

in Bovensart Peters :

Success and Failure
in Public Governance

17. Managing innovation: regulating the banking sector in a rapidly changing environment

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1 BANKING: A SPECIAL SECTOR

Nowadays, everybody has come to rely on banks.¹ While four or five decades ago, the possession and use of a bank account were still restricted to the wealthier parts of the population, today, in an increasingly cashless economy, almost every citizen has and uses a bank account to pay their bills, receive their salary and manage their money. This is especially true in (but not exclusive to) the industrialized democracies. As a consequence, the safety of these deposits is a matter of the greatest political and economic importance, requiring that the state have a close eye on the banking industry.

But even apart from such – electoral – considerations, regulation of the banking industry is important, because banking is a special sector. Among the various sectors of an economy, it occupies a distinguished position. In the first place, it makes credit available to all the other sectors in the economy and to consumers; a well-functioning banking sector is thus a vital prerequisite for a well-functioning economy as a whole. Secondly, it is particularly vulnerable: the failure of a bank can have distinctly different consequences from the failure of a business in another sector of the economy and threaten the viability of the whole banking sector. The reason for this is as follows: if a normal business fails, it is very likely that a competitor will step in and take over the failed firm's business. In the banking sector, however, such a failure could lead to contagion effects, either because other banks are affected by the failure and become insolvent, or because the public, unable to distinguish between sound banks and the failed bank, loses faith. A *bank run* might ensue, with unforeseeable consequences for other banks which are in principle economically sound, endangering the payment system as a whole, with negative consequences for other economic sectors and generally high social costs.

As a consequence, banking is historically something most states have paid particular attention to. They have taken action primarily in two ways which are

related to the points mentioned above. On the one hand, they have tried to put the banking system to use for purposes of economic and structural policy. This can be done by influencing the allocation of credit and channelling resources into preferred sectors and tasks – a task made easier if the state owns significant parts of the banking system. On the other hand, they have tried to ensure the safety of deposits through regulation, with a view to securing the viability of the banking system as a whole – avoiding systemic risk – and the protection of individual deposits.

There are a number of ways in which a state can try to achieve these various aims, such as the following:

- taking over the whole or part of the banking system, allocating resources to preferred uses and implicitly guaranteeing the deposits;
- issuing legal directives or using other mechanisms to influence the allocation of credit;
- imposing capital controls to ensure the functioning of such directives;
- imposing a separation of activities between commercial banks and investment banks to limit risk;
- leaving banking in the private sector, but limiting competition through cartelization or the imposition of caps and limits on deposit and lending rates;
- setting up a mandatory system of deposit insurance financed by contributions from all banks which will pay out depositors in the case of a bank failure.

States have historically mixed these ingredients in different ways and to a different extent, reflecting different political preferences and motives for regulation, which created specific national systems of banking regulation. While for some of them macroeconomic considerations were the main reason for intervention – using it as an instrument in a Keynesian strategy or to influence the transmission of monetary policy – other countries' situations reflected specific historical experiences such as severe banking crises (or the absence thereof) or social policy concerns about the safety of small depositors' deposits.

All these interventions, however, also incur costs which can take on various forms: a decrease in economic efficiency in the case of socialization of the banking industry due to the – intended – limitation of competition; similar effects in the case of regulation of deposit and lending rates; and the danger of unintended consequences as a reaction to regulation. The latter can most evidently result in the case of deposit insurance: as the protection of deposits is ultimately provided by a bank's competitors, each bank has an incentive to commit 'moral hazard'. This is done by offering higher interest rates to its depositors, thus extending its share of the market, but requires on the other

hand higher interest income from loans, which can only be obtained by increasing the risk portfolio. Thus deposit insurance can lead to a changed situation in the market place and an accumulation of risks in certain banks.

