of faithful service, but changes the identity of the regulator’s principal. It portrays patterns of long-run regulatory equilibrium as faithfully serving not taxpayers, but the goals of the industry being regulated.

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This paper's analysis of officials' goals and constraints emphasizes regulatory conflicts of interest. Conflicts exist between the bureaucratic interest of a regulatory entity, the individual career interests of its top managers and political overseers, the interests of the taxpayers who ultimately back the credit of most regulatory enterprises, and the varied interests of producers and consumers of the regulated product. Recognizing that the weight and urgency of the separate interests varies through time establishes a case for incomplete and variable capture of regulators by competing sets of societal interests. The model makes two important points: that policymakers in representative democracies face incentives that are systematically distorted by defects in their accountability to taxpayers and that over time the nature of the distortions tends to vary perversely (Kane, 1989).

My approach conceives of regulation simply as a valuable service. As with other goods and services, alternative producers compete with one another for market share. What sets government-provided regulation apart from other services is that its quality and quantity are determined in markets for political and bureaucratic services that are dysfunctional in important ways. The dysfunctional elements trace to short horizons and conflicts of interest that are abetted by informational and reputational asymmetries. These distortions make individual-firm competitive strategies more passive and reactive in character than we tend to observe with private competitors.

To lessen opportunities for confusion, let me stop to underscore three claims that I do not wish to make. I do not intend to challenge any of the following propositions:

1. Government financial regulators have important tasks to perform;
2. Government financial regulators include some of the finest individuals modern society can produce.
3. Especially in dealing with routine problems, government financial regulators sometimes act with heroic altruism, sacrificing their incomes and reputations to promote what they see as the common good.

What I do wish to claim is that, because of conflicts of interest and associated informational and reputational asymmetries, at critical times strong counterincentives develop that tempt and often coax regulatory officials into doing their jobs less faithfully than usual. By unfaithful regulatory performance I mean taking actions that have predictable effects directly counter to the long-run interests of an official decisionmaker's taxpayer or regulated-industry principals. In modern representative democracies, when a need arises to make truly severe financial adjustments, government officials' incentives to make these adjustments systematically tend to sour.

This incentive breakdown occurs in part because members of society tend to resent and punish officials who alert them to the existence and depth of serious problems. This leads officials to resist such a problem's rise to visibility on their watch, e.g., by acting as lenders of last resort to economically insolvent deposit institutions. We may describe societal punishments as career penalties imposed on those that bear bad news. In economic terms, these penalties may be described as perversely deterrent "costs of whistleblowing." In a representative democracy, whistleblowing often make it better serve the career interests and reputations of elected and appointed officials to cover up the true depth of
severe problems and to defer effective treatment of the difficult conditions to the watch of their successors. The upside of the gamble has two parts: the possibility of making a "clean getaway" to either another job or another term of office before the bad information surfaces and the "dirtier" prospect of taking advantage of opportunities to manage deceptively the flow of information after the fact to blame the debacle almost entirely either on other parties or on uncontrollable forces. What makes this a model of incentive breakdown is that officials know that their gambling on effecting either a clean or dirty getaway is bound to prove costly in a discounted expected-value sense to officials' taxpayer principals.

As an application of this model, I want to show you that the incentive-breakdown theory can explain a series of U.S. deposit-insurance messes, as well as weaknesses in the Risk-Based Capital Agreement that was negotiated in 1988 under the auspices of the Bank for International Settlements. These episodes illustrate unfaithful service by U.S. politicians and regulators. I hope to convince you that official solutions proposed for various deposit-insurance messes are dangerously inadequate and that the international capital agreement is not an effective medicine for the supposed "disease" of financial globalization that it is alleged to counteract. Authorities' tendency to adopt and oversell solutions that are time-wasting placebos reflects their perverse attraction to counterfeit reforms. The persistence of this attraction may be interpreted as further evidence of incentive breakdown.

I. PURPOSES SERVED BY FINANCIAL REGULATORY SERVICES

Financial regulation is a class of service valued not for itself, but for the benefits it confers on those who use the products of the regulated financial industry. Financial markets and institutions may be compared usefully to an intricate organic system of interacting subsystems that together maintain the life and health of the organism in which they exist. In biological applications, subsystems are named after the particular functions they perform. We speak, for example, of the digestive system, the nervous system, and the reproductive system.

In finance, the subsystems include markets in individual countries for an array of financial services and for a range of financial regulatory services that complement each service in the array. Financial regulation is supplied competitively by government bodies and private self-regulatory organizations. Because government suppliers of regulatory services play a very large role in the market for regulatory services, the demand for regulation links financial markets with political and bureaucratic markets.

