ONE

Introduction

> But what is government itself, but the greatest of all reflections on human nature. If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.
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> James Madison, *Federalist Papers*, Number 51

1.A. MOTIVATION

When budding entrepreneurs in Brazil, Egypt, Zambia, or Indonesia are turned down for loans or do not even bother to apply because banks instead funnel credit to the rich or politically powerful, this stymies innovation and thwarts economic growth. When households in Georgia, Nigeria, Russia, or Venezuela avoid placing their savings in financial institutions and instead buy foreign currency, physical commodities, or durable goods, this reflects queasiness about domestic banks and advertises the lack of efficient mechanisms for getting savings to productive firms. When bank managers in too many countries simply take deposits with one hand and pass them along to friends and related businesses with the other hand, this discourages business initiative and prevents the poor and unconnected with good ideas from realizing their dreams and improving their economic condition. When bad policies ignite or exacerbate banking crises in Argentina, Indonesia, or Mexico, this yields widespread bankruptcies, rising unemployment, and even soaring street violence. Thus, our main motivation for studying bank regulation and supervision is that banks matter for human welfare; therefore, we seek to identify which approach to regulation and supervision best enhances bank performance.

Formal econometric studies confirm that banks exert a first-order impact on economic development.[1] When banks direct the flow of capital toward those enterprises with the highest expected social returns and monitor firms carefully after providing funds, this encourages entrepreneurship and economic growth. New research further suggests that banks influence income distribution and poverty. Although sound banks alleviate poverty primarily by accelerating overall growth and therefore by "raising all ships," well-functioning banks also exert a disproportionately positive impact on the poor.[2] Countries with better banks experience faster reductions in poverty as capital flows to those with the best projects, not simply to those with the most wealth and power. The reverse is also true. Poorly functioning banks that simply funnel credit to connected parties and elites slow growth and exert a disproportionately negative influence on the poor and small businesses by depriving them of the capital they need to succeed. Unfortunately, billions of people live in countries with poorly functioning banks. Thus, banking policies matter because banks influence the ability of people, rich and poor, to improve their living standards.

Banks also matter when they fail. In Japan, the banking crisis in the 1990s was estimated to cost over 20 percent of GDP (Caprio, Klingebiel, Laeven, and Noguera, 2003). The fiscal costs of banking crises in developing countries alone exceeded $1 trillion in the 1980s and 1990s. In present value terms, this is about equal to all foreign assistance transfers to developing countries over the period 1950–2001 (World Bank, 2001, and authors' calculations)! The banking crises in Argentina and Chile in the early 1980s, and Indonesia in the 1990s, were of epic proportions with estimated costs surpassing 40 percent of a year's Gross Domestic Product (Caprio and Klingebiel, 1997; Caprio et al., 2003). Banking crises can completely disrupt economies, and the human costs can be very real, as, for example, when health and education programs are dramatically cut to fund a government bailout of the failed banks.

Besides studying bank regulation and supervision to identify policies that promote economic growth, reduce poverty, and minimize destructive

[1] See Levine (1997, 2005) and sources cited therein.
[2] See Beck, Demirgüç-Kunt, and Levine (2004b); and Beck, Demirgüç-Kunt, Laeven, and Levine (2004); and Honohan (2004).

financial crises, our research is also motivated by the influential "best practice" recommendations advocated by the Basel Committee on Bank Supervision. Virtually all countries adopted the 1988 Basel Capital Accord, which provided guidelines for assuring that banks have sufficient capital. In 2004, the Basel Committee released a new, much more expansive set of recommendations – Basel II. The first and main pillar develops far more intricate procedures than the 1988 Accord for computing minimum capital requirements. The second pillar recommends regulations that empower official supervisory agencies to scrutinize and discipline banks. The third, and least developed, pillar focuses on regulations that require accurate information disclosure and facilitate market oversight and discipline of banks.[3] Although not finalized, within three months of its official announcement, more than one hundred countries already signaled their intention to adopt the Basel II guidelines. Thus, part of our motivation for writing this book is to provide guidance to authorities as they consider whether and how to adopt Basel II or more generally how to reshape their regulatory frameworks.

