Interest Groups and Bank Regulation

Financial Regulation and the Grabbing Hand

Florian Buck[1]

Introduction

In economic theory there are two perspectives on the role of the government in the market place: the public interest world based on the premise that markets can fail so that intervention by a benevolent government is justified ("helping hand" view); and the private interest theory, portrayed by the "grabbing hand" by Shleifer and Vishny (1998), recognizing that both despotic and democratic governments are likely to pursue goals that are different from "social welfare". Instead, economic policy is designed in such a way that it benefits those who currently have political power.

This article tells the story of the "grabbing hand" and its influence on shaping peculiar financial regulation. The notion of a fully grabbing hand government is very likely to prove a rarity. If it exists at all, however, it is particularly helpful to frame the complex motivations underlying regulatory policies in banking. First and foremost, financial regulation is politics. To explain policy choices, this article focuses on private interests since politicians might not be in the business of supporting public interests, but of getting re-elected or remaining in power (Acemoglu and Robinson 2001). Thereby the allocation of finance via state intervention is one of the most powerful and silent instruments with which to achieve this. In this sense, a grabbing hand government aims to extract a private rent by forming a coalition with special interest groups to push for an initiative that implements its rent-maximizing policy and frames the issue as being in the public interest.

The history of financial regulation repeatedly demonstrates the importance of coalitions with interest groups, as well as transient events for determining long-run institutional history (Kindleberger 1996). My central argument is that successful political entrepreneurs have seized windows of opportunity to pass financial laws to fund activities to which they want to give preference, and have subsequently relied on political costs to avoid the law from being repealed. The remainder of this article shows that a number of tools have been used over the last century to prevent bank crises and limit their socially costly impact. The major rules reflect the changing political coalitions of a grabbing hand government and are collectively described as the safety net that most industrialized countries have introduced in the last century – consisting of bankruptcy laws, intervention procedures and deposit insurance systems. Ironically, co-evolving with the safety net, the banking sector has grown to a point where it now dominates the economy, and even the state may be unable to cope with a collapse.

The purpose of this article is twofold: in the first part, I take a grabbing hand view of the evolution of financial regulation to understand why the political power of banks has increased over time. In the second part, I give some idea of how financial conglomerates might be able to influence regulation today to remain the safety net and of when structural reforms can be expected to occur.

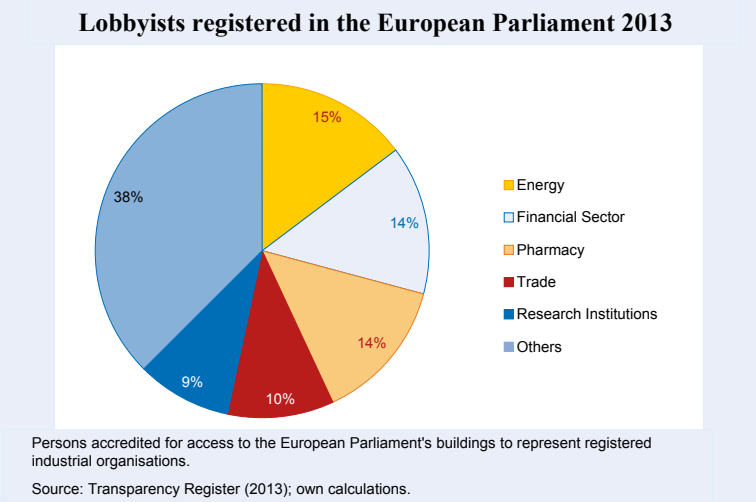
The nexus of politics and financial markets

The supply and demand of financial regulation play a major role in the grabbing hand theory. Supply concerns the incentives of the regulator and its power to constitute a separate interest group. Demand concerns the role of interest groups that pressure the regulator to pursue policies that promote private interests. Given the high stakes of regulation, especially when financial rules are developed, it is no surprise that tremendous efforts are undertaken every year to influence regulatory decisions. For the United States (US), the Center for Economic Responsive Politics estimates that total lobbying spending increased from USD 1.82 billion in 2002 to USD 3.31 billion in 2012. This lobbying is carried out by a myriad of organizations. The financial industry turns out to be the second largest sector in terms of lobbying expenditure, with a gradual upward trend. Gibson

