8

External Governance: Market Discipline

When internal governance fails to ensure the soundness of banks, private and public sector creditors of banks must themselves strive to ensure that their interests are not jeopardized. Creditors can reinforce bank's incentives to operate safely and soundly by providing oversight, exerting discipline on banks' activities, and driving poorly managed or unsound banks out of the market. Such market discipline helps prevent isolated problems at individual banks from contaminating others and building into systemic unsoundness.

Private Sector

Private capital markets impose discipline through creditors who monitor a bank's financial data and respond to signals of unsafe or unsound practices by requiring higher interest rates or by withdrawing resources from the bank. This could take the form of a run but it need not be an abrupt process, provided that the market has sufficient—and regularly available—information to distinguish weak banks from strong ones; it may involve weak banks being forced to pay higher rates for funds, or the gradual transfer of funds from weaker into stronger banks, and ultimately exclusion from the interbank market. An example of market discipline was provided in late 1995 by the premium charged to Japanese banks in the international interbank market. In response, Japanese banks sought to reassure markets by increasing their disclosure of nonperforming loans.[74]

Faced with the potential of higher costs or being forced out of business, shareholders and boards of directors will be cautious about allowing high-risk banking practices, because negative market reactions to such practices would damage their stake in the bank and ultimately force its exit from the market. The exit of weak individual banks is critical for

[74] See "Japan," November 1995.

the maintenance of a strong banking system. The prolonged operation of unsound banks permits them to spiral into deeper insolvency, and possibly to damage competitors through market practices that, although not viable in the long term, might enable short-term survival. Experience has shown that unsound banks are invariably in worse condition than their financial statements indicate and that the least intrusive and cheapest way of keeping a banking system sound is to force the early exit of nonviable banks.

Such market discipline requires that creditors—at least the larger ones—have funds at risk in the market (i.e., that their claims not be not fully protected) and have sufficient information about the banks in which they have placed their funds, so that they can avoid risk. Large and well-informed creditors, including other banks, typically are most effective in exercising market discipline because they have more resources with which to monitor and influence banks. Well-developed interbank, securitized debt, commercial paper, and money markets are usually capable of providing such discipline. Small-scale depositors cannot generally be expected to provide external discipline because they lack the necessary financial analysis skills; they may also lack incentives to do so because their deposits may be insured. Even so, smaller depositors may manifest their discomfort with individual banks or with the broader stability of a banking system through bank runs and capital flight. In addition to creditors, deposit insurance schemes, credit-rating agencies, credit bureaus, external auditors, and market analysts, all develop and express opinions on the soundness of banks. These contribute to market discipline by providing information not only to creditors but also to banks' owners and potential owners.

When market discipline is working, banks are forced to correct their deficiencies or exit the market before they become insolvent. One would not expect creditors to wait until their claims can no longer be fully covered by bank assets. Similarly, it is in the interest of a private deposit insurance scheme to force the early exit of a bank before it becomes insolvent and results in losses for the deposit insurer. Exit pressure is greater in a competitive market, where an individual bank is more dispensable, than in a highly concentrated market. Where the fact that a bank is not too big to fail is common knowledge among depositors, other creditors, owners, managers, regulators, and politicians, depositors will have no incentive to rely on official assistance for the ailing bank.

Exit pressure also may be exerted through the market for corporate control. While creditors exert discipline by depriving the bank of liabilities, shareholders can exert discipline by selling their ownership stake, and driving down the value of the bank. Where there are concentrated ownership stakes, shareholders will use the signals provided by market partic-

ipants (creditors, auditors, analysts) to guide their oversight of the bank and its management.[75]

Public Sector

Public sector creditors can also structure their involvement with banks (private or public) so as to provide oversight and external discipline for bank activities. Insofar as the government or other state-controlled entities maintain deposits at commercial banks or guarantee credits, they can act as any large, well-informed creditor to impose market discipline by withdrawing their deposits or guarantees. The most common public creditor is the central bank, which may provide credit to commercial banks generally for monetary policy purposes or temporary liquidity to individual banks as lender of last resort.[76] The central bank can restrict unsound banks' access to its credit facilities and thus force their market exit.

When deposit insurance is publicly provided, it is important to design the insurance system so as not to reduce the incentives for other market participants to exert discipline. Market discipline can be retained by creating an explicit deposit insurance system with clearly defined, credible rules that make insurance compulsory and confine guarantees to small depositors. Market discipline may be further reinforced by placing responsibility for funding deposit insurance on the banking industry rather than the government. A well-defined deposit insurance system can enhance market discipline by making the closure of insolvent banks more politically acceptable and therefore more likely to occur quickly.[77]

Public sector owners can play a role in disciplining state-owned banks parallel to the role played by markets with respect to privately owned banks. Responsibility for ownership oversight of state-owned banks must be clearly allocated to a particular ministry or agency that will monitor directors and managers of state-owned banks, and replace them if their performance is inadequate.

