

Bank Supervision, Corporate Finance, and Economic Development

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This précis briefly discusses ongoing research I have been conducting on the efficacy of different bank supervisory policies. The goals are to understand (1) which bank supervisory strategies work best to promote the development of banking systems that foster economic growth and (2) why countries choose different bank supervisory strategies.¹

Theory and Motivation

Economic theory provides conflicting conceptions about the role of the state in supervising banks. In a world with no information or transactions costs, well-behaved governments, and well-defined and enforced property rights, market participants will monitor banks in ways that achieve efficient outcomes (Coase, 1960). If the pre-requisites for this laissez-faire – “invisible hand” -- theory hold, government supervision of banks would be irrelevant or harmful (Stigler, 1971).

The traditional alternative theory stresses the existence of information and transactions costs, such that governments can play a “helping hand” by ameliorating these markets failures (Musgrave, 1959; Atkinson and Stiglitz, 1980). When applied to banking, this official supervision theory holds that private agents frequently lack the information, expertise, resources, focus, or enforcement capabilities to monitor powerful banks effectively.² From this perspective,

¹ This research is based on joint research with (i) Jim Barth and Jerry Caprio where we conducted a survey of 107 bank supervisory agencies and analyzed “what works best” to promote financial development and stability, (ii) Asli Demirguc-Kunt and Thorsten Beck where we investigate the impact of bank supervision on firm financing constraints, and (iii) Luc Laeven where we are studying the impact of bank supervision on firm valuations and the corporate governance of banks.

² See, Becker (1968), Becker and Stigler (1974), Coase (1988), and Polinsky and Shavell (2000). Also, Spiller and Ferejohn (1992) note that lawmakers do not have sufficient information and knowledge to anticipate all possible circumstances. Thus, there may be efficiency gains to delegating power to a supervisory agency that has the expertise and resources to set and change the specific rules as events evolve. Holmstrom and Milgrom (1991) argue that supervision will work better if the supervisor is focused, e.g., focused only on banks and not banks and securities markets.

a powerful supervisory agency will enhance corporate governance of banks, improve the incentives facing bank managers, and thereby boost the efficiency with which banks intermediate society's savings. This official supervision theory assumes that governments have both the expertise and incentives to overcome information and transactions costs.

An alternative to both the invisible and helping hand views argues that politicians are not well-behaved in that they do not necessarily maximize social welfare; they maximize their own welfare (Hamilton, Jay, and Madison, 1788; Buchanan and Tullock, 1962; Becker, 1983; and Olson, 1965). Thus, politicians may induce banks to divert the flow of credit to politically connected firms, or powerful banks may "capture" politicians and induce official supervisors to act in the best interests of banks rather than the best interest of society (Becker and Stigler, 1974; Stigler, 1971, 1975; Rajan and Zingales, 2003). This political/regulatory capture theory suggests that direct official supervision of banks may actually reduce the efficiency with which banks allocate credit. While powerful official supervision may increase the flow of credit to a few well-connected firms, the political/regulatory capture theory holds that powerful official supervision will hurt the availability of credit to firms in general.

Economists and practitioners have attempted to divine and derive mechanisms that recognize the importance of both market and political failures. Information and transaction costs may prohibit markets from reaching efficient outcomes. At the same time, politicians do not necessarily have the incentives to ease only those markets failures. From this perspective, the challenge is to create mechanisms that negate the "grabbing hand" of the government and induce

official agencies to focus on improving social welfare (North, 1990; Shleifer and Vishny, 1998; Haber, 1997, 2002, 2003).³

In the area of bank supervision, proponents of the “independent supervision” approach argue that creating independent supervisory agencies is a useful mechanism for balancing market and political failures. This view holds that if supervisors are independent from the government and if supervisors have proper incentives, then this reduces the likelihood that politicians will use the supervisory agency to induce banks to funnel credit to favored ends. Similarly, if the supervisory agency is independent from banks and if supervisors have proper incentives, then this lowers the probability that banks will capture the supervisory agency. Thus, the independent supervision views looks for a compromise that (i) creates a supervisory agency that has the expertise and resources to overcome information asymmetries and (ii) instills proper incentives and power in the supervisory agency so that it avoids political/regulatory capture and exerts sound corporate governance over banks.⁴

Finally, the “private empowerment” theory takes a different approach to confronting information and enforcement costs while recognizing that politicians act in their own interests. The private empowerment theory suggests that bank supervisory strategies should (1) focus on enhancing the ability of private agents to overcome informational barriers and exert corporate control over banks and (2) not assume too much power. Thus, the “private empowerment” theory seeks to limit certain powers of the supervisory agency so that the government is unable

³ Shleifer and Vishny (1998) use the phrase “grabbing hand” to describe the maximizing behavior of politicians in contrast to the “helping hand” view that assumes that governments maximize social welfare. These phrases form a nice contrast to the “invisible hand” theory.

