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ISBN 978-3-642-01629-5



> springer.com

KLEWES · WRESCHNIOK
(Eds.)



Reputation Capital

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Editors

Reputation Capital

Building and Maintaining Trust
in the 21st Century

 Springer

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Part III: The 21st century of reputation crisis

*One can survive everything, nowadays, except death, and live down
everything except a good reputation.*

Oscar Wilde (1854-1900)

Reputation and regulation

Hans Caspar von der Crone and Johannes Vetsch

Where information asymmetries are inherent in markets, reputation serves as an enforcement mechanism. Regulation takes the task of informing participants of their counterparties' standing by sending quality signals to support their reputation, thus allowing for efficient trade. Effective regulation creates expectations, which may force regulators to assume responsibility for the quality signals issued. The extent of both financial and reputational risk to which governments are exposed in financial markets requires strong regulation with clear rules for predictable intervention.

In discussions about the current financial crisis, two issues in particular seem to stand out: reputation and regulation. While the crisis has tainted the reputation of many financial institutions and audit companies, as well as regulating authorities, it has also increased the demand for stronger regulation as a means to solve the crisis. However, a closer look at the situation reveals a system of much more complex interdependencies between reputation and regulation. This essay aims to address questions regarding the mechanism of reputation in the context of regulation as well as challenges to regulation. The final section looks at the concept of regulation in the financial market.

The mechanism of reputation

Ideally, contracting parties have full access to all information necessary to define and assess the quality of the performance of the respective counterparty. Under such conditions of full and symmetrically distributed information, parties can write a complete contract specifying all details of their future interaction. Virtually no contract, however, is entirely complete, as some aspects of the performance relevant to the parties usually cannot be

defined in detail *ex ante* [5, 11, 15].¹ The resulting lack of specification reduces the ability of a court to assess and enforce the performance of a contract: when formal enforcement is not available, there is limited certainty regarding satisfactory performance.²

Knowing that important aspects of the performance cannot be formally enforced, parties will select their counterparties based on their reputation. When searching for the best physician or the best lawyer,³ for example, people will enquire amongst their friends or business relations for experiences they have had with potential candidates. Physicians and lawyers, in turn, know about the importance of their reputation for their business perspectives. Keeping their long-term reputation in mind, they will refrain from opportunistically making short-term use of the incompleteness of their contracts [10, 15, 26, 27]. Reputation therefore is a key element in the governance of some of the most important standard contracts of a modern economy,⁴ as the concern for one's own reputation serves as an alternative enforcement mechanism.

Mechanisms of reputation will only become effective on two conditions. First, there needs to be repeated interaction within a group of principals and agents: in a repeated play, parties know that cooperation will come to an end if performance does not meet expectations [20]. Reputation extends the mechanism of two-party repeated plays to multi-party interaction [15]. Second, since mechanisms of reputation infer from past to probable future behaviour, at least some aspects of past behaviour must be observable. Reputation, in this context, is an aggregate of the experiences other principals have had when dealing with the respective agent in the past, given that such information is at least partially available to other principals [1, 33].⁵

¹ A complete contract would lead to prohibitive costs both in drafting and enforcing the contract. Such a contract can only serve as a model.

² There are substantial variations in the degree of completeness of contracts: while contracts regarding standardised commodities usually are complete to a high level (because many such contracts are fulfilled in single transactions and thus are not subject to changes in circumstances), contracts for services show a much larger degree of incompleteness [15]. In Swiss law, the incompleteness and lack of formal enforceability of contracts for services is acknowledged with the option to terminate a mandate without notice (Art. 404 of the Swiss Code of Obligation) [32].

³ Lawyers and physicians are two professions dealing with the issue of information asymmetry due to hidden information, i.e. information not available to the principal despite his ability to observe the agent's activities [11].

⁴ Including all principal-agent relations, i.e. all relations in which a principal hires an agent to act on his behalf. On the principal-agent theory, see Jensen and Meckling [12].

⁵ One modern way to communicate experiences with certain agents is online feedback systems: especially in dealing with anonymous counterparts (e.g. sellers in online auctions), where information is hidden and distributed asymmetrically, their reputation becomes a dominant factor in the selection. Online feedback systems allow participants to share experiences and, by so doing, maintain the market [41].

