

# **Removing the F.I.G.\* Leaf:**

## **The Politics of International Banking**

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***W. Travis Selmier II***

*Political Science Department and  
Department of Finance, Kelley School of Business,*

*Indiana University,*

*1309 East 10th Street, Room 370*

*Bloomington, Indiana, USA 47405*

*Tel: (812) 856-0056*

[\*wselmier@indiana.edu\*](mailto:wselmier@indiana.edu)

[\*http://www.kelley.iu.edu/facultyglobal/FacultyProfile.cfm?id=8640\*](http://www.kelley.iu.edu/facultyglobal/FacultyProfile.cfm?id=8640)

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\* Investment banking terminology for *financial industry groups*

## Introduction

*“Financial force was often used to buy or build political friendship or alliance, was often lent or withheld in accordance with political calculations.”*  
*Feis, 1930*

This paper examines the politics of banking with a focus on international banking, regulatory capture and avoidance, lobbying, and incentives to grow large banks both domestically and across national borders. These incentives derive from enhanced influence over regulation and achieving “too-big-to-fail” status, as well as private gains incentives to the bank managers themselves. This paper is part of the theoretical core of my dissertation entitled, “The Politics of Cross-border Bank Acquisitions.”

Using the term “banks” loosely in this paper, I broadly define it to mean the banking activities and bankers, and I include non-bank banks in this category.<sup>1</sup> Non-bank banks include economic actors engaging in banking activities, but which are outside the purview of standard banking regulatory frameworks, and encompass hedge funds, mortgage issuing firms, investment banks, government-sponsored enterprises engaging in financial services,<sup>2</sup> and other entities. This sector has more recently been referred to as the shadow banking sector. In many cases these non-bank banking institutions have engaged in regulatory arbitrage to organize and incorporate as non-regulated, or less-regulated, businesses.<sup>3</sup> In addition, as traditional banks rushed to grow in asset size, product depth and spread, and geographic reach, many of the larger ones became enormous financial institutions with a significant amount of non-regulated, or less-regulated, operations.

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<sup>1</sup> For clarifications and definitions, see McCulley (2009); Stallings and Studart (2006); Allen (2001); Roubini (2008).

<sup>2</sup> For instance, Fannie Mae and Freddie Mac. See Jaffee et al (2009).

<sup>3</sup> Acharya and Richardson (2009), especially chapters 2, 3, 4, 7; Alessandri and Haldane (2009); Barth, Caprio and Levine (2005); McCulley (2009).

Politics of banking is an extensive topic. A brief explanation of my broader study will help the reader understand the selective nature of the topics in this paper. My broader study analyzes the world-wide bank merger wave which occurred between 1985 and 2007. Merger waves were not new phenomena, but the global nature of this wave was unprecedented, in scale and scope, on all measures: number of deals, amount of capital involved, business expansion across sub-industries, the number of countries affected.<sup>4</sup> In all, more than fifty countries were affected. I argue that this bank merger wave, which crested with the inherent financial liberalization aspects of globalization, was driven in large part by changes in national and international politics and policies over this period. These changes heralded a new era in which banks which were globally active, or aspiring to be globally active, were pushed to expand across borders. Acquisitions became the strategy of choice in these banks' expansions.

Acquiring banks pursued their acquisition strategies while considering both efficiency and political factors; at times, the strategies of participating actors have been fundamentally political in nature, and economic efficiency, narrowly defined, was of secondary importance. The wide dyadic variation in foreign acquisitions of other countries' banks was, I argue, largely driven by political factors which channeled and constrained actors<sup>5</sup> as they pursue their strategies and goals. This paper examines key political factors which influenced these banks to expand through acquisition.<sup>6</sup>

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<sup>4</sup> Gregoriou and Renneboog (2007) and Martyna and Renneboog (2005) place this wave in historical perspective; see also Toxvaerd (2008); Gorton, Kahl & Rosen (2007); Kolstad & Villanger (2007); Mester (2005).

<sup>5</sup> Actors here include government institutions and their constituent policymakers, multilateral institutions, banks and their managements, and other interested firms.

<sup>6</sup> Berger, Demirgüç-Kunt, Levine and Haubrich (2004) provide an overview of bank concentration studies. Note that some very large banks may pursue aggregation strategies to capture "too-big-to-fail" benefits (Brewer and Jagtiani, 2007) or be pressed to "eat-or-be-eaten" (Gorton, Kahl and Rosen, 2007; Toxvaerd, 2008), while small banks in the same markets can successfully pursue local customers (DeYoung, Hunter and

Banks are, of course, political actors. Banks rely on governmental support and guidance, and are monitored by national and international organizations established for governance purposes. Banks lobby these organizations as well as other political actors.<sup>7</sup> Banks are set up and prosecute their business practices to respond quickly to market opportunities; not infrequently, banks evade these regulators' intents in pursuit of business.<sup>8</sup> Banks are also "privately monitored" by investors and other interested parties. In the course of financing businesses and individuals, banks are privy to extensive amounts of non-public information. The information derived from this relationship banking is sought after by political leaders and other interested parties, who observe banks' actions. This informational advantage comes to banks at a price--banks are subject to severe financial fragility. This inherent fragility arises due to banks' intermediation roles: as institutions, they stand between depositor and borrower, funneling capital from one to the other. Failure or panic on either side could cause bank failure. Banks also tend to "fund short and lend long", in that depositors' funds are usually shorter-term in nature, while loans tend to be over much longer periods. Bridging this intertemporal gap brings great risk as well. Barth, Caprio and Levine note, "Banking crises are the train wrecks of finance,"<sup>9</sup> and these impacts often ripple beyond the financial sector.

