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Bank regulation and efficiency: What works for Africa?

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ABSTRACT

We use a new dataset on regulation and supervision in 42 countries to study the relationship between the regulatory framework and bank efficiency in Africa. Specifically, we examine how bank efficiency is influenced by requirements related to (i) Overall capital stringency, (ii) Restrictions on entry into banking, (iii) Restrictions on bank activities, (iv) Transparency requirements, (v) Restrictions on exit from banking, (vi) Liquidity and diversification requirements, (vii) Price controls (financial repression), (viii) Availability of financial safety nets and (ix) Quality of supervision. We find that increased availability of financial safety nets to have efficiency-enhancing effects for African banks. We also find that the effect of some bank regulation in Africa is highly dependent on the size and risk level of the bank. Specifically, our results suggest that more stringent restrictions on entry increase the efficiency of large banks, while restrictions on exit reduce the efficiency of small banks. Similarly, high-risk banks benefit, in terms of efficiency, from increased restrictions on entry whereas low risk banks do not benefit from increased restrictions on exit. Our results also suggest that small banks are the main losers from increased transparency requirements and price controls while more stringent capital requirements only enhance the efficiency of large banks and low risk banks. Overall, our findings support the argument that regulation should be adapted to the risk and size level of the institutions that are being regulated.

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1. Introduction

The 2008 global financial crisis has prompted a renewed interest in banking regulation and supervision to safeguard global financial systems. As a result, a number of reforms of the financial regulatory framework have been agreed internationally, most notably the Basel committee on banking supervision's reform package known as Basel III (Basel Committee on Banking Supervision, 2010a,b). While there is growing empirical evidence documenting the relationship between bank regulation, supervision and stability, there is still limited evidence, on the effect of the regulatory environment on bank efficiency. Notably, there is, yet, no consensus on the theoretical benefits of more stringent regulation and supervision on bank efficiency and performance.

Indeed, on the one hand, the public interest view suggests that official supervisors have the capabilities to eliminate market failures by directly monitoring and regulating banks. By doing so, tight regulation and supervision reduce corruption in lending, improve the efficiency of capital allocation, encourage competition and hence boost the efficiency of banks (Stigler 1971; Beck et al., 2006). Conversely, the private interest view (Shleifer and Vishny 1998; Djankov et al., 2002; Quintyn and

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Taylor 2002) suggests that powerful regulation and supervision are likely to lead to corruption in lending which impedes banking efficiency. According to this view, politicians and government supervisors maximize their own welfare and may not have incentives to fix market failures. They will rather use the regulation and their privileged positions to channel credit to special interest groups, such as politicians.

Available empirical studies use accounting ratios or frontier techniques to explore how regulation affects bank efficiency and performance (Chortareas et al., 2001; Ben Naceur and Kandil, 2009; Ben Naceur and Omran, 2011; Pasiouras, 2008; Barth et al., 2013a,b; Demirgüç-Kunt et al., 2004); Development and soundness of the banking sector (Boudrigua et al., 2009; Barth et al., 2001, 2004); and Bank risk level (Bourgain et al., 2012; Klomp and De Haan, 2011; Demirgüç-Kunt and Detragiache, 2011). This literature uses measures for regulation that are based either on the level of adherence to the core principles for effective bank supervision published by the Basel committee,[1] or data from the seminal survey conducted in 1999 by Barth et al. (2001).[2] Overall, the existing empirical findings did not help reach a consensus on this debate.

