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STOPPING INFORMATION ASYMMETRIES IN GOVERNMENT FROM PROMOTING RISK SHIFTING BY BANKS

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Theme of this talk: Bank managers are said to shift risks when the downside of the profit opportunities that the bank pursues is absorbed in nontransparent fashion by the bank's creditors and guarantors. Risk shifting is facilitated by information asymmetries that tempt government officials to snow creditors and taxpayers about how effectively government bureaus are controlling bank risk. The growing sophistication of financial products and financial institutions' net risk-taking positions demands a regulatory regime that --like Pinocchio's nose-- can create and enforce incentives for transparency and truth-telling about the nature and value of taxpayers' implicit stake in regulated financial institutions.

I. Overview

Mapping the locations of recent banking crises around the world supports the following three-step chain of reasoning. First, the map demonstrates convincingly that, around the world, more than a few banks have taken potentially ruinous risks. (Discuss color coding) Second, the bills taxpayers have paid to bail out depositors and deposit-insurance funds in particular crises clarify that a substantial amount of bank risk was in fact shifted to taxpayers. Finally, the repeated failure of authorities to check bank risk shifting until it surged into an actual or potential taxpayer disaster supports the hypothesis that changes in the risk-taking technologies used by FSFs have outstripped social controls on the job performance of government regulators asked to control the safety and soundness of the financial system.

II. Two-Layer Theory of How Incentive Conflict Leads to Banking Crises

A. Peeling the Layers of Conflict. Surreptitious risk shifting by banks plays a featured role in explaining the stages through which a real-world banking crisis evolves. Modern finance theory roots an individual bank's incentives to take and shift risk in the assumption that asymmetric information exists between deposit-institution managers and stockholders, on the one hand, and depository and government regulators, on the other. But a second layer of important information asymmetries exists that creates incentive conflicts between government regulatory officials and their taxpayer principals.

This governmental layer of information asymmetry turns regulation into a three-handed game. This trilaterality lets us understand incentive abuse in regulating and supervising banks as apolitical-economic equilibrium that is achieved in most countries. Politicians' revealed preference for weak supervisory systems is a consequence of incentives fostered by this deeper layer of asymmetric information. Information asymmetry between taxpayers and government officials is protected by incentives for individual taxpayers to view themselves as free riders

who may safely shirk the fundamental due-diligence obligations that representative democracy assigns to them.

Theoretically, the citizenry's due-diligence obligations are intermediated by three classes of watchdog institutions: a free press, a community of conscientious scholars who enjoy academic freedom, and opportunities for special-interest associations to inform and mobilize households into pressure groups to defend taxpayers' interests when and as they perceive them to be threatened. Unfortunately, the size of taxpayer losses in banking crises suggests that modern watchdog institutions have not been able to mount a timely challenge to half-true disinformation that has been deliberately introduced into official reports to cover up gradually accumulating breakdowns in financial regulation. [Incentives to misinform taxpayers and watchdog institutions imply the need to align the incentives of top financial regulators more closely and more reliably with those of ordinary taxpayers.] _

Politicians and the financial industry are unlikely to build a financial regulatory system strong enough to weather the stress of deep and widespread financial-institution insolvency unless and until information flows routinely used to describe regulatory performance and financial-institution condition can be made more transparent or more truthful.

- B. Incentive Conflicts in Handling Information. As information technology continues to advance, financial institutions more and more plainly reveal themselves to be information factories that simultaneously network relationships with customers and with other financial firms. Through these networks, institutions collect, verify, store, process, and transmit information for themselves and for customer accounts. The costs faced by individual institutions and their information networks can be reduced by contracting for the coordination and contract-enforcement services of an outside regulator. But network-enhancing regulation may mask rather than resolve problems of financial-system vulnerability. Conflicts in risk-management incentives for managers of regulatory enterprises parallel those that face the managers of private financial services firms. At times of widespread financial-institution insolvency, incentive conflicts in regulation typically induce government regulators to relax their enforcement activity and cover up problems in ways that reinforce rather than offset the incentives that tempt insolvent "zombie" institutions to take socially malefic risks.

Finance theory has rushed by the task of establishing accountability for truth-telling about regulatory forbearance decisions in an environment of asymmetric information. The most developed body of research adopts the convenient presumption that incentives to forbear are dramatically improved by giving banking authorities nominal "independence from the political process." But historical research on state-sponsored deposit-insurance systems (Bodenhorn, 1996; Calomiris, 1990; White, 1981) and on the politics of the Federal Reserve System suggests that bureaucratic independence becomes increasingly hard to sustain when incumbent politicians come under stress.