[1] Center for Economic Studies (CES), University of Munich.

and Padovani (2012) provide evidence that the announcement of the Dodd-Frank bill in 2010 was followed by significantly higher lobbying intensity by banks; and most importantly by banks that are larger, have more vulnerable balance sheets and more diversified business profiles. In contrast to the US, in the European Union (EU) there is only a voluntary public register of lobby groups. Therefore, only a small fraction of the 15,000 lobbyists working in the EU is registered. Figure 1 shows the main industries identified in active registrations by lobbyists in the European Parliament, and again, the financial industry seems to be one of the predominant interest groups.

Figure 1



Persons accredited for access to the European Parliament's buildings to represent registered industrial organisations.

Source: Transparency Register (2013); own calculations.

Although lobbyism can be an accepted element within society, providing the necessary input and feedback into the political system, it can incentivize the regulator to be "captured" at the same time when public policy is formulated. Pressure can be exerted either directly on politicians, through campaign contributions, or indirectly when the cooperative behavior of a politician may be rewarded with lucrative employment opportunities in the industry after leaving the government; a practice the Japanese euphemistically call "amakudari" or the "descent from heaven". Anecdotal evidence supports the relevance of these procedures with respect to the financial industry, for example, Mario Draghi was Vice Chairman of Goldmann Sachs before he became President of the European Central Bank in 2011, or, vice versa, Bernd Pfaffenbach who was Angela Merkel's Sherpa responsible for financial regulation in G8 meetings during the most recent financial crisis moved to JP Morgan as a "senior advisor" in 2011.[2]

However, as we will see below, in contrast to other sectors that engage in lobbying, the connection between the financial sector and the state is a special one and can be characterized by a *symbiotic relationship*. The state needs banks because they finance public expenditure and crucially determine economic growth by funding the private sector, while the banking sector also needs the state to establish confidence by reliable rules that enable financial intermediation. But one main argument developed in this article is that the influence of the banking sector continuously rose during the last century, meaning that the balance of power between the state and the banks successively shifted to the banking sector. This cozy relationship has deep historical roots.

Institutions made by politics

From the very beginning, the creation of banks was not driven by considerations of a benevolent social planner, but rather the sovereigns' private welfare, specifically his personal survival and overall stability. Starting with the rise of banking in the 13th century monarchs realized that bank resources play a crucial role in financing their armies. During the feudal system, sovereigns were constrained in retaining power by the absence of standing armies and by the lack of revenues to pay for them (Ehrenberg 1928). Over time changes in military technology – firearms, mass infantry and new styles of fortification – led to greater fix costs in war-fighting, which, in turn, increased the urgency of the demand for financing (Kennedy 1989).

As a result, sovereigns created a political coalition with financiers that were allowed to found a bank.[3] The political deal was simple. States selectively chartered banks

[2] The list of prominent Goldman Sachs alumni in government is very long, and includes two former US Secretaries of the Treasury (http://www.forbes.com/2007/01/10/treasury-governor-global-business-cz_nw_0111goldman_slide.html).

[3] The Bank of England was chartered in 1694 in return for a large loan, which helped the government wage war with France. Shortly afterwards, the Parliament considered founding a second bank. However, in return for a second loan, the Bank of England could keep her monopoly on joint stock banking in England and Wales, persisting for more than a century (Grossman 2010).

to use them as a source of funding. In fact, they restricted entry into the domestic banking business and rewarded early banks with a monopoly position as the regulatory rent. However, there was the risk of waging war in times of conflict. This turned out to be a heavy burden since kings regularly did not repay their debt. From the 14th to the 16th centuries, many of the world' premier private banking houses – the Bardi, Peruzzi, and Fuggers – were damaged by defaults on sovereign loans. As Kindleberger notes, "The Bardi and the Peruzzi of Florence helped finance the English side of Hundred Years' War. They were bankrupted when Edward III defaulted to them in 1348" (Kindleberger 1996).

