Regulatory Differences in Bank and Capital Market Regulations

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Major Topics

- Compare Two Financial Systems
  - The Bank System
  - The Capital Market System
- Focus on the Cost of Regulation
- Focus on the Cost of Enforcement

The Theme

- Any system does not function well unless accompanied by proper regulation and proper enforcement.
- The costs of regulation and enforcement are not zero.
- How to design and maintain effective regulation and enforcement is the key.

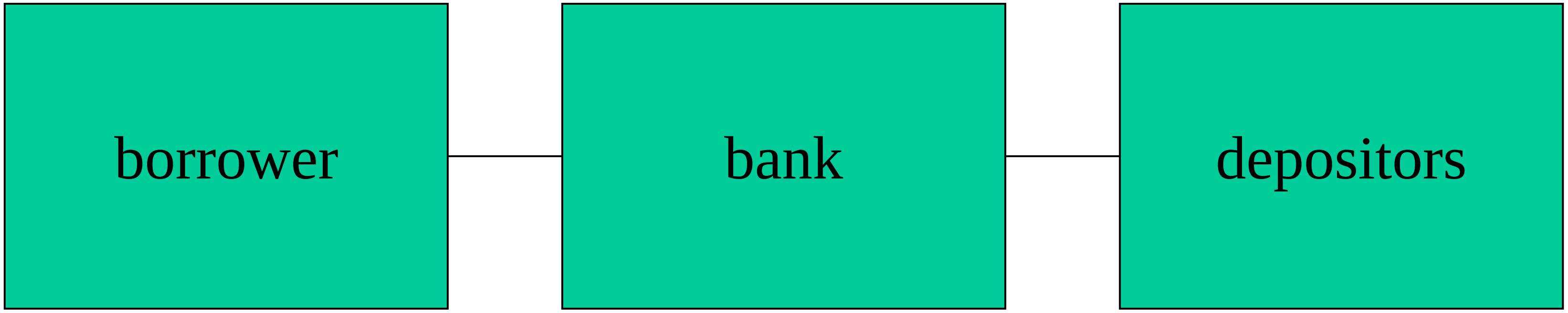
The Theme (continued)

- Imagine a world where there is one simple rule: “do not do bad things.”
- In this world, the cost of enforcement is prohibitively high.
- To reduce the cost of enforcement, there must be more specific rules. To write such rules is costly, and the optimal level is difficult to determine.
- For proper enforcement, there must be other legal infrastructures, such as a well-functioning judicial system.

Two Systems of Finance

- The Bank System
- The Capital Market System

The Bank System



Problems of the Bank System

- Banks continue to lend until they fail.
  - Moral hazard from deposit insurance
- Banks face not only credit risk but market risk and other risks as well.
- Banks, not depositors, take investment risks.

