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**Article**

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CESifo DICE Report

**Provided in Cooperation with:**

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*Suggested Citation:* Barth, James R.; Prabha, Apanard Penny; Lu, Wenling (2013) : Do Interest Groups Unduly Influence Bank Regulation?, CESifo DICE Report, ISSN 1613-6373, ifo Institut - Leibniz-Institut für Wirtschaftsforschung an der Universität München, München, Vol. 11, Iss. 4, pp. 19-25

This Version is available at:

<https://hdl.handle.net/10419/167140>

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## DO INTEREST GROUPS UNDULY INFLUENCE BANK REGULATION?

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### Introduction

It is well known that banks in countries around the world play a key role in allocating resources that are essential to economic growth and development. It is also well known that banks do not always allocate resources to the most productive projects based on both risk and return considerations. This was the case during the recent global financial crisis when some banks engaged in such excessively risky and less productive activities that they either failed or were bailed out. The severity of the crisis underscores the need for governments to put in place bank regulatory regimes that prevent such deplorable episodes.

What may be less well known is that even if governments know what works best to ensure safer and sounder banking systems, it does not follow that they will pass laws and implement regulations consistent with that knowledge. The reason is that governments may simply choose policies that cater to their own private interests, rather than those that promote the public interest. In short, there are two different views of the type of regulatory regime that may exist in countries. One view, the private-interest view, is that governments will shape bank regulations so as to enrich and protect their interests. The other view, the public-interest view, is that governments will provide regulators with sufficient power to effectively curtail excessive risk-taking by banks so that they behave in a socially beneficial manner.

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The view that dominates in a country will determine whether government leaders and regulatory officials choose those bank regulations that work best, or those that contribute to a less efficient and stable banking industry.

Of course, special interest groups, such as financial firms and consumer organizations, play an important role in the process by trying to influence the policies that are chosen. Some groups may lobby and provide campaign contributions to policymakers seeking preferential treatment for their narrow special interests, which tilts the balance towards the private interest view. For example, some existing banks will have an incentive to lobby in favor of regulatory policies that limit competition, such as those restricting the entry of new banks. As another example, some troubled banks will have an incentive to seek regulatory policies that grant them forbearance even as they compete in ways that may adversely affect other healthy banks. By contrast, other groups may provide useful information to policymakers that can lead to regulations allowing the introduction of new and innovative financial instruments that promote social welfare, which is consistent with the public interest view. For example, when savings and loans were devastated by interest rate increases in the late 1970s and early 1980s they successfully lobbied for permission to offer variable-rate mortgages and use derivative instruments to hedge their interest rate risk. In short, given the critical role played by banks in determining who gains access to funding and who does not, organized interest groups will surely devote substantial effort to shape national banking policies.

The purpose of our article is to discuss the private- and public-interest views of regulation. We will also briefly discuss the types of regulations that work best to promote well-functioning banking systems and the type of factors that either lead or do not lead countries to implement such regulations. As will be seen, it is the existence of certain political and institutional characteristics in countries that are likely to lead to the adoption of the public-interest view, rather than the private-interest view of regulation. It is therefore the extent to which these political and institutional characteristics exist in countries that will determine the degree to which spe-



cial interest groups will be able to exert undue influence on government leaders and regulatory officials to favor narrow special interests rather than the broader public interests.

#### **Private- vs. public-interest views of bank regulation<sup>4</sup>**

The private- and public-views lead to two diametrically opposed outcomes with respect to bank regulation. If the private-interest view dominates in a country, it will lead to less efficiency in the banking sector and increase the likelihood of banking system fragility. In contrast, if the public-interest view dominates, it will lead to more efficiency in the banking sector and decrease the likelihood of banking system fragility. These two views fit into an important body of literature that examines whether and how some interest groups in a country use the coercive power of the government to extract rents from others within society (for example, Stigler 1971; Peltzman 1976, 1989; Becker 1983). The public choice literature in particular holds that interest groups that significantly benefit from specific policies being chosen are better able to organize politically to support those policies than society at large is able to organize to defeat the same policies if they produce socially inefficient outcomes. Furthermore, Baron (1994) and Grossman and Helpman (2001) stress that when the general voting public has incomplete information about public policies and their outcomes, this increases the effectiveness of well-organized interest groups.