Thus, the risk of lending eventually ended up with the sovereign also stealing the banks' resources because the Leviathan's appetite rose. As a result, the king continuously gave away – with grabbing hands – an increasing number of bank licenses, gradually eroding the value of a domestic charter and cumulating in a form of "free banking". Interestingly, this early episode of banking not only shows that the origin of financial institutions is politically motivated, namely as a partnership arrangement between financiers and the state. Furthermore, the liaison illustrates a basic pattern of the grabbing hand theory: states have an incentive to create a regulatory environment, here an entry barrier, to open a channel for possible rent extraction. The regulatory rent created is shared with the government, for example, by making loans to the state at attractive rates of interest. Thus, in many countries the regulation of entry, the earliest form of financial regulation, was driven by the desire of states to establish monetary control. In other countries like the US, "political entrepreneurs" created restrictions on branching serving the interests of wealthy farmers at the expense of poorer farmers and industrialists (Rajan and Ramcharan 2011)[4], other countries like Scotland introduced unlimited liability for new banks as a barrier to entry to protect the rents of incumbent banks until the middle of the 19th century (Carr and Matthewson 1988).

As we will see in the following section, starting with the industrialization and the immense financing needs of merchants, political power slumbers within the newly created financial institutions which finds its concrete manifestation in the emergence of the so-called financial safety net. This safety net has three key components: first, investor rights and bankruptcy codes, second, the lender of last resort and third, the existence of an explicit deposit insurance system. Historically all three components reflect the interplay of industry and political forces (i.e. political coalitions in the sense of the grabbing hand theory) as well the occurrence of exogenous shocks.

The emergence of the financial safety net

The driving force for the demand for the first wave of financial regulation was a period of fast innovation and upsurges in productivity during the industrialization. Both the state and the merchants needed financiers. The reason was that, in the light of the experience of the French Revolution, sovereigns in Europe were afraid of a shift or destabilization of the political order and thus of losing power. Therefore they had an incentive to increase the citizens' expected loss in the case of a revolution by offering citizens the opportunity to accumulate wealth, for example, in the form of investment possibilities. At the same time, access to finance was also critical for merchants to facilitate transactions and to satisfy the growing needs of manufacturing. Thus, there was, even unknowingly, a political will among the state and merchants to create a financial market to invest the liquid wealth of citizens.

However, limited liability, whereby the shareholders are not liable for the debts of their company, might make them less likely to lend their money. This is because debt financing can trigger insolvencies by inducing excessive risk-taking. When the equity base is low, limited liability effectively truncates the probability distribution of income and thus creates an artificial risk-loving behavior (Jensen and Meckling 1976; Sinn 1982). In the absence of a system of government intervention into bank loss-sharing, the combination of the first-come first-served rule for depositors and the national insolvency regime for failed banks, determines the allocation of losses. The savings of citizens are at risk. They therefore discipline banks by withdrawing their savings when bankers jeopardize them. The citizens' rights to withdraw their deposits and the transfer of control-rights over banks in liquidation have the function of inducing banks to behave efficiently in managing their risk (Calomiris and Kahn 1991; Calomiris and Haber 2013). In order to invest, citizens need some expectation that once money is lent, any policy action taken will be consistent with eventual repayment. Unclear proper-

[4] The reason was that branching restrictions provided a commitment device that made banks more tolerant of declines in their loan customers' net wealth since there was no outside option for other investments. Borrowers paid for this in the form of higher interest rates (Calomiris and Haber 2013).

ty rights limit the ability to commit contractually and thus to raise funds. In other words, investor protection and bankruptcy laws can fulfill this function and enhance confidence (representation hypothesis, North and Weingast 1989; Dewatripont and Tirole 1994). The inherent political problem is that efficiency may conflict with the government's goal to channel funds to politically attractive groups.