2 CHALLENGES

Most of the aforementioned national systems were constructed in the time after World War II. This was a time when economic policy in most countries consciously imposed capital controls in order to control interest rates and thus manage the domestic economy as well as protect the new welfare state from capital flight induced by the burdens of social legislation (Helleiner, 1994, pp. 33ff). This situation hardly changed in the 1950s and 1960s, but was massively challenged in the following decades. It has been said that the 'internationalization and integration of capital markets has been the most significant change in the political economy of the industrialized countries over the past three decades. [...] No other area of the economy has been so thoroughly internationalized as swiftly as have capital markets since the 1970s' (Simmons, 1999, p. 36). After 1973, the breakdown of the system of fixed exchange rates – the system of Bretton Woods – altered conditions in international markets fundamentally. At the same time, the oil shocks of 1973–4 and 1978–9 plunged economies into recession and put enormous strain on the international financial system, while liberalization tried to lower the barriers to international exchange. Countries started to abolish the capital controls which had relied on the logic of a system of fixed exchange rates. While some started this process earlier than others, by the mid-1990s almost all OECD countries had completely removed all controls on capital movements (see the data in Simmons, 1999, p. 42; Freitag, 1999, p. 159). As a consequence, international bank lending – which had been low in the predominantly national financial systems – increased nearly twentyfold in the two decades after 1973 (Herring and Litan, 1995, p. 26). In the 1980s and 1990s, these developments were reinforced by the effects of computerization, the telecommunications revolution, the development of ever more sophisticated new financial instruments and increasing disintermediation.

As a result, the rules for conducting business, especially in financial markets, changed dramatically. New opportunities sprang up, but new risks as well. Competition in the banking industry increased, and at the same time margins in banking decreased. This was a major challenge for established systems of banking regulation in all countries to adjust to new circumstances. Given that by now most citizens – and no longer only the wealthy – held most of their assets in bank accounts and were threatened with bankruptcy in the case of failure, the situation also led to growing concerns about depositor protection (Gardener, 1992, p. 156). Liberalization brought new opportunities for bank

business which could increase their risk markedly. If banking supervision failed, bank failures and lost deposits could be the consequence. Thus the issues of financial liberalization and of banking supervision and regulation were directly linked, and if bank failures were to be avoided, the new risks demanded the finding of new ways of regulating banking (Franke, 1998, p. 293). What precisely these new ways would have to be, however, was uncertain. While change in the sector was *foreseeable*, its precise nature was unknown, making it *not controllable*.

Assessing the degree to which national systems of banking regulation managed to cope with the challenges just mentioned is the underlying question of the contributions in this part of the volume. Did the adjustment process succeed, or did it fail?

Clearly, not all countries in the world managed to meet the new challenges. In many of them, banking failures and crises ensued. The IMF has reported that no fewer than two-thirds of its 181 member countries have suffered from some kind of banking crisis in the period since 1980 (Lindgren *et al.*, 1996). These failures and crises have differed substantially in their severity, but some of them became very costly indeed.² The crisis of the savings and loans system in the United States, for example, cost approximately \$160bn, of which some \$130bn had to be borne by the taxpayer (Federal Deposit Insurance Corporation, 1997, p. 39). As a proportion of GDP, crises in some other countries were even costlier, as Table 17.1 demonstrates. This indicates that avoiding such costs may be a strong incentive for a country to get its regulatory system in order. But it also makes clear that the transition from an almost exclusively domestically oriented, strongly regulated financial system to one existing in an internationally oriented, deregulated system clearly had a distributive side to it as well. It was by no means only a technicality. Besides the bailout costs in case of failure mentioned above, there were consequences for borrowers and consumers, for example through the switch from fixed- to variable-rate loans and mortgages. Especially under conditions of high and variable inflation such as were prevalent in the 1970s and early 1980s, risk-averse borrowers could be adamantly opposed to such a change. This opposition could be picked up by interest groups and political parties and thus influence the political process shaping the transition.

Table 17.1 Costs of banking crises as a percentage of GDP

USA	3.2
Finland	9.9
Spain	15.0
Chile	33.0

Source: Dziobek and Pazarbaşıoğlu (1998, p. 4).

3 THE CASES UNDER CONSIDERATION

This section will try to give an overview of fundamental characteristics of the banking and financial systems in the countries under consideration in this study. This is done in a comprehensive manner in this place mainly in order to save space in each individual contribution, but also to facilitate comparison between the national systems.