Emergence of regulation

Establishing the reputation of potential counterparties can be a time-consuming undertaking, especially for outsiders who are not regularly contracting for the respective goods or services. Buyers (principals) may therefore incur substantial search costs in trying to establish the reputation of different service providers (i.e. agents). They will thus be interested in quality signals that reduce their search costs.

Under certain circumstances, agents as well are interested in quality signals: in highly reputation-sensitive industries, the reputation of peers will to some extent become interlocked. A bad reputation for the sector as a whole will negatively affect individuals offering services of high quality. As demonstrated with the market for used cars,⁶ high-quality providers in such markets will not easily succeed in proving that they offer superior quality, and thus, they will not be able to charge the correct price for their service. High quality providers can therefore be expected to act against low quality providers by establishing standards or labels and issuing quality signals to potential customers [11, 28]. Under such conditions, self-regulation can be expected to emerge. Examples are professional organisations of physicians or lawyers. If a sector is critical to the public interest, quality signals may be supported by specific laws, or the standard-setting function may be assumed entirely by the state.

Whether a quality signal actually leads to a reduction of search costs depends on its performance. The performance of a standard or the reliability of its setter is only partially measurable. Consequently, this issue is subject to information asymmetries as well and, therefore, to the mechanism of reputation. To some extent, the reputation of the individual service provider is complemented or replaced by the reputation of the standard or the standard setter.

⁶ An example of the so-called “market for lemons”. The term refers to a problem of information asymmetry: if there is a high level of information asymmetry in a market with potentially bad agents, the probability of getting a bad product (a “lemon”) rises; therefore, consumers’ willingness to pay high prices is reduced in general [1].

Regulation and moral hazard

Quality signals always have distorting effects. According to the “club theory”, it is typically attractive to only minimally meet the standards [6]. Standards thus foster a tendency to favour form over substance.⁷

If market participants observe that merely formal compliance is sufficient, the regulator risks not being taken seriously any more. The regulator’s reputation and its ability to issue a quality signal are compromised. Setting and enforcing standards resembles an arms race: the regulator will continuously be challenged by attempts to dodge its standards and, unless it accepts the risk of losing its reputation, the regulator will have to fight back with ever more sophisticated standards and enforcement procedures. Within such a cycle lies a risk of over-regulation, as the regulator is most likely to be challenged by the marginal – and not the average – market participant [13].

Regulation and risk awareness

Successful regulation gives market participants a sense of safety in dealing with a regulated counterparty. In selecting their counterparties, market participants become less attentive to the counterparty risk. In areas such as public transport electronic goods, or financial institutions, regulation replaces the natural risk awareness of consumers who thus tend to be less aware of the risks inherent in their contracting.⁸ While at first sight this may seem to be just another case of moral hazard, replacing mistrust with trust can create important social benefits. Complex markets such as the financial market could not function on the basis of mistrust; rather, it requires a certain level of trust [4].⁹ Such a “guarded trust” – a neither naive nor permanently suspicious attitude towards each other – relieves parties from burdensome search costs of individually establishing their counter-

⁷ One can typically get away with substantive, but not with formal non-compliance. One means to counteract such tendencies could be to argue with the abuse of rights; a measure, however, that is usually bound to very strict conditions [40].

⁸ Even if a cableway or a ski lift looks old, people will use it without further ado, trusting in proper maintenance prescribed and (hopefully) enforced by regulation. A study in Switzerland even showed that pedestrian crossings crosswalks tend to be the most dangerous place to cross a street, mainly due to the pedestrian’s inattentiveness based on their trust in the crossing’s safety [21].

⁹ There are, of course, still many advocates of free markets, as the current controversial discussion regarding the financial market crisis shows [13].

parties' standing. In this way, regulation can provide for faster and more efficient contracting, and thus creates a more efficient market as a whole.

