Selecting Regulatory Capacity:  
National Bank Supervision in International Markets

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Motivation

Two components of bank financial stability

- Bank regulation: rule *stringency*
- Bank supervision: rule *enforcement*

Bank supervision necessary for meaningful regulatory stringency

Puzzle: Developing country enforcement capacity exhibits wide variation across countries and time, but with a clear upward trend

*When do developing countries adopt independent bank supervision?*
When is independent bank supervision adopted?

![Graph showing the adoption of independent bank supervision by year for different income levels.](image)
Overview

When do developing countries adopt independent bank supervision?

Existing arguments

- Coercion initiated via international organizations (IOs)
- Competitive diffusion

My argument: adoption as signal from a country’s leader to IOs

- New leader holds opportunity to establish reputation
- Leaders seek IO benefits
- Adopt IO recommended policies to win favor with IOs
- Proactive change rather than reactive policy
Overview

Hypothesis: adoption at start of executives’ tenures

Evidence
- Illustrative case study: Turkey adoption in 1999
- Statistical test of 62 developing countries, 1991 to 2005
  - New executives increase adoption likelihood
  - IMF programs, conditionality not as robust a correlate
  - Little evidence of competitive diffusion

Implications
- Relevance of political leadership for international outcomes
- Political agency × systemic pressure drives diffusion
- Executive’s primary role within country-IMF relationship
Cronyism versus independent bank supervision

Government involvement in bank sector:
- Channel credit
- Fund government deficits, patronage
Cronyism versus independent bank supervision

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Bank supervision marked by cronyism:
- De jure interference (supervisory powers; political approval)
- Ad hoc interference
- Leads to *uneven enforcement* of prudential regulations

Bank supervision marked by independence:
- De jure and de facto delegation to supervisors
- All banks are supervised
- Leads to even enforcement of regulations across banks

Countries that choose to move toward independence:
- Politicians forgo interference
- Country builds enforcement capacity
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Evolution of global governance of finance since 1990

Emergence of international best practices
  • Basel Core Principles (1997 September)

Ongoing role of IFIs (IMF, World Bank) within countries
  • Both program and non-program years
Independent bank supervision as a political decision

Existing explanations:

- Coercion from IFIs (reflects developed country preferences)
  Greater country interaction with IFIs →
  Greater pressure to adopt

- Diffusion
  Greater number of other countries with policies →
  Greater market, social pressures to adopt
Independent bank supervision as a political decision

My argument: country executives *proactively* court IFI favor

The *beginning of an executive’s tenure* is when signaling is most effective and yields greatest future benefits

- Political executives always hold policy levers
- Incentives to signal cooperative type to IMF, World Bank
  Even in absence of current program
  New leaders open cooperative possibility (McGillivray & Smith)
- Expect benefits via IMF programs, ongoing positive reporting
Theories suggest distinct adoption timings

<table>
<thead>
<tr>
<th>Argument</th>
<th>Mechanism</th>
<th>Adoption Timing</th>
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<tr>
<td>New Executive</td>
<td>proactive reputation building</td>
<td>beginning of executive tenure</td>
</tr>
<tr>
<td>Coercion</td>
<td>reaction, IMF programs</td>
<td>during greatest IMF program conditions</td>
</tr>
<tr>
<td>Diffusion</td>
<td>reaction, neighbor states or competitor states</td>
<td>when similar states adopt</td>
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</table>
Illustrative case of Turkey

1990s: conglomerates in banking; government-bank collusion
Illustrative case of Turkey

1990s: conglomerates in banking; government-bank collusion

1999

- January 11: Ecevit caretaker government enters office
- January 17: “bank reform will attract an IMF loan”
- April 18: Elections, Ecevit formal Prime Minister
- June: Bank reform passes Turkish parliament
  New regulator (“BRSA”) to begin September 2000
- December 22: Turkey-IMF Stand-by Arrangement
  Performance criteria: board by Mar 2000; live by Sep 2000
Illustrative case of Turkey

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2000 September 1: BRSA goes live

New executive proactively courts the IMF via adoption
62 countries, 1991–2005

Survival analysis

- Controls for year-specific pressures
  Country-year observations
  Cox proportional hazards model
- Countries enter dataset in 1991
- Countries leave dataset year after independent bank supervision
**Statistical analysis for generalization**

**DV:** Does country adopt independent bank supervision? (Abiad et al.)
- Requires both de jure and de facto independence

**Explanatory variables**
- **New Executive Argument:** New Executive Years (DPI)
  - Ensure NOT just election effect (DPI)
  - Ensure NOT just partisan effect (DPI)
- **Coercion Argument:** IMF program years (IMF)
  - IMF programs with bank supervision conditionality (MONA)
- **Diffusion Argument:** simple geography (more tbd)

**Controls**
- Democracy, veto players, unified government
- Bank crisis, currency crisis, sovereign debt crisis
- Wealth, economic growth, capital openness
## Results

**Model 1**

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Parameter</th>
<th>Estimate</th>
<th>Lower CI</th>
<th>Upper CI</th>
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<tbody>
<tr>
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<td>New Executive&lt;sub&gt;t&lt;/sub&gt;</td>
<td>2.304***</td>
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Hazard ratios presented.

*** signif at 1%; ** signif at 5%; * signif at 10%
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**Summary:**
- New executive-years have higher likelihood of adoption
- IMF programs, conditionality not a robust correlate.
Effect magnitude

New Executive

Increased Likelihood of Adoption

Year


Selecting Regulatory Capacity
Meredith Wilf (Princeton University)
Conclusion

Developing countries are adopting independent bank supervision

Turkey adopts to attract an IMF program
In 62-country analysis, new executive years correlate with adoption
Developing countries are adopting independent bank supervision

Turkey adopts to attract an IMF program
In 62-country analysis, new executive years correlate with adoption

Executives precipitate adoption to \underline{signal} cooperative intent to IFIs

Highlights informal channels for international financial governance