Financial regulatory services promote industry or societal goals by developing and enforcing rules of financial-services competition to monitor, discipline, or coordinate behavior of one or more other parties. Financial regulation comprises purposeful efforts to monitor, discipline, and to coordinate the behavior of individual firms in the financial-services industry.
Regulatory efforts typically promote contradictory goals. Systemwide efficiency and stability often compete with demands to protect narrower sectoral or individual interests. The efficiency goals that individual regulators pursue may be described broadly as building and maintaining customer confidence in the integrity of the financial system and its component subsystems and efficiently enhancing the convenience that customers experience in using the system. These efficiency-serving purposes of regulation are readily acknowledged by all players. In contrast, statements of stabilization objectives are typically fudged and conflicting redistributional purposes of regulation are typically left unspoken. To an important degree, stabilization and redistributional objectives are jumbled together, with the composition of the mix deliberately masked from the public by those who promote redistributional goals. This masking seriously complicates the tasks of analyzing both incentive defects in existing regulatory systems and the redistributional effects brought about by regulatory change.

II. A GENERIC OR GENERAL-PURPOSE CONCEPTION OF A FINANCIAL-SERVICES FIRM

Economists are accustomed to thinking of competition in factor and product markets among financial-services firms (FSFs) whose character is fixed. Our profession has tended to neglect the effect on an FSF's character of parallel competition for cooperative and governmental rights to produce and deliver regulatory services. The competition for regulatory clients is rooted in opportunities to increase the efficiency, reliability, and safety of the financial system, but distorted by principal-agent problems between taxpayers and government officials. Whenever regulatory managers are not properly accountable to their stockholder or taxpayer principals, some of their efforts to wrest market share from other regulators may decrease the efficiency and stability of the financial system as a whole.

Species of financial-services institutions are defined by the products they have traditionally offered. Their distinguishing character is rooted in specific services authorized by a special-purpose corporate charter as a bank or insurance company. However, given the protean financial-contracting technology of today, these once-distinctive services have an expanding number of substitutes. To define a general-purpose or generic FSF, it is instructive to conceive of each individual FSF as directly peddling some mix of "funds-channeling services" to a targeted customer base of businesses, households, and governments.

The structure of an FSF is defined by the decisions it makes about five strategic elements this section delineates: the firm's specific product line; its targeted customer base; its technology; its organizational form; and its regulatory relationships. Taken together, these choices shape the character of the interfaces the firm has with actual and potential customers, regulators, and other financial-services players.

An FSF's relationships with its customers represent an intangible asset. The intangible value of this customer base depends principally on two factors:
(1) the confidence and loyalty that its past services have instilled in its customers, and
(2) the search and switching costs these customers would experience in moving their business to an alternative FSF.

Search and switching costs include the difficulty of communicating information that each customer's current servicer has accumulated over time about the profitability of the particular customer's service relationship.

Funds-channeling services consist of transactions services, documentation services, funding services, investment services, diversification services, safekeeping services, and information services. These services are embodied in instruments and accounts that are offered to and maintained for FSF customers. The distinctive pattern of services, instruments, and accounts a particular FSF or species of FSF happens to offer may be described as its product line.

FSF services, instruments, and accounts are produced by a combination of back-office and front-office technology. Front-office technology concerns FSFs' capacity to communicate with customers and to deliver services to them. Back-office technology concerns an FSF's procedure for processing funds-channeling transactions. This technology lets an FSF maintain and communicate with an integrated customer file. This file may be conceived generically as a "remote data base."

In this conception, the technology by which an FSF produces and delivers services includes the mix of information media it uses to communicate with: its individual customers; its remote data base; its regulators; and other FSFs. Other FSFs function mainly as competitors and suppliers of back-office services. In the current state of FSF technology, important information media are: checks, currency, deposit slips, computer screens, ATM keyboards, telephone and other communications networks, magnetic tapes, and regulatory reports.

It is useful to define the contracts and structural elements which a firm uses to charter and organize itself corporately and geographically as its organizational form. Organizational form covers an institution's charter type, ownership structure, and command structure. Charter type describes the firm's FSF species and the state or national authority under which it is empowered. Ownership structure varies between personal and corporate (i.e., holding-company) ownership and takes account of affiliations with other firms that at least partially share a common ownership. Command structure refers to the formal chain of decisionmaking authority. Such chains differ between branch, agency, and representative offices and also between divisional offices and separately capitalized subsidiaries and affiliates.

Regulatory relationships refer both to contractual relationships that are required by a firm's existing charter type and existing structure of control and relationships that a firm may alter without first changing its corporate form.

Regulation creates a combination of benefits and costs. Activities that foster confidence and convenience reduce a regulatee's costs, while user charges and restraints on regulatee behavior increase an FSF's costs. The net effect on client costs that a given
regulator offers to a prospective or actual client constitutes the "net regulatory burden" or opportunity cost of its regulatory relationship. In principle, changes in regulatory relationships may greatly alter a firm's regulatory environment and the net regulatory burdens to which it is subject. KANE (1984) likens the net burden to a regulator's offering price and describes as "structural arbitrage" any change in an FSF's strategic elements that is meant to increase the firm's value by lowering its net regulatory burden. Although the profitability of structural arbitrage is constrained by regulatory switching costs, technological change has in recent years been steadily reducing the level of these costs.

