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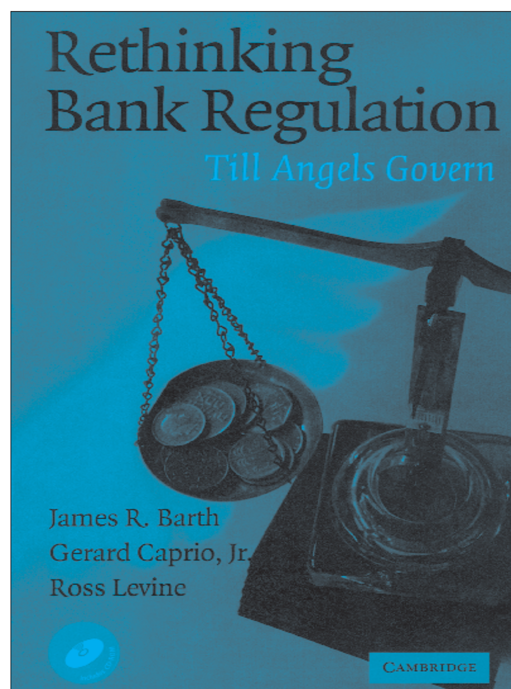
# *Rethinking Bank Regulation – Till Angels Govern*

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The starting point of the book titled Rethinking Bank Regulation – Till Angels Govern is that the operational features of a country's banking system are not only important from the perspective of the given country's finances but also from the aspect of its welfare, because well-functioning banking systems can greatly promote the economic growth of countries.[1] That is why the question is also of utmost important: what kind of bank regulation and bank supervision are needed to make the operation of banking systems the best possible, or rather, to ensure that the very bank regulation and supervision also contribute to greater social welfare.

The present book represents the first major step in answering the above question by making a comprehensive international comparison of the correlation between bank regulation and supervision and the development, efficiency, stability and corruptness of the countries' banking system. Within the framework of international comparison, the authors also attempt to reply to the question to what extent the new three-pillar Basel II Capital Rules support the better functioning of banking systems, and thereby, the economy as a whole.

With the aim of examining the subject, the authors have assembled a database (as part of a World Bank research project), including the data of 153 countries and addressing regulatory and supervisory questions. Data gathering took place in two phases. The 1998–1999 Survey covering 100 countries was expanded to a further 50 countries and to 275 questions in 2003–2004. A great merit of the book is that it comes together with a CD containing the database. The database made available to the readers also facilitates to prepare other analyses in the above-mentioned theme.

## THE TITLE AND APPROACH OF THE BOOK

The title of the book makes reference to a *James Madison* quotation from his essay published in 1788 as Number 51 of the Federalist Papers[2].

*"If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government 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."*

According to how we interpret it today, the passage cited highlights the importance of government failures as well as the checks and balances of power. So the title itself gives an indication of the book's approach: it examines - within the analytical framework of the new political economy – whether rethinking bank regulation is necessary in the economic policy – and in view of possible government failures, in the particular countries' bank regulation and supervision within that. If politicians and leading government officials behaved like angels, then government intervention would be an effective means of overcoming market failures. Otherwise, rethinking bank regulation may become necessary, at least for the "short time" until government failures disappear because the era of angels' governing comes.

In this interpretation, bank regulation is by no means a technical issue. The regulation and supervision of banks are permeated with the principal-agent problem in more then one dimension. In creditor relationships banks are the principals and enterprises the agents, and banks – with limited information in their possession – try to urge enterprises to behave in a responsible manner and repay the credit. It is the reverse in case of bank regulation and supervision, where banks are the principals and supervisors the agents, who even with less information available try to prompt banks to behave in a responsible manner. As the agent problem emerges between regulators and banks, so does it emerge between politicians and regulators. And finally, the question raised in the title also appears at the highest level of the problem, i.e. whether politicians really act on behalf of the society when controlling regulators and supervisors. Apart from the principal-agent problem, there is another problem influencing bank regulation and supervision: the possibility of corruption. One form it may take is – for example – if banks offer a job to regulators and supervisors, or if they try to get politicians to use their influence to further the interests of regulators or supervisors. But the case can also be mentioned here when politicians urge banks to finance those who are politically associated with them.

Economics proposes two approaches for bank regulation which are in sharp contrast with each other and arrive at different conclusions. The first is the public interest view. According to it, governments control banks on behalf of the society in order to promote the efficient operation of banks, which in the absence of state regulation would be significantly deteriorated by market failures. There is an abundance of literature on how incomplete and expensive information and principal-agent problems pervading all levels of activities are bound to lead to market failures in the financial markets (for instance, Akerlof, 1970, or Stiglitz – Weiss, 1981). Diminishing the negative effects of market failures arising from asymmetric information is the most frequently used and generally accepted argument in favour of the prudential regulation of banks by government.

