Of angels and banking

A new book highlights the danger of seeing banking regulators as a pure force for good

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THE last time anyone thought to connect angels and banking was in 1946, when James Stewart starred in "It's a Wonderful Life". Soft-hearted readers will recall that Stewart's character heroically prevents a Depression-era run on his bank, and is dissuaded from suicidal plans brought on by the bank's probable collapse by a guardian angel called Clarence Oddbody.

Sixty years on, three economists, James Barth, Gerard Caprio and Ross Levine, have published a book, called "Rethinking Bank Regulation: Till Angels Govern"*, which analyses the attempts by governments around the world to make the banking system safe from calamities such as the run that nearly did for Stewart's fictitious institution. Alas, the book resists the claim that Clarence Oddbody has been moonlighting at the Federal Reserve, calling himself Alan Greenspan. Instead, it provides controversial criticism of what the authors regard as the other-worldliness of much bank regulation.

The book's title is inspired by the words of James Madison, one of America's founding fathers:

> 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.

The difficulty of getting government to control itself is one aspect of what economists call regulatory failure. The central argument of the new book is that although much bank regulation is introduced for the best of reasons—for instance, to tackle market failures such as bank runs—it tends to be written without due consideration for the risk of regulatory failure. As a result, such failure often occurs and frequently has worse consequences than the market failings it is supposed to address.

To reach this conclusion, Messrs Barth, Caprio and Levine have built the first comprehensive global database of bank regulations. This they were able to do by extracting information from normally reticent governments using the clout of the World Bank, where Mr Caprio worked until January. Indeed, conscious that they have only scratched the surface of this data, and keen that it be put to good use, each copy of the book comes with a CD-ROM containing two databases, one from 1998-99, the other from 2003, spanning 150 countries.

The absence, until now, of good data may be one reason why so much bank regulation has been written without a sense of what actually works in practice, reckons Mr Barth, a veteran of bank regulation who recently led an international team that advised the People's Bank of China on banking reform. With their new data, the economists analysed the relationship between different sorts of regulations and indicators of the health of a country's banking system, including the efficiency of its banks, the extent of corruption, how developed the system is and, of course, the likelihood of a crisis.

Pillars of respectability

In particular, they focused on the three broad categories of regulation that are championed in the Basel 2 banking regulations now being urged on the world. The first of these three "pillars" requires banks to set aside a certain amount of capital as a reserve against losses, varying with risk. The second involves stronger supervisory powers to enable government regulators to scrutinise and discipline banks. The third pillar consists of monitoring by markets, and stresses transparency, full disclosure of information and private, dispersed ownership of banks. As well as finding huge differences in banking regulations around the world, which makes them sceptical about the notion that there is an effective "one size fits all" model of banking regulation, the economists drew several striking conclusions.

First, they found that raising capital requirements had no discernible impact on whether a country had a more developed banking sector (measured by the amount of credit extended to private firms as a proportion of GDP), had more efficient banks (measured by net interest rate margins and overheads) or was less likely to experience a banking crisis.

Second, regulatory policies that boost private-sector monitoring of banks—even in countries with poorly developed capital markets, accounting standards and legal systems—tend to make banking systems more developed, banks more efficient and crises less likely. But the more generous deposit insurance is, the more likely is a banking crisis: however well intentioned, such protection seems to aggravate "moral hazard" by making savers less careful about whom they trust with their money.

Perhaps the most surprising result concerned the supervisory powers of bank regulators. Strengthening supervision had a neutral or negative impact on banking development, reduced bank efficiency and increased the likelihood of a crisis. Why? One clue is a finding that corruption in bank lending tends to be higher in countries with stronger supervisors, except in places with strong legal systems and political institutions. Stronger supervisory powers in countries with weak governance may give bent officials more chance to help themselves. Although some economists question whether stronger supervision really causes these problems, rather than merely coinciding with them, the authors worry that Basel 2's second pillar might do a lot of damage: "The overriding message is that simply strengthening direct official oversight of banks may very well make things worse, not better, in the vast majority of countries." Where's Clarence Oddbody when you need him?

* Cambridge University Press, 2006

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