Our paper builds on this existing literature by providing an empirical assessment of the relationship between bank efficiency, regulation and supervision practices in Africa. Our contribution to the literature is twofold. First, we explore new aspects of the regulation that were not studied before in the literature such as restrictions on exit from banking and price controls. This was possible thanks to our original database based on a survey conducted by the African Development Bank in collaboration with the Making Finance Work for Africa Partnership to describe the regulatory and supervisory environment in Africa. The database covers 46 African countries and provides a snapshot of existing regulation in Africa in 2010.[3] To the best of our knowledge this is the first time this survey is used in the empirical literature and this allows us not only to explore new aspects of bank regulation but also to have a better coverage of African countries and to conduct tests on this topic using another dataset than the Barth et al. (2001) widely used in the literature. Second, we are the first to document how the relationship between bank regulation and efficiency is affected by the size and risk of banks. Previous studies look at only one of these dimensions without any consideration for the other (e.g., Barth et al., 2013a,b; Berger and Bouwman, 2013 for size and Chortareas et al., 2001 for risk). Studying the effect of size and risk (separately and jointly) allows a better understanding of how these characteristics affect the way regulation and efficiency interact with each other. Available empirical evidence suggests that the relationship between Bank regulation and efficiency in Africa may be different from other regions. Indeed, it has been well documented in the literature that the level of economic development and institutional settings influence the way regulation affects bank efficiency, development and stability. For instance, Chortareas et al. (2001) find that tighter capital requirements and empowering supervisors lead to enhanced bank efficiency mainly in developed countries. The relationship is inverted when a sample of less developed countries is used.

Studying Africa is of particular interest for policy purposes. Following multiple episodes of banking crises during the 80's and the 90's, most African countries implemented reforms to align their practices with international standards with the expectation that this will enhance banking system efficiency and stability and consequently promote economic development. Largely as a result of these reforms, fragility in African banking systems subsided.

Yet African countries are increasingly criticized for preventing the continent from delivering greater financial development and inclusion because of their conservative approach to regulation. Beck et al. (2011) argue that Africa should adopt a different approach to regulation based on a"best fit" rather than a "best practices" approach. Therefore, it is important to empirically examine which regulatory practices are associated to better efficiency outcomes in the African context to inform future reforms and help the continent reap off the growth enhancing effects stemming from well-functioning banking systems. The results could also be useful to inform policy makers in other developing regions facing similar challenges to Africa.

Our results show strong variations in the relationship between regulation and bank efficiency in Africa; and these variations are very often influenced by the risk level and size of banks. We find that the efficiency of large African banks improved with tighter restrictions on entry whereas the efficiency of smaller banks is hindered by tighter restrictions on exit. Similarly, high-risk banks benefit from increased restrictions on entry whereas low risk banks do not benefit from increased restrictions on exit. Moreover, the availability of financial safety nets seems to have positive effects on bank efficiency. These results hold for different bank size and risk groups we consider. Our results also suggest that financial repression through price controls negatively affects the efficiency of small banks only regardless of their risk level. A similar conclusion is found for increased transparency requirements. We also find that more stringent capital requirements only enhance the efficiency of large banks and low risk banks. Overall our findings support the risk proportionality approach in regulation and a departure from the "one size fits all" approach that has been used so far in Africa.

The remainder of the paper is structured as follows. Section 2 summarizes the relevant literature for our work while Section 3 provides a brief overview of the African Banking system with a particular focus on recent regulatory changes and reforms. This section aims at providing the reader with a good understanding of the environment under study in this

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[1] The Basel Committee on Banking Supervision developed a set of principles as a guide for best regulatory and supervisory practices in the banking sector also known as the Basel Core Principles (BCP). The BCP aspire to improve banks' efficiency and soundness along with preventing major crisis in the sector.

[2] The latter was updated 3 times in 2001 and 2006 and 2011, providing the most comprehensive snapshot of bank regulation and supervision around the world. The 4 rounds of surveys provide a snapshot of bank regulation and supervision respectively in 1999, 2002 and 2005/2006 and 2011/2012. They respectively cover 118, 151, 143, and 142 countries. Their coverage of African countries is as follow: 16, 35, 32, and 31.

[3] Our dataset for regulation covers 46 countries but out tests use 42 African countries because 4 countries were lost due to missing data to calculate necessary variables for our regressions.

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