Professor Kane has written an excellent and thought provoking paper on a topic, which is currently widely discussed in many countries. Much of the public discussion on regulatory issues in general and the regulation of financial markets in particular still conveys the impression that the benevolent dictator paradigm is generally applied to these problems. This approach maintains that market outcomes disliked by a particular group, usually discredited as market failures, can relatively easily be corrected by appropriate legislative action. As a result, an increase in the general welfare of the citizens can be reliably predicted.

In this context, it is instructive to remember briefly the origins of current regulatory practice in many countries. In the United States, about 10'000 banks failed at the beginning of the Thirties. Many rather poor citizens lost their savings in the process. Today, we know that the Federal Reserve did not fulfill its function as a lender of last resort properly, leading to a massive loss of reserves, bank runs and a collapse of the financial system. At the time, scapegoats were sought and banks managers were found to play that role. Consequently, a number of regulations were enacted in order to protect bank creditors and to prevent such events in the future. Examples are the institutional separation of commercial and investment banking, branching restrictions and Federal Deposit Insurance. To achieve the same purpose, a banking law was enacted in Switzerland in 1934, stipulating capital and liquidity requirements.

Professor Kane questions this line of thought by applying public choice theory to the problem of financial regulation. Not surprisingly, he concludes that observed regulatory practice in the financial area has many weaknesses. One striking example, which Professor Kane has analyzed in a sequence of papers, is the deposit insurance mess in the United States. In this specific case, the American taxpayer will eventually be forced to pay hundreds of billions of dollars because regulation has resulted in the failure of many banks by systematically distorting the incentives of both depositors and bank managers.

The major question asked by Professor Kane in his paper is, what mechanisms protect the citizen from the regulators. The history of banking regulation shows that it is legitimate to analyze this issue. It is important to recognize, as Professor Kane does at the beginning of his paper, that the problem is not that regulatory jobs are generally occupied by immoral people. The problem is that the consequences of regulatory actions are on average not determined by the individuals performing such tasks but by the incentives and constraints implied by the chosen institutional setting.
To analyze the issues, Professor Kane draws a very useful analogy between bank customers as the constituency of banks and citizens/taxpayers as the constituency of regulators. I fully agree with the arguments and conclusions put forward by Professor Kane. In the following, I therefore want to make a few additional remarks using the framework adopted in the paper and draw a number of conclusions with respect to current issues in financial regulation. In my arguments, I will emphasize the importance of agency costs and competition in the analysis of regulatory issues.

As all individuals, bank managers will most likely try to maximize their own utility function. Therefore, they will not exclusively act in the interest of the bank customers and shareholders. But deviations in behavior can only occur until the marginal benefits from such actions equal their marginal costs. Consequently, the costs of monitoring bank managers determine their freedom of choice. Due to competition on various markets relevant for bank managers, these agency costs are quite low, especially in a totally unregulated financial system. Some examples may illustrate the point. If customers are not satisfied with the services of a particular bank, they can easily move their business to another supplier. As a consequence, the banks shares will fall in value on the stock market, alarming shareholders to do something about the situation. An extremely simple alternative is to sell the shares on the stock market. Furthermore, the market for labor and takeovers ensure that managers can be replaced quite rapidly. Already the threat of such actions generally prevents managers to diverge substantially from behavior expected by customers and shareholders.

The example of deposit insurance in the United States shows that these control mechanisms may be severely hampered by regulation intended to achieve just the opposite. The reason is that customers no longer have the same strong incentive to control the banks performance and riskiness if their deposits are guaranteed by the state. Consequently, bank managers enjoy more freedom to pursue their own goals. Obviously, the question now becomes whether regulators have incentives to perform this supervisory task as efficiently as bank customers.

In order to answer that question, Professor Kane uses the concept of a market for regulation with its own incentive structures and ageny costs. The analogy is very useful because the answers again depend on the degree of competition as in the market for banking services. The task of regulation is usually fulfilled by government agencies enjoying a considerable degree of monopoly power. Consequently, competition among regulators is fairly limited. The resulting higher agency costs allow regulators to act in a more discretionary manner in maximizing their own utility functions. In difficult times, it may even happen that necessary adjustments are delayed substantially. This situation is described by Professor Kane as the breakdown of government officials’ incentives. I suspect that regulators would be quickly out of a job under such circumstances if agency costs would be as small as in the competitive market for banking services.

But agency costs are not infinite. Financial innovation and the international integration of financial markets allow banks and their customers to avoid “inefficient” regulation relatively easily. Regulators therefore have to compete in order to make their financial
marketplace attractive. In Switzerland, several features like legal, political and economic freedom and stability are regularly pointed out in that context. To keep their constituency, regulators must and often do respond by adjusting the rules they impose. Quite often, banks also exert considerable political pressure in that direction. The attempts to abandon the stamp tax on financial transactions in Switzerland is a good example. But, as the so-called capture hypothesis maintains, collusion between regulators and regulatees can also occur, sometimes as the expense of taxpayers and clients.

Taxpayers are the other group involved in the process because they eventually may have to pay for bad regulatory practices by bailing out banks, as the example of deposit insurance in the United States demonstrates. For taxpayers it is more difficult to avoid such burdens. Emigrating to another country is one possible course of action. The other is trying to change the rules through the political process. Both alternatives involve high costs and low expected benefits. It is therefore no wonder that most taxpayers deliberately choose to remain uninformed about these issues.

The framework outlined by Professor Kane also leads to a quite interesting interpretation of the current discussion on the international harmonization of capital requirements for banks. The proposals may be seen as attempts to form a cartel among regulators leading to a decrease in competition and an increase in agency costs of banks and their customers as well as of taxpayers associated with the control of regulators. If we believe Professor Kane’s analysis, doubts about the usefulness of such endeavors are certainly not misplaced.

As a conclusion, Professor Kane has shown that government regulation cannot just be seen as a cure for market failures but involves problems of its own. Usually, the choice is between two or more imperfect alternatives. A comparison between a regulated and an unregulated financial system may even reveal that the absence of regulation produces more desirable outcomes. In fact, this is exactly the answer usually given by economic analysis. It is pointed out that financial markets are stable even if they are totally unregulated. Of course, changes occur and some firms may fail over time, as in markets for other products and services. If a danger of disruptive bank runs should occasionally emerge, it can be prevented by the central bank acting as a lender of last resort. Moreover, even relatively uneducated bank creditors would not remain naive when it becomes costly to behave that way. Rather, they would evaluate the relevant tradeoffs between risks and expected returns rather carefully. And finally, there is always the fundamental question why citizens allowed to vote on complicated issues have to be protected from the consequences of their freely taken financial decisions.