Since the recent global financial crisis, there has been a tectonic shift in the policy world towards more onerous regulation of the banking sector, primarily, though not exclusively, through the Dodd-Frank Act. Bank regulators not only have more power given to them through Congress, but also from the increase in power of the Federal Reserve and the other major banking regulators in the U.S (OCC, FDIC, etc.). At the same time, there has been widespread acknowledgement that incentives were at the core of the problem leading up to the financial crisis, but little actual research on what those underlying incentive problems were and how they may be resolved.

My new working paper attempts to address that question. A bank exists to engage in maturity transformation: borrowing short and lending long. A bank manager is necessary to improve credit risk on its loan portfolio because of internal agency problems. However, various contractual constraints internally prevent the writing of an efficient contract. So there still exists a problem inside the bank, where the manager does not have the same incentives as the shareholders. Disclosure of credit risk to the financial markets can resolve this residual agency problem because it offers a channel through which the external investor can discipline the internal manager. The investor lends to the bank each period, and can therefore condition its second stage interest rate on information from the first stage, if it is available. Knowing this, the manager will work harder early on in order to secure a better cost of funds in the later stage. He does this because he is paid on output; his pay for performance contract, while imperfect, is nonetheless vital to induce him to work more.

The theoretical model in my research paper, Bank Disclosure and Managerial Incentives, provides explicit disclosure as a form of market based regulation. While the various banking regulators and accounting rule makers have moved toward a regime of more disclosure, the move has been tentative and preliminary without explicit justification of why disclosure matters. My paper seeks to provide that reasoning and to show clearly and forcefully that disclosure is an alternative channel to the kind of bank regulation that currently operates behind closed doors. Disclosure allows the market to adjust how it interacts with the bank. Allowing information from the bank to spill into the market permits outside investors to tailor their decisions with the bank in the future. Knowing this, managers will constrain risk taking early on. This is precisely the disciplining force that a market can impose on a firm, leading to a socially optimal outcome. I hope this research will give regulators an effective alternative form of regulation, and give them pause in expanding the broad reach of the Federal Government throughout the banking arena – one that is largely opaque and outside of the shining light of Congress. Disclosure puts more information in the market for everyone to see, and this information can have dramatic incentive affects.