We will first look at the characteristics of the banking systems, before assessing differences in the regulatory systems and then discussing the differences.

Types of Banking Systems

In the literature, a number of attempts to classify national financial systems exist. Most of them agree on a main distinction between *capital market*-based and *bank*-based systems according to the main source of finance for enterprises (for example, Zysman 1983; Cox, 1986; Story and Walter, 1997). With respect to the latter category, an additional distinction is often made relating to the role the state plays in the price-setting process. Among the countries covered in this study, only the United Kingdom can be classified as a capital market-based system, while Germany and France are counted among the bank-based systems (with the state playing an important role in the latter), along with the other continental European systems. Furthermore, banking systems are usually classified according to the sort of business they are allowed to take on. Here the main distinction is between a *universal bank* and a *specialized bank* (cf. Canals, 1997). The reason for such specialization can lie either in legal regulation (as in the United States) or in historical development, as is the case in the United Kingdom, where a banking system characterized by a clear functional differentiation primarily between commercial and investment banks has emerged as a product of self-imposed constraints and restrictive practices (cf. Llewellyn, 1992). The banking systems of France, Germany, the Netherlands, Spain and Sweden, can be classified as universal banking systems where banks may conduct business that can include deposit, lending, discount, securities, guarantee and checking activities. Only in the case of Sweden are there some regulations limiting banks' business concerning the areas of real estate business and investments in non-financial firms (Barth *et al.*, 1997, Table 5).

On theoretical grounds, the literature seems inconclusive on whether a universal bank system or a specialized bank system is preferable with respect to risk and safety of deposits. On the one hand, it is argued that universal banks may be less efficient than their specialized counterparts, thus increasing the risk of failure and therefore default. Furthermore, circumstances can be modelled where universal banks are particularly prone to moral hazard which

may increase the obligations of deposit insurance in the case of failure over those incurred in a specialized banking system (Canals, 1997, pp. 127–32; Boyd *et al.*, 1998). On the other hand, specialized banks may run an inherently greater risk of default because their revenues are less diversified than those of universal banks, either sectorally or geographically, posing a threat to them in the case of a recession. Since an optimal allocation of risk is impossible, they run a higher risk of failure (Canals, 1997, pp. 127–32; Herring and Litan, 1995, pp. 52–61). Unfortunately, empirical examples can be found for both positions, so that no general statement seems possible in this respect.

It has to be stressed that these classifications have to be treated with some degree of caution anyway, for most of the data on which the above-mentioned classifications rest are somewhat dated, so that their merits are probably open to some debate. Also, they do not take into account historical developments and change. But above all, as was stressed before, the whole banking industry has been in a process of considerable structural change, which ultimately may well render some of those distinctions negligible. As will be seen in more detail in the studies that follow, some states have made considerable attempts at strengthening the role capital markets play in their economy. The French state, for example, in the 1980s very actively tried to overcome the system of specialized banks imposed originally by the Banking Act of 1941 and create a system of universal banks. As a result, it can be classified as a universal bank system, but only since 1984. Over the same period, France has seen the – previously dominant – share of credit provided by the banks decrease substantially owing to a process of disintermediation, moving it away from the bank-based type (see Coleman, Chapter 18, below, and Klein, 1991, p. 37). In addition, more detailed empirical research indicates that classification on the national level hardly seems appropriate since it neglects the substantial differences existing within countries, such as between firms of different sizes (Sauvé and Scheuer, 1999). Thus the classifications summarized in Table 17.2 can only serve as a very rough guide to distinguish the systems.

Institutions of Banking Supervision

Contrary to financial systems, no attempts have been made so far to classify regulatory systems. It used to be possible to distinguish broadly between two groups of countries (cf. Pecchioli, 1989, p. 45), namely those where banking supervision was conducted in an informal way and essentially without legal regulations, and those with a formal system of banking supervision with detailed legal regulations.