The other approach is the private interest view. This view is built on the fact that politicians and state authorities (including the regulatory and supervisory authorities of banks) loop upon the maximisation of their own wel-

fare as the objective function rather than the greater social welfare. According to this view, in the majority of countries the political system and the legal order are not well-developed enough to ensure the elimination of potential corruptions arising from the features of banking activity, i.e. to ensure that politicians and public officials do really act on behalf of the society. In this case, market failures cannot be corrected by government measures, because it would merely mean replacing market failures with government failures.[3]

Practical testing of the two views – and thereby contributing to the selection of the most viable regulatory structures – is one of the main goals of the book.

## PRESENTATION OF THE INTERNATIONAL STATE OF BANK REGULATION AND SUPERVISION – SUMMARY OF THE QUESTIONNAIRE SURVEY

The third chapter of the book attempts to provide a comprehensive description – by summarising the results of the questionnaire survey – of what bank regulation and supervision were like in the 153 countries covered by the survey in 2001 (in terms of numerical data) and in 2002 (as regards qualitative variables). We provide a brief outline of the major findings in the following paragraphs.

### The structure, scope and independence of regulation and supervision

In the majority of countries (127 of the 153[4]) one single authority performs the government supervision of banks; it rarely happens that the task of supervision is divided between more than one institutions. In 69 of the 153 countries, the central bank is the sole supervisory authority. Among the 26 countries having more financial supervisory authorities, in the case of 21, one of the authorities is the central bank. Thus, all in all, the central bank conducts financial supervisory activity in almost 60 per cent of the countries examined.

In response to the integration of the activities of financial institutions and to the evolving risk transfers in the past two decades, in more and more countries so-called integrated supervisory agencies were created with supervisory powers over the full rage of financial institutions. Based on the survey, the number of integrated supervisory agencies was 46 out of 151.

The issue of supervisory independence is somewhat more complex than the previous two issues. The authors constructed an index for evaluating supervisory independence and it was evaluated in the function of the responses given to three questions. The questions were as follows:

1. Is the supervisor responsible to the executive or legislative power?
2. Are supervisors legally liable for their actions?
3. Is the head of the supervisory agency appointed for a fixed – at least a four-year – term ?

Based on the aggregate index, the supervisory agency of 22 of 148 countries can be considered expressly independent (including Hungary), that of 58 partially independent and the supervisors of 68 countries cannot be considered independent. The degree of supervisory independence shows no correlation with either a country's geographic region or its level of development[5].

### What is the meaning of “bank” in the different countries?

Although the banking activity is subject to licence in every country and a great variety of prudential rules applies to it, there are consid-

erable differences between the individual countries as to what kind of activity is exactly meant by "banking activity". There are discrepancies in the field of commission-based activities as to what attitude the individual regulatory authorities take towards the performance of investment, insurance and real estate transaction within banking organisations. Experience shows that regulators impose the least restrictions on the banks' securities activities (with only 4 of 152 countries clearly prohibiting their banks from conducting these activities and with a further 21 imposing partial activity restrictions). On the other hand, the most restrictions are placed on real estate activities (they are expressly prohibited in 48 of 152 countries with a further 36 countries imposing partial restrictions). Insurance activities tend to fall under the ones which are licensed to a limited degree with 39 and 53 partial licences.

The national rules on financial conglomerates also differ, namely, whether banks may own non-financial firms, whether non-financial firms may own banks and whether non-bank financial institutions may own banks? Although the picture is rather mixed, it can perhaps be stated that the proportion of countries limiting banks ownership of non-financial firms is higher than those placing restrictions on non-financial firms' ownership of banks.

While in terms of activity restrictions of banks a negative correlation can be demonstrated with the given country's development, no such relationship can be shown between the development and the restrictions imposed on conglomerates.

## Entry into banking, capital rules and the strength of supervision

In most countries, regulators do not permit an automatic bank entry to banks which comply with the formal requirements for entry, but they try to make sure that the applicant is fit and proper. The range of information required for the assessment of whether an applicant is fit and proper varies from country to country. (Hungary is among the countries requesting the widest range of information.) In addition, it is also frequent that foreign owners' entry into the local market as well as their acquisition is limited by national rules. There are merely one or two among 149 countries that categorically prohibit foreign acquisitions of banks (Turkmenistan) and foreign establishment of subsidiaries (Costa Rica). Additional 17 countries prohibit foreign entities from opening a bank branch.