Investor protection and bankruptcy laws

Importantly, the degree of legal protection is a political choice and can be influenced by private interests. As suggested by Rajan and Zingales (2003), this regulatory choice emerges as a trade-off between the rents from restricting access to finance and the associated welfare loss for citizens. Intuitively, external finance is critical for less established merchants, so poor investor protection can hinder competition. Weakening access to finance via poor legal certainty is therefore an effective channel for blocking competition in the private sector, also because it is less explicit than formal barriers. Thus, there are reasons why the very first financial regulation might be captured by the current economic elite.

Empirical support for such a coalition with the industrial elite comes from Berglöf, Rosenthal and von Thadden (2001); they show that bankruptcy laws tend to be soft in countries where the economic elite strongly influences the political outcome. As an illustration, they make the point that the very soft 1841 US bankruptcy law was pushed by the Whigs, which represented the economic elite in 19th century America. When this law was repealed by Congress, the New England Whigs, the richest people in the US, still voted in favor of it (Berglöf et al. 2001). The US have a more debtor-friendly bankruptcy law than Britain as a result. To a large extent, US bankruptcy law took its current shape through a sequence of crises (the 1898 debt moratoria, the Great Depression) during which borrowers negotiated favorable legislation via the political process.

As far as investor protection is concerned, we interestingly observe two distinct regulatory clusters since this era reflecting the new political agreement that was reinforced by later legislation. Continental European countries and Japan have low investor (and high employment) protection. Anglo-Saxon countries have high investor and low employee protection (La Porta et al. 1998). Both patterns are consistent with the political-economy model of corporatism by Pagano and Volpin (2005). In their setting, controlling stakeholders ("elite") want low investor protection to extract larger private rents, and may obtain it with the political support of workers. To form such a coalition that captures regulation, they have to make some compensation to workers, which takes the form of limiting their discretion in firing decisions. The success of this corporatist coalition depends on the distribution of equity ownership in the economy. If workers own little equity, as is the case in continental Europe, the elite and workers will strike a political agreement whereby workers trade low shareholder protection for high job security. This coalition enables both interest groups to preserve their rents. Moreover, both creditors and workers tend to prefer a less risky environment, even when this reduces profits, so that they tend to be political allies against shareholders, and to support bank- over equity-dominance (Perotti and von Thadden 2006).[5]

The German Chancellor Otto von Bismarck was one of the most successful "political entrepreneurs" of this era. He shaped not only the banking system to finance both the newly created German nation state and industrial firms; interestingly, he also built a coalition with the elite to coordinate the creation of the powerful industrial cartels that characterized German manufacturing. The combination of (weak) investor protection and the introduction of the social security system then provided the ground for the bank-dominance in Germany (making equity financing unattractive), as well as for the stabilization of the status quo within society. Again, Bismarck did this because he understood that the socialists would otherwise come to power and completely overturn the political order he was establishing (Gerschenkron 1962; Webb 1982; Calomiris 1995; Fohlin 2007). Economically, the predominance of debt finance with high rents for the elites (and newly insured workers) and inefficiency in the form of equity rationing was the result. It is worth mentioning that this first element of the safety net, the privilege for debt finance, erodes the discipline of depositors to monitor banks. This is because the repayment for savers only breaks down if there is a significant prospect of default, therefore, unlike equity financing, debt provides the smallest incentives for collecting private information by citizens.

[5] Complementing this view, Roe (2003) looks at European social democracy as affecting regulatory outcome. If product market competition is weak, capital owners and workers have rents to share. If owners do not keep their ownership interests concentrated, they will not capture those rents. They have no incentive to support regulation that would strengthen financial markets, because they keep a focused ownership interest in the firm so that when supra-competitive spoils are divided, they get a good share of the pie.

Box 1

Loan interest restrictions and the Marquette decision

The political deal between the state and industrial elites is also mirrored in other financial regulatory decisions such as price restrictions on credits. However, the history of usury laws in the US demonstrates that the judicial system can effectively constrain regulatory rents and can put an end to such a coalition.