Governmental actors are both pulled by, and pushed toward, banks' power. They are pulled by banks' ability to gather and deploy capital, and pushed by the perceived need to monitor and regulate banking activity to avoid train wrecks and to maintain power.

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Udell, 2004).

<sup>7</sup> See Boot & Thakor (1996) on self-interested bank regulation; Vines & Gilbert (2004) and Baker, Hudson & Woodward (2004) examine this in the context of international financial architecture; Barth, Caprio and Levine (2005) consider the interplay between banks and regulators; Jubasz (2002) offers a biting criticism of Citigroup lobbying to achieve its ends.

<sup>8</sup> See Alessandri and Haldane (2009); McCulley (2009); Barth, Caprio and Levine (2005) among others.

<sup>9</sup> Barth, Caprio and Levine (2005), p. 26.

These government officials experience an additional tug of war in that they face a conflict between acting for the public good or pursuing their private gain in their dealings with banks and banking regulation.

In short, banks are embedded in webs of national politics by virtue of their basic function as financial intermediaries. The power which banks derive from their informational asymmetry has long been recognized and appreciated by political leaders.<sup>10</sup> But this information comes at a cost—both banks and the banking system are financially fragile. The results of these crises are much deeper and wider than just in the world of finance. In 2005, banking scholar Aliber commented that the years since 1970 “have been the most tumultuous in international monetary history.”<sup>11</sup> His comment rings even truer with subsequent events. Systemic crises are an important factor in the politics of both domestic and international banking.

I lay out my argument in four sections. The first examines banking’s unique position in political economies, using studies from financial economics to lay out the ideas that banks are inherently political animals. The second applies the ideas of pursuit of private interests and regulatory capture to banks’ political strategies; the third examines perverse incentive structures which have led banks to pursue too-big-to-fail policies, and the use of acquisitions to achieve this government-protected status. The third continues the discussion of too-big-to-fail in an institutions context, and lastly, I briefly sum up. Throughout the balance of the paper I weave ideas of cross-border bank acquisitions into my narrative.

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<sup>10</sup> European leaders used the Rothschilds’ letter envoy system to send messages (Ferguson, 2000); see also Feis’ descriptions of the interplay between international politics and finance (1930); Gilpin (2001); Polyani (2001); Pauly (2001); Cohen (1996). Development state and economic development theories see Geddes (1994); Haggard & Maxfield (1996); Kang (2003); Kessler (2000); Stallings & Studart (2005), among others.

<sup>11</sup> Aliber (2005).

## II. *Banks are Inherently Political Institutions*

*“...as is the wont of capitalists, [bankers] love leveraging the sovereign’s safety nets with minimal prudential regulation. This does not make them immoral, merely astute interpreters of the circumstances they face.”*

*McCulley, 2009*

Banks and banking are embedded in politics for five interrelated reasons: by virtue of dealing in that “commodity” by which all other goods are priced, money, banks are placed in a prominent political role; banking is at the epicenter of modern national and international economic systems; banks’ intermediation roles give them powerful informational advantages, and these information asymmetries engender economic and political power; governmental actors seek to channel, govern and sometimes manipulate this power; and banking systems pose great risk to not only their domestic economy but to the international economy as well.

Banks perform the economic role of intermediation by interposing themselves between those who have money, the depositors, and those who require money, the borrowers.<sup>12</sup> Banks are, in effect, “delegated” to conduct research (due diligence) on borrowers and make appropriate decisions to loan or not. We might consider this a quasi-public monitoring responsibility, and indeed many governments have government banking operations partly for this purpose. This critical role allows economies to balance supply and demand in that good in which all other goods are priced--money. Liquidity of money, as the *numeraire* good, makes money supply a critically important issue in all economies. And banks are the institutional pumps and pipes through which money flows.

It is beyond the scope of this paper to provide detailed comment on the debate raging

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<sup>12</sup> Allen (2001) summarizes the critical position of banks in an economy as well as their uniquely fragile position; Diamond (1984) examines banks’ role in closing the information gap between borrowers and lenders.

in financial economics as to whether banks exacerbate or ameliorate liquidity problems through credit rationing.<sup>13</sup> It is, however, beyond debate to state that money is the fundamental basis for economic exchange beyond simple truck and barter. Banks are the critical agents in the transmission of credit through their intermediation role in most, if not all, national economies, and this makes their dealings in money, the *numeraire* good, of primary political as well as economic importance.