The idea that regulators face unresolved incentive conflicts can explain two puzzles: (1) why regulators around the world energetically resist accountability and (2) what regulatory schemes and truth-telling requirements could improve accountability for regulatory performance (Boot and Thakor, 1993; Kane, 1995).

III. Fitting Accountability Resistance into the Theory of Financial Crisis

This section fits governmental accountability resistance into the finance profession's two-prong asymmetric-information theory of financial crisis. This theory is summarized by Rick Mishkin in a forthcoming article in the World Bank Economic Review. The theory's first prong consists of the literature on asymmetric information and principal-agent conflict that our profession uses today to explain why banks and banking regulation exist. As clarified by Doug Diamond (1984), banks emerge as an efficient solution to society's need to observe and analyze what would-be borrowers take to be hard-to-communicate "inside information" about their future earnings. Banks solve these problems by establishing "information-based relationships" with customers (Kane and Malkiel, 1965). These relationships provide a two-way flow of continuing benefits to banks and customers alike. These benefits make it costly for either side to behave opportunistically toward the other.

In this theory, government regulators are introduced as a way to overcome incentives for banks to engage in excessive risk-taking that are associated with limited liability and government deposit insurance. This literature (which is reviewed in Kane, 1995) briefly notes that incentives for government regulators to control bank risk-taking may be distorted by careerism and by influence peddling in government. But it offers no solution to the age-old question of how society ought to watch its watchmen.

The second prong of the theory explains how adverse selection and moral hazard that bank regulators prove unable to control become a foundation for poor credit decisions. Each bad loan an insured bank puts on its books increases the bank's exposure to loss --and in a nontransparent way. The nontransparency sets up a game of hide and seek with creditors, outside auditors, and government examiners. As hidden bad loans multiply at a single institution, that firm becomes vulnerable to macroeconomic shocks and customer runs. When hidden bad loans multiply across the banking system, that system becomes vulnerable to crises and panic.

[Empirical evidence in support of this theory comes less from model-based regression estimates than from case studies that show how consistently the two-prong model can make sense out of individual financial crises observed currently and in the past.] The model tells a plausible story of how banks contribute to macroeconomic fluctuations and crises. The outlines of this story can be made plainer by resorting to metaphor.

The asymmetric-information theory conceives of a bank's hidden bad loans as if they were termites that eat away surreptitiously at the bank's net worth. To complete the metaphor, we may view a bank's opportunity-cost or market-value net worth as beams supporting a roof that is supposed to protect taxpayers, customers, and other bank stakeholders against being soaked by occasional financial storms.

Using this imagery, an institution falls into crisis when the weakened roof of its particular enterprise collapses in a storm. A wider financial crisis occurs when many bank roofs give way at the same time. The more important are the roofless banks individually, the more extensive the destruction their troubles pass on the real economy. This is because damaged banks temporarily shift their priority from servicing customer financial needs to rebuilding their own roofs. This sudden reordering of bank priorities hampers the ability of household and business customers to lay their hands quickly on resources they need to preserve or improve their own houses.

Even at banks that are eventually able to repair their buildings, the flow of credit to information-based relationship customers is impaired until the storm has passed. Customers whose relationship banks are trashed beyond repair are hurt more and hurt longer because, before they can fill their credit needs, they have to establish an information relationship with a new lead bank.

Any event that can sharply decrease the perceived value of financial assets can qualify as a metaphorical “storm.” Recent work in the financial-institutions subfield emphasizes sudden sharp increases in interest rates or in aggregate uncertainty. But a larger literature offers the following catalogue of unanticipated events that may have those postulated effects:

- failure of a prominent institution
- recession
- political instability
- stock-market crash
- deterioration of corporate balance sheets
- sharp unanticipated disinflation
- unanticipated evaluation or exchange-rate depreciation
- sharp decline in the demand for a region’s real products.

IV. Understanding Incentive Conflict in the Regulatory Sector

Jane Jacobs (1961) revolutionized planning for urban safety by emphasizing that the safest areas in city parks and streets were those that provided no opportunities for a bad guy to hide. Dark places, picturesque nooks, and shrubs that block lines of sight encourage evil-doing by making crime hard to observe.

