Why Banking Systems Succeed—and Fail

The Politics Behind Financial Institutions

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People routinely blame politics for outcomes they don't like, often with good reason: when the dolt in the cubicle down the hall gets a promotion because he plays golf with the boss, when a powerful senator delivers pork-barrel spending to his home state, when a well-connected entrepreneur obtains millions of dollars in government subsidies to build factories that will probably never become competitive enterprises. Yet conventional wisdom holds that politics is not at fault when it comes to banking crises and that such crises instead result from unforeseen and extraordinary circumstances.

In the wake of banking meltdowns, one can rely on central bankers, Treasury officials, and many business journalists and pundits to peddle this view, explaining that well-intentioned and highly skilled people do the best they can to create effective financial institutions, allocate credit efficiently, and manage problems as they arise but that these Masters of the Universe are not really omnipotent. After all, powerful regulators and financial executives cannot foresee every possible contingency and sometimes find themselves subjected to strings of bad luck. Supposed economic shocks that could not possibly have been anticipated destabilize an otherwise smoothly running system.

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According to this view, banking crises are like Tolstoy's unhappy families: each is unhappy in its own way.

This conventional view is deeply misleading. In reality, the same kinds of politics that influence other aspects of society also help explain why some countries, such as the United States, suffer repeated banking crises, while others, such as Canada, avoid them altogether. In this context, "politics" refers not to temporary, idiosyncratic alliances among individuals but rather to the way a society's fundamental governing institutions shape the incentives of officials, bankers, bank shareholders, depositors, debtors, and taxpayers to form coalitions with one another in order to shape laws, policies, and regulations in their favor—often at the expense of everyone else. A country does not choose its banking system; it gets the banking system it deserves, one consistent with the institutions that govern its distribution of political power.

THE GAME OF BANK BARGAINS

One obvious way to underline how politics influences the stability of banking systems is to note that some countries have had lots of banking crises whereas others have had few or none. Consider the records of the 117 countries that have populations in excess of 250,000, that are not current or former communist countries, and that have banking systems large enough to report data on private credit from commercial banks for at least 14 of the 21 years from 1990 to 2010. Only 34 of those 117 countries (29 percent) avoided crises entirely between 1970 and 2013. Sixty-two of those countries had one crisis. Nineteen experienced two. One underwent three crises, and another weathered no fewer than four crises. In other words, countries that underwent banking crises outnumbered countries with stable banking systems by a ratio of more than two to one.

To remain competitive, modern economies need to establish banking systems capable of providing stable access to credit to talented entrepreneurs and responsible households. Why are such systems so rare? How can it be that a sector of the economy that is highly regulated and closely supervised works so badly in so many countries? The crux of the problem is that all governments face three inherent conflicts of interest when it comes to the operation of their banking systems. First, governments supervise and regulate banks while looking to them as sources of government finance. Second, governments enforce the credit contracts that discipline debtors on behalf of banks while

relying on those debtors for political support. Finally, although governments must spread the pain among creditors in the event of bank failures, they also simultaneously look to the most significant group of those creditors—bank depositors—for political support.

The property rights system that structures banking is thus the product of political deals that determine which laws are passed and which groups of people have licenses to contract with whom, for what, and on what terms. These deals are guided by the logic of politics, not the logic of the market. The fact that the property rights system underpinning banking systems is an outcome of political deal-making means that there are no fully private banking systems; rather, all modern banking is best thought of as a partnership between the government and a group of bankers, and that partnership is shaped by the institutions that govern the distribution of power in the political system. Government regulatory policies toward banks reflect the deals that gave rise to that partnership, as well as the power of the interest groups whose consent is politically crucial to the ability of the factions in control of the government to sustain those deals. Banks are regulated and supervised according to technical criteria, and banking contracts are enforced according to abstruse laws, but those criteria and laws are not created and enforced by robots programmed to maximize social welfare; they are the outcomes of a political process.