This intermediation role is critical not only across space--between lenders and borrowers--but also across time, as the horizons of money supply and demand differ for different depositors and borrowers.<sup>14</sup> Much of the risk inherent in banking derives from intermediating between these different time horizons. Such risk is termed “asset-liability mismatching,” where the time horizons of assets and liabilities do not match.<sup>15</sup>

Intermediation increasingly takes place over wider spaces as supply and demand balance globally with fine degrees of pricing to allow for different risk profiles of depositors and borrowers.

And banks occupy the center of this modern global economic system because financial markets have become the most global of markets.<sup>16</sup> Banks, through their intermediation roles, remain the key players in supplying credit through time and space,

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<sup>13</sup> To illustrate the debate using two seminal papers examining US banking, Berger & Udell (1992) argue that credit rationing is not a significant practice by banks over business cycles, but also that the “equilibrium rationing,” which banks do practice, has little impact. Benanke, Gertler & Gilchrist (1996), however, summarize previous literature showing a “financial accelerator” does exist which indicates banks may exacerbate macroeconomic liquidity problems arising from credit allocation and rationing.

<sup>14</sup> Greenbaum and Thakor (1995) describe this as “qualitative asset transformation,” wherein liquid liabilities, deposits, are transformed into illiquid assets, or loans. See also Rajan (1992); Rajan & Winton (1995); Song & Thakor (2006).

<sup>15</sup> Governments sometimes force banks, particularly those banks owned by the government, to take on higher levels of these risks. Song & Thakor (2007) note that banks may lessen this risk by matching similar liabilities and assets in long-term relationships, thereby lessening the time horizon risk.

<sup>16</sup> See Garrett (2000); Prominent bankers emphasize this: JP Morgan Chairman Jaime Dimon noted, “Where the products are ‘manufactured’ is of little interest” to customers. ICICI Bank, India’s largest private bank, launched an on-line savings account product in England of such success its servers in India were swamped. Quoted and cited, respectively, in Cottrell, 2006a & 2006b.

although some “disintermediation” has occurred in more advanced economies as other channels of linking lender and borrower have arisen. This intermediation role assumes greater importance in less-developed economies, as clients in developing countries generally utilize banks more than in economically-advanced nations where credit and investment markets are more developed.<sup>17</sup>

Acting on the proprietary information which they gather through relationships with their clientele, banks allocate or withhold credit. In this process of providing or denying credit, banks may also provide information to observers who do not have access to the same information set to which banks are privileged, but can observe banks’ actions. An important paradigm of banking theory is that banks overcome market inefficiencies by acting as information conduits.<sup>18</sup> Several key political questions arise regarding this proprietary information: do banks sometimes screen out, withhold, or signal-jam information for their own benefit;<sup>19</sup> whether, and under what circumstances, banks surmount the difficulties of obtaining accurate information;<sup>20</sup> and exactly which players benefit from the informational advantage.<sup>21</sup> While these questions are of interest to financial economists analyzing banks, they are paramount for political economists. Banks’ ability to access and control information make them repositories, as well as wielders, of enormous political power. International banking generally, and bank acquisitions specifically, occupy center stage in good economic times, but in financial crises the

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<sup>17</sup> See Claessens, Demirgüç-Kunt & Huizinga (2002), also Clarke, Cull, Martinez Peria & Sánchez (2003); Dymski (2002).

<sup>18</sup> This theory is posited to exist in highly efficient markets, as explained in Diamond (1984), Rajan (1992); Rajan & Winton (1995); Winton (2006).

<sup>19</sup> Purposeful non-disclosure of information through hidden actions, signal-jamming is quite consistent with the recent financial crises outcomes (Morgenson and Story, 2010), and historical crises as well (Reinhardt and Rogoff, 2009). AIG purposefully withheld information on credit default swap exposure, for instance.

<sup>20</sup> *Economist* (2009); Acharya and Richardson (2009).

<sup>21</sup> Stallings and Studart (2005); Reinhardt and Rogoff (2009).

tragedy which unfolds around affects all other players.

Other actors are quite interested in the information content behind banks' actions and watch closely the signals transmitted by those actions. This information set develops in the course of lending to and, in some countries, advising borrowers and is the foundation of "relationship banking." This information is gleaned through banking relationships which may develop over years, decades and, in cases of some merchant banks, centuries.<sup>22</sup>

Banks garner significant economic and political power through this asymmetric information advantage. Information on clients, industrial sectors and national economies may be shared or may be more closely guarded. The knowledge of the health of those industrial sectors and regions of the national economy to which a bank may lend is not only of interest to the government, but the government may seek to suppress informational transfer to other parties as well as to "guide" lending practices by the banks.