III. THE STRUCTURE OF THE MARKET FOR FINANCIAL REGULATORY SERVICES

As may any other valued service, regulation may be presumed to have a market in which it is voluntarily purchased and sold. Sellers consist of governmental bodies and private self-regulatory organizations. Buyers consist of financial-services firms (FSFs).

Economic theory leads us to suppose that financial regulators compete with each other. Regulation is supplied in what is a worldwide industry by self-interested agents who respond to economic incentives. These agents use productive resources to pursue broadly identifiable goals and are subject to recognizable political, bureaucratic, market, and technological constraints. The partial endogeneity of these incentives implies that markets for regulatory services have an endogenous global market structure. This structure may be analyzed by the same contestable-markets analysis (BAUMOL, PANZAR, and WILLIG, 1988) that economists use to explain the market structure of FSF products.

In the market for regulatory services, suppliers compete not just in the quality and resource efficiency of the confidence-building and coordinating services they provide their regulatees. Regulators also compete as to where they ultimately lay the burden for financing their costs of production. This creates the possibility of an unhealthy competition in laxity. Whenever (as in government deposit-insurance schemes around the world) the cost burden can be laid surreptitiously on taxpayers in general rather than on the specific beneficiaries of these services, regulatory markets subject net regulatory burdens to an incomplete benefit-cost efficiency test. Opportunities for decoupling regulatory burdens and benefits makes it possible for a regulatory entity, without losing its market share, simultaneously to lower the benefits of the confidence and convenience services it offers and to raise their cost of production.

In the face of continuing technological change, it is more realistic to portray regulation as purchased relatively freely in the marketplace than it is to portray regulation as a well-meaning, authoritarian response to a series of specific financial market failures. Regulation seldom truly represents a one-way flow of command and compliance. To survive, regulatory structures must be accepted by the regulatees as economizing information and transactions-coordination costs.

Regulation is supplied competitively, in the sense that entry and exit opportunities exist for consumers of regulatory services. Dissatisfied regulatees can almost always turn to
alternative suppliers. In particular, geographic overlaps in the market for financial regulatory services expand as entry and exit costs for foreign players decline. Ongoing downward trends in these costs make regulatory competition increasingly world-wide.

The market for regulation comprises a body of persons that carry on extensive and, at least partly, voluntary transactions in the specific activity of promulgating and accepting regulatory restrictions. Although regulation is shaped and reshaped by market discipline, competition in regulatory markets is inherently imperfect. While it is important that society strive to minimize the degree of imperfection, the market discipline to which labor, capital, and political markets subject regulators (including elected politicians) is less than complete. Any individual regulatory entity that can lower the net benefits of its operations without losing much market share possesses market power.

Regulatory market power exists for two reasons. First, the number of potential new entrants that can economically supply regulatory services is limited, at least in the short run. Second, the cost of entering and exiting particular regulatory market are typically high. Would-be entrants need specific skills, financial strength, and prior reputational capital. They must be able to promise credibly that they can carry out the necessary tasks and are prepared to do so for years on end. Everyone knows that it takes a system of rewards and punishments to effectively change people's behavior. This means that entrants need a capacity for raising and distributing funds and a capacity for exercising disciplinary power. Along with the financial strength impaired by the right to shift costs to taxpayers, the right to use the force of law to punish violators gives government entities inherent advantages in the market for regulation.

Put briefly, in pursuing market share, differential entry and exit costs confer definite competitive advantages on government and well-established private regulators. Put differently, the market structure that emerges in regulatory services is distorted by two kinds of market power that the law freely gives to governments and that established contractual arrangements give to longstanding classes of private and public regulators. One is that the law temporarily confers special monopoly powers to make and enforce rules on elected politicians and appointed bureau heads. This power becomes all the stronger, the more confidently either that politicians may count on re-election or that top bureaucrats may count on holding onto their offices. The second is that incumbent regulatory firms such as stock exchanges and central banks that achieve dominance in a particular financial-services sphere have strong cost and enforcement advantages over new entrants.

For regulators, market discipline acts through political and bureaucratic transactions and not just through voluntary economic trades. Hence, given a nation's existing constitution and bureaucratic empowerments, imperfections in regulatory competition can only be improved within limits.