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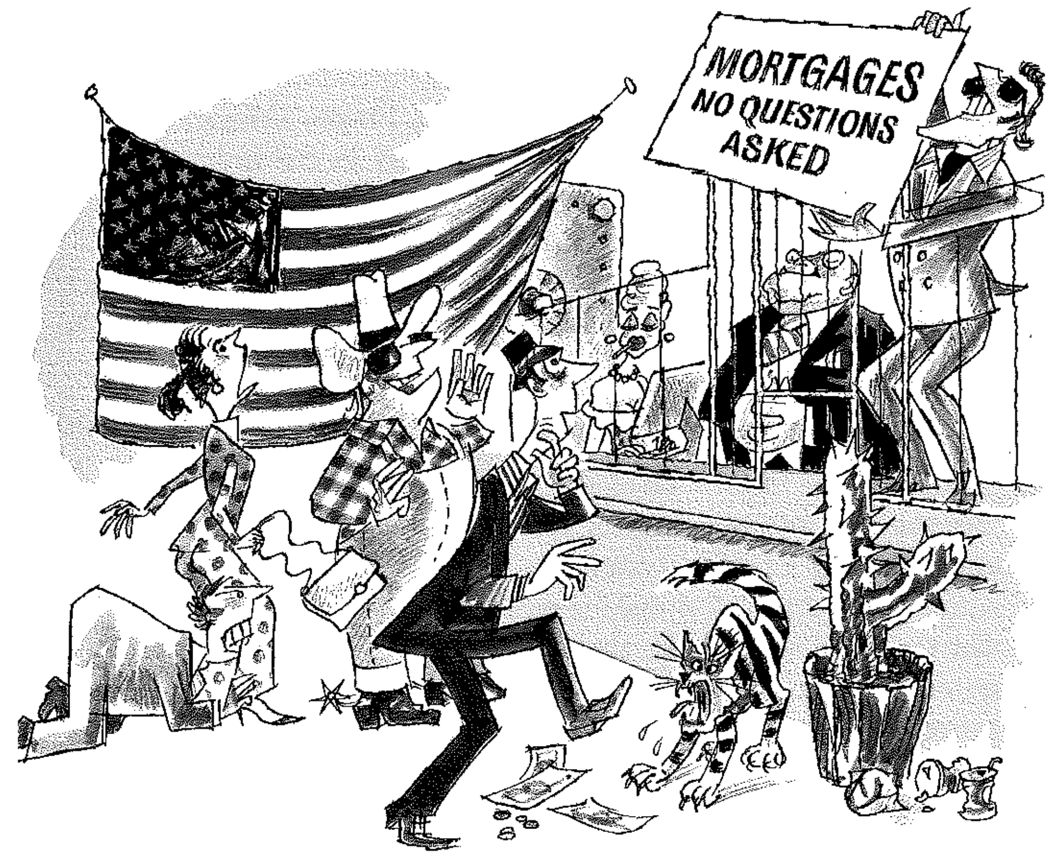
Call it the Game of Bank Bargains. The players in the game are the actors with a stake in the performance of the banking system: the group in control of the government, bankers, shareholders, debtors, and depositors. The rules governing play are set by the society's political institutions: those rules determine which other groups have to be included in the government-banker partnership, or, alternatively, who can be left out because the rules of the political system render them powerless.

Coalitions among the players form as the game is played, and those coalitions determine the rules governing how new banks are created (and hence the competitive structure and size of the banking sector), the flow of credit and its terms, the permissible activities of banks, and the allocation of losses when banks fail. What is at stake in the



Game of Bank Bargains is, therefore, the distribution of the benefits that come from maintaining a system of chartered banks.

Contrary to the way debates about banking are generally framed, the focus should be not on whether banks require more or less regulation but rather on the goals that give rise to regulation and the way those goals are shaped by political bargains. In some countries, the institutions and coalitions combine to produce regulation that improves market outcomes. In other countries, they establish regulations that primarily serve special interests, often with disastrous consequences for the rest of society.

One way to understand the intersection of politics and banking is to examine two pairs of relatively similar neighboring countries where political systems and historical forces produced very different banking systems: England and Scotland and Canada and the United States.

LUCK OF THE SCOTTISH

When the Bank of England and the Bank of Scotland were chartered, in 1694 and 1695, respectively, England and Scotland were separate kingdoms with separate parliaments but were ruled by the same sovereign,

William III. At that time, William was hunting for a way to finance his war against France. Since Scotland was poor and remote, the king realized that he would gain little by creating a monopoly Scottish bank to help finance his military exploits and instead relied on England to generate war funding. Moreover, the creation of such a bank would have required negotiating with the Scottish parliament, which was not as committed to the idea of financing the king's imperial ambitions as was its English counterpart. In fact, the charter of the Bank of Scotland prohibited it from lending to the crown without an act of parliament; the Scottish parliament was quite conscious of the problems that could arise if the Bank of Scotland were turned into a vehicle of public finance. Thus, from the king's point of view, it was easier to adopt a policy of laissez faire with respect to the Scots and simply use the Bank of England (as well as other English companies) to finance the war.