Given banking's central role in political economies—dealing in the numeraire good, intermediating between those who have and those who need capital, possessing critical proprietary information, possessing great economic power and posing great risk to economic health—it is no wonder that governments recognize, seek to govern and sometimes manipulate this power. The interplay between banks, bankers, government institutions and officials leads to opportunities for self dealing. The next section considers the perverse incentives to pursue private gains which arise.

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<sup>22</sup> Boot (2000) provides an overview of relationship banking; Song and Thakor examine the fragility inherent in relationship banking and explain banking strategies to alleviate this fragility. Niall Ferguson's excellent 2-volume history of the Rothschild Bank is indicative of centuries-old banking relationships.

### III. Private Interests: Governments and Cross-border Bank Acquisitions

*“Managers generally hold only a small fraction of the claims in the firm and enjoy a high degree of discretion because of the incompleteness of the contracts that dictate their decisions.” Acharya et al, 2009*

An important part of my argument rests on the idea that banks, bankers, and regulatory institutions experience conflict between pursuit of private gain or public benefit. These issues arise in part due to the privilege information access to which banks and bankers are privy. Due to this conflict, these actors sometimes make decisions which are sub-Pareto-optimal to the society, nation, or organization they serve. Government officials, the institutions in which they work, banks and the multilateral organizations which monitor them are embedded in social and political webs.<sup>23</sup> The resulting social and political pressure means private interests may intrude into even highly disciplined bureaucracies.

In the 1970’s, three seminal articles by Stigler, Peltzman and Posner defined the private interest view of regulation. I expand on these three pieces by highlighting recently published insights which shed light on the issues of the politics of banking.

Stigler (1971) considered regulation from a purely economic view as economic groups demanded regulatory intervention and governmental agents supplied such intervention.<sup>24</sup> Regulation may both help and hurt these interest groups, and so groups intently and intensively lobby to achieve desired outcomes. The concentrated efforts and interests of these lobbying efforts empower these groups vis-à-vis the less concentrated, often less-interested groups who may be affected by the efforts of such lobbying. This

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<sup>23</sup> Broad comparative pieces include: Evans (1989, 1996); Polyani (2001). Latin America: Geddes (1994); Pastor & Wise (2005); Penido de Freitas & Magalhães Prates (2000, 2001). Asia: Haggard (1990); Kang (2002); Dahlman and Sananikone (1993).

<sup>24</sup> Stigler (1971).

process of lobbying sometimes results in regulatory capture. I define “regulatory capture” here as the acquisition of private benefits through governmental policy channels not institutionally sanctioned in a particular political economy.

In the distribution of benefits, group size matters. First, the size of the group benefiting from regulatory capture may be limited.<sup>25</sup> Peltzman (1976) formalized Stigler’s model in which diminishing returns cap group size,<sup>26</sup> noting: “what the ‘capture literature’ treats as an ad hoc detail—that the political process automatically admits powerful outsiders to the industry’s councils’—is in fact integral to the regulatory processes.”<sup>27</sup>

Those firms in the charmed circle have powerful incentives to lobby for benefits. Not only might banks accede to such positions of influence: Beck, Demirguc-Kunt and Maksimovic (2005) show larger borrowers, as well as banks, are also empowered, especially those engaged in business in weaker institutional environments. These large borrowers often gain capacity to lobby for foreign banks’ entree to their market.

Claessens et al (2001), in fact, find a drop in domestic banks’ profit after foreign banks enter their markets. This would naturally motivate banks with an established presence in a market to lobby for regulatory benefits, including resisting market entry by newcomers. Chari and Gupta (2007) find concentrated industries in India are much more effective at preventing foreign entry. They further find that state-owned enterprises, particularly profitable ones, are more successful at this than private firms.

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<sup>25</sup> Note that Posner (1974) and others point out that private interests may be successfully pursued with very large groups as well (i.e., groups with significant voting blocks or those able to mobilize around a single issue), leading to the possibility of a U-shaped function of group size and effectiveness.

<sup>26</sup> Peltzman. 213—222. Peltzman summarizes as follows: One, “imperfect information about gains and losses...restricts the size of the winning group.” Two, “but this winning group will not obtain even a gross gain through political action as great as is within the power of the political process to grant it.” Three, “political entrepreneurship will produce a coalition which admits members of the losing group into the charmed circle.” Quotes from pp. 221—2.

<sup>27</sup> Peltzman (1976), p. 217, with Stigler book quote.

One can clearly see that allowing the expansion of banking business, whether through organic growth or acquisition, is an aspect of regulation subject to significant influence from those private interests. Those private interests include banks already participating in the market in question, as well as those powerful banks outside that market but wishing to enter. Political questions revolving around banking expansion is not exceptional; firms in other industries may act similarly. Governmental agents ultimately decide whether and in what form to permit banks, and other firms, to expand.<sup>28</sup>

The efficacy of such resistance, and the means employed to resist, would be determined in large part by the institutions, legal foundations and social norms under which corporations in host countries and their managers operate. But, in the same situation, how do incumbent firms act when they are of foreign origin? Apparently the same way: Eden and Molot (2002) find foreign first movers resist new foreign entrants by exercising the political power of incumbents, and are able to draw on additional resources to do so.<sup>29</sup> Not only do entrenched foreign firms lobby the host government, they also interact with their home government and multilateral institutions to promote their policies. The foreign first movers' interests are now more closely aligned, perhaps concordant with, the host country's firms.<sup>30</sup> They would then seek to exclude newcomers.