While the former group comprised countries such as Australia, Canada, New Zealand and the United Kingdom, the latter consisted of Japan, the countries of continental Europe and the United States. Factors such as the nature of the

Table 17.2 Characteristics of financial and banking systems

	FRA	GER	NL	SPA	SWE	UK
Financial system type	bank universal	bank universal	bank universal	bank universal	bank (universal)	capital mkt specialized
Banking system type	69.9%	18.4%	74.4%	56.8%	n.a.	38.4%
Market concentration						

Note: Market concentration measured in percentage of client deposits in top five banks, 1989.

Source: Valdez (1993).

Table 17.3 Characteristics of supervisory systems

	FRA	GER	NL	SPA	SWE	UK
Agency in charge	Commission bancaire	FBSO, Central bank	Central bank	Central bank, treasury	FSA	Central bank
Deposit insurance established	compulsory 1980	voluntary 1966	compulsory 1979	compulsory -1977	compulsory 1974	compulsory 1982
run by	industry	industry	government/industry	government/industry	government	government
Coverage (in 1995 US\$)	80 000	30% of bank's equity	25 000	12 000	35 000	28 000

Source: Barth *et al.* (1997).

legal system, the number of banks and the degree of concentration of the banking system played a role in structuring the regulatory system. Over the last two decades, however, most countries have switched to a more formalized mode of conducting banking regulation. Nevertheless, there are still substantial differences between the national systems, both with respect to institutional factors and to the way in which legal regulations are being handled. An overview is given in Table 17.3.³

The institutionalization of banking regulation in the countries considered seems to differ most prominently with respect to the role played by the central bank. It is either exclusively in charge (Netherlands and United Kingdom), shares responsibility with another agency (Germany, Spain and France) or is not involved at all (Sweden). Since the demands of monetary policy may conflict with those of banking regulation (for example, if raising interest rates is avoided because that might negatively influence the viability of a number of banks; or if the pursuit of tight monetary policy causes banks to fail), this might be an important aspect and, as the cases of Sweden and Spain in this sector show, it indeed is.

Different Approaches to Economic Policy

While we have so far primarily looked at institutional characteristics, it may be much more helpful to distinguish between two kinds of concerns driving the behaviour of public officials and policy makers: those focused on *macro-economic* objectives and those concerned with the *microeconomic* characteristics of financial markets. The experiences described in the case studies may be classified as falling somewhere on a continuum with those dominated by macroeconomic problems and dynamics at one end and those driven primarily by microeconomic dynamics at the other. Such an approach not only highlights an important dimension in the changes experienced by national financial systems, but also helps to explain the differing perspectives taken in the individual contributions.

The cases of *Sweden* and *Spain* are located at the *macro* end of that scale. They are similar in that they both originally had banking systems which were instrumentalized by the state to achieve goals of macroeconomic policy. In Sweden, the state also owned significant parts of the banking system, which was an additional help. In both cases, attempts were made to reform this system for reasons of improved control over monetary policy – and it comes as little surprise that in both cases the respective central banks were the driving force behind the reforms. In either case, the macroeconomic strategy changed: in Spain, to shed the legacy of the Franco era and prepare the country to profit from the integrated European financial market; in Sweden, to turn a highly regulated and largely isolated financial system into a liberal and open system.

As a result, the two case studies adopt a macro-oriented perspective and a systemic approach, which is fitting, because the problems that arise in both cases are of a systemic kind as well.

France probably has to be positioned somewhere in the middle of the continuum, for here sectoral considerations drove state activity (with a view to positioning French banks in the coming European financial market). But the French macroeconomic policy machine had already been reformed before: the banking sector played no important role, and capital and credit controls had been lifted. Accordingly, the problems encountered were not of a system-wide nature, but surfaced at *Crédit Lyonnais*, the state-owned bank that was instrumentalized to push the strategy.

The Dutch case is similar to the French in that the government tried to influence and encourage the consolidation of the banking industry by means of structural policy. It refrained, however, from detailed intervention, not least because it lacked the means, like a bank comparable to *Crédit Lyonnais*. But it was also spared comparable disasters.