⁴ There is an active literature on balancing law and regulations to enhance the operation of securities markets. LaPorta, Lopez-de-Silanes, and Shleifer (2002) examine which types of laws and enforcement mechanisms work best to promote securities market development across 49 countries. Glaeser, Johnson, and Shleifer (2001) provide theory and examples from transition economies concerning the incentives facing judges and regulators in monitoring financial markets. More broadly, Glaeser and Shleifer (2001) analyze the reasons underlying the increased use of

to use bank supervision to achieve political ends. At the same time, the private empowerment theory provides the supervisory agency with sufficient power to force accurate information disclosure so that market participants can more easily monitor banks (Hay and Shleifer, 1998). This will boost private monitoring of banks and thereby enhance the incentives of bank managers to allocate capital to firms based on efficiency considerations (Grossman and Hart, 1980). Furthermore, this view argues that many empowered bank creditors will be less susceptible to capture by politicians and banks than a single government supervisory agency. Thus, special connections and corruption may play less of a role in countries that foster private monitoring.

Banking policy concerns, broad public policy debates, and corporate finance theory motivate this research. First, bank supervision is a crucial public policy decision for each country. Bank supervision is frequently discussed in the context of avoiding banking crises. However, this cannot be the only criterion for bank supervision because policymakers can eliminate banking crises through a 100 percent reserve requirement. Thus, an important objective of bank supervision – though perhaps often under-stated – is to foster the efficient allocation of capital; that is, to provide external finance to worthy firms. This is the first research to assess the impact of bank supervision on the obstacles firms face in obtaining external finance. Second, beyond bank supervision, this research provides information on a policy issue that cuts across different areas of finance and economics. In a host of circumstances, public policymakers face the question, should governments do nothing, empower the private sector, or directly oversee private activities? This paper addresses this broad concern by conducting an investigation of different bank supervisory approaches. Finally, banks are an important source of external finance and corporate governance. While a growing literature examines how laws and

regulation in the United States, while Glaeser and Shleifer (2002) develop a theory and provide comparative evidence from England and France concerning why different legal systems involve to regulate behavior.

regulations concerning equity holders influence corporate finance (La Porta et al 2002), there is no cross-country work on how bank supervision influences corporate finance.

Data

The paper “Bank Supervision and Corporate Finance” uses firm-level data on almost 5,000 firms across 49 countries to examine the impact of bank supervision on the obstacles that firms encounter in raising external capital. This dataset includes information on firm characteristics, including (i) the obstacles that firms face in raising capital, (ii) the degree to which special connections are important to raising bank loans, and (iii) the degree to which bank corruption is important to raising capital.

The bank supervisory data are for 1999 and come from Barth, Caprio and Levine (2003, henceforth BCL). This database includes information on the official supervisory power, such as the ability of bank supervisors to intervene and/or banks, replace managers, force provisioning, stop dividends and other payments, acquire information, etc. BCL also have information on the degree of supervisory independence from the government and whether banks can sue bank supervisors. BCL collect information on the empowerment of the private sector. This includes information on whether bank directors and officials face criminal prosecution for failure to accurately disclose information, whether banks must disclose consolidated accounts, whether are banks audited by an international accounting firm, etc. Finally, to measure the incentives facing private sector monitors of banks, we use data on the generosity of the deposit insurance system.

Results

The results are inconsistent with the official supervision view and supportive of the political/regulatory capture view. Specifically, official supervisory power is positively associated with the financing obstacles faced by firms and positively associated with both special

connections and corruption in raising external finance. Even after controlling for firm-specific traits and country-specific factors, the results suggest that official supervisory power hinders external financing opportunities and raises the need for special connections and corruption.

The data also lend support to the independent supervision corollary. In particular, when the supervisory agency is independent, this is associated with lower obstacles to obtaining external finance. Moreover, independence reduces the negative effects from powerful supervision. As independence rises, the negative effect of powerful supervision dissipates and indeed vanishes at the highest levels of supervisory independence. Also, independence from the government in particular tends to reduce the need for special connections and corruption in raising capital. Thus, the results suggest that independence tends to reduce political control of the supervisory authority and hence political manipulation of the flow of credit to firms.

The paper also presents evidence that supports the private empowerment view. Regulations that force accurate information disclosure lower obstacles to firm financing and lower the impression that corruption of bank officials is important for raising external finance. Furthermore, moral hazard – as measured by the generosity of the deposit insurance system – is also important. Greater moral hazard tends to raise the corporate financing obstacles faced by firms. The data are consistent with the view that governments that force accurate information disclosure to the private sector and do not distort the incentives of banks through excessively generous insurance of bank liabilities will tend to lower financing obstacles

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