Regulator as guarantor

While this reduction of risk awareness allows for more efficient trading, it also creates certain expectations of market participants towards the regulator.¹⁰ The effect of regulation on the behaviour of market participants is similar to the effects of an insurance contract: within a regulated market, participants will behave differently in screening, selecting and monitoring their counterparties. Under an insurance contract, though, the insured pays the insurer for the assumption of a specific risk, and receives, in return, a well-defined claim against the insurer upon the occurrence of the event insured. The regulator typically does not assume a formal liability for the quality of the regulatory signal, just as he is not specifically compensated for assuming the relevant responsibility. As a consequence, while market participants grow inattentive of inherent risks, they do not receive a legally enforceable claim for compensation against the regulator even if the regulatory signal was wrong. Regulation creates expectations without assuming responsibility.¹¹

During testing times – such as natural disasters, plane crashes or the current financial crisis – this fact may come to the attention of market participants. In a singular occurrence, the regulator will try to sustain the validity of the regulatory signal, for example by explaining the incident with factors not related to the signal. If, however, the crisis turns out to run deeper, the reputation of the regulator is questioned, and the regulatory signal itself no longer considered trustworthy. There is a risk that mistrust might replace the “guarded trust” amongst market participants.¹²

¹⁰ Expectations rise with a positive track record (i.e. a good reputation) of the regulator, since market participants become accustomed to a certain level of trust.

¹¹ The case is different if a regulator violates its own duty to supervise the implementation of regulatory standards. This could lead to a legal responsibility of the government based on a law regarding the liability of the state (Verantwortlichkeitsgesetz, SR 170.32). The conditions are strict, as demonstrated when a liability claim against the Swiss Federal Banking Commission (SFBC) was rejected in a 1990 decision of the Swiss Federal Supreme Court (BGE 116 Ib 193, 196); see also [39].

¹² This could be seen in the current financial crisis: while banks reacted to the loss of trust by refusing interbank credits, customers withdrew their savings from ‘infected’ banks.

Re-establishing the reputation

Deregulation

One radical answer to regulatory failure might be deregulation. What cannot be effectively regulated is better not regulated at all: no wrong signals are sent. Without “guarded trust” instilled by regulation, people will again become risk conscious. As attractive as such an approach may seem at first, it cannot work in complex markets for two reasons: first, regulatory signals are a prerequisite for efficient trading in complex markets. Replacing regulatory signals by market participants’ individual caution would lead to astronomically high transactions costs, in effect strangling such markets. Second, market participants are accustomed to a certain degree of regulatory protection. Once the market has become used to trading based on a certain level of trust, the road back to Hobbes’ state of general mistrust is blocked.

Assuming responsibility

Lacking the alternative of fundamental deregulation, regulators will therefore have to fight to re-establish their signalling capability. One strategy for reaching this goal is to assume the responsibility for the expectations created by the regulatory signal. In deciding whether to assume responsibility, the regulator will find itself in a precarious position. If the regulator does not act against market participants complying only formally with standards while neglecting its substance, the regulator’s reputation will be affected. On the other hand, if the regulator does offer help to companies facing difficulties, it could face opportunistic behaviour from market participants who bet on and seek to profit from such an implicit government guarantee.¹³ In general, assuming responsibility for past signalling can therefore only be an intermediary solution.

¹³ This balancing act could be seen in the financial crisis in 2008, during which some banks were saved by financial support from regulators (to strengthen the system), and others were not (to set examples) [18].

Strengthening regulation

In the long run, the regulator has little choice other than strengthening regulation. There are different ways to do so: with a long-term perspective, the regulator may choose a new approach to regulation, i.e. restructuring market supervision as a whole. It may introduce changes in the regulation's concept, or new requirements. This, however, takes time, and is not an adequate short-term response to an imminent crisis. Another approach to strengthen regulation is to set up tougher rules, i.e. to eliminate flaws in the previous framework.¹⁴ Finally, the focus may be shifted to the enforcement of existing rules. Because lawmakers tend to focus on rules and neglect their enforcement, many regulations are conceptually sound but insufficiently enforced.¹⁵

Regulation of financial markets

The financial sector – as one of the most important but also most complex markets of the economy – provides a good example for the interaction of reputation and regulation.

Financial markets: Need for reduction of complexity

The financial stability of a company is assessed based on its balance sheet, i.e. the assets and liabilities a company has. The relatively simple mathematics of the balance sheet may give the impression that the total worth of a company can be represented and its future performance assessed with plain and reliable numbers. The valuation of the individual assets and liabilities, however, reveal the complexity behind it.

¹⁴ Although such action is certainly required, one cannot overlook the political dimension: usually, regulators ask for tough rules, which are scaled down in the course of the political decision-making process. By acknowledging the failure of the existing regulation and setting up new and tougher requirements, the regulator is able to openly criticize previous political decisions, and thus create momentum for future actions.