Posner (1974) examined public interest and private interest (regulatory capture)

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<sup>28</sup> Kroszner (2000), Kroszner and Strahan (1999) examine expansion in the U.S. in general terms and in regard to bank branching, respectively; Boehmer, Nash, Netter (2005) look at privatization in developing countries. As an example, any foreign bank acquisition in Brazil has required Presidential approval since the 1988 Constitution enactment; see Penido de Freitas and Magalhães (2000)

<sup>29</sup> Eden and Molot (2002) analyze the Canadian auto industry and U.S. firms' first mover incumbency.

<sup>30</sup> See also Grossman and Helpman (2001). Note that Posner (1974) provides an interesting point in my overall argument. He critiques the "political science" version of private interest theory by saying "Exceptions to the general rule that regulatory agencies are captured by the regulated firms are explained away by facile references to the personality of the legislators, public opinion, ignorance, folk wisdom, etc". He supports the economic theory of private interests as more "precise and hard-edged." While I agree, my model seeks to bring back in the idiosyncratic political aspects of different countries and their bilateral and international interaction effects. [Posner, 1974, pp. 342-344.]

theories, finding in favor of a transactions cost-based private interest theory. He noted that excusing regulatory failure by suggesting that implementation was weak, and experience lacking, ignored the empirical evidence and slighted the obvious level and success of lobbying by interest groups. Kane noted the dynamic process of regulation proceeded in a series of moves and countermoves by the regulator and the regulated: “market institutions and politically imposed restraints reshape themselves in a Hegelian manner... [consisting of] repeating stages of regulatory avoidance (or ‘loophole mining’) and re-regulation.”<sup>31</sup>

This process, in many ways akin to Polanyi’s description of the development of law and regulation in response to market advances in the English economy,<sup>32</sup> permits change in not only regulation but also increasing levels of private interest or public good to enter the equations of all actors. In effective governments, government agents attempt to counterbalance market abuse through institutional design and implementation.<sup>33</sup>

In these cases, actors’ reasons may include private gains as well as public benefits and, in fact, may be driven solely by private gains calculations which collaterally deliver a public gains benefit.

The private interest view I employ does not, in fact, exclude public-minded servants, bankers acting for the good of their stakeholders, or multilateral institutions’ officials acting for the greater good. Many government actors may, in this private interest model, derive great benefit (utility) from acting for the public benefit. In this dynamic view,

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<sup>31</sup> Kane quoted in Barth, Caprio, and Levine (2005), p. 44.

<sup>32</sup> Polanyi (2001) on English legal development: “for a century the dynamics of modern society was governed by a double movement: the market expanded continuously but this movement was met by a countermovement checking the expansion in definite directions.... The market system... developed in leaps and bounds; it engulfed space and time, and by creating bank money it produced a dynamic hitherto unknown....” P. 135

<sup>33</sup> Becker (1983) suggests this leads to an efficiency of sorts in regulation as increasingly costly policies, benefiting one party or group, are opposed by those who bear the increasing costs. Public costs are therefore lowered as the private benefits captured by the interest group decline.

government actors may act more or less in the public interest as counterparties exert varying levels to influence the outcome of regulation.<sup>34</sup> Many bank managers may acquire across borders purely to increase shareholder value. But the preponderance of data indicates there are, at best, mixed motives in most cases and a strong motivation to rent-seek in some cases of bank expansions.

Opportunities to pursue private gains arise when parties are able to construct socially-suboptimal deals in which side payments can be made. These deals are more prevalent in instances of weak institutional design (de jure problems),<sup>35</sup> poor institutional implementation (de facto issues)<sup>36</sup> and where such deals do not come to light through public and private monitoring. Monitoring, especially private monitoring, is enhanced through open information availability as well as through institutional design and implementation and the freedom to form into groups and organizations for this purpose.<sup>37</sup> Whether this monitoring function is effective depends not only on information availability but, of course, on quality of information as well.

Perhaps in no other industry is pervasive, reliable, timely information more important than in banking finance.<sup>38</sup> As critical an input as capital to banking, information

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<sup>34</sup> Boot and Thakor (1993) provide a model in which even a small amount of self-interest on the regulator's part, based on bounded knowledge of that regulator and a desire to show his worth, leads to sub-optimal outcomes.