1.B. OBJECTIVES AND CONTRIBUTIONS

In this book, we:

- Assemble a new, detailed database on bank regulation and supervision in over 150 countries.
- Conduct the first, comprehensive, cross-country assessment of the impact of bank regulatory and supervisory practices on bank development, efficiency, stability, and the degree of corruption in bank lending, including an examination of the three pillars of Basel II: capital regulations, official supervision, and market discipline.
- Provide an empirical evaluation of the historic debate about the proper role of government in the economy by using the laboratory of bank regulation and supervision around the world.
- Analyze why countries make different regulatory and supervisory choices.

The absence of data on bank regulation and supervision around the world has made it impossible to assess empirically which policies boost bank development and efficiency, and which ones reduce the susceptibility

[3] Powell (2004) describes the detailed features of Basel II. The underdevelopment of the third pillar was a theme of the 2003 Chicago Fed conference on Market Discipline (Borio, Hunter, Kaufman, and Tsatsaronis, 2004).

of economies to systemic banking crises and limit corruption in finance. Data limitations have impeded cross-country examinations of: (i) why countries choose different banking policies, (ii) whether policies adopted in countries with particular legal and political institutions will work in countries with very different systems, and (iii) which broad approaches to the role of government in society work best in fostering efficient functioning banks. There has been an enormous gap between empirical evidence on the efficacy of different banking policies and the enunciation of best practice recommendations by international experts.

Our main contribution is to assemble a new database on bank regulation and supervision around the world, so that researchers and policy makers can for the first time compare what countries actually do and assess which policies work best to improve human welfare. We use the phrase "bank regulation and supervision" to encompass a wide range of policies and enforcement procedures that apply specifically to the banking sector. Regulation typically refers to the rules that govern the behavior of banks, whereas supervision is the oversight that takes place to ensure that banks comply with those rules.[4] To collect information on both bank regulations and supervisory practices, we conducted two surveys (in 1998/1999 and in 2002/2003). Chapter 3 discusses these data and we provide the data on the CD that accompanies this book.

In addition to constructing a database, we also examine which banking sector policies and strategies enhance bank development and efficiency, and which policies lower banking system fragility and the degree of corruption in lending. Because banks affect economic prosperity, our goal is to provide empirical evidence on which regulatory and supervisory practices improve the functioning of banks. We examine regulatory impediments to the entry of new domestic and foreign banks, restrictions on bank activities, the generosity of the deposit insurance regime, the power of the official supervisory agency to close banks, change managers, stop dividends and other payments, the degree to which regulations force the disclosure of accurate comparable information, the extent of government ownership of banks, rules regarding prompt corrective action and loan classification, and many other policies. We use broad cross-country comparisons, bank-level data, and firm-level data to assess

[4] In many cases, we will simply use the term regulation as a generic description of banking sector policies and compliance mechanisms. In some cases, however, we will use regulation and supervision less generically, such as when we discuss particular regulations (e.g., the activities in which banks are permitted to engage) or particular aspects of supervision (e.g., taking corrective actions).

the impact of these different banking sector policies on the operation of the banking system. Throughout, we test whether banking policies operate differently in countries with distinct political and institutional settings.