Usury laws, restricting the interest rates a bank can charge, go back to the Colonial period in the US. According to the private interest theory the existence of these laws can be explained by protecting politically powerful borrowers. The mechanism is simple: by limiting the maximum interest rate, usury laws cause credit rationing that increases entry costs in the market and consequently impede competition. Consistent with this view, Benmelech and Moskowitz (2010) show that in the 19th century states with more powerful elites tended to have tighter usury restrictions and to respond less to external pressure for repeal. Only during financial crises, when elites become credit rationed themselves, were usury laws relaxed.

Interestingly, the relevance of state usury laws has been permanently reduced since the Supreme Court undermined the state's ability to enforce them in the Marquette National Bank v. First Omaha Service case in 1978. In her decision, the court ruled that a lender is allowed to charge up to the maximum amount permitted in its home state, regardless of the location of the borrower. "Because credit card lending was not geographically based, this decision created an incentive for states to raise their usury limits to compete for banks" (Kroszner and Strahan 2013). As a result, 18 states had removed interest rate ceilings by 1988, and the supply of credit card loans expanded over the subsequent 20 years. However, the Marquette decision also had its dark side: the increase in supply was concentrated mostly among high-risk borrowers and therefore personal bankruptcy rates started to increase steadily.

Bailouts and the lender of last resort (LoLR)

The next major shock to market discipline on the part of depositors occurred with the establishment of a bailout policy providing support to illiquid, but solvent banks at a penalty rate. The Bank of England was the first institution to develop into a consistent lender of last resort elaborated in the 19th century by Thornton (1802) and later Bagehot (1873). Again, historically this was the result of a political deal of a grabbing hand government that succeeded in shifting the burden of a bailout to the central bank.

As the prize for maintaining the special privileges of her monopoly position, the Bank of England got a political mandate to provide liquidity to other banks in times of crisis with the 1844 Peel Act. Clearly, as a by-product, this policy measure also subsidized powerful risk-taking conglomerates. Moreover, when a central bank commits to lending money to the market, such a commitment can feed the risk appetite of bankers, who feel protected by their ability to sell paper to the central bank. A Parliamentary Report of July 1858 exposed the concern of moral hazard and acknowledged that the existing intervention procedure, itself a manifestation of a political coalition rather than an explicit law, may not be a prudent policy (Calomiris and Haber 2013). In fact, with the LoLR facility the allocation of loss in a bailout is no longer determined by the law, but by the discretion of a resolution authority closely operating with the state under circumstances that are not transparent to taxpayers. Despite this opaqueness that undermines the property rights and is highly sensible for lobbyism, this ad hoc policy was successful in England in the sense that traditional banking panics were eliminated with the LoLR facility. White (2011) shows that the Banque de France used a similar two-tiered risk sharing technique in its coordination of assistance for the Paris Bourse in 1882. Thus, similar policy instruments were quickly established in Europe by the end of the 19th century. There is, however, no denying the fact that the effect of any bailout operation is a redistribution of wealth away from taxpayers and towards the debtors, thus creating a subsidy for high-risk banks.

Deposit insurance

The third element that constitutes the safety net today was the introduction of the federal deposit insurance, first established in the US by the Banking Act of 1933 to prevent bank runs à la Diamond and Dybvig (1983). Bank runs generate externalities that threaten the stability of the political order, something which the government is concerned about. The stated purpose in the public interest was to protect small depositors, but

effectively it limited also the private cost of a bank's bankruptcy. According to Friedman and Schwartz (1963, 434), "federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic … and … the … structural change most conducive to monetary stability…".

The underlying political deal is simply described. In theory, federal deposit insurance implies the cross-subsidization of risk across states. Accordingly, states with banks that suffered higher risks of failure would gain at the expense of other states' banks and possibly at the expense of the rest of the nation's taxpayers. In the US case, federal deposit insurance was preferred by unit bankers located in the more risky rural states since it offered high protection at lower cost. However, they would never have been able to successfully lobby for the introduction of deposit insurance against the pressure of the politically powerful urban branching banks if the Great Depression had not occurred and had not eroded public confidence in the political order and financial stability.

