Market discipline: challenges and limitations

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Market discipline is necessary

In theory:
- Investors have ‘skin in the game’, imposing an incentive to closely monitor and discipline financial institutions, governments, companies, etc.
- Investor decisions reflect supply and demand in a neutral manner, independent of policy biases or political preferences.

Therefore, market discipline is encouraged by regulators:
- Since Basel II, disclosure requirements part of regulatory framework (Pillar 3)
  Disclosure requirements also included in Solvency II (Pillar 3)

But does it work in practice? What are the market failures?
Problems with market discipline: information asymmetry
Market reactions are late, abrupt, excessive, contagious
Problems with market discipline: structural distortions

Too big to fail problem limits incentive to monitor banks

Banks still profit from implicit government safety net

Average rating uplift of the largest banks per country

Source: Moody’s, own calculations
Policy measures to limit excessive market reactions

Stress testing reduces information asymmetry

Average behavior of CDS prices of major U.S. and European banks (2009)

Policy measures to limit investors’ complacency

Ending too big to fail reduces moral hazard

Bail-in priced in at holding level
Risk premium in bp, index of 3 British banks

Markets react to German bail-in proposal
Change in prices of senior debt, proposal introduced March 10th, 2 march = 100

Source: Bloomberg, own calculations
Concluding remarks

Market discipline is necessary
⇒ Regulators should tackle existing limits to market discipline (such as information asymmetry and structural distortions)

But not enough
⇒ There are limits to market discipline (markets react late, abruptly, excessively and contagiously). Market discipline needs to be complemented with policy discipline and strong regulatory standards