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Editors' Introduction

Special issue: Banking and bank regulation: Challenges for the future

Recent turmoil in the banking industry following the deterioration of mortgage-backed securities has intensified the centuries-old debate on whether banks are properly governed and regulated. When bank managers are subject to sound regulations and governance mechanisms, the likelihood that banks will efficiently mobilize and allocate savings is enhanced, and sound governance of the firms they fund is encouraged. Thus, appropriate regulations and governance systems can reduce inefficient bankruptcies, lower firms' cost of capital, and accelerate economic growth.

While a considerable body of research provides a macro-prudential analysis of optimal bank regulation, increasingly scholars are examining how regulations affect the incentives of a bank's shareholders, managers, bond holders, and borrowers. The *Journal of Financial Intermediation* and the World Bank organized a conference at the World Bank's Headquarter in Washington, DC, on October 26–27, 2006, to stimulate research on optimal bank regulation that employs methods and tools from corporate finance to focus on the incentive problems and information asymmetries shaping decision-making within banks.

A selection of the papers submitted for the conference were considered for publication in the *Journal of Financial Intermediation*, with three papers passing the review process before the publication deadline for the special issue: (1) "Banking on the Principles: Compliance with Basel Core Principles and Bank Soundness," by Asli Demirgüç-Kunt, Enrica Detragiache, and Thierry Tresselt; (2) "Does the Market Discipline Banks? New Evidence from Regulatory Capital Mix," by Adam Ashcraft; and (3) "Banking with Nominal Deposits and Inside Money," by David Skeie. These three papers are included in this special issue of the journal. Other papers presented and discussed at the conference dealt with a variety of topics, including bank merger control, governance of banks, regulatory reluctance to close failed banks, market discipline and bank runs, bank competition and stability, and bank–firm relationships. A panel discussion focused on the trade-offs between stability and competition. Governor Randall Kroszner from the Federal Reserve Board stressed the importance of political economy in financial sector reforms in his keynote address, quoting the example of the US, where states opened their banking systems at different points over the 1970s and 1980s depending on the strength of various lobby groups.

On transparency and market discipline, several papers emphasized the importance of giving market participants the tools and incentives to monitor banks and exercise market discipline to limit the ability of bank owners to take excessive risk. The paper by Adam Ashcraft, in particular, shows that market discipline effectively disciplines bank managers in the US. These findings not only stress the sometimes forgotten third pillar of Basel II—market discipline—but also help motive a rethinking of bank regulatory and supervisory advice advanced by international financial organizations, such as the International Monetary Fund and the World Bank. Indeed, even when focusing on developing economies, Asli Demirgüç-Kunt, Enrica Detragiache, and Thierry Tresselt show that market discipline is a more effective regulatory strategy for promoting sound banking than more traditional approaches to bank regulation. However, the political interests and constraints of regulators must be taken into

account as well, especially in times of widespread distress, as pointed out by Craig Brown and Serdar Dinc.

On concentration, competition and stability, Arnoud Boot and Matej Marinc argue that the relationships among competition, capital regulations, and stability depend materially on the health of banks. They find that when there is little competition in the banking industry, capital regulations reduce the entry of new banks. However, in a highly competitive banking industry, more stringent capital requirements will tend to increase the entry of high-quality banks while reducing the entry of low-quality banks. Thus, proper regulations may depend on various characteristics of each country's banking industry. Indeed, jointly considering competition, stability, and efficiency when assessing entry, mergers, and acquisitions might require an authority outside the bank supervisory agency to avoid intra-agency conflicts of interest, as was argued by Elena Carletti, Philipp Hartmann, and Steven Ongena. At more fundamental level, David Skeie develops a model of bank runs. He shows that many existing models of bank stability presume that the withdrawal of demand deposits during bank runs implies a real effect on the economy. While appropriate in some settings, Skeie argues that these models do not capture modern banking, where deposit withdrawals typically involve the purchase of other financial securities. Thus, other frictions are required to generate real effects from bank runs.

The discussion at the conference emphasized that concentration is not the same as lack of competition. Researchers need to consider the definition of the relevant market, the switching costs faced by customers, and the contestability of markets when drawing inferences about competition from market structure.

Several papers shed new light on how financial intermediaries mitigate asymmetric information problems between firms and investors. On the one hand, a closer, more exclusive relationship between banks and borrowers can reduce agency problems between banks and borrowers, resulting in lower interest rates, as shown by Joao Santos and Kristin Wilson. On the other hand, a strong exclusive lending relationship can have negative repercussions for the market liquidity of the borrower's stock, as shown by Nishant Dass and Massimo Massa.

Basel II was a big topic of the conference, especially during the panel discussion. The lack of prompt corrective action and the limited role for market discipline were criticized. While Basel II and the risk-based capital requirements it postulates might encourage the development of more sophisticated models of risk by banks, Charles Calomiris of Columbia University stressed concerns about potential manipulation of these models by banks and subsequent undercapitalization. Given asymmetric information between banks and supervisors, this might only come to light when it is too late to take any prompt corrective action. While calls for Basel III might be too early, Edward Kane of Boston College suggested seeing Basel as a process, not as a consensus about a final document.

All papers, presentations and the transcript of the panel discussion are available at <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/EXTPROGRAMS/EXTFINRES/0,,contentMDK:20992781~pagePK:64168182~piPK:64168060~theSitePK:478060,00.html>.

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