Comment on the paper by NIKLAUS BLATTNER «Capital Adequacy Regulation»

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Two traditional functions of banks include the screening and monitoring of borrowers and the supply of short term, liquid deposits. The joint offering of loan and deposit services is perceived as facilitating the collection of informations and the monitoring of borrowers. An important implication of the lending role of banks is that private information held on borrowers will make the secondary loan market fairly illiquid, and that banks will face the risk of run on deposits.

As Professor BLATTNER (1996) recommends, any analysis of banking regulations must start with an analysis of the potential market failures in the functioning of private markets. Two such failures are identified. The first is the need to protect investors who are uninformed about the solvency of banks. Very much as consumers demand the public certification of the quality of medical services or food, uninformed investors demand the public certification of a minimum degree of solvency. Related to the protection of uninformed investors is the fear that shareholders of banks could exploit the uninformed investors by increasing the riskiness of the bank. Indeed, MERTON (1977) has shown that equity is similar to a call option, the value of which increases ceteris paribus with the volatility of the underlying asset. Moreover, even when shareholders are not fully in control, there is a danger that the effort of the management to control risk could be inadequate (DEWATRIPONT/TIROLE, 1994). A second market failure is the fear of bank runs and systemic risk. A run on a bank or a series of banks is inefficient as, collectively, it would be better for depositors not to run and liquidate the bank in an orderly fashion; a run on deposits forces a bank to sell illiquid assets at a loss to fund the deposit outflow (DIAMOND/DYBVIG, 1983). In addition to the inefficient run on deposits, one can mention the fear that the closure of large banks (too big too fail) could have costly macroeconomic effects such as a reduction of production and an increase in unemployment.

The comments on the paper of Professor BLATTNER will relate first to the importance of capital regulations. Next, two suggestions will be made to reduce the market failures.

Professor BLATTNER calls for a review of existing regulations and suggests the preeminence of capital regulations. If I agree with the need to review the efficiency of existing regulations, I would emphasize that the need to conduct supervision on a discrete time basis and imperfect informations create a need for regulations which are complementary to capital regulations. If information was freely and continuously available to supervisors, these could compute in principle the probability of failure of a bank and assess on a continuous basis the need for capital. However, when obvious cost reasons force regulators to assess the degree of risks only periodically, the need for complemen-
tary regulations arise, in the interest of both regulators and banks. Take as an example liquidity. In the absence of liquidity regulations (liquid assets to deposit ratio), banks would be required by conservative regulators to finance their illiquid assets with 100% equity. By agreeing to meet some liquidity requirements on a continuous basis, regulators can impose a much lower capital. The same argument holds true in the case of large lending exposure for which limits on loans to a single borrower can facilitate the task of regulators. Moreover, when there is uncertainty, that is when regulators find it difficult to measure risk, the housing of some activities outside the banking system or in separately capitalised subsidiaries may help both banks and regulators. Finally, if the abandon of many regulations such as deposit rate control or portfolio constraints is welcome, it remains that, in our current state of knowledge, fairly little is known theoretically or empirically about the actual costs caused by regulations of bank capital.

Two proposals to reduce market failures are presented. The first proposal suggests to alter the nature of the insured deposit contract. The second one suggests how to reduce the cost incurred with bank failures.

BALTENSPERGER-DERMINE (1987) recommended to change the nature of the liquid deposit contract by allowing regulators to go after depositors even if they had run. As losses due to bank default would be shared by both current depositors and by those who had run, the incentives to run would be substantially reduced. My first proposal suggests to modify again the deposit contract but in a different way. It proposes to render insured deposits first order claim. The ordering of bank liabilities would reduce substantially the cost of deposit insurance, putting the burden on uninsured deposits (DERMINE, 1996). The assumption is that large uninsured corporate or interbank depositors should be in a better position to assess the solvency of their bank.

The second proposal attempts to reduce the costs inherent with bank failures. As the recent financial distress cases of Crédit Lyonnais in France or of the major Swedish banks have shown, it appears very difficult to put a large bank into default. The issue is not so much the fear of a domino effect whereby the failure of a large bank would create the failure of many smaller ones; strict analysis of counterparty exposures has reduced substantially the risk of a domino effect. The fear is rather that the need to close a bank for several months to value its illiquid assets would freeze a large part of deposits and savings, causing a significant negative effect on national consumption. My proposal is to accelerate the bankruptcy process for large financial institutions quoted on a stock exchange. Since the valuation of illiquid assets will take time, I suggest to close a bank for very few days and force an exchange of X% of deposits for equity shares (debt for equity swaps). The bank would be reopened and the shares would be priced on financial markets. The shares being tradable, investors will have the choice to keep their shares or to sell them. As the correct valuation of assets would take time, shareholders could have incentives to hold to their position, but illiquid investors could sell to resume consumption. The need to scrutinize more carefully the bankruptcy process for large financial institutions appears timely as a major restructuring trend has reduced the number of banks to very few in a large number of European countries.
In summary, I support very much the call of Professor Blattner for a review of regulations, suggest to render first order claim all uninsured deposits, and recommend to review the bankruptcy process for large financial institutions.

REFERENCES:


Blattner, N,: «Capital Adequacy Regulation: There is Hardly an Alternative», this journal.