There is a growing body of evidence that finds that interest groups can exert sufficient influence so as to help explain both the enactment and elimination of bank regulations. For example, researchers document that the comparative political power of small banks relative to large banks – rather than broader public interest considerations – has shaped regulatory restrictions on branching in the United States. Other research notes that some regulations influence small firms differently from large firms and stresses that the comparative power of these different interest groups influences regulatory policies (for example, Kroszner and Strahan 1998, 1999, 2001). In addition, Laeven (2004) shows that deposit insurance policies around the world are more consistent with the private-interest view than the public-interest view. Moreover, Hardy (2006) argues that differences in the regulatory regime across jurisdictions may persist because each adapts its regulations to suit its dominant

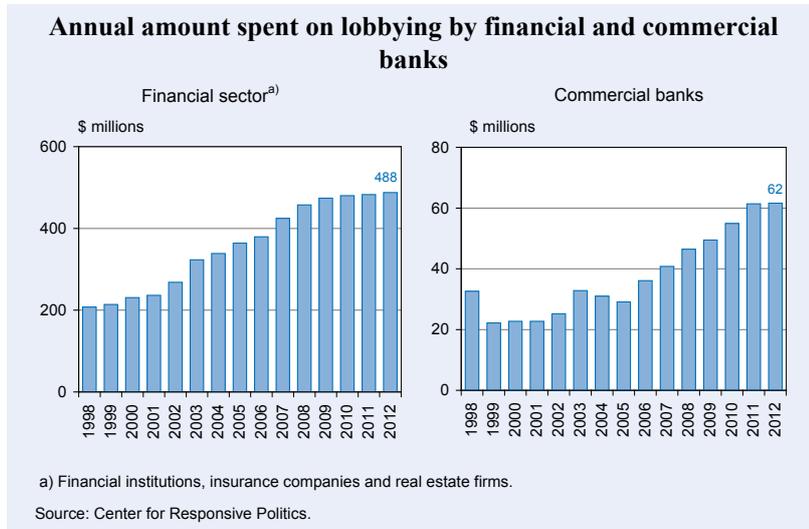
<sup>4</sup> This section draws heavily upon Chapter 5 in Barth, Caprio and Levine (2006).

incumbent institutions. Furthermore Barth, Caprio and Levine (2006) empirically show that, despite evidence that private monitoring promotes better functioning banking systems, not all countries adopt such a regulatory policy.

More generally, there is a growing body of other research that focuses on how interest groups use lobbying to exert a disproportionate impact on public policies so as to benefit themselves. In the case of the United States, Figure 1 shows the annual amount spent on lobbying by the financial sector and the corresponding amount of spending by just commercial banks over the period 1998 to 2012. It is quite clear that the amounts spent in both cases increased considerably over the past decade. Specifically, the amount spent by financial institutions, insurance companies, and real estate firms increased to USD 488 million in 2012 from USD 214 million in 1999, or 128 percent, while for commercial banks the amount increased to USD 62 million from USD 22 million over the same period, or 178 percent. It is quite interesting that the biggest year-over-year increases in spending occurred shortly before and continued to increase during the financial crisis, the government's support of a large number of financial firms under the Troubled Asset Relief Program (TARP) in October 2008, and the passage and subsequent implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) in July 2010. With respect to the crisis, research indicates that the pressure exerted on the government by special interest groups played an important role in the rise and collapse of the mortgage market (for example, Mian, Sufi and Trebbi 2010a, 2010b; Igan, Mishra and Tressel 2012). In addition, Angkinand and Willett (2008) find strong support that certain characteristics of political institutions play an important role in affecting governments' abilities to reduce the costs of 45 banking crises in 27 countries by limiting undue influence of interest groups. Furthermore, Hardy (2006) argues that in the event of a large negative shock, the banks may succeed in obtaining forbearance and a loosening of regulations.