In assessing which policies work best, we devote special attention to Basel II's three pillars. Basel II was developed primarily by bank supervisors from the world's richest countries, but the recommendations are having worldwide repercussions. Although there is an appealing logic to following the advice of rich-country supervisors, there are two equally compelling concerns. First, there is no evidence that any single set of best practices is appropriate for promoting well-functioning banks in every country. Specifically, practices that appear to succeed in the United States, Europe, or Japan may not succeed in countries with different institutional or political settings.[5] Thus, "one size may not fit" for all countries. Second, the Basel II approach to regulation stresses direct official supervision, which may not work as well as an approach that emphasizes market discipline. In fact, there is a risk that policies developed by official supervisors will unduly emphasize and empower official supervision. Too much trust may be accorded government officials and too little attention devoted to the potential abuse of this trust or to inefficiencies introduced by excessive reliance on supervision. Although it is possible to imagine institutional environments in which abuses are limited (e.g., in which both the judiciary and the media are both independent and honest), the opposite environment may be more common in practice, as posited in Chapter 2 and sources cited therein. Thus, recommendations rooted only in supervisory wisdom may push countries in the wrong direction, as argued for example by the Shadow Financial Regulatory Committee (1999) and Shin et al. (2001). This book contributes to filling the gap between the Basel recommendations and the response of a number of experts in the academic community by providing cross-country empirical evidence.

Although the rationale for the first two objectives – assembling the database and examining which regulations and supervisory practices work best – are clear, many may wonder why this book grants such prominence

[5] The point that policy recommendations can vary with the institutional environment was shown for deposit insurance by Demirgüç-Kunt and Kane (2002), and also the World Bank (2001). The point is that if the rule of law, bank regulation and supervision, or the information environment is sufficiently weak, deposit insurance, which reduces market discipline, could so weaken monitoring of banks that it would make the banking system more vulnerable to crises. Where institutions are stronger, and both official supervision and market monitoring better developed, any weakening of market discipline may be less significant.

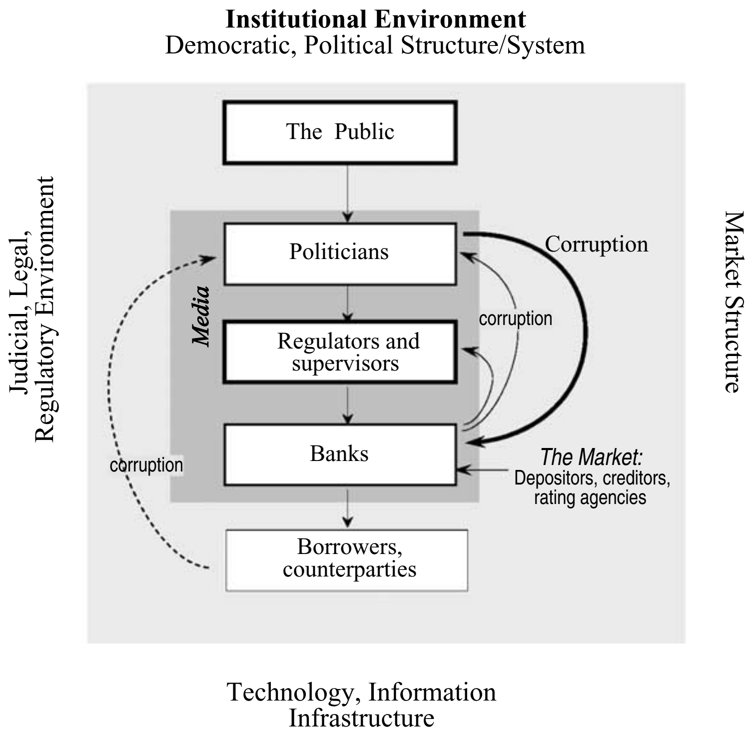

Figure 1.1. Framework for Bank Regulation.

to the last two objectives – assessing the proper role of government in society and investigating the determinants of banking policies. Many may consider bank regulation a technical specialty, akin to the mechanics of clearing and settling equity transactions. From this technical perspective, bank regulation and supervision involve defining and measuring capital, determining the number of days a loan needs to be in arrears before classifying it as nonperforming, and similar issues. From that perspective, this book should focus only on assessing which regulations work best. This technical view would not place much weight on viewing bank supervision and regulation within a broader political economy context that stresses how political philosophies and institutions shape both policy choices and the impact of those decisions. Although we began our investigation with this technical perspective, the data quickly induced us to rethink our approach to bank regulation.