In any representative democracy, taxpayers may be likened to stockholders in each and every government enterprise. It is in their interest to establish a political and economic environment in which efficient regulatory enterprises routinely receive opportunities to expand and inefficient ones routinely come under pressure to contract. A critical structural
weakness is that government enterprises are not subject to continuous takeover discipline in the market for corporate control. To substitute for this discipline requires subjecting government regulatory entities to reliable accounting and auditing standards and to statutory requirements for explicitly rebalancing their capital accounts in timely fashion whenever events push the value their assets below the level needed to cover the actuarial value of their contingent liabilities.

Taxpayers must come to appreciate the wisdom of demanding that regulatory officials be at least as accountable to them for cumulative changes in the market value of each regulatory enterprise as the managers of the firms they regulate are to corporate stockholders. At a minimum, this means making authorities analyze honestly the distributional and longer-run market consequences of domestic and international regulatory arrangements and expose this analysis formally to the light of outside criticism.

Incentive conflict makes it dangerous under current performance-measurement schemes for taxpayers to trust imperfectly accountable officials to negotiate agreements and statutes that function as anticompetitive domestic and international blueprints for reassigning regulatory turf. For taxpayers, the efficiency problem is to prevent such reassignments from protecting undercapitalized and technologically maladapted institutions and regulatory systems from the gales of healthy market discipline.

IV. DIFFERENCES IN THE STRUCTURE OF REGULATORY AND FSF DECISIONS

Economics presumes that at each individual FSF and regulatory entity a management strategy is adopted that maximizes the value of an objective function subject to a series of market, technological, and statutory constraints. To spotlight the effects of conflicts of interest in government service, it is convenient to assume that managers of private and public enterprises differ in the objective functions they pursue. Private managers choose to maximize the value of the discounted future profits of the enterprise they control. While government officials also pursue this goal, they operate with a much shorter decision-making horizon and have additional goals and powers that conflict with that of value maximization. Short horizons and conflicts of interest tempt government officials to pursue strategies that redistribute resources from taxpayers toward themselves and some or all of their regulatory clients.

Exogenous changes in any elements of a firm’s strategic opportunities lead FSFs and regulators to make endogenous adjustments in other elements. To model the ongoing globalization and general-purpose reorientation of FSF competition, a broadly realistic mental experiment is to assume that exogenous changes in technology, customer needs, and the macroeconomic environment alter the costs and benefits of pre-existing regulatory arrangements. Thinking through such an experiment lets us explain observed changes in

1. This section and the next draw heavily on Kane (1988).
FSF product lines, organizational forms and locations, targeted customer bases, and regulatory relationships as responses to autonomous changes in individual FSFs' market opportunities and regulatory burdens. It also lets us explain parallel evolution in the market structure of regulatory suppliers.

Incentives for self-interested adaptation by regulators flow from opportunities for regulators to extend their dominion to new kinds of institutions and instruments and from the existence of even greatly constrained options for regulated firms to switch regulators. Without tough sunset laws, it is almost prohibitively costly to force the complete exit of a government regulatory agency, particularly one rooted in a national government. Nevertheless, declines either in an agency's share of regulatory activity or in its accounting profit tend to shrink the size of its budget and its political prestige. Because the unpleasant consequences of potential losses in regulatory domain undermine an agency's goals, they bring economic pressures on its management both to use accounting tricks to overstate the agency's income and net worth and to lighten many of the burdens that the pre-existing system of regulation would in a changing marketplace otherwise impose on client regulated firms and their customers.

In the increasingly global and generic financial-services industry of today, regulatory conflict is only occasionally driven by aggressive acts of bureaucratic expansion. The exceptional cases are to be found in the efforts of a few countries to attract financial business to their shores by transforming themselves into tax or regulatory havens. Regulatory conflict develops more often as a delayed response to prior structural arbitrage undertaken by financial-services providers. The initiating structural changes reflect profit-seeking efforts by individual FSFs either to invade nontraditional markets or to construct a more desirable net regulatory burden for themselves. Such institutions may be described as revising their organizational structures and extending their product lines and geographic reach to serve new markets and to select a set of regulatory microclimates that will minimize their burdens. As structural arbitrage disrupts the inherited regulatory equilibrium, what we may call a "law of one net burden" forces even nonassertive regulators to struggle to defend or redefine the borders of their domains.

Structural arbitrage causes problems for society because of defective incentives for elected politicians to monitor and minimize the opportunity cost for government agencies of producing regulatory services. A good portion of the reductions in net regulatory burdens that multinational and multipurpose financial firms win for themselves by structural arbitrage is generated by shifting real costs onto the taxpayer in hidden fashion. The most important of these hidden costs are subsidies that flow from the improper pricing of explicit and implicit government and international financial guarantees. These guarantees dramatically lower individual firms' risks in extending their product lines and geographic markets. Supporting these guarantees imposes implicit and largely conjectural liabilities on governmental financial regulators. The unaccounted expense and unrecognized liabilities that governmental guarantors incur pass through to unwary taxpayers and well-capitalized "survivor" financial institutions that as a matter of practical politics bear the final responsibility for making good on contingent governmental commitments.
Democratic governments around the world respond to political pressure to bail out
important enterprises when they become spectacularly insolvent. The predictability of
this response implies the existence of valuable implicit taxpayer guarantees. The desira­
bility of limiting these guarantees and imposing user fees on their recipients provides a
clear rationale for governments to construct and enforce explicit deposit-insurance
contracts. However, to minimize taxpayer costs, managers of deposit-insurance enter­
prises must be made accountable for pricing and managing implicit as well as explicit
claims upon their fund of reserves and be required to recapitalize their fund promptly
whenever the fund becomes deficient.

