Selecting Regulatory Capacity:

National Bank Supervision in International Markets

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Motivation

Two components of bank financial stability

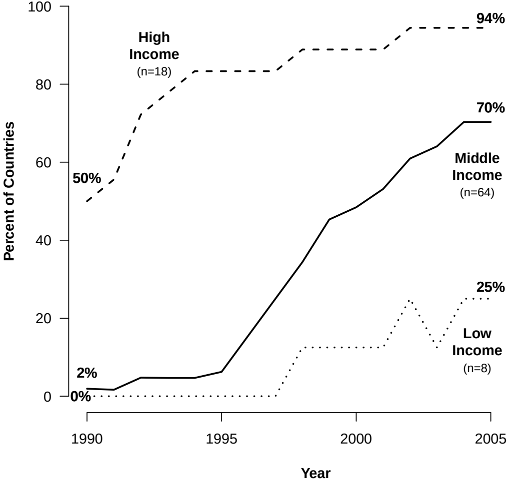
- Bank regulation: rule *stringency*
- Bank supervision: rule *enforcement*

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?



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 $\times$ 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

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Bank supervision marked by cronyism:

- De jure interference (supervisory powers; political approval)
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- All banks are supervised
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Countries that choose to move toward independence:

- Politicians forgo interference
- Country builds enforcement capacity

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 $\rightarrow$
  Greater pressure to adopt
- Diffusion
  Greater number of other countries with policies $\rightarrow$
  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

Argument	Mechanism	Adoption Timing
New Executive	proactive reputation building	beginning of executive tenure
Coercion	reaction, IMF programs	during greatest IMF program conditions
Diffusion	reaction, neighbor states or competitor states	when similar states adopt

Illustrative case of Turkey

1990s: conglomerates in banking; government-bank collusion

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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

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2000 September 1: BRSA goes live

New executive proactively courts the IMF via adoption

Statistical analysis for generalization

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)
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- **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
H1: New Executive	
New Executive$_t$	2.304***
	[*1.23, 4.31*]
H2: International Coercion	
IMF Program$_{t\text{-}1}$	1.171
	[*0.63, 2.18*]
IMF Program with Bank Supervision Conditionality$_{t\text{-}1}$	
H3: Diffusion	
Regional Diffusion (% Change)$_{(t-1,t)}$	1.002
	[*0.99, 1.02*]
country-year observations	644
countries in sample	62
country failures	44
year coverage	1991-2005
logrank p	0.040

Hazard ratios presented.
*** signif at 1%; ** signif at 5%; * signif at 10%

Results

	Model 1	Model 2
H1: New Executive		
New Executive$_t$	2.304***	2.206**
	[*1.23, 4.31*]	[*1.16, 4.19*]
H2: International Coercion		
IMF Program$_{t\text{-}1}$	1.171	
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IMF Program with Bank Supervision Conditionality$_{t\text{-}1}$		1.707*
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	Model 1	Model 2	Model 3
H1: New Executive			
New Executive$_t$	2.304***	2.206**	2.248**
	[*1.23, 4.31*]	[*1.16, 4.19*]	[*1.21, 4.17*]
H2: International Coercion			
IMF Program$_{t\text{-}1}$	1.171		
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IMF Program with Bank Supervision Conditionality$_{t\text{-}1}$		1.707*	1.721
		[*0.90, 3.24*]	[*0.87, 3.41*]
H3: Diffusion			
Regional Diffusion (% Change)$_{(t-1,t)}$	1.002	1.000	1.010
	[*0.99, 1.02*]	[*0.99, 1.01*]	[*0.99, 1.02*]
country-year observations	644	644	607
countries in sample	62	62	61
country failures	44	44	42
year coverage	1991-2005	1991-2005	1991-2005
logrank p	0.040	0.032	0.041

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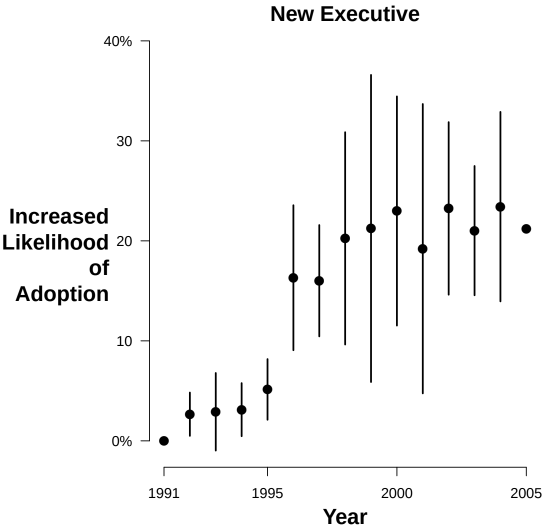
Summary:

- New executive-years have higher likelihood of adoption
- IMF programs, conditionality not a robust correlate

Effect magnitude



Conclusion

Developing countries are adopting independent bank supervision

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In 62-country analysis, new executive years correlate with adoption

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Executives precipitate adoption to signal cooperative intent to IFIs

Highlights informal channels for international financial governance