Market discipline has the benefit of avoiding unduly strict and costly official regulation and supervision. It also avoids creating the impression that the government vouches for the banking system through its regulatory and supervisory policies. Market discipline will create incentives for banks to keep themselves sound, and the occasional exit of weak banks

[75] This points to the potential importance of large shareholders. Poland recognized this in its approach to bank privatization, which attempted to ensure the presence of strategic shareholders with significant ownership stakes (see Bonin, 1995). In other systems, it is assumed that if the bank is poorly managed a corporate raider will emerge to assume this role.

[76] In some countries, the central bank also provides long-term credit to key sectors to meet development objectives.

[77] See Garcia (1996).

reinforces those incentives, by emphasizing that market discipline is working.

Failures in Market Discipline

Market discipline may fail if there is inadequate information, inconsistent incentives, or a lack of informed market participants. The experience of the sample countries, shown in Table 15, suggests that market discipline was not able to contribute to maintaining a sound banking system in almost all of the cases. It must also be recognized that market discipline may impose some negative externalities, and it may not be appropriate to rely on market forces in all circumstances. Even when market discipline against a particular bank does take hold, there is the danger of undesirable systemic or welfare repercussions.

Insufficient Effectiveness

Market discipline will fail if there is insufficient information available to market participants, or if the incentive structures are inadequate.[78] This was a factor in most of the cases in the sample. Effective market discipline requires that financial information be disclosed promptly and that it presents a true picture of the value of the bank, based on generally accepted accounting standards and on proper loan-valuation procedures. Where banks operate as part of larger financial groups or have overseas operations and do not report their consolidated position, they may operate with losses hidden in other operating units and their true condition undetected by the market. Failure to consolidate the different activities within conglomerates with off-balance-sheet, offshore, and foreign subsidiaries made it difficult to detect weaknesses in the condition of Bank of Credit and Commerce International (BCCI) and Meridien Bank before those banks failed. As discussed above, banks may have incentives to withhold or distort information. At the same time, market participants cannot be given access to all bank data because some information may be commercially sensitive. While accounting standards and practices may vary from country to country, certain common objectives, definitions, and valuation practices can be identified (see Appendix I).

Even when information is disclosed, the opacity of bank assets limits the ability of markets to fully assess the information disclosed, even in the most advanced markets where the best external auditors and third-party credit ratings of borrowers are available. Market discipline exerted by large depositors, particularly in the interbank market, typically will come

[78] Lane (1993) discusses the conditions for effective market discipline.

Table 15. Deficiencies in Market Discipline[1]

Argentina (1980-82): The state bore the full cost of deposit insurance until 1979, when a new, limited, voluntary scheme was introduced, although state banks remained fully guaranteed by the government. Borrowers were subsidized to the equivalent of between 11% and 13% of GDP. Foreign exchange exposure was guaranteed.

(1989–90): Deposit insurance ended in 1989. Depositors suffered significant losses when banks failed. The culture was anticreditor.

(1995): There was no deposit insurance until April 1995.

Bangladesh (1980s–present): Insolvent banks continue to operate. Weak accounting and information availability impede the markets. Politically directed and insider lending that flourish in opaque environments are blamed for most of the nonperforming loans.

Bolivia (1994–present): Two banks have been liquidated and 3 of 4 problem banks have new owners. The central bank compensated small depositors of the liquidated banks, but depositors with more than US$5,000 incurred losses.

Brazil (1994–present): There was no deposit insurance, except for saving accounts, until November 1995.

Chile (1981–86): An implicit government guarantee on deposits weakened market discipline. A dual deposit insurance system was introduced in 1986, providing full coverage for demand deposits and coinsurance for limited amounts of time and savings deposits.

Czech Republic (1991–present): The problem of moral hazard has been worsened by the resolution of pre-reform debts via transfer to a separate bank and the repeated bank recapitalizations that occurred until late 1994.

Egypt (1991–95): State-owned banks dominate the system.

Estonia (1992–95): There was no system of deposit insurance during the banking problems in the early 1990s and depositors suffered losses when banks failed. However, the authorities have subsequently been reluctant to liquidate banks and have supported them instead.

Finland (1991–94): A full guarantee of the savings banks and full deposit coverage weakened market discipline. Moreover, the underfunding of the deposit insurance schemes inhibited closure. The culture was antiregulation.

France (1991–95): Information is generally good, but there are unequal advantages and constraints between public and private institutions, which distort competition and allow risky operations. Crédit Lyonnais had an implicit state guarantee as a state bank and its portfolio was explicitly guaranteed in 1993.

Ghana (1983–89): The government guided credit allocation and interest rates, which, along with government ownership of banks, impeded market discipline.