So began the English banking system's history as a crony enterprise. Until well into the nineteenth century, the Game of Bank Bargains in England was structured to serve the fiscal interests of the state and the personal interests of a small group of well-connected private citizens.

From 1694 to 1825, the Bank of England was the only English bank that was allowed to take the form of a joint-stock corporation, in which the company is owned by shareholders. All other banks had to organize themselves as partnerships limited to six partners, which kept them relatively small. Other banks were also subject to strict usury laws, which discouraged them from expanding their circle of borrowers. But the English government effectively exempted itself from those laws, thereby channeling credit to itself rather than the private sector. This repressive banking system constrained capital accumulation by the private sector during the early years of the Industrial Revolution, as investment was financed out of the pockets of tinkerers and manufacturers rather than through bank lending.

In the past 180 years, the United States has suffered 14 major banking crises. Canada has suffered two.

Merchants and manufacturers complained about the scarcity of credit that resulted from constrained bank chartering, which resulted in a reliance on small country banks as the main source of private credit, and so the Bank of England attempted to mollify them by committing to buy the short-term debt obligations issued by other banks and brokers to finance trade. But this only made England's fragmented system of banks even more unstable than it already was: knowing that the Bank of England would buy their bills regardless of the circumstances, country banks and other small lenders had little incentive to behave responsibly. As a result, English banking was prone to boom-and-bust cycles, and England suffered frequent major banking crises in the eighteenth century and quite a few in the nineteenth century, as well.

In sharp contrast to England, Scotland, by the middle of the eighteenth century, had developed a highly efficient, competitive, and innovative banking system, which promoted rapid growth. Unlike in England, where the crown's demands on the Bank of England required the state to protect the bank's monopoly, in Scotland, the government allowed for the free chartering of banks. Also unlike in England, in Scotland, the banks were able to link their urban headquarters with branches that operated in areas that could not otherwise have supported banks. Free from the obligation to finance the state and allowed to compete and invest everywhere, Scottish banks pursued profit-seeking strategies that provided credit to all sectors of the economy.

As a result of Scotland's free chartering rules, competition among Scottish banks was fierce during the nineteenth century, spurring the banks to innovate, inventing new services such as interest-bearing deposits and lines of credit. Scottish banks enjoyed remarkably narrow spreads (roughly one percentage point) between the rates of interest charged on loans and the rates they paid on deposits. Nevertheless, they earned respectable rates of return for their shareholders, indicating a high level of efficiency.

The Scottish system served the public well, too: by 1802, the value of bank assets per capita in Scotland was 7.5 pounds, compared with just six pounds per capita in England. Scottish banks were also less likely than English banks to fail or impose losses on their debt holders. Between 1809 and 1830, bank failure rates in England were almost five times as high as those in Scotland, a reflection of the Scottish banks' greater size, competitiveness, and portfolio diversification.

The United Kingdom's defeat of France in 1815 began a period known as the Pax Britannica. A combination of reduced war-financing needs and expanded suffrage brought pressure for political change that led England to imitate Scotland's success: it relaxed its bank-entry restrictions and reformed its bailout policies. By the last quarter of the nineteenth century, the United Kingdom's unified system was a model of stable, efficient, and competitive branch banking.

POPULIST POWER

Perhaps no pair of countries more clearly demonstrates the way politics determines banking stability than Canada and the United States, two countries that are very similar but that have had starkly different experiences when it comes to banking crises. The banking system in the United States has been highly crisis-prone, suffering no fewer than 14 major crises in the past 180 years. In contrast, Canada—whose southern border with the United States stretches 4,000 miles and whose society and culture closely resemble those of its big brother to the south—experienced only two brief, mild bank-illiquidity crises during that period, both of which occurred in the late 1830s, and neither of which involved significant bank failures. Since then, some Canadian banks have failed, but none of those failures led to a systemic banking crisis. The Canadian banking system has been extraordinarily stable—so stable, in fact, that there has been little need for government intervention in support of the banks since Canada's independence, in 1867.