Because of regulatory lags, underpriced opportunities for shifting risk onto govern­
mental guarantors are especially great for innovative activities. Market participants that
put their own wealth on the line inevitably receive more timely and better-analyzed
information on the risk implications of developing investment opportunities than govern­
mental regulators do. Lags inherent in governmental information, monitoring, and regu­
latory-response systems are exacerbated by self-interested management of information
concerning the changing market value of government guarantees. Such information needs
to be published in transparent and timely fashion for taxpayers to monitor. Mispricing
governmental guarantees creates strong incentives for financial institutions to search out
new forms of risk taking and for foreign financial firms and nonfinancial domestic
institutions to devise inventive methods of folding government-guaranteed financial
subsidiaries or affiliates into their organizational form. Because the resulting increase in
a firm’s market capitalization derives from increasing the risk that the firm may fail,
defective regulatory incentives are undermining secularly the stability of the world’s
financial system. Destabilizing structural arbitrage is increasing the failure rates of deposit
institutions and complicating the task of measuring and controlling the money stock.

V. COMPETITION AMONG REGULATORS FROM DIFFERENT COUNTRIES

Competition for regulatory jurisdiction is inherent in the multinational organization of the
world economy. To the extent that it improves an FSF’s regulatory climate, opening an
international branch office or acquiring or forming an international banking or nonbank­
ing subsidiary is an act of structural arbitrage. Restrictions on the entry and expansion of
foreign financial firms and on domestic institutions’ capital exports have long been
common features of individual countries’ regulatory architecture. Because they limit
foreign regulators’ access to the home country’s markets and institutions, restrictions on
foreign entry and expansion protect not just domestic financial-services firms but domes­
tic financial regulators as well.

In virtually all countries during recent years, competition from foreign regulators for
domestic financial opportunities has become more intense. Macroeconomic events have
made restrictions on international financial competition more burdensome to regulated
firms while technological change has made them easier to circumvent. For both reasons, traditional restrictions have been progressively losing force.

As international patterns of activity change, efficient parallel adaption of the market structure for financial-services regulation is hampered by administrative entry barriers and by inflexible concepts of appropriate regulatory strategy and tactics. CORRIGAN (1987) argues that "much greater harmony in structural, supervisory, accounting, and tax policy as they apply in international banking and financial markets is needed and needed badly." An important question is whether an international regulatory agreement is necessary to accomplish this. Might not improved discipline on individual-country regulators give us an appropriate degree of harmony and do this in timely fashion?

CORRIGAN (1987) and LAMFALUSSY (1989) claim that market discipline actually works the wrong way, leading in particular to capital requirements for banks that are too low. Our model clarifies that this claim amounts to a presumption of short horizons and conflicted behavior on the part of individual-country regulators. Moreover, our industrial-organization perspective underscores that the difficulty of arranging durable patterns of international regulatory cooperation reflects difficulties inherent in forming and maintaining a worldwide cartel in any product.

Because regulatory lags are longer than avoidance lags, the ability of regulated firms to shift selected parts of their operation to other nations or to other domestic regulators expands the scope of regulatory competition. Although the intensity of the competition is restrained by government regulators' need to operate largely from within national or administrative boundaries and by the infrequency of exits by national regulators, it is heightened by opportunities to regulate multinational and affiliated firms as a single entity.