¹⁵ Again, for political reasons, the approach of focusing changes on the enforcement of rules is very popular among regulatory authorities: it translates into further powers and higher budgets for regulators.

Balance sheet

The balance sheet of the Credit Suisse Group – one of the few big European banks that until now has managed to refinance itself without state support – may serve as an example for the developments in bank balance sheets within the last fifty years. Looking back to 1957, Credit Suisse was mainly a domestic bank. All markets in which it was active were heavily cartelised and, consequently, volatility was low. Back in 1957, the bank had assets with a book value (corrected for inflation) of CHF 4.5 bn and an equity ratio of 7.5% [24]. Today, Credit Suisse is a global player in highly competitive and highly volatile markets. The reported capitalisation by far exceeds regulatory requirements. In 2007 Credit Suisse had assets of CHF 1.415 bn. The equity ratio, however, has dropped to 3.17%. While the balance sheet of Credit Suisse is rather conservative compared to other banks, it has become more than twice as risky since 1957, notwithstanding the fact that the bank today is confronted with market risks which would have been inconceivable in 1957.

Valuation models and intangibles

A glance at the assets reveals important changes as well. In 1957, all assets had to be reported at historical value, reflecting the initial purchase price of an asset, minus depreciations. Historic accounting tends to understate asset values: in 1957, the bank's real estate, for example, was booked at roughly one-fifth of its fair value [25]. Such understatement creates latent reserves. Under today's IFRS rules,¹⁶ assets have to be reported at fair value, i.e. at current prices. Conceptually, fair-value accounting is clearly superior to historic accounting: while the latter requires booking assets at the initial purchase price, fair-value accounting reflects the current value of the assets. The benefit of the conservative (historical) approach was its cushioning effect: companies could go through shorter restructurings without announcing them to the markets, and could thus protect their reputation. The paradigm shift has revolutionized accounting by making it much more accurate. But with the disappearance of latent reserves, companies' balance sheets became substantially more risky.

Fair-value accounting aims to reflect the current worth of the company in its balance sheet. Assets that are traded on liquid markets are booked at their market value (mark-to-market). Other assets are valued based on

¹⁶ IFRS 7, IAS 39.

valuation models (mark-to-model). While such models may give a reasonable estimation of the value of an asset under the model's assumptions, the true value of the asset is difficult to determine [34]. Liabilities as well are valued according to the fair-value rule: the fair value of a liability depends on the creditworthiness of the debtor, and is either equivalent to its nominal value (if the company is in good financial standing) or lower. Consequently, the downgrading of a company results in a profit booked in the profit and loss statement.¹⁷

A further complexity stems from assets or liabilities that are non-tangible. If in a takeover a premium is paid to the seller, that amount is booked as goodwill in the balance sheet.¹⁸ Moreover, certain intangible assets such as patents, know-how or innovations are booked at estimated values [9].¹⁹

Self-regulation and government regulation

These difficulties in the valuation of assets and liabilities clearly show that accounting cannot resolve all information asymmetries between market participants. As a consequence, market participants cannot evaluate all risks inherent in financial transactions themselves.²⁰ They have to rely on signals regarding traded assets, counterparty risks as well as the stability of the market as a whole. To that effect, standards and rating procedures have been developed aimed at ensuring a certain quality of assessment. However, these measures of self-regulation do not fully eliminate information asymmetries, either. Financial reporting, for example, reduces information asymmetry by providing financial information in aggregate form. As shown, though, the reliance on valuation models leaves the market with few means for establishing the accuracy of this representation. This requires yet another quality signal: by giving formal audit clearance, the

¹⁷ According to its third-quarter financial statement of 2008, Swiss bank UBS was able to book a profit of CHF 2.2 bn solely on valuation gains on its liabilities [31].

¹⁸ According to IFRS rules, there are clear rules on how to book goodwill (see IFRS 3 and IAS 36.15), but companies may still 'hide' goodwill by assigning that amount in ways so as to compensate for losses.

¹⁹ Such distortions of a company's balance sheet may create expectation gaps. Zurich Financial Services distinguishes between the IFRS balance sheet and the "Available Financial Resources", i.e. an economic view of financial resources to cover policyholders in the event of a worst-case loss. In such a calculation, among other adjustments, intangible assets are removed and intangible liabilities added to the shareholders' equity [42].