The causes of this disparity stretch all the way back to the Colonial era. The original 13 colonies that went on to become the United States were surrounded by hostile neighbors. The colonists faced constant threats from the Spanish in Florida, the French in Quebec and the Ohio Valley, and Native Americans nearly everywhere else. In order to survive, the colonies had to defend themselves with force. There was no obvious source of wealth that could pay for a large standing army to keep enemies at bay. But the colonies did enjoy seemingly endless expanses of farmland suitable for growing tobacco, maize, and wheat, provided that the colonists were able to clear the Native Americans off the land. This combination of hostile neighbors, abundant land, and storable crops that could be grown on modest scales meant that some of the most influential colonists were small, freeholding farmers—who happened to be armed to the teeth.

When the large landowners and merchants who composed the colonies' economic elite decided to declare independence from Great Britain, they had to secure the loyalty of this class of armed, independent farmers. That was no easy trick: the revolutionary leaders were asking the farmers to go toe-to-toe against the most disciplined and best-equipped army in the world. Motivating them to do so required promises that the farmers would actually enjoy a measure of liberty, freedom, and equality if they won the fight.

In the immediate decades following independence, the merchant elites still managed to maintain the upper hand when it came to economic policy, including bank chartering. But their grip on the banking system soon succumbed to populist challenges, culminating in the failure, in 1832, of the attempt to recharter the federal government's nationwide Bank of the United States. From that point until the late twentieth century, U.S. banking policies were determined by a durable alliance between small unit banks (banks with no branches) and agrarian populists—farmers who distrusted corporations of nearly every type and the elites who controlled them. The populist support for unit banking reflected, in part, the fact that local banks depended on local economies, making unit banks more willing than big banks to provide credit to existing borrowers even during lean times.

The economic organization of U.S. banking during this rural populist era entailed significant costs: a banking system composed of thousands of unit banks was inherently unstable, noncompetitive, and inefficient. The absence of branches meant that banks could neither spread risk

across regions nor easily move funds in order to head off bank runs or coordinate collective responses to problems that arose. As a result, the United States became and remained the most banking-crisis-prone economy in the world. Furthermore, the fact that unit banks operated local monopolies meant that they were able to charge more for loans and pay less for deposits than would have been the case had they had to compete with one another. But the rural populist coalition survived, thanks in part to the decentralization of authority over bank chartering, which allowed the coalition to defeat efforts to allow the federal government to charter its own banks. Even the banking crises of the Great Depression failed to undermine the coalition that supported this inefficient and unstable system.

In the 1990s, U.S. banks seeking to become nationwide enterprises formed unlikely alliances with urban activists.

Indeed, not until the 1990s was the U.S. banking market completely opened up to competition. A steady process of liberalization that had begun in the 1970s culminated in 1994, when Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act, allowing banks to open up branches within states and across state lines. The new law sounded the death knell of the populist coalition that had shaped U.S. banking institutions since the 1830s and permitted a wave of mergers and acquisitions that created the megabanks that now have branches in nearly every city and town in the United States.

In this new American Game of Bank Bargains, populism continued to play a central role in determining the allocation of credit and profit. However, by the late twentieth century, the center of populist power had shifted from rural areas to big cities. In 1977, Congress passed the Community Reinvestment Act to ensure that banks were responsive to the needs of the communities they served. The CRA required banks that wanted to merge with or acquire other banks to demonstrate that responsiveness to federal regulators; the requirements were later strengthened by the Clinton administration, increasing the burden on banks to prove that they were good corporate citizens. This provided a source of leverage for urban activist organizations such as the Neighborhood Assistance Corporation of America, the Greenlining Institute, and the Association of Community Organizations for Reform Now, known as ACORN, which defined themselves as advocates for low-income,

urban, and minority communities. Such groups could block or delay a merger by claiming that the banks were not in compliance with their responsibilities; they could also smooth the merger-approval process by publicly supporting the banks. Thus, banks seeking to become nationwide enterprises formed unlikely alliances with such organizations. In exchange for the activists' support, banks committed to transfer funds to these organizations and to make loans to borrowers identified by them. From 1992 to 2007, the loans that resulted from these arrangements totaled $850 billion. From the point of view of an ambitious banker who was seeking to create a megabank of national scope, making such loans, which represented risks that the banks might not otherwise have taken, was simply part of the cost of doing business.