Figure One and economic analysis support the view that, when hidden insolvencies develop, incentive incompatibilities inherent in representative democracy make government financial regulators inordinately quick to deny the importance of emerging problems and inordinately slow to take actions needed to protect taxpayers. They act like termite exterminators who are reluctant to make sufficiently frequent home inspections and are afraid to use the poisons that are their stock in trade. The longer and deeper an institution’s insolvency remains untreated, the more well-informed uninsured depositors can move their funds away before the bank’s losses are resolved and charged against bank stakeholders. These “silent runs” allow sophisticated and well-connected private stakeholders to shift losses to other depositors and to unwary taxpayers. [In time, silent runs create pressure on regulators to act. But

because of industry pressure against tough action, the first round of regulatory action is usually too timid to stop the deposit outflow for long. Eventually, the pressure resumes and becomes strong enough to reveal the regulatory disarray.

Although silent runs act as forcing events, the central problem in forestalling bank insolvencies does not lie in building a fund of dedicated deposit-insurance reserves large enough to make government guarantees credible. It lies in promptly measuring and controlling the losses that credible guarantees and expedient delays pass onto healthy institutions and taxpayers. For taxpayers to be able to enforce better supervisory performance requires increasing the transparency of the loss-control decisions that government officials make.

Around the world, but especially in developing countries, officials enjoy private benefits that conflict with the goal of minimizing taxpayer losses. Government officials have discretionary control over their reporting frameworks and a propensity to use this control to cover up emerging problems and to postpone fully effective treatment.]

Whenever a crisis begins to brew, officials can and do routinely distort information about the quality of their performance and repeatedly put off at least some of the painful adjustments that banks need and taxpayers deserve. Efficiency in policymaking requires that the costs that forbearance decisions generate be rendered observable enough that regulatory decisionmakers can be suitably disciplined both in the press and in the market for post-government employment. When and as taxpayers' exposure to losses mount, the press, academia, and consumer watchdog groups must be enabled to observe and communicate to the public the facts about taxpayer loss exposures and sectoral influence-peddling. To fully remedy incentive conflicts in financial regulation, society needs a scheme for establishing accountability for policy delays and other kinds of implicit regulatory subsidies. Perfect accountability exists when authorities are immediately and completely answerable for their actions. This requires that officials' decisions, their motives, and the consequences for taxpayers be transparent enough for outsiders to monitor and for labor markets and budgetary control systems to discipline.

Defects in public-sector accountability do not occur by happenstance. Far from being embraced by real-world policymakers, accountability is systematically resisted. The economic function of defects in accountability is to "insure" the reputations of top government officials against the prompt emergence of embarrassing facts and to permit unacknowledged trade-offs to be made between overt policy goals and various covert conflicting reasons for following policies that benefit politically powerful financial-institutions stakeholders at the expense of taxpayers.

Accountability resistance exists because high officials and top institutional managers value opportunities to report on their performance in self-serving ways. They intend to use these opportunities to alibi their way out of embarrassment and blame by creating disinformational "cover" that convincingly misrepresents their true motives and the consequences they truly anticipate.

Shifting to a medical metaphor, when facing an incipient financial crisis, government regulators (including elected politicians) resemble doctors that are subject to inadequate social controls against self-

interested regulatory malpractice. Like doctors awakened by a patient telephone call in the middle of the night, their first responsibility should be to find out what's going wrong and to treat it promptly. But the instinctive response of modern regulatory doctors is to "blow off" the call: to ignore important symptoms, to schedule delayed and superficial accounting tests that are bound to develop inadequate information, and to prescribe inappropriately timid therapies.

Although the FDIC Improvement Act of 1991 has improved regulatory incentives in the U. S., a disinformational and time-wasting resistance to duty may still be seen in the refusal of federal banking regulators to set up an information system for measuring, controlling, and reserving for interest-rate risk.

V. Reducing Information Asymmetries and Incentive Conflict in Government Financial Regulation

Three complementary mechanisms exist that can lessen the three-way incentive conflict among banks, regulators, and taxpayers.

One mechanism is to extend limits on stockholder liability for creditor claims in bank insolvencies to a multiple of two or three times the capital stockholders have invested in the bank. Extended stockholder liability was widely and successfully used in the United States in the century before federal deposit insurance was enacted (Wilson and Kane, 1996).