²⁰ As one bank manager put it: "The requirements for information [...] have gone beyond our abilities to gather it." [4].

auditor confirms that the financial reports are an accurate and adequate representation of the company's financial standing.²¹ Similar mechanisms are in operation regarding the valuation of a company's risk exposure or the assessment and rating of complex financial instruments [4].

In the end, financial standards, rating agencies and auditors – all institutions in charge of providing the market with quality signals regarding certain aspects of the financial market – are subject to mechanisms of reputation themselves. Again, the determination of such reputation is difficult and time-consuming, and thus expensive. Given the important economic and social function of the financial sector,²² governments cannot afford inefficiency in financial markets. Governments, therefore, are required to issue quality signals regarding the various aspects of the market: the state, through its regulator, supports quality signals regarding financial institutions, reporting standards, auditors or rating agencies, thereby assuring the soundness of the financial market as a whole.²³ By issuing such signals, the regulator creates a “guarded trust” among market participants, and thus provides for the possibility of efficient interaction.

The current financial market crisis

Moral hazard

Market participants rely on quality signals when selecting counterparties, traded assets or risks. In other words, they favour form over substance: transactions in complex financial instruments²⁴ as well as the assessment of counterparty risk²⁵ are based on ratings or regulatory approval. In effect, they are thus based on the reputation of the respective regulatory institu-

²¹ “Accountants are the gatekeepers of our financial markets. Without accountants to ensure the quality and integrity of financial information, the markets for capital would be far less efficient, the cost of capital would be far higher [...]” [38]; see also [22].

²² In Switzerland, the financial sector alone accounts for about 10% of GDP, generates up to 14% of value added, and contributes to around 10% of total tax revenues at all levels. Moreover, the financial sector employs more than 5% of the total workforce in Switzerland [30].

²³ The state could do so by introducing licences for banks, auditors or rating agencies. Also, it can support or prescribe the usage of certain reporting standards.

²⁴ Within the past decade, financial institutions have increasingly traded derivatives, although according to Frank Partnoy, University of San Diego expert on derivatives, “[n]o one, including regulators, could get an accurate picture of this market” [13; see also 4, 7].

²⁵ In June 2008, the Belgian bank Dexia, for example, reported a risk-weighted (Basel II) equity ratio of 11.4% and thus met regulatory requirements. But its core capital ratio (i.e. the ratio that determines long-term creditworthiness) at that time was only 1.6% [3].

tions [4, 17]. The reliance on quality signals creates an incentive to just minimally meet the respective requirements. Financial reporting and assessment procedures leave room for individual adjustments of substantive issues. A company's management could be tempted, in case of negative developments, to take a short-term view and cover up losses with assessment adjustments, hoping that things will straighten out before the day of reckoning.²⁶ The risk in such a procedure is well known. Yet knowing that governments would ultimately step in to save failing banks for systemic reasons, there is no incentive – either for a bank's managers or its owners – to stop speculating or to question the system of quality signals currently in place.

Failing regulatory signals

The concurrence of low capitalisation and a reliance on risk and valuation models have led to the current crisis in financial markets. Like most market participants, regulators did not have the mathematical knowledge for their own independent assessment of risk-control concepts. As a consequence, they restricted themselves to a rather distant review of the banks' internal risk-control and valuation models. By doing so, banking regulators sent a positive signal regarding the capitalization of the big international banks without fully understanding their balance sheets. During the summer of 2007, the markets started to realise that regulatory capital requirements were inadequate, notably in the case of banks that had many basically illiquid assets on their balance sheets.

Banks knew from their own balance sheets that complying with formal requirements did not mean that one was sufficiently capitalised to be creditworthy. Blind trust was thus replaced by realistic credit risk assessment; quality signals were no longer trustworthy, and market participants were no longer prepared to bank on these regulatory signals at more or less risk-free rates [2, 37].

The consequence was a breakdown of the regulatory signalling capacity. The current crisis in financial markets, therefore, is also a product of regulation. The megatrend towards much riskier balance sheets, combined with complex accounting standards, could not have happened without regulators

²⁶ When market prices fell dramatically during the current financial crisis, banks tried to convince regulators that the "true" value of their assets was not reflected by the mark-to-market rule, but rather by applying models (such as the discounted cash flow model) even to frequently traded (but undervalued) assets [19].

issuing approving signals which replaced the market's natural risk awareness with trust among participants.