Henry Steagall and other politicians with populist constituencies focused the public's attention on the issue of banking reform and offered the supporters of deposit insurance the opportunity to wage a campaign convincing them that federal deposit insurance was the best way to combat the financial crisis. According to Calomiris and White (1994), "In the case of federal deposit insurance, entrepreneurial politicians defined an issue they thought would be beneficial to their constituents, structured the forum in which it would be debated to serve their purposes, and organized constituent support for their proposals – including political logrolling in Congress and other transient influences". Depositors of small, less stable rural banks were clear winners of this political deal, while depositors of relatively stable urban banks were the losers.[6] Laeven (2004) finds support for this redistribution mechanism by providing evidence that deposit insurance coverage is higher in countries where poorly capitalized banks dominate the market. Risky banks simply lobby for extensive coverage and the grabbing hand government agrees.

Thus this episode shows that support of financial reforms will also depend on the banking structure of the country and is likely to be greater in banking systems where weak banks hold a large share of the market.[7]

After the adoption of the insurance system in the US, a growing number of countries copied the US deposit insurance legislation, meaning that an insurance scheme for domestic banks is a common feature of banking sectors in industrialized countries today (Barth, Caprio and Levine 2006).

However, as in the case of an anticipated bailout, deposit insurance facilitates risk-taking to the extent that it encourages depositors to relax their monitoring efforts and that it reduces the risk premium in their cost of funding. Demirgüc-Kunt and Detragiache (1998) and Barth et al. (2006) show that explicit deposit insurance is strongly negatively associated with banking sector stability. It institutionalizes financial support to the small depositor and small bank, but at the potential expense of taxpayers. This is not only a way to hand out subsidies and eviscerate market discipline, it has also created perverse incentives for banks to grow and build empires, a discussion to which we now turn.

Consequences

Paradoxically, domestic bank safety nets, originally proposed as a means of stabilizing the economy and created by political deals and historic accidents in the past, have become an important destabilizing influence. Most importantly, they incentivize banks to invest in highly correlated, risky portfolios since the interbank network serves as an insurance mechanism for bank creditors. Intuitively, if a bank failure is associated with a positive bailout probability, connections to other banks increase the expected repayment of uninsured creditors. The pattern is striking. Banks can optimally exploit these transfers by getting systemic: they create high interbank exposure, and maximize the government subsidy per invested unit of capital. Leitner (2005) and Eisert and Eufinger (2013) show that interbank linkages can be optimal ex ante because they act as a commitment device to facilitate mutual private sector bailouts. In such a situation, politicians seem incapable of credibly committing not to intervene to support troubled banks. Thus today, virtually the entire financial system is protected by government insurance and other assistance.

[6] Lobbying can also rationalize why deposit insurance is underpriced in most countries, i.e. the insurer charges less for its service than the expected opportunity cost. Below flat-rate deposit insurance premium rates will often be set in such a way that they are affordable for the smaller banks and acceptable for the larger banks. As a result, deposit premiums will be set below the actuarially "fair" value of deposit insurance (Laeven 2004).

[7] The introduction of deposit insurance in Canada in 1967 was also a reaction to a loss in confidence in the sound practice of deposit-taking institutions, despite the protest of Canada's large banks that did not want to cross-subsidize their smaller rivals, which were perceived to be riskier.