<sup>35</sup> Kroszner (1999: 10-11) provides a great example of institutional design in his description of the effectiveness of Glass-Steagall in promoting a financial system in which different entities provided financial services and competed for government regulatory benefits. Germany, with its huge main banks, had no regulatory competition and did not develop the competing financial institutions. However, this did not protect the German banking system from dangerously excessive exposure to U.S. mortgage-backed securities and credit default swaps in the recent financial crisis.

<sup>36</sup> The gap between design and implementation (de jure and de facto) is critical to my argument that actions are more important than words. Barth, Nolle and Wanvimol (2007) show this significant gap in their analysis of GATS implementation by 123 countries studied, where agreement matters much less than action.

<sup>37</sup> In the interests of space, I do not explore this concept further here but take this as an accepted fact.

<sup>38</sup> It is beyond the realm of this paper, but an argument could be made that the information industry itself, and military actions, are subject to the same requirements. However the information industry deals in information, and military actions are not considered an industry, so I will leave this matter for future papers.

guides and monitors all interested economic actors: banks monitoring their clients through the public and proprietary information they gather and process;<sup>39</sup> banks are, in turn, monitored and regulated by governmental agents and monitored by private agents through information discovery;<sup>40</sup> government agents use the banks' information to manage the economy;<sup>41</sup> all interested actors monitor government's handling of the financial system and the economy through information from banks and about banks;<sup>42</sup> financial price discovery occurs through information about credit, money and capital markets.

As noted above, acquiring banks' seek out target banks for many reasons. A key reason is to gain access to those targets' embedded information. Acquiring banks must overcome informational opacity in the potential host country if they are to avoid losses. This informational opacity varies tremendously across countries. Part of support for encouraging financial liberalization generally and cross-border bank acquisition specifically was based on the expectation that global banks would remove some of the host countries' informational opacity because there would be more disclosure. This theoretical basis is now under attack from many quarters. Reasons for non-disclosure have included inability to actually determine what is in the banks system;<sup>43</sup> risk management failures;<sup>44</sup> unwillingness to disclose information;<sup>45</sup> and non-required disclosure.<sup>46</sup>

Directly supporting the idea that privately negotiated outcomes vary depending on institutional protection, Dyck and Zingales (2004) found that the company control premia

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<sup>39</sup> Rajan (1992); Rajan and Winton (1995); Claessens, Demirgüç-Kunt, Huizinga (2001); Boot (2000).

<sup>40</sup> Boot and Thakor (1993); Kane (2001); Kroszner (1999); Levy Yeyati and Micco (2003)

<sup>41</sup> BIS#4, #26; Cohen (1996); Hakenes and Nainz (2008).

<sup>42</sup> Barth, Caprio and Levine (2005); Haggard and Maxfield (1996); Stallings and Studart (2006); see also Beck, Demirguc-Kunt and Maksimovic (2005) policy suggestions at end of piece.

<sup>43</sup> See Ryan (2009); Ellul and Yerramilli, (2010); Economist (2009).

<sup>44</sup> See Ryan (2009); Ellul and Yerramilli, (2010).

<sup>45</sup> Morgenson and Story (2010); McCulley (2009).

<sup>46</sup> See Ryan (2009); McCulley (2009).

obtaining in the market increased as the ability of corporate owners to extract private benefits increased.<sup>47</sup> Their research provides a rough “price” on ownership of corporate control, indicating that as the capacity to engage in rent-seeking increases, the potential value of the company increases to an actor who can exercise ownership control over that company.

Insisting on more effective governance alone cannot change these rent-seeking tendencies. Publicly provided governance is an important part of regulation, but not a complete solution. Financial economists have proposed private monitoring as the answer. In their book, *Rethinking Bank Regulation: Till Angels Govern*, Barth, Caprio and Levine find that government regulation is considerably weaker even in systems where institutional foundations are solid: they argue that private monitoring provides an additional, necessary governance mechanism in effective regulatory regimes.<sup>48</sup> Private monitoring includes the ability of investors to shun banks or countries, depositors to vote with their feet, borrowers to look to other alternatives and auditing firms to issue critical opinions. Private monitoring may also discipline regulators by demanding more effective legal frameworks and better execution. Allowing the discipline of governance through improving corporate disclosure, privileging investor signals through market action, and generally improving rule of law are the most direct ways to address this problem, but are not the only ways and may not be feasible or completely effective. Pagano and Volpin (2005) have argued that politics is endogenous to political economy types; teasing out the effects of politics requires employing proxy measures for a country’s political economy type and the

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<sup>47</sup> Dyck and Zingales (2004) looked at merger premia obtaining in the sales of 393 controlling blocks of stock in 39 countries. This study may provide one source of my estimates for private control in the cross-border banking model.

<sup>48</sup> Barth, Caprio and Levine (2005).

institutional changes which occur in that country over time.