As regards TARP, Blau, Brough and Thomas (2013) find that the financial firms that lobbied or had other types of political connections were more likely to receive TARP funds. Indeed, they report that for every dollar spent on lobbying, financial firms received between USD 486 and USD 586 in TARP support. In addition, Gibson and Padovani (2011) find that banks are more likely to lobby when they are larger, have more vulnerable balance sheets, are less creditworthy, and have more diversified

Figure 1



business profiles. Lobbying has also been found to affect legislative outcomes. For example, Igan and Mishra (2011) report that lobbying expenditures by the financial industry were directly associated with how legislators voted on key bills before the crisis, and that bills proposing regulation that the industry considered unfavorable were far less likely to pass than bills proposing financial deregulation. However, they did indicate that it is hard to identify exactly what drove the financial industry's lobbying efforts. If it was to promote rent-seeking activities they consider it socially undesirable, while if it was to offer information to policymakers and to promote innovation they consider it socially beneficial. Importantly, the fact that lobbying and campaign contributions exist in a country does not necessarily mean that that country is dominated by the private-interest view. It may be that they do, however, tilt the balance somewhat toward the private-interest view insofar as there is a spectrum of grey between the extreme private- and public-interest views.

There is also interesting information regarding the Federal Reserve's role in implementing the Dodd-Frank Act. Specifically, McGrane and Hilsenrath (2012) discuss the far greater role that the Federal Reserve now plays in bank regulation as compared to earlier years. They specifically emphasize that the Fed is implementing regulations based on the Dodd-Frank Act almost completely without public meetings. McGrane and Hilsenrath point out that the Fed only held two public meetings after July 2010 as compared to as many as 31 public meetings a year in the 1980s and 1990s. They argue that: "...the Fed's cloistered approach deprives

the public of insight into how rules are being written and makes it harder for Congress and others to hold them accountable for their decisions." At the same time, however, many big banks, both domestic and foreign, are able to meet privately with the Fed. Table 1 shows the number of such meetings with selected big banks from 2010 to September 2013. These types of meetings certainly provide an opportunity for this particular group of banks to try to influence

the leniency or stringency of the regulations that are eventually implemented.

#### Interest groups, political institutions, and bank regulatory regimes

Acemoglu, Johnson and Robinson's (2001) provide a useful analytical framework to help understand the emergence of political institutions and their relationship to the emergence of bank regulatory regimes. Using this framework Barth et al. (2006) argue that political institutions help understand cross-country differences in bank regulatory policies. In particular, they point out that the ability of interest groups to influence policies and promote their own interests depends on the political system. Some political systems discourage transparency, participation, and competition. Indeed, as they note, some political systems are controlled by entrenched elites and remain secretive about the exact nature of public policies. Thus, these types of political systems may be less successful in creating socially efficient banking regulations than open, competitive, democratic systems that encourage transparency and penalize corruption. As a result, even if one accepts that interest groups influence the choice and operation of bank regulations in an open democracy such as the United States, the degree to which private interests can easily manipulate public policies for their own gain may depend on the organization and operation of political institutions. Clearly, a narrow interest group consisting of elites has greater control over bank regulations in an autocracy than a democracy.

Table 1

Number of private meetings with the Federal Reserve by selected big banks					
Bank	2010	2011	2012	September 2013	Total
JP Morgan Chase	6	8	13	1	28
Bank of America	6	9	4	0	19
Goldman Sachs	3	7	7	2	19
Morgan Stanley	2	8	5	0	15
Barclays	1	8	1	4	14
Deutsche Bank	1	1	1	4	7
Wells Fargo	4	6	2	0	12

Source: McGrane and Hilsenrath (2012) and Federal Reserve (2013).