A country's willingness to provide (or inability to prevent the extraction of) implicit regulatory subsidies to financial-services firms affects the international division of labor and distribution of wealth. Such subsidies place a net burden for financing financial-services export promotion on the general taxpayer and on the stockholders, managers, and customers of smaller institutions that do not participate in international financial transactions. Moreover, subsidy-seeking structural arbitrage tends to shift at least part of the subsidies from multinational institutions of the home country to depositors and borrowers in the host country. In this way another country's regulatory subsidies can squeeze the lending margins earned by financial intermediaries in their domestic markets. The existence of subsidies from the home country accentuates political demands on home-country regulators to impose regulatory assessments against domestic banks' foreign deposits or loans. It also supports the efforts of institutions of the host country to push simultaneously for countervailing restrictions on foreign firms and for offsetting concessions from foreign regulators to ease reciprocal expansion into their competitors' home countries. Finally, the conjectural nature of incompletely financed government guarantees raises doubts about the reliability of home-country guarantees of the debts of increasingly more highly leveraged structural arbitrageurs. These doubts are invariably felt more strongly by an FSF's foreign customers.
In large part, the extent to which regulators in the home or host country gain or lose regulatory market share from structural arbitrage depends on the extent to which the services exported consist of truly new business for the relocating firm. Taking a single-entity view of multinational FSFs, new business creates regulatory services in the home country by expanding the home regulator's jurisdiction over the new activity into foreign markets. Displacing business that was previously conducted domestically in the home country is experienced as a diversion of regulatory service. Whenever a regulated firm's traditionally domestic business is simply displaced to foreign locations, the home regulator is disadvantaged. This regulator loses market share and regulatory revenue while continuing to absorb at least some of the costs of producing confidence-building and coordinating services that support the activity.

In the U.S., domestic competition exists between specialized regulators of FSFs with different organizational forms. This domestic competition spills over into the international arena, particularly when the regulator that loses volume in domestic markets differs from the regulator of the class of institution that is expanding abroad. For example, to circumvent Glass-Steagall restrictions that exclude U.S. commercial banks from domestic investment banking, the nation's major banks have established overseas investment-banking networks. The federal securities regulator (the Securities and Exchange Commission or SEC) and individual state securities departments have jurisdiction over corporate underwriting and deal making in the United States. This means that the ancillary foreign service volume that federal banking regulators gain unambiguously improves their market share. Although banking regulators may seek to recover any net costs that this activity imposes on them, they are apt to resist efforts by the SEC to close the loophole in domestic regulatory walls that permits a U.S. bank to operate a foreign securities subsidiary.

Picking up foreign clients does not always improve the market share of the host-country regulator. Every foreign client is shared in some proportion with regulators in its home country. Although sharing of offshore business tends to expand the host regulator's market share, any business that is diverted from host-country firms entails at least a small diversion of traditional market share to foreign regulators. Moreover, governments and legislatures cannot ignore the plight of firms and workers in invaded industries. Foreign entry tends to lessen the autonomy of host regulators by putting downward pressure on domestic profit margins and increasing domestic demand for greater freedom for host-country institutions to expand abroad reciprocally. Foreign institutions must be expected to discover ways to arbitrage differences in home and host net regulatory burdens, and foreign entry into the domestic market creates incentives for their domestic competitors to study opportunities for expanding abroad.

VI. SOME APPLICATIONS OF THE INCENTIVE-BREAKDOWN MODEL

In competing for clients, governmental regulators have two complementary advantages over private suppliers of regulatory services. Their governmental status confers reputa-
tional capital that makes it hard to force their exit when they are operating inefficiently. It permits them both to bear the financial strains of subsidizing critical elements in their service package for years on end and to manage self-interestedly the short-run flow of information concerning the effectiveness and cost-efficiency of their performance. Concealing regulatory subsidies from taxpayers makes their long-run effects destabilizing in that disinformation policies make it hard for taxpayers to fill the disciplinary role that stockholders and creditors play in a private firm.

Conflicts of interest between taxpayers and governmental regulatory agents account for four dangerous propensities that high-ranking government officials exhibit virtually everywhere:

1. A propensity to keep themselves underinformed about dangerous situations. I call this the blindfold or ostrich reflex. The value of this propensity is that it creates a deniability option that helps to deflect blame whenever a longstanding problem finally surfaces as a public scandal.

2. A propensity to use the weight of their high office as a weapon with which to reassure doubters even in the absence of reliable information. I call this the denial or trust-me reflex.

3. A propensity to conceal past mistakes and to discredit critics in watchdog institutions such as the press and academia by covering up unfavorable information. I call this the cover-up or speak-no-evil reflex.

4. A propensity to look for convenient, credible scapegoats. This secondary form of cover-up is essentially an effort to rewrite history. We may call this the guilt-redistribution or weasel reflex.

ADAM SMITH emphasizes that humans have a natural propensity to truck, barter, and exchange. I believe that the four propensities listed above are equally natural for high governmental officials.

U.S. Deposit-Insurance Debacles of the 1980s

During the last decade in the U.S., state deposit-insurance funds for savings and loan associations in Ohio and Maryland failed spectacularly. So did the parallel federal fund, the Federal Savings and Loan Insurance Corporation (FSLIC).

My research (1990) shows that, when faced with a surge in client insolvencies, each fund’s leadership and the politicians to whom they had to report pursued delaying tactics, tactics that were costly to taxpayers in an expected-value sense. In each case, politicians and bureaucrats sought to deny and cover-up massive mistakes and to bail out severely affected parties once their fund’s shortage was incontrovertibly revealed. The U.S. Congress’ repeated resistance to adequately recapitalizing the FSLIC fund and its successor institutions exemplifies all four propensities.