Again, I can only reiterate that this idea of reliance on private monitoring has come under extensive attack.<sup>49</sup>

#### **IV. Growing Big Banks, and the Too-Big-To-Fail Problem**

*“...there is one key difference between the situation today and that in the Middle Ages. Then, the biggest risk to the banks was from the sovereign. Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed.”*  
*Alessandri and Haldane, 2009*

Acting on public information and proprietary information which they gather through relationships with their clientele, banks allocate or withhold credit. To remain profitable, banks must also generate significant numbers of transactions based on these information sets and their capital base. Competitive pressures drive margins lower, thereby creating more incentive to grow transaction volumes; growing transaction volumes lowers cost-per-transaction in increasing returns-to-scale businesses, putting further pressure on margins as competition drives scalable products' prices lower.<sup>50</sup> Larger banks are thereby incented to grow larger, while smaller banks usually choose to focus on higher margin, local relationship business.<sup>51</sup>

Large banks' managers are incented to grow ever larger banks for more than simply business reasons, however. These incentives may also promote mergers. Bliss and Rosen (2001) found that bank CEO compensation increased at banks which grew through

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<sup>49</sup> See Ryan (2009); Ellul and Yerramilli, (2010); Economist (2009); Morgenson and Story (2010); McCulley (2009).

<sup>50</sup> As Berger and Udell (2006) note, different banking products have differing cost structures; some may show increasing returns-to-scale while others may not. Policy choices affect the profit structures of these products and the resulting industrial structure of the banking industry.

<sup>51</sup> Berger, Demirgüç-Kunt, Levine and Haubrich (2004) provide a comprehensive summary of this argument. Berger, Miller, Petersen, Rajan, Stein (2005) make a case that banks' organization form incentivizes bankers to lend to either SMEs or larger clients, so “function follows form”, thereby creating small and large banks.

mergers even when those mergers produced no shareholder value. Clearly growing a megabank delivers significant private gains to bank managers.<sup>52</sup>

In larger, developed economies, both large and small banks exist profitably, leading to a bifurcated industrial organization structure as in the United States.<sup>53</sup> Recent studies, like Hughes, Mester, and Moon (2001), found significant scale economies in risk diversification, thereby better explaining very large banks. Bossone and Lee (2004) find support for “systemic scale effects” in which larger financial systems enable financial services firms of a significant range of sizes to garner higher profit than similarly-sized firms in smaller financial systems. Ennis (2001) and others have noted several different models, based on informational costs, product differentiation, and other key factors, which explain the existence of small banks’ niches in financial systems like the United States. As noted, there are also strong political reasons for expansion.

Yet Berger and Udell (2006) note that large banks are empowered to compete in smaller banks’ SME markets through appropriate informational and transactional technologies.<sup>54</sup> Importantly, they note that much of the banking finance literature ignores the “chain” through which such lending technologies come into being, which includes government policies.

Whether large or small, banks and their managements garner significant economic and political power through their asymmetric information advantages. Knowledge of the

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<sup>52</sup> One should note Bliss and Rosen found significant stock ownership reduced this perverse incentive.

<sup>53</sup> Mester (2005) points out numerous previous studies “suggest that a single function may not be able to incorporate both large and small bank technologies or that some important factor that varies with bank size is excluded from the model.”

<sup>54</sup> On the one hand, Berger, Demirgüç-Kunt, Levine and Haubrich (2004) argue that “the literature is strongly consistent with the hypothesis that large banks tend to make hard-information-based transaction loans to larger, safer, more transparent borrowers, while small banks tend to make more soft-information-based relationship loans to smaller, riskier, more opaque borrowers.” [p. 437] On the other, Ennis (2001) suggests that, as the final barriers to horizontal (scale) and vertical (scope) expansion are gone in the U.S. banking system, integration may continue, leading to a Canadian model of very large banks and branching systems.

health of those industrial sectors and regions of the national economy to which a bank may lend is not only of interest to the government, but the government may sometimes seek to suppress informational transfer to other parties as well as to “guide” lending practices by the banks or to influence industrial policy through banks.<sup>55</sup> Much of the theory behind development states and even the concepts of development, revolve around banking policy as one might expect.<sup>56</sup>

While banks’ advantages, derived from non-public information, give them huge power, there is a price. Spanning demands for money across both space and time, banks are exposed to counterparty risks arising from both dimensions: the ever-present danger of a borrower failing and temporal exposure due to the danger that a sudden demand for deposits which may cause a run on the bank.<sup>57</sup>

Banking system fragility is endemic, and as banking has become more global, so have systemic risks to the global financial system. As noted above, the results of these crises are significantly deeper and wider than just in the world of finance. A cursory knowledge of banking systems reveals both developing and developed countries have experienced banking system problems.<sup>58</sup> Lowering the level of this systemic risk is a major motivating factor behind the actions of many national and international political actors. Policymakers attempt to factor these risks into their policy decisions about the financial system and the broader economy.

The near-collapse of Continental Illinois National Bank in 1984, and subsequent

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<sup>55</sup> Note that directing lending through public banks may be the most efficacious way to distribute funds in a well-governed economy with strong institutions, as Hakenes and Hainz (2008) point out.

