Rethinking Bank Regulation

Gerard Caprio

(Based on a forthcoming volume with James Barth and Ross Levine)
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.

James Madison, Federalist Papers, Number 51
1. Overview

- **Evidence on supervisory / regulatory policies**
  - New data
  - Examines what works best
    - Which of the pillars of Basel II work?

- **Evidence on proper role of government**
  - Public vs. Private Interest view of government

- **Evidence on determinants of regulatory choices**
  - Political interests vs. Ignorance / Mistakes
A Framework for Bank Regulation and Supervision

Institutional Environment
Democratic, Political Structure/System

- Politicians
- Regulators and supervisors
- Banks
- Borrowers, counterparties

Market Structure

- Depositors, creditors, rating agencies

Media

Technology, Information Infrastructure

Judicial, Legal, Regulatory Environment

Corruption
1. Our Limitations (some of them…)

- **Measurement**
  - Errors, omissions, *time-series* in measuring supervision / regulation?
  - Impact of supervision on the ground (only have proxies)
  - Better aggregate indexes of approaches to supervision / regulation?

- **Gauging Government Role**
  - Policies may work differently in different political / institutional regimes
  - Do we capture these nuances?

- **Regulatory choices**
  - Does X-C evidence add much?
2. Debate about government’s role

<table>
<thead>
<tr>
<th>Public interest view</th>
<th>Private interest view</th>
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</thead>
<tbody>
<tr>
<td>- Gov’t maximizes social welfare</td>
<td>- Gov’t maximizes Gov’t welfare; so do regulatees</td>
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<tr>
<td>- Gov’t has incentives / ability to ameliorate market failures</td>
<td>- Gov’t does not necessarily have incentives / ability to fix failures</td>
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<td>- If we identify “best practices,” countries will change.</td>
<td>- Need more than “best practices”:</td>
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<td>- Combination of incentives for regulators and regulatees will not maximize social welfare</td>
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**Laissez-Faire**: Market failures minor $\rightarrow$ no need for government
2. Basel: Assumes Public Interest

- Basel II Pillars – “Best Practices”
  1. Capital
  2. Supervisory oversight
  3. Market Discipline

- World Bank / IMF – Apply “Best Practices” in DCs
  … to foster growth & poverty alleviation
  … to reduce fragility & contagion
2. Private interest at work

1. Survival of the sovereign
2. Finance government
3. Finance cronies
2. Private vs. Public interest: Different predictions

- Capital regs, entry restrictions, bank activity restrictions, etc.
  - Needed to overcome market failures … predictions.
  - Used to protect elite … predictions.

- Strong official supervisory oversight
  - Needed to overcome market failures …. predictions.
  - Used to protect elite … predictions.

- Private monitoring
  - Insufficient to overcome market failures … predictions.
  - Necessary to protect against control by elite … predictions.
3. Official supervision

- **Supervisory power**
  - Power to take legal action against auditors, director, officers
  - Force bank to provision, change organizational structure
  - Power to suspend dividends, bonuses, management fees
  - Legal power to declare insolvent
  - Power to supercede shareholder rights, remove/replace managers, directors

- **Forbearance discretion**

- **Loan classification and provisioning stringency**

- **Diversification: domestically and abroad**

- **Supervisory resources**
3. Private monitoring

- Certified audit required
- Percent of 10 biggest banks rated by international rating agencies
- Accounting disclosure and liability
  - accrued but unpaid interest
  - consolidated statements
  - liability of directors
- No deposit insurance

Private monitoring ≠ Laissez-Faire
Private monitoring involves supervision
4. What Works Best?

What “works”

- Bank development
- Efficiency
- Integrity
- Stability
- Bank governance?
Private monitoring boosts bank development
Official supervisory power lowers bank development
4. Results on Bank Development

- Basel II
  - Capital requirements: ?
  - Official supervisory power: hurts
  - Private monitoring: helps

- But, official supervisory power is not bad when
  - There is a high level of democracy.
  - But, need to be a “top 10” country

- SOBs are bad.

