Bank Supervision and Corruption in Lending

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Banks provide a large share of external finance to businesses around the globe. The Basel Committee, International Monetary Fund (IMF), and World Bank promote the development of powerful supervision agencies to monitor and discipline bank behavior. Yet there are few studies of international differences in bank supervision and how they influence the obstacles that corporations face in raising external finance. There is also little cross-country evidence on which bank supervision policies facilitate efficient corporate finance and which reduce bank corruption.

Beck, Demirgüç-Kunt, and Levine empirically assess the relationship between bank supervision policies and the degree to which corruption in lending prevents firms from raising external finance. Three theories of government regulation provide a framework for their findings. The first, known as the supervisory power view, holds that strong official supervision of banks can improve their corporate governance, because private agents often lack the incentives and capabilities to monitor powerful banks. This theory assumes that governments have the expertise and incentives to ameliorate market imperfections and improve bank governance.

An alternative theory, the political/regulatory capture view, argues that politicians and supervisors do not maximize social welfare, but rather their private welfare. Thus, if bank supervision agencies have the power to discipline noncompliant banks, politicians and supervisors may use this power to induce banks to divert credit to politically connected firms.

Finally, the private monitoring view argues that bank supervision policies should focus on enhancing the ability and incentives of private agents to overcome information and transaction costs, so that private investors can exert effective governance over banks.

Beck, Demirgüç-Kunt, and Levine use data on supervision from Rethinking Bank Regulation: Till Angels Govern by Barth, Caprio, and Levine and firm-level data from the 1999 World Business Environment Survey of more than 2,500 small, medium-size, and large firms in 37 countries. The authors estimate the relationship between the degree of corruption—based on the answer to the question, “Is the corruption of bank officials an obstacle for the operation and growth of your business?”—and measures of supervision power (such as the ability to intervene in banks, replace managers, force provisioning, stop dividends and other payments, or acquire information) and of the degree to which regulations require information disclosure by banks and give private creditors incentives to monitor banks (such as whether bank directors and officials face criminal prosecution for failure to disclose information, whether banks must disclose consolidated accounts, whether international accounting firms audit banks, and whether there is implicit or explicit deposit insurance). The authors control for a range of firm- and country-specific characteristics and use instrumental variables to control for endogeneity.

The results strongly refute the view that powerful supervision agencies with the authority to monitor and discipline banks facilitate efficient corporate finance. Firms tend to face greater obstacles in obtaining bank loans as a result of corrupt bank officials in countries with stronger supervision agencies than in countries with weaker agencies.

The finding that powerful supervision agencies are associated with lower integrity of bank lending provides support for the political/regulatory capture view, which emphasizes that these
agencies are prone to capture and manipulation by politicians, regulators, or both. But this conclusion needs to be tempered. Powerful supervision is so strongly correlated with poor national institutions (ineffective government, absence of the rule of law, high corruption) that it is difficult to identify an independent relationship between supervision power and bank corruption when controlling for these institutional traits.

Finally, the authors’ findings are consistent with the private monitoring view: bank supervision strategies that focus on forcing accurate information disclosure—and not distorting the incentives of private creditors to monitor banks—facilitate efficient corporate finance. This view recognizes that private agents face substantive information and enforcement costs when monitoring banks, but also that politicians and regulators act in their own interests and not necessarily to reduce market friction. Private monitoring has an especially beneficial effect on the integrity of bank lending in countries with sound legal and administrative institutions.

Bank supervision clearly matters. Policies that redress market failures by forcing accurate disclosure of information reduce the obstacles that firms face in raising external finance, and active bank supervision can help reduce information costs and improve the integrity of bank lending. Powerful supervision agencies too often do not act in the best interests of society.