The *United Kingdom* had been a case on the *macro-oriented* end of the spectrum until the 1970s. But already in the early 1970s, it pursued a change of strategy by deregulating its banking sector – interest rates – and abolished all capital controls in 1979 (Vogel, 1996, p. 66). It thus underwent a change during an early phase, which was completed and codified in the 1979 Banking Act. While some problems occurred after 1973 (the ‘Secondary Banking crisis’), they were of a minor character. Since then, the UK has been a liberal system forgoing capital and credit controls, in which the banking system was not instrumentalized for macroeconomic purposes.

In *Germany*, such an attempt had never been made since World War II. Germany had already abolished all capital and interest regulations by the late 1960s. It has thus to be placed at the *micro-oriented* end of the spectrum from the beginning. In both the latter cases, the perspective adopted by the contributors is one focusing not on the banking system, but on individual cases of failing banks and the way the political system coped with this failure.

4 ASSESSING SUCCESS AND FAILURE

Since the individual chapters will have to assess success or failure of the policy episodes under consideration, there are obviously common indicators needed. These indicators have to be of a nature compatible with the widely varying institutional and other characteristics of the systems under consideration. Three main indicators have been suggested to the authors of the case studies to assess the *programmatic* dimension of success or failure: (a) bank failures (both the number of failed banks and their assets in proportion to those of the whole

banking system), (b) costs of bailing out (both in absolute terms and as a percentage of GDP), and (c) the time point of state intervention (early or late intervention).

There are some ambiguities with these indicators, however. With respect to bank failures, there is a problem if a bank does not openly fail, but is being taken over by or merged with a competitor. It can be argued, however, that the latter case does not constitute failure with respect to governance, since market exit is a common – and necessary – feature in market economies. Thus a bank failure is determined only when a bank crashes with losses to one or several parties, not in the case of a merger which saves a bank which would otherwise have failed.

With respect to the costs of bailing out, the problem is that they may be hard to find out in cases where deposit insurance is organized along private lines and not by the state – as in the German case. It should, however, be possible to assess whether substantial costs have been incurred, for example by looking at the premia banks have to pay for deposit insurance.

A further word of caution is necessary. While such indicators may help to structure the assessment, the concrete case studies demonstrate that the authors must be given considerable latitude in rating their cases. Failure does not show up in each of the indicators alike as they may pick up different variants of crisis. In the Swedish case, for example, no bank failed, owing to state aid, which on the other hand proved very costly, causing the author to rate it as failure.

In assessing the *political* dimension of success or failure, the authors will look at such things as ministerial resignations, official inquiries, public trials and the like. While these are obviously only relevant in the case of programmatic failure, we find an obvious asymmetry here between losses in terms of money and political consequences. As was demonstrated above and is shown in more detail in the respective case studies, very considerable costs had to be borne by the public sector in the cases of Spain, Sweden and France.⁴ But, in spite of that, no substantial political fall-out was noted apart from a number of public reports (in the case of France, not even that). In terms of political victims per public money lost, this certainly begs explanation. The reason, I would suggest, can be found in the low degree of politicization of the financial sector. This is a policy area that is commonly held to be very 'technical', accessible only to 'experts' and thus lacking in transparency. Since programmatic measures in such fields are usually uncontested because of their technical nature, they are unlikely to become the subject of political controversy after the fact. In addition, politicians are often shielded from having to accept responsibility because that is delegated to subordinated authorities which can be blamed in the case of failure. Often, however, as the case studies show, there is little public interest even in an inquiry about the reasons for the failure. It may be that the characteristics of the field are such that there are simply no 'frames' (Schön

and Rein, 1994) available to politicize it.⁵ On the other hand, the fact that a small policy community dominates the field may also play a role, for the people that perform the post mortem, conduct the inquiries and write the reports are often close to or even the same people that initiated the failed reforms in the first place (particularly evident in the cases of Britain, France and Spain). Dealing with failure is also made easy if 'rogue traders' can be singled out that have overstepped their brief or acted in a fraudulent manner, as occurred in the (much more limited) failures in the German and British cases: if these individuals can be blamed, then no systemic and political questions need to be asked. Lastly, it should not be forgotten that, even if losses had to be covered, it was precisely in the nature of deposit insurance that potential political crises were diffused: the depositors were more or less completely covered and the – often substantial – amounts were spread very evenly and non-transparently over time and over the electorate.