A second mechanism is to make greater use of opportunities for private participation in proactive supervisory processes for controlling bank loss exposure. The idea is to reassign to the private sector through coinsurance provisions whatever responsibilities for loss-control monitoring and loss resolution can be safely stripped away from the government (Kane 1995b). Such schemes seek to unbundle the catastrophic risks that banks inevitably shift to society from risks that are in fact privately insurable. Because free-riding problems are mitigated in private enterprises, stakeholder monitoring of coinsuring private monitors is bound to be more intense than taxpayer monitoring of government supervisory enterprises. At the same time, private coinsurance can also help to reduce and simplify the monitoring and loss control activities in the catastrophic risks that remain with the government and taxpayers. Market signals are emitted in capital markets, in insurance markets, and in managerial markets by poor private monitors that poor government monitoring does not and cannot trigger. These observable signals can help to alert society when mistakes are being made in the back-up government supervision of catastrophic risks.

Appropriately blended competition between private and government regulatory entities can neutralize weaknesses in the incentive structures that apply respectively to government and private regulators.

- A. Incentives in private regulatory systems such as securities exchanges favor a proactive stance: top regulators expect to be rewarded for responding quickly and flexibly to evolving opportunities. But they can also be rewarded for enabling cartel-like behavior.
- B. Because government regulators do not have these expectations, they may be expected to fight private cartelization but to be reactive rather than proactive in dealing with change. The layered responsibility of appointed regulatory bureaucrats to elected politicians render incentives to make

beneficial adaptations in government regulatory systems more conflicted and dysfunctional than they would be in a private system.

A third mechanism is to improve the regulatory information system. Watchdog institutions need official measures of regulatory performance to become more informative. A better information system would increase accountability within government for supervisory decisions that affect taxpayer loss exposure in financial institutions. Moreover, such an information system could be used to establish incentive-based pay for top regulatory officials. In countries with explicit deposit insurance, incentives paid could be tied to movements in opportunity-cost measures of the loss exposures that pass through to taxpayers from the insurance fund. Even without positive performance incentives, ethical reforms can be promulgated by adopting a penalty structure that characterizes operationally the duties of loyalty, care, and competence that regulatory officials owe to taxpayers and increases the weight and enforceability of penalties for violating these duties.

VI. A Summary Perspective

Finance theory explains how and why informationally efficient capital, labor, and product markets may be presumed to reward and discipline risk-taking by bank creditors, stockholders, and managers. Unfortunately, capital markets do not trade debtor stock whose payoffs are based on the stand-alone performance of the government regulatory enterprises that oversee taxpayers' stake in this risk-taking. Nor do the fixed-pay contracts labor markets offer to government officials reliably discipline officials after the fact for hiding evidence of poor performance during their watch on the bridge.

Figure Two clarifies the incentive conflict a conscientious regulator routinely faces. This incentive conflict has intensified financial crises in the U. S., Latin America, Japan, and Australia. The solid lines indicate the call of regulatory duty. The dotted lines indicate the subtle and unsubtle channels through which this call can be muffled and sometimes shouted down by disinformation and influence peddling.

The first step in weakening the lines of influence peddling is for taxpayers to address them explicitly. Taxpayers must acknowledge that they have a moral duty to demand information systems that can control elected and appointed officials' opportunities to shift the downside of financial-institution risk-taking onto them. This duty is enshrined in the saying: "Fool me once, shame on you. Fool me twice, shame on me."

Issuing this call to duty puts an ethical twist on my analysis and challenges the longstanding view that economics should seek to keep itself from incorporating ethical values. This view has led principal-agent theory to the ethical quandary of seeming to approve opportunistically dishonorable behavior. Models of financial regulation may usefully be rebuilt on the premise that every principal and every agent has an ethical obligation to control its counterparty's temptation to behave dishonorably. The replacement premise would maintain that each contracting party owes common-law duties of loyalty, competence, and care to the other side. Penalties for violating these reciprocal duties and mechanisms for enforcing these penalties need to be introduced into our modelling to explicitly constrain opportunistic utility maximization ex post.

This mild ethical extension of conventional positive economics holds that regulation exists precisely to temper the opportunistic pursuit of self-interest. Regulation does this by defining and enforcing additional ethical constraints on the way that individuals formulate their utility-maximization problem. These constraints impose behavior-changing “duties” of loyalty, competence, and care on parties that transact with each other.

The hypothesis underlying the ethical-benefits theory of regulation is that enforcing reciprocal duties on transactors increases dynamic economic efficiency by lessening the aggregate value of all three kinds of agency costs:

1. Costs of monitoring and constraining agents incurred by society and by individual agents;
2. The costs an agent incurs itself to bond its performance;
3. The residual waste and damage that the principal suffers because of the uncorrected defects in contracting, bonding, monitoring, or enforcement.