Figure 1.1 illustrates a broader framework in which to view bank regulation and supervision that involves a sequence of agency problems surrounded by the entire apparatus of political, legal, cultural, and technological forces influencing the operation of banks.[6] At each level in this figure, there is a principal-agent problem. For example, in the lending relationship, the bank is the principal, the borrower is the agent, and the bank's problem is how to induce the borrower to behave in a responsible way and service the debt. Information asymmetries – the borrower having better information about issues such as their own busines activities, behaviors, and effort than the bank – make this problem difficult, and lead to a variety of loan characteristics, such as the demand for collateral and short maturities. Similar agency problems continue at the next level as bank regulators and supervisors with imperfect information about banks seek to design rules and enforcement procedures that induce banks to behave in desirable ways. At this same level, traditional corporate governance problems plague the oversight of banks: informational asymmetries make it difficult for the market – depositors, equity holders, other creditors, and rating agencies – to monitor and control bank managers. The series of agency problems continues at the next level, where "politicians," including officials from all branches of government, seek to influence bank regulators. Just as regulators face agency problems in controlling banks, politicians face similar problems in controlling the regulators. Regulators have much more information about bank activities, regulatory policies, and enforcement procedures than politicians, which may make it difficult for politicians sitting in national capitals to control regulators throughout the country.

At the highest level of the sequence of complex agency problems lies the most difficult problem: How does the public induce politicians to act in the best interests of society? As explained in Chapter 2, sometimes politicians are motivated to behave with society's best interests in mind (the "public interest" view) and at other times, politicians promote their own private well-being to the detriment of society (the "private interest" view). The ability of the public to monitor and control politicians has key implications for the selection and operation of bank regulations and supervisory practices, and hence for bank performance and economic prosperity.

Beyond this series of agency problems (the straight lines with vertical arrows pointing down), the framework for bank regulation and

6 This is a modified version of the figure in Berger and Udell (2002). Note that among other changes, we have consolidated bank owners, managers and loan officers into one category, "banks," in order to address the issues under consideration. Those interested in more on the principal-agent problems within banks should see their informative discussion.

supervision is further complicated by possible corruption as powerful individuals try to influence the flow of society's savings (the upward-pointing arrows). Bankers may try to influence regulators and supervisors with offers of jobs or other emoluments. Perhaps more commonly, banks may try to buy influence with politicians who in turn can affect the actions of regulators and supervisors. Wallis (2004) refers to this channel as venal corruption, illustrated by the upward-curved arrows in Figure 1.1 from banks to politicians and to regulators and supervisors. Perhaps more insidious is what he describes as systematic corruption, which is when politicians try to use their influence to maintain or augment their political position, such as by leaning on or conspiring with bankers to extend credit only to those supporting the ruling party, restricting entry to those who will play by these rules and so on, as captured in the curved line pointing from politicians to banks. Furthermore, borrowers may seek to influence politicians – lobbying for regulatory/supervisory policies that will favor their own interests. Although many lines may complicate Figure 1.1, the crucial point is that we cannot usefully examine banking policies without considering the private interests of those setting and implementing policies in each country.

In Figure 1.1, we frame the sequence of principal-agent relationships and political connections within an even broader institutional setting. Banks are inextricable parts of a nation's social fabric. For example, the presence and quality of checks and balances in government influence the degree to which politicians behave in a public or private interest manner. The power and independence of the judiciary as well as legal statutes shape the level of corruption, the extent to which rules and regulations are actually followed, and the ability of private market participants to exert corporate control over banks. An independent and active media can play a key role in monitoring corruption and investigating each of the relationships in the sequence of agency problems depicted in Figure 1.1. Furthermore, the level of information technology affects the flow of information about banks, which can influence both official and private oversight of banks. This framework suggests that an array of factors influences the effect of banking policies on social welfare.