In a relatively recent book, Barth et al. (2006) examine the role that private monitoring, among other factors, plays in promoting prudent banking behavior. In particular, they argue that the public-interest view predicts a positive relationship between open, competitive, and democratic political systems and banking policies that foster private monitoring. Their empirical work indicates that this type of political and institutional structure does indeed positively and significantly increase private monitoring. This means that countries with more open, competitive, democratic political systems tend to adopt bank regulatory practices that focus more on information disclosure.

Using a similar approach to Barth et al. (2006), we also assess the relationship between private monitoring and selected political and institutional variables. They relied on the World Bank Banking Supervision Survey II (2003) to construct their measure of private monitoring. However, we rely on information from the World Bank Banking Supervision Survey IV (2011) to construct the same measure of private monitoring. This variable includes information on whether subordinated debt is allowable or required as part of capital, off-balance sheet items are disclosed to the public, risk management procedures are required to be disclosed to the public, and formal enforcement actions taken against banks are required to be made public. Moreover, since our purpose here is only meant to be illustrative, we use a slightly different set of political and institutional variables in assessing their impact on the private monitoring variable. If the impact of these and related variables is positive, we interpret this as meaning any undue influence of narrow interest groups is substantially reduced, if not eliminated. Otherwise, we would expect a negative impact for these types of variables.

Specifically, we use four indicators of the political and institutional structure in a country to assess whether differences in structure do indeed influence the choice of bank regulatory policies. These indicators provide information about whether each country's political system and institutional environment tends to favor the private-interest view (or narrowly focused interest groups) versus the public-interest view (or broadly focused interest groups). Two of the four indicators we use come from the Polity IV Project (Marshall, Jaggers and Gurr 2011), which provides a database on political regime characteristics for a broad cross-section of countries, and the other two come from the International Country Risk Guide (ICRG). These indicators capture the following characteristics in a country:

- Executive Constraints: the extent of formal constraints on the decision-making powers of chief executives.
- Democracy: the presence of institutions and procedures through which citizens can express effective preferences about alternative policies and leaders; the existence of institutionalized constraints on the exercise of power by the executive; and the guarantee of civil liberties to all citizens in their daily lives and in acts of political participation.
- Law and Order: the assessment of the strength and impartiality of the legal system, and the popular observance of the law.
- Bureaucracy Quality: where the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services.

We choose these indicators because they are likely to exist to a greater degree in countries in which the dominate

view is the public-interest view. A political and institutional structure in which there are formal constraints on the decision-making powers of chief executives, citizens can express effective preferences about alternative policies and leaders, the legal system is impartial and popularly obeyed, and a strong and expert bureaucracy is likely to be focused on protecting and promoting the well-being of the public. The resultant political and institutional system is also likely to put in place bank regulatory policies that do not strictly cater to special interest groups without regard to the interests of the public.

Table 2 presents our illustrative empirical results indicating the relationship between political and institutional characteristics in a country and private monitoring, which has been found to be significantly and positively related to good banking outcomes, by Barth et al. (2006). We find a significantly, albeit weak, positive relationship between greater constraints on the chief executive and a bank regulatory policy that fosters accurate information disclosure to the public. We also find a significantly, and again weak, positive relationship between the impartiality of the legal system and popular observance of the

law and private monitoring. It might be noted that Barth et al. (2009) find that objective court and better law enforcement tend to reduce bank-lending corruption. They indicate that this is to be expected since bank-lending corruption is generally related to other illegal activities and the expropriation of creditors' rights, so that a well-functioning legal environment helps reduce these practices. Moreover, in countries where the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services, we find a strong and positive relationship to private monitoring. Lastly, however, we do find a positive, but not robustly significant, relationship between democracy and private monitoring. More generally, consistent with the public-interest view of regulation, we find that countries that have the type of political and institutional characteristics considered here will tend to implement regulations that require banks to provide accurate information to the private sector. At the same time, this finding is consistent with an environment in which interest groups that promote only narrow self-interests, rather than broader public interests, would be limited in unduly influencing bank regulatory policies.