The alliance between megabanks and urban activist organizations became even more ambitious as it drew in a third set of partners: the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, commonly known as Fannie Mae and Freddie Mac. CRA-mandated loans posed higher levels of risk to banks than more traditional mortgage loans. To reduce the potential harm to the their bottom lines, banks made it clear to their activist partners that there was an upper limit on how much credit they would extend. In response, activist groups successfully lobbied Congress to require Fannie Mae and Freddie Mac to repurchase the mortgage loans that banks had made to low-income and urban constituencies to meet the obligations of the CRA. After Congress enacted those requirements in 1992—and especially after the Clinton administration progressively increased the proportion of Fannie Mae and Freddie Mac loan repurchases that met the low-income or urban criteria—even more credit could be directed to targeted constituencies at less cost to the banks. The banks were now able to resell some of their CRA-related mortgages to Fannie and Freddie on favorable terms.

The government mandates on Fannie and Freddie were not vague statements of intent. They were specific targets, and in order to meet them, Fannie and Freddie had little choice but to weaken their underwriting standards by permitting higher leverage, weaker mortgage documentation, and lower borrower credit scores. By the mid-1990s, Fannie and Freddie were agreeing to purchase mortgages with down payments of only three percent, compared with the 20 percent that had long been the industry standard. By 2004, they were purchasing

massive quantities of "liar loan" mortgages, made to borrowers who were not required to document their incomes or assets at all.

Fannie and Freddie, by virtue of their size and their capacity to repurchase and securitize loans made by banks, set the standards for the entire industry. When Fannie and Freddie weakened their underwriting standards in order to accommodate the partnership between megabanks and urban activist groups, their weakened underwriting standards ended up applying to everyone. Thus, when Fannie and Freddie started taking huge risks, they changed the risk calculus of large numbers of American families, not just the urban poor. Middle-class families could now borrow heavily and buy much bigger houses in much nicer neighborhoods than they could have bought previously. The result was the rapid growth of mortgages with high probabilities of default for all classes of Americans—and the widespread effects of the subprime crisis. By distorting the incentives of bankers, Fannie and Freddie, government agencies, and large swaths of the population through implicit housing subsidies, the new American Game of Bank Bargains led to a crisis of phenomenal proportions. For a while, almost everyone who played was a winner. When the bubble burst, of course, almost everyone—most particularly and tragically the urban poor—became a loser.

THE TRUE NORTH, STRONG AND FREE—AND STABLE

During the 2008 financial crisis, hundreds of banks failed in the United States, and the U.S. Federal Reserve and the U.S. Treasury had to marshal massive quantities of taxpayer dollars in loans, guarantees, and bailouts to prevent the collapse of still more banks, including some of the very largest. Canada's banks, meanwhile, never came under severe pressure. None had to be bailed out by taxpayers. Americans were envious and puzzled by the good fortune of their northern neighbors; Canadians were unsurprised. After all, the extraordinary stability of the Canadian banking system had been one of Canada's most visible and oft-noted characteristics for nearly two centuries. This achievement is especially remarkable in light of the fact that Canada's economy has relied heavily on exports and is thus quite vulnerable to changing market conditions overseas that are out of Ottawa's control. More remarkable still, the stability of Canada's banks for nearly two centuries has been maintained with little government intervention.

Many observers have attributed the Canadian system's relative success to its structure, one that is very different from that of the U.S. system. The Canadian banking sector has always been composed of very large banks with nationwide branches. This has not only allowed Canadian banks to diversify their loan portfolios across regions; it has also allowed them to transfer funds in order to shore up banks in regions affected by adverse economic shocks. Nationwide branch banking has also allowed Canada's banks to achieve economies of scale while competing among themselves for business in local markets. Historically, Canadian banks have had lower interest-rate spreads than U.S. banks, especially in remote areas.

One potential shortcoming of a concentrated system such as Canada's is that it could undermine competition among banks, resulting in less accessible, more expensive credit for households and businesses. But Canada's democratic political institutions have limited the extent to which the banks can earn monopoly profits. For more than 150 years, the Canadian parliament has carried out periodic legislative reviews and recharterings of the country's banks. Until 1992, this occurred every ten years; since 1992, it has occurred every five years. The practice of revising the Bank Act (the primary legislation governing banks in Canada) and rechartering the banks is not solely a stick with which to threaten bankers; it is also a carrot that rewards sound business practices by giving the bankers themselves a voice in the crafting of new legislation. Mindful of parliament's power, Canadian bankers follow the dictum "Pigs get fat, hogs get slaughtered." The stability of Canada's banking system, therefore, is not the mechanical result of its branching structure; after all, if branching alone guaranteed stability, U.S. banks would have avoided falling prey to the subprime crisis. The true source of Canadian banks' stability has been Canada's political institutions.