Thus, we reject the narrow, technical approach and instead adopt a broader, more complex approach to banking policies for a very simple reason. People have a powerful interest in the supervision and regulation of banks, as these policies influence who gets to use society's savings and who does not, who gets to start a business and who will not fulfill his/her dreams, who can expand and who is thwarted by a lack of capital, who remains economically and politically powerful and who will never realistically experience entrepreneurial and political success. Thus, powerful people will try to influence politicians, supervisors, and regulators in ways that promote their selfish interests. Their ability to manipulate the rules of the banking game depends, importantly, on each nation's political, legal, and cultural institutions. This view suggests that to have banks that promote social welfare, a country needs political and other institutions that "oblige" its officials to develop policies that maximize social welfare, not the private welfare of officials or bankers.

The quotation at the beginning of this chapter from James Madison's contribution to the *Federalist Papers* is consistent with this broad and necessarily complex view of bank regulation. Madison clearly recognizes a role for government, "If men were angels, no government would be necessary." Madison was equally clear in recognizing that government would not necessarily strive to maximize social welfare, "If angels were to govern men, neither external nor internal controls would be necessary." Thus, although recognizing the necessity of government, Madison stressed that to maximize social welfare, political systems must unequivocally reject the presumption that governments naturally maximize public welfare and instead must adopt mechanisms that induce governments to promote the public interest and limit government officials from abusing their power to maximize their private interests: "In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."

Madison's view has direct implications for bank supervisory and regulatory strategies. Popular approaches to bank supervision assume either that bank supervisors and politicians naturally behave like angels or that sufficient institutional mechanisms exist to ensure such behavior. Strengthening official supervision may not have desirable outcomes, however, when politicians and bankers – with or without the cooperation of supervisors – conspire to promote the interests of narrow elites. Strengthening official oversight of banks may only work when political institutions minimize political and regulatory capture, thwart officials from using their public power for private gain, and oblige supervisors to act in the best interests of society. It is an empirical question, therefore, whether countries have sufficiently well-functioning political institutions so that strengthening direct official supervision of banks fosters aggregate growth, stability, and efficient resource allocation, or whether strengthening official oversight advances the interests of the privileged.

The likely connections between political institutions and the origins and implications of banking policies, in conjunction with the view that politicians may attempt to maximize private gain, compel a rethinking of bank supervision and regulation. We use case-studies and our cross-country data to examine the linkages between political institutions and bank supervisory and regulatory choices. In essence, we use the laboratory of bank supervision and regulation to assess different views of the role of government. We do not believe it is possible to understand the basis and hence the implications of banking policies without a comprehensive understanding of the political institutions driving policy choices. Furthermore, we do not believe it is possible to make policy recommendations without a sound understanding of the country's political institutions. For example, during President Suharto's regime in Indonesia, a few families controlled the economy and the government. The media did not enjoy independence, and any formal checks and balances in government simply did not function. In this environment, although formal attempts to increase the independence of supervision could have been made to look great on paper, those with Suharto connections had overwhelming influence and would have circumvented any formal reforms that satisfied international standards. Empowering official supervision would have had at best a nugatory effect, and may have given the elites even greater control over resource allocation.

From this perspective, it is misguided and potentially counterproductive to develop a unified checklist of best practice recommendations with the belief that closer adherence to the checklist will produce better functioning banks. We have more modest ambitions. Rather than construct a checklist of best practices, our goals are to better understand the forces influencing bank regulatory and supervisory choices, identify which broad approaches to bank regulation tend to produce better functioning banking systems, and provide a useful database for comparing and assessing bank regulation and supervision.

1.C. KEY FINDINGS: A BRIEF SYNOPSIS

As emphasized, the key contribution of this book is to assemble, present, and summarize new data on bank supervision and regulation across more than 150 countries. In collecting and summarizing these data, we observe enormous cross-country diversity in bank supervisory and regulatory practices, which advertises the importance of exploiting this information to better understand banking policies. For example, minimum