<sup>56</sup> See, for instance, Geddes (1994); Haggard & Maxfield (1996); Stallings & Studart (2005); for the corruption aspects, see Kang (2003); Kessler (2000), among others.

<sup>57</sup> Diamond (1984); Diamond and Dybvig (1983); Song and Thakor (2006); Rajan (1992); Rajan and Winton (1995); Reinhardt and Rogoff (2009); Reinhardt (2009).

<sup>58</sup> Acharya and Richardson (2009); Alessandri and Haldane (2009); McCulley (2009); Barth, Caprio and Levine (2005); Rajan (1992); Rajan and Winton (1995); Reinhardt and Rogoff (2009); Reinhardt (2009).

testimony regarding the use of FDIC funds to assist the bank, indicated the presence of a too-big-to-fail policy (henceforth TBTF) in the eyes of U.S. regulators.<sup>59</sup> Thus began a frenzied debate about possible moral hazard engendered by TBTF; it has been argued that subsequent attempts to fix this policy problem through the 1991 passage of the Federal Deposit Insurance Corporation Improvement Act have not completely addressed the problem.<sup>60</sup> Both direct and indirect incentives exist which may drive banks, particularly U.S. banks, not only to acquire domestically but, in some circumstances, may encourage cross-border acquisitions. Banks might not only incur additional risk-taking given an implicit TBTF guarantee. Becoming TBTF may lower cost of funds, particularly on uninsured deposits, as noted by Mester (2005) and Hughes and Mester (1993).<sup>61</sup>

Additional, indirect benefits may be even more important still: Mishkin (2006) notes that TBTF may not be entirely accurate. Rather, “too politically important to fail” may be more accurate, particularly in emerging markets: “This is certainly true for emerging market countries, where bankers are particularly powerful, leading governments to bail out almost all banks.”<sup>62</sup> Whether banks can grow to become TBTF, or to be “too politically important to fail”, this adds up to banks’ possible willingness to pay more for such benefits. In a creative paper, Brewer and Jagtiani (2007) argue just that. Analyzing U.S. bank acquisitions between 1991-2004, they found those deals in which the combined bank “became TBTF” by growing assets to at least \$100 billion included, on average, \$14

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<sup>59</sup> Brewer and Jagtiani (2007); Mishkin (2006) gives a good review of the history and attempts to address the moral hazard issues created by an implicit TBTF through the 1991 passage of the Federal Deposit Insurance Corporation Improvement Act.

<sup>60</sup> Mishkin (2006) provides a survey.

<sup>61</sup> Interestingly this result is actually consistent with Stigler’s seminal AER article (1950), in which he argues that acquisitions leading to both monopolistic and oligopolistic may delay of entry by new firms, thereby allowing the larger firms to price at marginal cost and increases profits.

<sup>62</sup> Mishkin (2006) debates whether any bank is really TBTF, suggesting politics determines if bank failures are allowed or not. This is an interesting argument from someone with extensive government experience.

billion in added size premiums. They interpreted this to be the average amount paid to achieve TBTF status. In fact, Mishkin (2006) argues “too politically important to fail”, rather than TBTF, was the reason for the American S&L crisis of the 1980’s.

Hence we might argue that cross-border bank acquisitions may provide access to the political capital needed to gain political support.<sup>63</sup> This political support would not only enable banks to achieve policy goals, but also may make them too politically important to fail.

## V. Summing Up

Banks are inherently political institutions for five interrelated reasons: by virtue of dealing in that “commodity” by which all other goods are priced, money, banks are placed in a prominent political role; banking is at the epicenter of modern national and international economic systems; banks’ intermediation roles give them powerful informational advantages, and these information asymmetries engender economic and political power; governmental actors seek to channel, govern and sometimes manipulate this power; and banking systems pose great risk to not only their domestic economy but to the international economy as well.

Perverse incentives exist which encourage bankers who cannot self-discipline themselves to engage in self-dealing. Regulatory capture, paying themselves too much, and pursuing growth at all costs are pervasive problems; the present financial crisis is due in no small part to these problems.

An interesting recent article by Andrew Large, *Former Deputy Director, Bank of*

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<sup>63</sup> Of course, political protection may not always be there. The Argentine government’s treatment of foreign banks during the 2001-2003 crisis indicates this is not always the case; numerous other similar cases of obsolescing bargains exist.

*England*, analyzes how authorities might establish an effective macroprudential policy to retard and ameliorate financial crises. Establishing such an authority is fraught with difficulties, and Mr. Large cogently summed up the issue of effective multilateral governance for financial institutions: “Although policy delivery should ideally be on an international basis, the lack of global government makes this impractical to achieve.”<sup>64</sup>

Banking mergers and acquisitions provide significant insight into the politics of banking. Banking scholar Pennacchi (2000) cogently argued four possible reasons exist as to why banks merge: to increase efficiency; to expand regulatory benefits and access; to increase management’s private benefits; and to increase market power. Clearly politics is at the core of the last three.

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<sup>64</sup> Large (2010), p.200.

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