5 EXPLAINING SUCCESS AND FAILURE

In a way, it is much easier to explain failure, not only because there is a substantial literature on it (see Bovens and 't Hart, 1996; Bovens *et al.*, 1998), but also because the degree of change and innovation in the field was so enormous that failure seems in a way natural. But why then did some countries *not* fail? In the literature on financial regulation, it is readily admitted that description and analysis of the processes and consequences of liberalization 'are in their infancy' (Quinn, 1997, p. 531).⁶ But we can offer some speculations. On the basis of the studies in this section, it seems that the probability of failure increases with the degree and speed with which the parameters of the environment changed. This was particularly strongly the case in Sweden and Spain and to some extent in France, where changing conceptions of policy multiplied the shocks coming from a changing international environment. The addition of both effects was apparently more innovation than the systems could handle properly. In the British and German cases, the systems could concentrate on the external challenges, leaving more time and capacity to cope with them.

Evidently, there is also a correlation between the *micro-macro* classification proposed above and the 'success' rate of the cases: the failures tend to lie in the macro cases, the successes in the micro cases, with France falling in between in both aspects. The macro cases can also be described as the 'latecomers' to the consensus that has emerged with respect to the conduct of macroeconomic policy, and it comes as little surprise that adaptation proved costly.

In terms of the relevant policy actors, another interesting distinction emerges. Here it seems that the number of relevant policy actors is inversely correlated

to the probability of failure. In Sweden and Spain, the reforms were initiated and pushed through by the respective central banks,⁷ who pursued their goal of increasing control over monetary policy without much concern for side-effects and possible collateral damage. Central banks have been identified in the literature as the typical 'epistemic communities' prompting ideational change in economic policy (cf. Haas, 1992), and it therefore comes as little surprise that they would be the agents to implement the emerging macroeconomic consensus in their countries. In contrast, the successful cases of Germany and Britain (and to a degree France) are characterized by policy networks which have been described as (meso-) corporatist, where a greater number of actors – such as industry associations – are involved in policy formulation and often implementation. In addition to the fact that there was less 'to reform' in these countries, innovation was easier to handle and progressed at a slower pace. Finally, it should be noted that, even in the cases classified here as failures, there were no policy reversals.

A final remark concerns the role of the European Union. Contrary to the case studies in, for example, the steel sector, the EU (or its predecessor, the EC) has not played a very prominent and active role in these sectoral studies. Why is this? I would argue that the major challenges in this sector came up at an early stage, before European institutions started playing an important role in this field (which arguably was the case with the Second Banking Directive of 1989). Prior to this, interaction in this field was primarily of an intergovernmental character with little influence from the Commission, and countries had to cope with their problems themselves. Indirectly, however, European integration played an important role by favouring liberalization and shifting the objectives that inspired state authorities, most clearly in the French and Spanish cases, where the impending integrated financial market prompted reforms, and probably also in the Swedish case, although here internationalization may better characterize the driving force than Europeanization. In addition, it becomes clear that, even after the adoption of the Second Banking Directive, we have not seen the abolishment of nationally specific institutional set-ups of banking supervision, because harmonization of regulatory content does not necessarily need harmonization of institutional structures. Whether we will see it in the future remains open. While the European Central Bank was not given specific tasks in banking supervision in the Maastricht Treaty, the argument for a single bank supervisor in the Eurozone can still be made. Furthermore, national central banks such as the Bundesbank, bereft of their powers in the field of monetary policy, may be looking for new tasks in the field of supervision. It will thus certainly be interesting to watch developments in this area in the future.

6 GLOSSARY

Capital controls

Limitations on the free movement of capital across borders. Originally imposed in many countries as a reaction to collapsing financial markets to stabilize currencies and prevent capital flight in the early 1930s, they were kept in place in the Bretton Woods system to facilitate management of the domestic economy and the exchange rate. The collapse of the system of fixed exchange rates and the growth of offshore markets led to the gradual abandonment of capital controls from the mid-1970s. Today, almost no capital controls exist in OECD countries.