Moreover, as Kane (1989) has argued, when the stakes are high enough banks cajole regulators to assist them in abusing the safety net at the taxpayers' expense. The established institutions not only persist over time because lock-in effects are at work; but there is also a form of path dependence in the political balance of power. Once established, the political status quo determines the future regulatory outcome. In other words, there are concentrated and well-funded interests that are willing to fight hard to maintain their access to the subsidized global safety net and block any reform. A basic principle of political economy is that powerful minorities (in our case, well-organized banks) generally will be successful in obtaining the implementation of policies, especially when regulation is technically complex and asymmetric information for outsiders is pervasive (Laffont and Tirole 1991). When we still stick to the view of a grabbing hand government, legislators have a systematic incentive to create a system of specialized, standing committees to formulate policy, which facilitate repeated interactions and long-term relationships between the financial lobby and the members of the committee (Kroszner and Stratmann 1998). This maximizes contributions by the banking lobby. Thereby much industry effort is aimed not at erecting new regulation, but at reducing regulatory requirements. For example, the *Institute of International Finance*, the key lobbying organization of banks, convinced part of the regulatory community that the planned Basel III reform would substantially raise interest rates on bank loans in the US and Europe and lower real growth; roughly 0.6 percentage points of GDP for

Box 2

The persisting erosion of banks' equity capital

Clearly, the creation of the safety net marked the starting point of the unbroken trend of shrinking banks' equity - and simultaneously the rationale for capital requirements to limit the banks' incentives for excessive risk. The reason is that, with increasing public confidence in the safety net, the expected private costs of failure decrease, so that banks prefer substantially lower levels of equity capital. For example, consider the US (Herring 2011): Before 1863, no federal banking regulation existed and banks did not enjoy access to any of the described elements of a safety net. The equity-to-asset ratios by banks (55 percent) declined markedly to 30 percent with the enactment of the National Banking Act of 1863, since depositors delegated monitoring to the state. Then the introduction of explicit deposit insurance in 1933 led to the next sharp reduction in equity with ratios falling to the five-ten percent range where they remained until the introduction of the Basel requirements in 1990.

With the so-called Basel approach, capital requirements became the central tool in international banking regulation to strengthen the financial architecture. However, when banks are forced to hold capital ratios exceeding their preferred level, they naturally view these requirements as a form of "regulatory taxation" and have successfully lobbied for deregulation. Intuitively, for banks with sizeable asset bases, a tiny percentage of reduction in capital requirements can represent a windfall of billions of euros.

In a recent case study, Lall (2012) shows that the implementation of the model-based approach in the Basel capital requirement framework, itself a lifting of equity constraints on large banks, was the regulatory outcome of lobbying by the Institute of International Finance (IIF), a powerful Washington-based lobby representing major US and European banks. Not just the IIF's contact with regulators per se has led to a regulatory capture, but more importantly its timing at an early stage in an opaque policy-making process; long before other groups like regional banks had a chance to intervene. Derived from its personal links with the Basel Committee, from the very beginning the IIF had superior information about the regulatory agenda in Basel and therefore gained a first-mover advantage in the regulatory process. The longest-serving Chairman of the Committee, the Bank of England's Peter Cooke (1977–88), was in fact one of the co-founders of the IIF. As a result, the IIF was able to use its position as the well-connected, peak association to interact with the Committee participants on a regular basis, working within the same "cultural bubble". Informational campaigns as well as closed meetings with private sector groups followed, so that the Basel Committee and its "model task force" (a subgroup working on the structure of risk modeling) used these discussions and data from the IIF as part of their overall research. Since policy decisions made at this early stage tend to be self-reinforcing, Lall (2012) concludes that the IIF exerts disproportionate influence over the content of the Basel II rules. As the Vice-President of a leading association of American community banks puts it, "We did not get involved until what turned out to be a late stage… and when we did, the modeling approach was already set in stone. The Basel Committee had been convinced by the large banks."

an increase of one percentage point. In this context there are also some topics on the reform agenda, e.g. a subsidy in the form of zero risk weights for government debt, where the interests of banks and the state coincides in a way that makes agreement easy (Buck and Maier 2014). The cozy state-bank nexus, described above, reinforces itself.