Consequences for the regulator

Assuming responsibility

The fault, of course, cannot be solely assigned to the regulator. Yet it was an unavoidable consequence of the regulators' signalling that the state had to step in and assume responsibility to a certain extent. At first, the regulators sought to control the situation by helping a few banks while neglecting others, and explaining their failures with factors not related to regulatory issues. The crash of Lehman Brothers, though, proved that the bankruptcy of systemically important institutions is no reasonable option for financial markets. That incident led to a massive loss of trust and to the failure of the credit market in 2008. Although governments realised the importance of interventions their actions were unpredictable both in scope and aims [4] and thus further decreased the level of trust in the financial market.

In the financial sector, the implicit government guarantee [16] is a consequence of the constant and strong exposure of the government's regulatory signals and their inherent assurance regarding the market. What is lacking, though, is a clear set of rules for predictable and balanced intervention [4].

Strengthening of regulation

The state cannot refrain from strengthening the rules. The regulatory framework is constantly updated in line with the evolution of the financial market itself. Tougher rules and better enforcement procedures are being discussed [8, 29, 36].

The assumption of responsibility in certain cases can strengthen the regulatory signal. This concept of an implicit government guarantee, however, leaves the state in a precarious position: while companies will always bet on the government not letting down an important market, the government does not have enough influence to control its own risk exposure. The massive negative impacts of the failure of a bank (for example, Lehman

Brothers), has put an end to the idea that the assumption of responsibility would be the regulator's choice: in markets as complex and important as the financial sector, the government will always be a lender of last resort [16]. A long-term solution thus has to focus on the institutional setting.²⁷ Regulation can no longer be delegated to various state and non-state actors with uncoordinated powers. It has to be acknowledged that the regulation of the financial market is a core task of the government. Predictable state intervention requires a clear set of rules, including the assignment of responsibility to a central authority and the adjustment of risk exposure based on a state's financial strength.²⁸ An effective control of the government's regulatory signal can only be based on better access to information, and thus a stronger integration of the government in the financial market.²⁹

Conclusion

In incomplete contracting, i.e. contracting based on asymmetric information, the reputation of parties is a key factor in selecting counterparties. Especially for repeated interactions within a group of players, reputation is often the only mechanism to enforce performance. In order to simplify the process of selecting counterparties, reputation signals are issued, usually by some standard-setting body or the state. If such a quality signal becomes strong, market participants will no longer test their counterparties' qualities themselves, but rather rely on the signal. However, a quality signal may not be based on a thorough analysis of the whole market, and, thus, its signal may fail. For regulators of complex markets, the answers to such regulatory failure are limited: while deregulation is not an option, the regulator will have to both assume some responsibility for the expectations created, and try to strengthen the regulation.

An economy's most fundamental sectors cannot be left unregulated. The financial market especially, where information is distributed highly asymmetrically, cannot function without regulatory signals. Regulation in these markets is to be viewed not as an interruption to market forces, but as a fa-

²⁷ The Group of Thirty, a think tank of economy leaders, in its 2008 "A Framework for Financial Stability", proposed steps aimed at "[r]eforming the structure of prudential regulation, including the role of central banks, the implications for the workings of 'lender-of-last-resort' facilities and other elements of the official 'safety net' [...]" [8].

²⁸ The financial power of a state may be assessed by its GDP. The problem has become apparent in Iceland, where the failed banks were almost too big to rescue [35].

²⁹ The economic and social importance of financial markets is comparable to that of national security, a public good that is ensured by classical state institutions. Many financial institutions have been (partially) nationalised in the course of the current crisis [23].

cilitator of efficient trade – and thus, regulation has to be viewed as a core task of government. In light of weaknesses of the signalling capacity due to the difficulty of accurately assessing many market risks, a regulator's signal is likely to overreach, or fail, at times. In such situations the regulator (i.e., in effect, the government) has to take responsibility for the expectations created, based on the mechanism of reputation. In order to provide for predictable circumstances of state intervention, a stronger regulatory framework requires a clear set of rules to that end.

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