Derivative

An asset or security whose value is derived from another basic variable which is called the basis. The basis can, for example, be a stock or commodity price, an index or an interest or exchange rate. The value of the basis at a particular point in time determines the value of its derivative products which have names such as options, forwards, futures, swaps or warrants. Ever more sophisticated and complicated derivatives have been developed over the last two decades in financial markets with the main aim of managing risk.

Disintermediation

Change in financial relationships characterized by decline of the role of banks (intermediaries) and an increase in the direct relationship between the ultimate suppliers and users of financing. An example would be companies lending funds directly to each other or issuing bonds and selling them directly to savers. The likelihood of further disintermediation may impose limits on authorities' abilities to impose controls and regulations on financial intermediaries.

Macroeconomic policy

Economic policy aimed at influencing economic aggregates such as the rate of growth or inflation or the level of unemployment.

Microeconomic policy

Economic policy aimed at influencing the efficiency of certain markets in an economy, for example by altering regulations.

Monetary tightening

A move towards a more restrictive monetary policy by the central bank, generally by raising interest rates. This may put a squeeze on banks' profits, as market conditions may force them to raise the rate they pay to their depositors, while their income from outstanding loans remains constant.

Moral hazard

The presence of incentives for individuals to act in ways which maximize their own utility while incurring costs that they do not have to bear. For example, the owner of a car that is insured against theft has less incentive to be careful to protect it. In case of a theft, the costs are borne by the insurance community.

Oligopsony

A market which is dominated by a few large buyers with consequently great influence on the setting of market conditions such as price. It is the demand-side equivalent of an oligopoly and thus another deviation from perfect competition.

Regulation

Governmental actions to control price, sales and production decisions in order to protect the public interest. Measures include, for example, the required certification or licensing of products, the setting of safety or environmental standards and the provision of antitrust laws.

Second banking directive

A European Community directive of 1989 which is part of the Single Market (1992) programme. It introduced the 'single passport' principle, which meant that all banks licensed to do business in one country of the EC could do business in any other member country. Banks are supervised according to the 'home country control' principle, which required further harmonization such as the own funds directive and the solvency directive to make regulation comparable across the EC.

Self-regulation

Execution of regulatory tasks by producers of goods or services themselves, often to prevent the imposition of regulation by state authorities.

Specialized banking system

A system in which individual banks specialize in certain banking activities and do not offer the full range of them. In the Anglo-Saxon tradition, for example, investment banks and brokerage firms deal with stocks and securities, while deposit taking and lending is performed by retail banks. Such a specialization can either develop historically, as in Britain, or be imposed by law, as in the United States.

Universal banking system

The opposite of a specialized banking system where individual banks engage in all sorts of banking business, from deposit taking to brokerage. Such banking systems are traditionally found in continental Europe, most notably in Germany and Switzerland.

NOTES

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2. Comparative data on banking crises can be found in Caprio and Klingebiel (1996), Dziobek and Pazarbaşıoğlu (1998) and Goodhart *et al.* (1998, ch. 1).

3. The information given here relates to the time covered in the contributions in Part IV of this volume, namely the mid-1970s until the mid-1990s. It should be noted, however, that in the meantime changes have occurred in some countries, most notably in the UK, where responsibility for banking supervision was transferred from the Bank of England to the new Financial Services Authority (FSA) in 1997.
4. In the British and German cases, no public money had to be paid and no deposits were lost.
5. An interesting counterexample is provided by the case of 'Black Wednesday' (October 1992), when the British pound had to leave the ERM: while the technical details of exchange rate policy are just as arcane as those of banking supervision, this case was politically disastrous. Of course, sterling's membership in the ERM was hotly contested, and currency policy, with its association with national sovereignty, is 'high politics'.
6. The analysis of Demirgüç-Kunt and Detragiache (1998) which claims to give answers is in fact of little help, as it suffers from simplistic operationalization of variables and evident selection bias.
7. This is, by the way, an interesting contrast to the British case mentioned above, where policy change was to a considerable degree prompted from outside, through the IMF in 1976.