**Table 2**

Regression results								
Political variable								
	Executive Constraints		Democracy		Law and Order		Bureaucratic Quality	
Political variable	0.196**	0.157*	0.088**	0.053	0.237*	0.263*	0.419***	0.299**
	(0.075)	(0.083)	(0.038)	(0.040)	(0.126)	(0.137)	(0.106)	(0.141)
Legal origin - English		1.374***		1.327***		1.296***		1.139***
		(0.357)		(0.356)		(0.337)		(0.328)
Legal origin - French		-0.197		-0.236		-0.047		-0.121
		(0.368)		(0.376)		(0.347)		(0.356)
Legal origin - German		-0.320		-0.302		-0.486		-0.629
		(0.324)		(0.323)		0.362		(0.397)
Constant	6.798***	6.968***	7.290***	7.518***	7.120***	6.751***	7.027***	7.101***
	(0.452)	(0.619)	(0.304)	(0.452)	(0.561)	(0.668)	(0.307)	(0.465)
Observation	99	67	99	67	91	67	91	67
F-test (p-value)	0.0108	0.0001	0.0236	0.0001	0.063	0.0001	0.0002	0.0001
<p>The dependent variable is the private monitoring index from the World Bank Banking Supervision Survey IV (2011). The regressions are estimated using the Ordinary Least Squares with robust standard errors. Each of the four political and institutional variables is entered separately in each regression, with and without dummies for legal origin. The data for political variables are from 2007, prior to the onset of the financial crisis; therefore, the impact of these institutional variables is not driven by any change of political institutions as a result of the crisis.</p> <p>***, **, * indicate the significance levels of 1%, 5% and 10% respectively. The numbers in parentheses are standard errors.</p>								

Source: The authors and World Bank Banking Supervision Survey IV (2011).

The dependent variable is the private monitoring index from the World Bank Banking Supervision Survey IV (2011). The regressions are estimated using the Ordinary Least Squares with robust standard errors. Each of the four political and institutional variables is entered separately in each regression, with and without dummies for legal origin. The data for political variables are from 2007, prior to the onset of the financial crisis; therefore, the impact of these institutional variables is not driven by any change of political institutions as a result of the crisis.

These illustrative results and, more importantly, those of Barth et al. (2006) indicate that identifying sound policies is a necessary condition for formulating appropriate reform strategies, but successful reform recommendations would also need to consider the political and institutional forces at work in each country. Specifically, as they point out, making policy recommendations that actually induce socially efficient reforms will require an understanding of national political and institutional systems and almost certainly involve custom-designing bank regulatory reform based on these systems.

## Conclusion

Our basic message is that the organization and operation of political and institutional systems shape bank regulations. Political and institutional systems are also important because they can limit the degree to which narrowly-focused interest groups can unduly influence policy choices. For instance, governments (or countries) with systems that grant disproportionate power to a narrow interest group are less likely to choose policies that distribute economic resources to the broader public based on merit and place more importance on promoting economic efficiency.

In terms of policy implications, our illustrative results and the more compelling results of Barth et al. (2006) emphasize that, in many countries, improving bank regulation requires more than identifying those bank regulatory policies that work best to improve the operation of banks and thus enhance social welfare. Clearly, a crucial component of implementing policies that maximize social welfare is to discover those policies that accomplish this goal. However, if policymakers do not choose to maximize social welfare, it follows that discovering the “best” policies will not lead to their adoption unless policymakers find it in their interest to do so. In other words, socially efficient regulatory reform that subverts

the narrow interests of special interest groups makes effective reform extremely challenging. Thus, the research finding that political and institutional systems substantively shape national bank regulatory policies implies that successfully implementing banking sector reform requires a full appreciation of the political and institutional differences between countries.

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