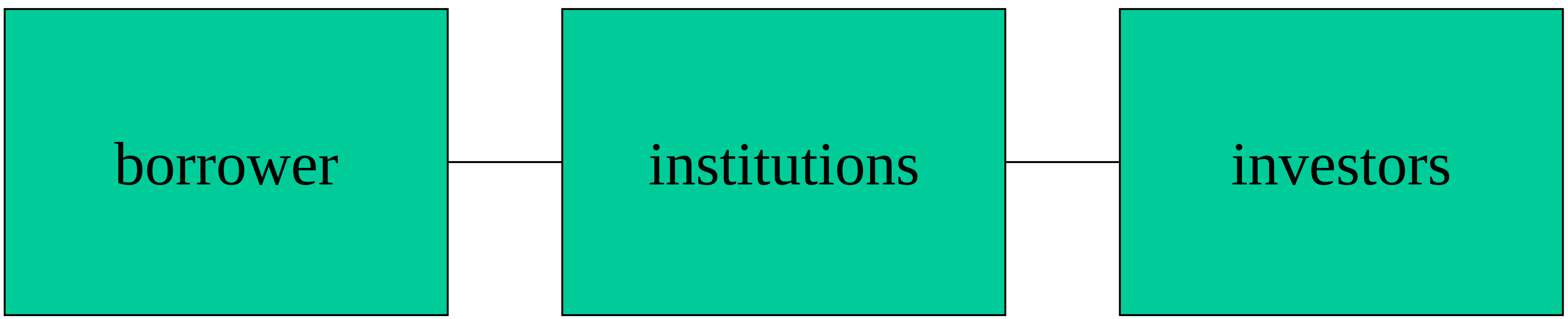
Regulation of Banks

- Ensure proper risk management
- Solve the “bad loan” problem
  - Proper assessment of loan portfolio
  - Strong examination may work?
  - Market discipline may not work ?

- Relatively easier to regulate?
- Misregulation leads to disaster.

The Capital Market System: Basics

The Capital Market System: Reality



Problems of the Capital Market System

- In general, the capital market system is better than the bank system – if the costs of regulation and enforcement are zero.
- Investors, not intermediaries, take investment risks.
- Opportunities to defraud investors

- Relatively difficult to regulate, because there is no focal point?
- Misregulation leads to disaster.

Regulation of Capital Markets

- The need of three strong regulations
  - Strong investor protection
  - Strong watchdog or enforcer (“SEC”)
  - Strong regulation of institutional investors
- Note that in academic literature, the benefit of regulation has not been well established.
- Preparing and maintaining these three strong regulations are costly.

Regulation of Capital Markets (1)

- Strong investor protection
  - Transparency and fairness
  - “mandatory disclosure” and “anti-fraud rules”
- Dealing with the collective action problems of bondholders
  - Trust Indenture Act of 1939 (U.S.)
- Broker-Dealer Regulation
  - Conduct regulation and segregation rules
  - Safety-net and capital regulation

Regulation of Capital Markets (2)

- Strong enforcement
  - For disclosure, proper accounting rules and proper auditing requirement must be provided.
    - A reliable CPA system must exist.
  - Both for disclosure and anti-fraud, a strong enforcer (SEC) is necessary.
  - The role of private litigation may be important.
    - A well-functioning judicial system must be provided.
    - A class action system must be recognized.

Regulation of Capital Markets (3)

- Strong regulation of institutional investors
  - The capital market system does not mean the lack of financial intermediaries.
  - Intermediaries, such as mutual funds and pension funds, are popular.
  - Strong fiduciary regulation on these intermediaries is necessary.
  - Strong enforcement is necessary here, too.

The Long-Term Credit Bank System

The Long-Term Credit Bank System

- The intermediate system between the two systems: LTCBs issue “bank notes” and use the proceeds for long-term lending.
- There is a focal point for the regulator to look, but LTCBs, not depositors, take investment risks, and other problems with the simple bank system exist.
- Even stronger bank regulation may be necessary than in the simple bank system.

Which System?

- In a small economy, the bank system may be better, because the costs of regulation and enforcement matter more than other costs.
- In a large economy, the capital market system may be better, because the benefits of capital market financing offset or outweigh the costs of regulation and enforcement.

Two Footnotes

- In reality, the bank system and the capital market system coexist, and the costs and benefits of the two systems must be considered in aggregate rather than separately for each of the system.
- Globalization of financial markets may permit firms to fund outside their home country: “borrowing” of market and regulation from outside.

Coexistence of Banks and Capital Markets

	Supplier of Capital	Supplier of Liquidity
Country 1	Bank	Bank
Country 2	Bank Capital market	Bank
Country 3	Capital market	Bank
Country 4	Capital market	Bank Capital market

Tentative Conclusion

- One system does not fit all – each country must make its policy decision in choosing a system that would fit the country best.
- Whether one system is better than others depends on many factors, including corporate governance.
- The costs of regulation and enforcement in the country are the key.
- There are additional costs when a country moves from one system to another (for example, the Japan's Big Bang program).