This proclivity toward deception and short-sightedness is rooted in officials’ desire to project a favorable image of their capacity to control events that fall within their administrative purview, their interest in developing and sharing regulatory rents, and their
belief that current taxpayers are relatively insensitive to the deferred costs of following coverup and bailout policies. Reforms that fail to recognize that regulators are tempted to engage in self-interested, career-enhancing conduct rather than purely altruistic behavior cannot deflect the U.S. Bank Insurance Fund from suffering a similar fate.

Managers of failed U.S. deposit-insurance funds knew well in advance of any visible loss of customer confidence in their clients that their fund was threatened by capital shortage. They knew that important clients were both economically insolvent and engaging in inappropriate forms of risk-taking. But top officials repeatedly rejected academic and staff proposals for openly pressuring these clients to recapitalize their firms and for making complementary adjustments in net burdens that might bring client risk-taking under administrative control.

Authorities' interest in buying time without using this time to solve problems promptly is supported by a reward system that penalizes officials careerwise for revealing damaging information and rewards them for shifting the emergence of unfavorable information to a successor's watch. This reward system explains why FSLIC's leaders undertook through the fund's last two decades:

(1) to pooh-pooh the unbooked losses that were imbedded in client portfolios as mere "paper" values that had no economic implications;

(2) to develop absurdly lenient accounting standards and to lower the level of official capital requirements to help economically insolvent institutions to live with and grow out of their insolvency; and

(3) to resist economists' attempts to educate officials and the financial press as to how severely a condition of unbooked economic insolvency distorts risk-taking incentives at insured firms.

International Agreement on Risk-Based Capital Requirements

The common international framework of risk-based capital requirements negotiated in 1988 has two stated purposes. First, it seeks to link a bank's capital requirements systematically to the riskiness of its activities, taking particular account of various off-balance-sheet forms of risk exposure. Second, to promote world stability, it seeks to coordinate supervisory definitions of bank of bank capital, risk assessments, and standards for capital adequacy across countries.

For U.S. regulators (especially E. G. CORRIGAN) and arguably for Bank of International Settlements General Manager LAMFALUSSY as well, an additional purpose was to constrain the market-share expansion of Japanese banks and regulators. They interpreted Japanese banks' and regulators' sudden emergence as leading players in world financial markets as evidence of inefficient regulation by Japanese authorities and not at all as evidence of falling world confidence in the banks of countries (such as the U.S.) whose market capitalization had been allowed to shrink to extraordinarily low levels. They claimed that the relatively low levels of book-value capital (i.e., accounting net worth)
that Japanese banks had previously enjoyed constituted a funding advantage conferred on them by growth-minded Japanese regulators.

The problem with this claim is that Japanese banks had such large accumulations of hidden economic capital from unrealized capital gains that they were and are dramatically better capitalized on a market-value basis than the Western institutions whose markets they have invaded. The efficient-market theory of corporate finance insists that increases (decreases) in the market value of capital lower (raise) the cost of issuing or rolling over uninsured deposit debt, irrespective of whether these increases and decreases are formally booked by bank accountants. This market-based advantage Japanese banks enjoy in funding cost was widened not by capital regulation, but by restrictions on domestic and foreign banks competition for domestic Japanese deposits. These restrictions subsidize Japanese banks as they attempt to win the right to intermediate internationally that high-saving country’s massive capital exports (KANE, 1991).

The new capital requirements are a nuisance for Japanese banks. Their stockholders must accept some combination of dilution from issuing new stock and increased taxes from speeding up the realization of accumulated capital gains. But the costs the agreement imposes on ordinary citizens of all countries are far more serious. This is because the capital agreement promises to paper over and unreasonably prolong inefficiencies in financial regulatory tactics and strategies in the world’s two most-important financial centers: U.S. deposit-insurance subsidies to risk-taking and Japanese barriers to foreign entry into domestic deposit markets.

VII. REPAIRING THE INCENTIVE BREAKDOWN

Ideally, globalization should help efficient (i.e., low-cost) financial-services firms and regulators to grow at the expense of inefficient ones. To establish whether this is happening, we need information about the efficiency of regulatory enterprises that no one has yet bothered to compile. This is because around the world top government officials prefer to produce disinformation rather than to release performance statistics that would expose them to timely and informed criticism. Officials everywhere have fostered an accounting framework that conceals rather than emphasizes differences in relative performance.

In a representative democracy, political processes define and often sharply distort operational perceptions of what constitutes the common good. It is striking that, in U.S. regulators’ mounting call for the international “harmonization” of financial regulatory structures, the need for adequate performance information for individual-country regulators has yet to be given any heed.