One overarching factor shaped Canada's political economy, including its banking sector: following the American Revolution, British policymakers were determined to hold on to Canada. But the vast majority of Canadian colonists in the late eighteenth century were of French origin and not particularly loyal to the United Kingdom. Keeping control of Canada thus required British policymakers to make concessions to the colonists' demands for increased self-government while also limiting the political power of the large French population. The British solution was a federal system that diminished French-Canadian influence and gave the central government control

over economic policymaking. One result was that even after Canada became functionally independent from the United Kingdom, Canada's provinces, such as Quebec, never enjoyed the power to create local banks that could serve as the nucleus of a coalition opposed to a national bank, as happened in the United States.

There were populist challenges to Canadian banking laws, but Canada's political institutions made it difficult to change the basic rules of the country's Game of Bank Bargains. Banking reforms had to originate in the House of Commons, where it was much harder to create and sustain a winning agrarian populist coalition than would have been the case had bank laws been enacted at the provincial level. Any reform that got through the House of Commons then had to be approved by the appointed Senate, where groups favoring the status quo were usually able to delay changes, propose watered-down compromises, or block proposals entirely. Throughout the twentieth century, this system fended off populist calls for bailouts when banks failed.

In the latter part of the century, Canada's system was effectively immune to the capture of banking policy by special interests, such as the alliance of urban populists and emerging megabanks that led the United States into the subprime crisis. After World War II, the return of hundreds of thousands of Canadian servicemen led to rapid urbanization and an explosion of demand for housing in Canada's cities. The government took a number of steps to provide housing credit to this crucial new urban constituency, but it did not do so by pressuring the banks. Rather, the government initially responded to the demand by passing legislation and reforms that, in essence, encouraged insurance companies to underwrite mortgages. And when the market looked unattractive to insurance companies, the federal government directly subsidized homebuilders using taxpayer dollars. This form of support avoided the sort of dangerous subsidization of extremely risky mortgages that took place in the United States. Thus, when Canada's banks finally entered mortgage markets in the 1980s, they did so with quite conservative underwriting standards.

Many observers of the Canadian banking system attribute its superior performance and stability to its regulatory structure, but effective regulation is best seen as a symptom of deeper political forces. In the United States, regulators permitted instability because it served powerful political interests: rural populists and unit banks prior to the 1980s and urban populists and megabanks afterward. In Canada, the government

did not use the banking system to channel subsidized credit to favored political constituencies, so it had no need to tolerate instability.

TOO FLAWED TO FIX?

If deeply rooted political and historical forces largely determine the quality of countries' banking systems, it is fair to ask how reformers can hope to improve those systems. Within a democracy, effective reforms in banking require more than good ideas or brief windows of opportunity. What is crucial is persistent popular support for good ideas. That is easier imagined than accomplished. Self-interested parties with strong vested interests distract and misinform the public, making it very hard for good ideas to win the day. Banking is a complicated subject, and dominant political coalitions exploit that complexity to make it difficult for the majority of voters to understand how banking systems can be manipulated.

Compounding that problem, it can be hard for ordinary people to identify disinterested third parties, especially in the mass media. If you are a financial wizard, being a reporter tends not to pay as much as being a banker. The result is that many reporters, even at top news outlets, deal with financial reform on a superficial level. Partly as a result, the only ideas for reform that have much hope of gaining widespread popular support are those that can be conveyed in simple terms. Consequently, it is harder for reformers to push for good policies in banking, since good policies almost always reflect the complexity of the system and are hard to reduce to sound bites.

Nevertheless, an unvarnished appreciation for the realities and ironies of the political world and the difficulties of bank regulatory reform should not lead to cynicism or hopelessness. Despite its challenges, political entrepreneurship within a democracy can reshuffle the deck in the Game of Bank Bargains by getting participants in the game to revise their views of what best serves their interests. Those who wish to improve banking systems must begin from a clear sense of how political power is allocated and identify gains for those who have the power to change things for the better. It does no good to assume that all the alternative feasible political bargains have already been considered and rejected. As George Bernard Shaw wrote, "The reasonable man adapts himself to the world: the unreasonable one persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man." Meaningful banking reform in a democracy depends on informed and stubborn unreasonableness.