- Restrictions hurt bank development

These results are more consistent with private rather than a public interest view

**Bank Corruption**: “How problematic is the corruption of bank officials for obtaining financing?”
4. Corruption in Lending

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<td>-12.052***</td>
<td>0.226*</td>
<td>-0.137**</td>
<td>-0.403***</td>
<td>-0.245***</td>
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<td>0.076***</td>
<td>-0.231***</td>
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<td>-0.136***</td>
<td>-4.181*</td>
<td>-0.179***</td>
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</tbody>
</table>

Controls for firm level traits: foreign, exporter, government, manufacturing, services, sales, & competitors
4. Corruption vs. Supervisory Power

Inconsistent with public interest view.

Very consistent with private interest view.

Madison: If supervisors were angels …
4. Summary

<table>
<thead>
<tr>
<th>Capital Regulation</th>
<th>Bank Development</th>
<th>Efficiency</th>
<th>Stability</th>
<th>Lending Integrity</th>
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</thead>
<tbody>
<tr>
<td>Supervisory Power</td>
<td>-</td>
<td>0</td>
<td>- -</td>
<td>++</td>
</tr>
<tr>
<td>Private Monitoring</td>
<td>++</td>
<td>++</td>
<td>0</td>
<td>++</td>
</tr>
<tr>
<td>Activity Restrictions</td>
<td>- -</td>
<td>0</td>
<td>- -</td>
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</tr>
<tr>
<td>Entry Restrictions</td>
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<td>- -</td>
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<td>- -</td>
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<tr>
<td>Deposit Insurance</td>
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<tr>
<td>Government Banks</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Diversification</td>
<td></td>
<td>++</td>
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Basel II: Remember Pillar III

Private vs. Public interest: Suggests wariness of relying on official intervention
5. Choosing policies

Q1: Why do some countries choose policies that foster sound banking, while others choose policies that encourage inefficiencies and corruption?

Q2: What does the answer imply about the usefulness of identifying what works best?
5. An example from Stephen Haber

- **Mexico-Diaz (1876)**
  - Porfirio Diaz consolidates power
  - Loans ↔ Bank Charter
  - 2 banks / They write regulations!
  - Directors of Banamex:
    - President of Congress, Under-Secretary of the Treasury, Senator for the Federal District, President’s Chief of Staff, brother of the Secretary of the Treasury, etc.
    - **ALL** loans → directors
  - Self-reinforcing – durable

- **U.S. States post 1789**
  - States short of revenues
  - Loans ↔ Bank Charter
  - Links: federalists-banks!
  - But:
    - Political competition
      - Philadelphia
      - NY
      - Jefferson
    - Competition for people
      - Suffrage
      - Free banking
5. How Do Countries Choose?

- **Key results**
  
  - **Open, competitive, democratic political institutions:**
    - Foster private monitoring, transparency.
    - Less likely to limit bank entry, activities.
    - Less likely to have state banks.
  
  - **Closed, uncompetitive, autocratic political systems:**
    - Do NOT favor transparency (surprise!).
    - Limit bank entry, activities.
    - Tend to have state banks.
6. Qualified Conclusions

- Until angels govern, the data suggest …
  - Avoid relying on official oversight, restrictions, & ownership
  - Emphasize private monitoring / incentives (deposit insurance)
  - Stress Basel II’s 3rd pillar (not capital and official oversight)

- Supervisors have crucial role
  - Precommitment model
    - support market discipline, not supplant it
  - Foster / force information disclosure

- Do not fax “best practices to countries!”

- Let the richest countries adopt Basel early, wait for Basel 3.0, 4.0,..
Implications

- Recommend private monitoring approach in Nigeria? Indonesia?
  - Yes
    - Evidence suggests that empowering official supervisors will work even less well in weak institutional settings!