Government reporting systems downplay the overwhelming parallels that exist between operating a regulatory agency and operating an ordinary business. These parallels tell us that the performance of a government agency deserves to be judged predominantly by quantitative measures of the discounted value of the net regulatory benefits (NRB) it
can be expected to produce for society. This net benefit constitutes the difference between a measure of average quality of a regulator's coordinating and confidence-building services and a measure of the average cost of producing services of this quality.

What matters is not whether all regulators use the same control framework, but whether they can economically justify potentially observable net differences between the benefits and costs of the way in which they generate confidence and convenience for the customers of the firms they regulate. The appropriate efficiency criterion should focus on the discounted value of net benefits, analogous to the discounted-cash-flow criterion stock analysts use to evaluate the success of a private firm.

Of course, a less-perfect, first-cut performance criterion does exist. A statistic that has the virtue of being easily estimated is the trend of changes in different countries' and different agencies' regulatory market shares. It is ironic that, on this looser efficiency criterion, the successful firms and regulators turn out to be the very ones that Bank for International Settlements chief LAMFALUSSY, New York Fed President CORRIGAN, and SEC chief BREEDEN portray as dangerously undermining world financial stability.

This market-share shift is the apparent source of political pressure for "harmonizing" regulatory structures across countries. The existence of proposals to eliminate differences in regulatory structures across countries shows that someone is unhappy with the current arrangements. But it is disturbing that the pressure for regulatory adjustment is coming, not from unhappy taxpayers or customers in the countries and sectors that are expanding, but from competing suppliers, from competing regulators, and from politicians whose fortunes are directly or indirectly associated with these competing entities.

In effect, a system of competing institutions and regulators wants to use the force of international or domestic cartel agreements to gain back financial-market share for which the firms in other countries or industry sectors have previously outcompeted them. The desperately needed ingredient that taxpayers should see as missing in proposals for global financial harmonization is increased accountability for individual-country regulators.

The alleged desirability of regulatory harmonization is the watchword of international regulatory agreements such as the Basle accord on risk-based capital and of international regulatory associations such as the Bank for International Settlements and the International Organization of Securities Commissions. However, by harmonization such parties mean a convergence across countries and across types of FSF to a single and universal set of rules for financial competition and of mechanisms for their enforcement.

To appreciate why convergence is an inappropriate goal, it is useful to contemplate the meaning that harmony takes in esthetics. In art, harmony refers to the effect of combining two or more disparate elements into a pleasing aggregate that nevertheless preserves the individual identity of the component elements. The sound of a barbershop quartet illustrates the idea beautifully and emphasizes the value of not trying to force everyone either to sing precisely the same tune or to adopt the same voice quality.

Globalization reduces differences in the net regulatory benefit or burden (NRB) particular regulators may offer to (or impose on) a client FSF. As noted earlier, a client's NRB may be defined as the net value of regulatory services received, after deducting
explicit and implicit charges that inhere in its regulator's scheme of regulation. The key point to see is that — ignoring switching costs — net, not gross burdens are what market forces equalize across countries and sectors. Gross benefits and burdens can and should differ as much as a country's informed regulatees and taxpayers would be willing to tolerate.

In the past, inefficient elements in the country-specific character of inherited patterns of financial regulation were protected by distance-related, culture-related, currency-related and language-related costs that serve as barriers to entry for foreign financial firms. In dramatically reducing the significance of these barriers in recent years, technological change is imposing painful adjustment or transition costs on previously self-satisfied operators of regulatory enterprises. These adjustments will produce more efficient regulation and do this faster, the more accountable the affected regulatory enterprises happen to be.

Globalization of real and financial markets may be defined as a process in which increasing international competition imposes market discipline on government regulators. A technology-driven and irreversible downward trend in the costs of switching regulators and coordinating a multinational enterprise implies shrinking spheres of autonomy for economic policymakers in different countries. What is ultimately constricted is the freedom of politicians, government regulatory bureaus, and self-regulatory organizations such as exchanges to impose or maintain burdensome differences in the rules of financial competition.

The problem is that most officials see themselves as only temporarily occupying a regulatory or political hotseat. A short term in office makes it rational (albeit less than perfectly ethical) to suppress evidence of serious regulatory weaknesses as it develops and to defer costly action in the hope that they can make a reputationally clean getaway either to another job or at least to another term in office.
REFERENCES


SUMMARY

Private and government enterprises compete globally for the regulatory business of financial-services firms. This competition is rooted in opportunities to increase the efficiency, reliability, and safety of the financial system. However, the benefits this competition achieves are lessened by principal-agent problems that exist between taxpayers and government officials. These principal-agent problems lessen the contestability of regulatory markets. They let government authorities shift part of their costs onto unwary taxpayers, thereby decoupling regulatory costs and benefits. To make such shifting more difficult, it is essential that the net worth of government enterprises be measured by market-value accounting standards and kept positive at all time.