The comparison of national capital rules explains why the Basel I Capital Rules are widespread. There are only nine countries (out of 151) in which the risk-weighted capital-asset ratio requirement is lower than 8 per cent. The capital requirement is exactly 8 per cent in 81, while it is higher in 62 countries.

There are great national differences in respect of what supervisors can do if banks violate the written rules or if supervisors find that certain banks fail to behave prudently. In such a case, supervisors are obliged to take a prompt corrective action in several countries, while in others supervisors have more room for deliberating whether a prompt corrective action is necessary or it is more practical to adopt a permissive-tolerant attitude. The requirement of prompt corrective action – together with the elimination of the room for discretion – means, at the same time, protection against the political influencing of supervisions. In numerous countries, the court has the right to limit or delay supervisory intervention. In 129 of 149 countries, bank owners may seek remedy at the court of law against the decision of supervisory authorities. There are however only 22 countries in which a court approval is necessary for supervisory interventions (for example, the suspension of shareholders' rights, ousting the management, revoking licences).

## Market information and corporate management, the role of foreign ownership

The banks' behaviour is just as greatly affected by the activity of supervisors as by market forces. Therefore, in addition to regulatory issues, the authors have also raised questions as to what extent is appropriate information available to markets about banks. It can be considered a general practice today that the financial statements of banks have be audited (out of 152 countries, the only exceptions are China and Italy in this regard) and that special regulations apply to bank auditors (except Bahrain, Burundi and Jersey). It is also important, however, what percentage of banks are rated by international or domestic credit rating agencies and to what extent the given country's accounting rules support the transparency of banks (for example, can accrued but unpaid interest and principal enter the income statement while the loan is performing or not performing). For assessing the availability and transparency of market information, the authors have constructed a market information index which indicates a positive correlation with the development of countries.

As regards corporate management issues, the authors have examined how many countries applied international accounting standards. One hundred and eighteen countries (of 152) are applying the IAS[6], with 27 among them using the US GAAP[7] too. Two countries – the USA and Gibraltar – are only using the US GAAP, while 32 countries do not use any of the international standards, but have their own accounting rules. This is the first statement of the book which we treat with reservations in the light of the available Hungarian data, because Hungary is listed here among the countries applying the IAS. It has also been examined within this group of questions what authorisations supervisory agencies have in their consultation with auditors, and how transparent the statements of banks are. As apparent from the definitions, there is a strong – but not complete – correlation between market information and corporate management issues, since they address the same series of questions, though in a slightly different way. So it is not surprising that this latter is also in positive correlation with the development of the individual countries.

The authors have also surveyed whether a bank's ownership structure (the role of state and foreign ownership) had an impact on what kind of regulatory and supervisory system a country had. They found that supervisory agencies of countries with a higher proportion of state-ownership in the banking system were generally less independent than the ones with a privately-owned banking system. Apart from this, state-owned banking systems are usually also coupled with a lower extent of market information and poorer corporate management practices.

## WHAT KIND OF BANK REGULATION FUNCTIONS BETTER?

After processing the huge database of the questionnaire on bank regulation and after presenting the situation, the question necessarily arises: what type of bank regulation functions better, and what are the regulatory means that do and what are the ones that do not support bank development and efficiency. Namely, coming back to the initial question of the book, what bank regulation and supervision are necessary to enhance social welfare?

Apart from the information of the database assembled by the authors, they have used a wide selecion of other data available (country-specific, banking system-specific and bank-specific data) and analysed them with various econometric methods. In the course of this, the

following concrete questions were raised: What kind of regulation and supervision support better the development[8], stability and efficiency[9], corruption-free operation and corporate management practice of the banking sector?

The results of the econometric analysis conducted on the individual questions point to one and the same direction and clearly back up the private interest view as against the public interest view. Every bank regulation and supervision criterion, which expects and supports banks to publish more and better information about themselves, will contribute to bank development, improve bank efficiency and reduce corruption in lending. The banks' better corporate management practice is clearly best supported by the strengthened rights of private investors.

On the other hand, the rules that grant more powers to supervisory agencies (for instance, permit them to control the provisioning practice of banks, to obtain direct information from auditors and to intervene in the banks' organisational structure, and enable supervisory agencies to suspend dividend and bonus payment, etc.) or that prescribe more rigorous capital requirements have never demonstrated any positive correlation with bank development, efficiency and stability. Neither do the larger state ownership share in banks, regulatory restrictions on activities and limits on bank entry have a positive impact on banking systems.

