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Can Delegating Bank Regulation to Market Forces Really Work?

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Abstract

A major theme in the literature on bank regulation is that greater reliance on market forces can help alleviate the moral hazard problem inherent in government sponsored deposit insurance. Proposals include minimum requirements on (1) uninsured subordinated debt financing (either fixed-term or with option-type features), and (2) private co-insurance on deposits. Such policies amount to delegating the responsibility for bank regulation to various private-sector claimholders. Our results show that, in general, such delegation (even if the claims include option-type features) is at best ineffective in lowering bank risk, at least within the present framework of deposit-taking institutions. We also show, however, that there are alternative mechanisms that will minimize regulatory costs, alleviate the moral hazard problem, and achieve first-best. But, the regulator (deposit insurer) must be an integral part of any solution; thus, such solutions are not attributable to market discipline.

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