Jamie B. Stewart, Jr.

Opening Remarks

I am delighted to welcome you today to the Federal Reserve Bank of New York and to this conference, "Beyond Pillar 3 in International Banking Regulation: Disclosure and Market Discipline of Financial Firms." I would like to begin by thanking our cosponsor, the Jerome A. Chazen Institute of International Business at Columbia University's School of Business. In particular, I want to thank Rick Mishkin for his help in organizing this conference. Rick is a special friend to many of us here at the New York Fed, having served as director of research from 1994 to 1997 before returning to Columbia as the Alfred Lerner Professor of Banking and Financial Institutions at the Graduate School of Business.

It is a great pleasure to welcome to the conference such a distinguished group of researchers, many of whom have contributed in important ways to the literature on market discipline and disclosure in the banking industry. I am also pleased to see that many of you are bank examiners and supervisors. Your presence is very important because, despite the academic nature of many of the presentations, the goal of this conference is really to inform and improve "best practices" in bank regulation and supervision. Having spent a good deal of my earlier career in a commercial bank and much of the past five years helping to run an institution that supervises banks, I have become firmly convinced of the ongoing need for strong and effective regulation and supervision.

Before turning the program over to our first speaker, I would like to make a few observations about the role of disclosure and market discipline as it relates to the Basel II Accord. As you no doubt know, disclosure and market discipline represent the third pillar of Basel II, an ambitious initiative to which many at this Bank, and at this conference, have contributed enormously. While the first two pillars—which relate to capital requirements and the supervisory review of capital adequacy—have been much discussed, a consensus is emerging that the third pillar merits additional attention. Indeed, it is because we share this view that we have organized this conference, devoted entirely to the topic of market discipline and disclosure.

What are we really getting at when we talk about disclosure and market discipline? "Disclosure" has been in the press a lot since Enron and other corporate scandals came to light. But with banks, transparency—or opacity—has always been an issue. Some people see banks as black boxes. Money flows in and money flows out, but the risks taken in the process of intermediation can be difficult to observe from the outside. Let us suppose, then, that banks *are* more opaque than other kinds of firms. Is that opacity inherent in the business of banks, or has the government safety net—deposit insurance, access to a lender of last resort, and the possibility of bailouts—essentially made banks opaque, removing them from investor scrutiny and allowing the effectiveness of their risk management

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strategies to go unmonitored? In other words, is the veil between banks and the public an inevitable consequence of the business itself, or just the other side of the safety net? Deliberations at this conference will help illuminate this question.

And what about market discipline—the other issue at this conference? Market discipline is a complex concept that can mean different things to different people. Allow me to make some distinctions that may prove useful over the course of the conference.

The issue of market discipline of banks is often confused with the issue of corporate governance. These issues are related, but there is a subtle difference. Strictly speaking, corporate governance is about safeguarding the interests of firm *owners*—the shareholders. Market discipline, as applied to banks, is about safeguarding the interests of depositors and their insurer, the Federal Deposit Insurance Corporation. As is well known, deposit insurance may invite excessive risk taking by bank owners. Excessive risk harms the FDIC and uninsured bondholders alike. The discipline that bank bondholders apply in protecting their own interests should protect FDIC interests as well. Monitoring by bondholders, in other words, can protect FDIC interests just as monitoring by a corporate board is supposed to protect shareholder interests. In that sense, market discipline and corporate governance are related, but different.

As today's first paper will make clear, market discipline can function either as a substitute for or as a complement to government supervision. Instead of laboriously examining individual bank assets, supervisors may be able to rely to some extent on bond spreads or stock prices as signals of a bank's relative risk. Information produced by market analysts, in other words, may substitute for information produced by supervisors. By contrast, a visible collapse in bank bond or stock prices may *force* regulators to take action. In this sense, it is possible to think about the market disciplining the regulators rather than the banks.

Discipline can come at different stages. In principle, investors should monitor banks' lending or portfolio strategies and penalize shifts toward riskier strategies. We can call that ex ante discipline. Ex post discipline occurs if and when problems arise. Once investors recognize a problem, the higher spreads they will command may force troubled banks to rethink asset strategies, reshuffle management, or alter funding choices. Of course, the extent to which investors actually do influence bank owners and management is arguable, as you will see in the conference papers.

Different markets can provide different sources of discipline. Bond markets are usually considered the first line of market discipline because bondholders' concerns about downside risk are aligned in some measure with the interests of supervisors and insurers. Stock investors gain more on upside risks, but their views can still inform supervisors and provide market discipline. One issue currently under consideration by economists here is the extent to which spreads on bank loans—the primary asset of banks—can provide information about bank risk for supervisors and outside investors. All of these issues will get a good airing in our sessions today and tomorrow.

As we take part in these discussions, however, bear in mind that market discipline is not always perfect. Did the banking crises in Latin America and Southeast Asia in the 1980s and 1990s reflect too much market discipline, too little, or just the wrong kind? Market discipline can also be subverted, as the recent accounting and governance scandals in this country have made all too clear. Government discipline can be undermined as well, of course. As one paper today argues, supervisory actions can be postponed for political reasons. Clearly, our goal should be to get the right amount and mix of discipline—market and government—at the least cost.

I have tried to highlight just a few of the issues to be considered over the next two days. I am delighted you are all here, and I look forward to hearing your views and exchanging ideas with you.