The authors have come across with only a few cases in which the political system of countries was so open and democratic that the negative impacts of strong supervisory powers did not manifest themselves. Coming back to the Madison-quotation cited in the title, the above-mentioned countries are the ones in which the system of checks and balances of power is so well-developed that governments do perhaps really work for maximising social welfare.

But since the overall number of such countries is extremely low, the main conclusion deriving from the book's analyses is this: bank regulations designed to support as strongly as possible the markets' ability to judge the banks' activity functions better than those which open up a door of strong intervention to supervisors. These findings do not mean to suggest that the state has no duty in the field of bank regulation and supervision. Those governments further the development, efficiency, stability and corruption-free operation of banking systems that create a legal environment which assists markets in monitoring and assessing banks with the help of adequate information, and that operate supervisory agencies which help markets judge the fairness of the information published and promote the development, efficiency, stability and corruption-free operation of banking systems.

In view of the econometric results which prove the predominance of private interest in regulation and supervision, it is questionable whether the international practice of bank regulation is fit and proper. It may be problematic that international institutions (especially the Basel Committee on Banking Supervision and the IMF) regularly formulate standards and make recommendations, the latter of which are based on the practice of the most developed countries and related to the best practice to be followed by banks, and the institutions expect that these standards and recommendations are implemented even by countries on a lower level of political development in which the checks and balances do not operate properly .

The soft formulation of the conclusions drawn is of no coincidence (even the authors use the conditional mode in the book). Although the results point to one and the same direction, it must not be left out of consideration that the methods of analysis applied have a number of limitations, which makes us cautious in interpreting the results. For this reason, reservations can be made with special regard to the causality nature of correlations

and to the entirety of attempts made at eliminating third factors. (These reservations are, correctly, also expressed in the book.)

## ARE THE BASEL II CAPITAL RULES POINTING TO THE RIGHT DIRECTION?

In the light of the correlations explored in the book, the authors were able to draw strong conclusions from the new Basel II Capital Rules[10] as well. Naturally, they did not deal directly with the Basel II Capital Rules during the questionnaire survey (due to the date of the document), but they did study the issues associated with the room for supervisory intervention with respect to the rigorousness of the capital rules and to the determination of the capital level. No significant correlation whatsoever was observed between the above two issues and the development, efficiency, stability or level of corruption of the given country's banking system.

Therefore, the results of the book's analysis do not provide grounds to generally apply the second pillar of the Basel II Capital Rules (the supervisory review of capital adequacy). It is apparent in the case of most countries that increasing the strength and powers of supervision will make things worse rather than better. Unless countries are among those with the most developed political system, the results of the analysis indicate that the widening of supervisory powers is detrimental to bank development and increases corruption, while there are no visible effects counteracting them.

The results achieved strongly underline, at the same time, the justification and significance of the third pillar of the Basel II Framework (disclosure requirements, market discipline). Since the rules furthering bank transparency and market access to more and better bank information expressly support the banking sector of the given country, the regulatory prescription of disclosure requirements, the provision of understandable information in an appropriate content can be considered a highly important forward-looking element of regulation and supervision.

By the end of the book, the conclusions drawn about the Basel II Capital Rules will no longer make the readers surprised because it seems evident by then that the second pillar rules on supervisory review are built on the public interest view, whereas the disclosure requirements of the third pillar are in line with the private interest view.

## NOTES

[1] Among the three authors, Ross Levine is the one who played an outstanding role in exploring the relationship between economic growth and the depth of financial intermediation, see, for example, King – Levine (1993/a and 1993/b), Levine (1997). A summary of the literature related to the subject matter is to be found in: Mérő (2003)

[2] The goal of the series of articles which were written by the three “Founding Fathers” and consisted of 85 essays was to persuade readers to accept the new Constitution which is based on a much stronger union than before among the states, see: Hamilton – Madison – Jay (1998)

[3] This is most markedly formulated by the Nobel Laureate George Stigler, see, for example Stigler (1971)

[4] Altogether 153 countries were included in the sample. However, not all countries answered all questions, so the maximum possible responses for the individual questions may be lower than the number of countries.

[5] Measured with per capita GDP

[6] International Accounting Standards

[7] Generally Accepted Accounting Principles

[8] By banking sector development we mean the ratio to GDP of credits transmitted to the private sector by the banking system.

[9] By characterising better efficiency by lower interest and cost level.

[10] See: Basel Committee on Banking Supervision (BCBS) (2004)

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