[Cocktail-Party Parable for the Positive Economics of Regulation. At the door of the party is a sign that reads “Danger: Moral Vacuum.”]

VII. Summing Up

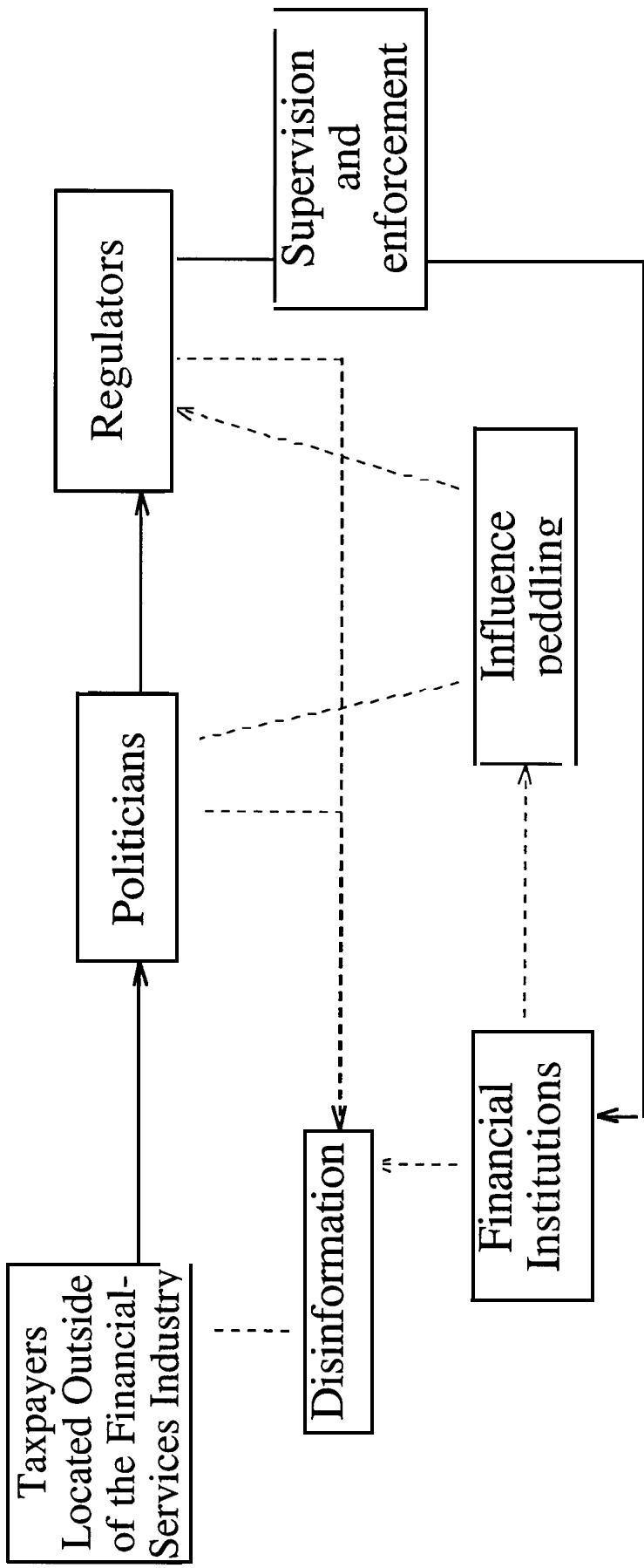
20th-Century macroeconomics has fallen under the spell of logical positivism. Logical positivism hypothesizes that all ethical values are individualistic and emotive. This hypothesis provides a poor foundation both for understanding either what financial regulators should do or why regulation has repeatedly broken down in stressful circumstances. Centuries-old common law and ethical theory promulgate the alternative hypothesis that in every contract agents and principals owe one another duties of loyalty, competence, and care. The operative problem for a society is to organize its regulatory system to enforce these reciprocal duties at minimum cost. The most difficult part of this problem is to find reliable enforcement systems that can prevent government regulatory officials from shirking their share of the task. The allegedly value-free positive macroeconomics of the 20th Century allows regulators to act opportunistically without acknowledging that opportunistic regulation violates the social objective of minimizing aggregate agency costs.

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Figure One: CHAIN OF DELEGATION IN FINANCIAL REGULATION



_____ call of regulatory duty channels that muffle the call of duty