Hungary (1987–present): There were repeated government-funded recapitalizations. Extensive preferential and guaranteed loans that were granted in 1994 further undermined incentives for market discipline.

Indonesia (1992–present): Disclosure is weak and the markets' perceptions that distressed banks will be bailed out limit market discipline. However, the interbank market is responsive to information.

Table 15 *(continued)*

Japan (1992–present): The "too-big-to-fail" philosophy applied to the 21 major commercial banks and the full deposit guarantees extended in mid-1995 may weaken market discipline. Deposit insurance is underfunded. The postal savings bank's deposits have long been fully government guaranteed. Poor disclosure prevents the public from distinguishing weak from strong banks.

Kazakstan (1991–95): Banks not meeting prudential standards are excluded from the interbank market. Bank closures are taking place. Past subsidization of large loss-making enterprises (which has now largely disappeared) weakened incentives in the past. The Housing Bank's deposits are fully guaranteed.

Kuwait (1990-91): Although there was no formal system of deposit insurance, there was an implicit guarantee, which was honored by a bailout of the system in the mid-1980s.

Latvia (1995–present): There is no system of deposit insurance and compensation to depositors of failed banks has been minimal.

Lithuania (1995–present): Market segmentation according to type of borrower (agricultural, energy, interbank) has reduced competition. The state-controlled banks' deposits are fully guaranteed. A new deposit insurance law limited the compensation received by depositors of failed banks in 1996. However, some banks have been provided with full deposit insurance under special laws.

Malaysia (1985–88): The lack of transparency, arising from poor accounting and reporting, delayed the recognition of, and impeded the markets' responses to, the problems that were building up. Audits were sometimes two years overdue at nonbanks. There was no deposit insurance and depositors were permitted to lose money.

Mexico (1994–present): Although the explicit deposit guarantee by FOBAPROA (the deposit insurance agency) is limited to the resources available in the deposit guarantee fund, official announcements indicate that FOBAPROA guarantees all banks' obligations, except for subordinated debt. In addition, there are debtors' organizations that contest the repayment of bank loans. Interest rates were lowered after a borrower defaulted, giving an incentive to default.

Norway (1987–93): Debt was subsidized by the tax system, which consequently discouraged equity issuance. The deposit insurance scheme, which offered a full guarantee, was underfunded.

Pakistan (1980–present): Competition from the poorly run state banks is destructive. The pro-debtor culture allows customers to avoid meeting their obligations.

Paraguay (1995–present): Competition from unlicensed institutions is destructive of the soundness of other banks.

Philippines (1981–87): The underfunded deposit insurance scheme was unable to meet all of its obligations or to improve depositor confidence. (Only 52% of depositor claims had been met by 1987.) The culture was pro-debtor and the bank closure process was slow. There was political interference in the banking sector.

Poland (1991–present): State banks have an unlimited guarantee through 1999. Limited deposit insurance was introduced for other banks in 1995. Data reporting and disclosure are weak.

Table 15 *(concluded)*

Russia (1992–present): Requirements that enterprises hold deposits in only one bank, the existence of government guarantees on household deposits in the Savings Bank, and inadequate disclosure of financial information have all severely limited market discipline. Because of risks, top-rated banks trade only among themselves.
Spain (1977–85): Lending was directed. Deposit insurance was instituted in 1977 but the system was revised in 1980. Weak disclosure discouraged market discipline.
Sweden (1990–93): Depositors expected to be bailed out even before a blanket guarantee was granted for the duration of the crisis.
Tanzania (1988–present): Repeated recapitalizations, loan guarantees to state banks, and the practice of exceeding deposit insurance limits have all weakened incentives and rewarded bad managers. Inadequate accounting rendered disclosure meaningless. Minimal market discipline is now imposed by clearinghouse practices; however, until recently there was no interbank market and the central bank provided overdrafts to cover shortfalls in payments.
Thailand (1983–87): Although there was no formal system of deposit insurance, depositors were bailed out, which reduced market discipline. The culture was pro-debtor, disclosure was weak, and there was political interference in the banking system.
Turkey (1994): Disclosure is impaired by weak accounting standards. Guarantees impede incentives; for example, the blanket guarantee for all household deposits, extended in early 1994, is still valid and loans to state enterprises are considered implicitly guaranteed.
United States (1980–92): The "too-big-to-fail" doctrine and the practice of merging banks rather than closing them protected depositors above the insurance limit until the FDIC Improvement Act of 1991.
Venezuela (1994–present): Depositors in failed banks were paid in full from 1978 through 1985 and again in 1987. Nonstandard accounting practices hid losses from depositors and the Superintendency of Banks.
Zambia (1994–present): Competition from unregistered and insolvent banks harmed their competitors.

[1] Years in parentheses denote the period of banking problems.

into play in an active sense only after there is clear indication of weakness. This is often too late to fully protect the failed bank's creditors.

