

Rethinking Bank Regulation — Till Angels Govern

James R. Barth, Gerard Caprio Jr. and Ross Levine
(Cambridge: University Press, 2006)

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Angels and banks are two terms that are normally not used in the same context. However, there exist some popular approaches to bank supervision that assume bank supervisors behave like angels in the sense that they try to guarantee the safety and security of the banking system. This paternalistic, quasi-angel behaviour of bank supervisors is strikingly attacked in this new voluminous book authored by three economists, James R. Barth, Gerard Caprio Jr. and Ross Levine. The unique title of their book, *Rethinking Bank Regulation – Till Angels Govern*, was inspired by James Madison, one of America's founding fathers. He made the following fundamental statement that underscores the complex and difficult issues addressed by this book:

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.¹

As Madison explains, the general difficulty is to enable the government to control the governed. Furthermore, governments need effective regulatory and law enforcement tools for this purpose. Where they are lacking, economists speak about regulatory failure. Regulatory failures arise in many economic sectors including the banking sector, even though banks are one of the most heavily regulated industries. In many jurisdictions complex measures regulating banks were introduced to

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¹ James Madison, *Federalist Papers*, Number 51.

ensure the solvency of banks and prevent instability to the financial markets. Despite the vast regulatory framework covering lenders, banks sometimes fail and there have been numerous banking crises over recent decades, particularly in developing countries. Barth, Caprio and Levine show that regulatory failure is more common than we might suppose, and it frequently has worse consequences than other types of market failures.

Their central argument is based on the first detailed database of bank regulation and supervision in over 150 countries, compiled by the authors. Based on their considerable expertise in this field, the authors conducted a comprehensive, cross-country assessment of the impact of bank regulatory and supervisory practices on bank development, efficiency and stability, including an examination of the three pillars of Basel II (*i.e.*, capital regulations, official supervision and market discipline). Supporting this assessment, Barth, Caprio and Levine also trace the historic debate about the proper role of government in the economy and consider why countries make different regulatory and institutional choices.

Because of the considerable size of the database, the book comes with a CD-ROM containing two sets of regulatory information: one covering the period 1998-99 and the other from 2003, together covering over 150 countries. This attachment is very useful for the reader who wishes to explore each country's system of bank regulation and supervision, since the data is thorough and structured in a clear and understandable manner.

Before this database was compiled, commentators interested in comparative bank regulation lacked access to the empirical information. The new data assembled enables the analysis of the relationship between different regulations as well as the indicators of the functioning and health of a country's banking system by reference to the efficiency of its banks, the extent of corruption, the development stages of the financial system or the likelihood of a banking crisis.

The authors' diagram of the "Framework for Bank Regulation" (figure 1.1) usefully illustrates the overall framework of bank regulation and supervision. They carefully show the various agency problems that may afflict the operations of banks. These principal-agent problems can be found in the context of the lending relationship when the bank is the

principal and the borrower the agent, as well as between banks and their stakeholders such as shareholders and depositors. On this level, traditional corporate governance problems arise because it is difficult for depositors, equity holders or creditors in general, as well as rating agencies to monitor and control bank managers, to monitor the behaviour of bank managers. On the next level, politicians and government bureaucracies seek to influence bank regulators. Just as regulators face agency problems in controlling banks, politicians face similar problems in controlling the regulators who hold significantly more information about bank activities, regulatory policies or enforcement procedures. The most difficult agency problems, suggest the authors, are at this highest level of the framework for bank regulation. They argue in chapter 2 that it is hard to induce politicians to act selflessly in the best interests of society. The basic ability of the public to control politicians has significant implications for the selection and operation of bank regulations, as well as the resulting performance of banks and economic prosperity.

From this general conceptual framework, the authors explore the significant cross-country diversity in bank supervisory and regulatory practices. For example, in chapter 3 they look at the minimum required capital ratios around the world, which vary from 4 to 20 percent, and the foreign presence in banking sectors, which vary from 0 to 100 percent. In chapter 4 the authors discuss the results of numerous specific regulations by covering the main aspects of the various relationships involved, such as bank regulation and supervision in relation to the goals of bank development, stability and bank governance. Barth Caprio and Levine stress that enhancing direct official supervision of banks and strengthening capital standards is important for improving bank efficiency, reducing corruption in lending and lowering the fragility of the banking system in general, although in practice it may not always achieve such aims. The significance of the book also comes from its detailed analyses of the new Basel II framework, which is currently being implemented in various countries.

Another interesting aspect of this book is that the data provides clear evidence that many countries do not have the legal and political institutions necessary to support effective market-based monitoring of banks. In this context, the authors show that regulatory restrictions on bank activities, impediments to the entry of new banks, government

ownership of banks and the reliance on powerful official supervisors to oversee banks, may each have adverse effects on the operation of banks. Indeed, in countries with weak political and legal institutions, the empowering of official supervisors is potentially most detrimental.

Furthermore, regarding the determinants of bank supervisory and regulatory policies, the data provided indicates that political institutions exert significant influence over policy choices. It is interesting to note that countries with a rather open, competitive and democratic system that effectively constrain executive powers show a tendency to rely more heavily on private (market) monitoring of banks and impose fewer regulatory restrictions on banks. Contrary to this, countries with a more closed and autocratic system of governance tend to use government-owned banks to channel credit toward the interests of the politically powerful, and this generally limits competition in the banking sector and interferes with the efficient allocation of capital in debt finance markets.

Overall, this book makes a number of salient contributions to the understanding of comparative banking governance. The authors reveal substantial differences in bank regulation worldwide, and cast doubt on the prevailing belief of the “one size fits all” approach to banking regulation. Barth, Caprio and Levine also demonstrate that raising capital requirements has not necessarily translated into a more mature banking sector, more efficient banks or fewer banking crises. Conversely, they found that regulatory policies that facilitate the private-sector monitoring of banks have had the positive tendency of enhancing the development of banking systems, increasing the efficiency of banks as well as preventing crises in the banking system. They imply, therefore, that the “strengthening” of bank supervision does not necessarily improve the banking system.

In this light, *Rethinking Bank Regulation – Till Angels Govern* is a well-researched and thought-provoking study that arguably constitutes a milestone in the literature on bank regulation. It provides – by using comprehensive data from more than 150 countries – evidence that strengthening the power of bank supervisors and regulators in countries with a weak institutional framework tends to cause a lower level of bank development, more corruption in lending and minimizes the efficiency and safety of the banks and the financial system in general. Therefore, the book shows that the promotion of market discipline can be more

efficient than command and control regulations prone to discretionary abuse by administrators. In the context of banking law, the problem of regulatory failure is more striking than generally assumed; the difficulty of first enabling the government to control the governed and then obliging it to control itself seems to be a tougher problem to solve than expected. We need to think more deeply about bank regulation, and through this book we might find the path to angels that govern.