The private sector also cannot be counted upon to discipline banks efficiently if it is known or expected that the government or central bank will bail out institutions that run into trouble. The possibility of lender-of-last-resort (LOLR) support creates a potential for moral hazard; banks may be less careful in managing their assets and liabilities given the availability of a such a lender. The LOLR becomes subject to adverse selection—it lends to banks that cannot obtain funding elsewhere and may not be able to identify which of the illiquid banks are also insolvent. To the extent that funds are provided at below market rates, LOLR lending may

subsidize the operation of weak banks and encourage them to gamble with public funds in an attempt to recoup previous losses.[79] LOLR credit that is not limited to providing liquidity to solvent banks so as to discourage unwarranted runs by uninsured depositors can contribute to delays in remedial action. Similarly, when governments place deposits of state entities in unsound banks specifically to shore them up, market discipline is undermined and government funds placed at risk.

Excessive deposit insurance coverage can remove the incentives for the market to impose discipline on banks that are weak or take excessive risks. Partial coverage would retain creditors' incentives to press for early closure of weak (but not yet insolvent) banks. Where it has not been properly designed to combat the risks of adverse selection and moral hazard attendant on the guarantee, deposit insurance can diminish market discipline and foster incentives for poor internal governance. In particular, deposit insurance that provides excessive coverage can increase resolution costs and harm competitors by creating opportunities for owners and managers to continue to operate a troubled bank that would otherwise be closed by market discipline. Government loan guarantees carry a similar moral hazard risk; banks will have reduced incentive to be careful in loan assessments if the government bears the credit risk.

Governments may have public welfare and political incentives to provide deposit or credit guarantees that may undermine private sector market discipline. In particular, during a systemic banking crisis the authorities may be tempted to issue a blanket guarantee. The advantages of such short-term measures must be weighed against the direct cost as well as the future difficulty of re-establishing an incentive structure that will be compatible with a sound system over the long run. Similarly, banks are sometimes declared to be "too big to fail" because it is considered that closing them would carry systemic risks. Although this is occasionally a valid consideration, too often it serves as a convenient excuse to postpone needed actions. Policies that foster an open and competitive banking market can help to create a banking system in which no single bank is too big to fail.

A strong framework regarding bank exit (mergers, closure, and liquidation) is at least as important to a market system as allowing competitive entry, if not more important. In many systems, however, there are few market participants (creditors) capable of forcing exit. This is particularly true when wholesale deposit markets are underdeveloped, as participants in those markets tend to be more sophisticated than the average individual depositor. In systems with less-developed capital markets or concentrated and closely held banking systems, there may be few outside investors capable of influencing bank owners and managers through a

[79] This appears to have been the case in the United States; see U.S. House of Representatives (1991).

market for corporate control. The legal and political systems may also prevent creditors' attempts to force the exit of unsound banks; for example, in some countries, the closure of a bank requires the consent of the shareholders. In many countries, bankruptcy procedures are excessively long or are biased against creditors.

Potential Negative Externalities

Exit imposed solely by market forces may produce negative externalities. While an effective withdrawal of funds by the market can result in closure, it will not be a smooth process. A liquidity shortage due to segregation in the interbank market, or a run by depositors, may force the disorderly failure of a bank, with potentially dangerous repercussions. A fire sale of assets may further decrease the bank's net worth. The sequential servicing of deposit withdrawals may impose a socially inefficient distribution of losses and could result in a domino effect if other banks remain exposed. As exposed creditors scramble to cover their positions, depositor confidence may be shaken. If depositors are unable to distinguish problems in an individual bank from systemic conditions, a crisis of confidence and widespread runs may result. Uncertainty will linger until the situation is resolved and may spread throughout the system. As noted above, most markets have difficulty assessing the quality of opaque bank assets, which may lead to pressures on sound banks as well.

Market preferences for liquidity and profit over stability do not take into account the public policy concern for banking system stability. Furthermore, the distribution of losses attendant on a market-led closure may not accord with public preferences. Thus, in most countries there are both limits to how much reliance can be placed on market discipline and limits on the extent to which unfettered operation of market forces is desirable. Additional forms of external oversight and methods to ensure that individual banks fail with minimal systemic impact are required.

One country planning to rely almost entirely on market discipline is New Zealand. The Reserve Bank of New Zealand is moving from a system of detailed rules and monitoring by the supervisor to a system of improved public disclosure of financial information, relaxed supervisory regulation, and enhanced market discipline.[80] It should be noted, however, that only around 10 percent of bank assets in New Zealand are held by locally owned banks. Thus, in this case, even if the authorities did pursue detailed official bank supervision and regulation, it would have little bearing on the risk profile of the banking sector.

[80] See Reserve Bank of New Zealand (1995).