Some policymakers are aware of this problem. In the last decades many proposed remedies to minimize the social costs of the safety net were considered. Their proposals can be divided into two groups: those that intend to limit bank risk-taking by the implementation of minimum capital regulation etc., and those that would charge banks fees depending on the risks they undertake. However, given the influence of a few very large bank-industry groups, many of the recent policy instruments turned out to be Potemkin villages in the end (see Box 2 for the discussion of capital regulation); or in the words of Admati and Hellwig (2013), "requirements reflect the political impact that these banks have had on the policy debate and the flawed and misleading claims that are made in the discussion". The rest of the article briefly describes how the banking lobby operates and has proven capable of capturing financial regulation in the recent years to maintain the subsidies of the safety net.

Modus operandi – on the instruments and targets of banks' influence

Today the financial sector employs a much wider variety of mechanisms to shape the regulatory landscape. Traditional channels of influence rely upon campaign contributions, pressure on politicians and the "revolving door" by offering the politician lucrative employment opportunities in compensation for being cooperative. However, recently new mechanisms seem to becoming increasingly relevant. It is conceivable that cultural capture, through the shaping of assumptions and vocabularies, and informational lobbying, by supplying politicians with one-sided technical information, can be used to influence the regulatory outcome.

Informational lobbying

Regulators depend upon the regulated industry because they need information to do their job properly. The financial sector is also the regulator's only dialogue partner; because of the safety net, taxpayers have incentives to remain ignorant. Griffith-Jones and Persaud (2008) point out that industry influence will occur, when the financial sector possesses better technical expertise and superior resources than regulators. Hence, the highly technical character of regulatory networks like the Basel Committee can make the regulatory community susceptible to capture. According to Hellwig (2010), "When the model-based approach to capital regulation was introduced regulators were so impressed with the sophistication of recently developed techniques of risk assessment of banks that they lost sight of the fact that the sophistication of risk modeling does not eliminate the governance problem". A recent model by Hakenes and Schnabel (2013) formalizes this special case of informational lobbying and analyses when banks successfully persuade the regulator that banking regulation is not necessary. Due to a discrepancy in the degree of sophistication between banks and regulators, a more sophisticated bank can produce arguments that the regulator may not understand. If career concerns prevent him from admitting this, he rubber-stamps even bad banks, which leads to regulatory forbearance.

Contributions

A recent strand of the literature in the US finds evidence that contributions are a profitable investment for firms since they determine the voting behavior on banking regulation. Mian, Sufi and and Trebbi (2010) show that the amount of campaign contributions from the financial sector is a strong predictor of voting on the Economic Emergency Stabilization Act of 2008 that provided the Treasury with up to USD 700 billion in bailout funds that could be used to support the financial industry. According to Blau et al. (2013), for every dollar spent on lobbying, firms received between USD 485 and USD 585 in the support of the Troubled Asset Relief Program (TARP). Firms that lobbied had a 42 percent higher chance of receiving TARP support than firms that did not lobby. Moreover, Nunez and Rosenthal (2004) provide evidence that interest group interventions are important in voting on bankruptcy legislation in the US Senate. Roughly 15 votes in the US House of Representatives appeared to have been changed directly through interest group pressures proxied by campaign contributions.

Revolving doors and network connections

Career incentives can play a role, since the regulators' human capital is highly industry specific and the best

job for people holding that specific human capital are with the regulated industry. As argued above, people regulating the financial industry largely come from that industry or interact with that industry in their social live. Becker and Morgenson (2009) documented this in their 2009 article on Tim Geithner's social inter–actions during his time as head of the Federal Reserve Bank of New York. Interestingly, these personal ties seem to have a market value. Acemoglu et al. (2010) find that Geithner-connected financial firms gained abnormal positive stock market returns following the announcement of Geithner's nomination for Treasury Secretary. In a broader context, Igan and Mishra (2011) empirically examine the relationship between network connections of financial firms and voting patterns of legislators, using US data from 1999-2006, which include the bills targeted, lobbyists hired, lobbying expenditure and campaign contributions as a measure of network connections. They find strong evidence that network connections were positively linked to the probability of a legislator changing position in favor of financial deregulation. The evidence also suggests that hiring connected lobbyists who had worked for legislators in the past enhanced the effectiveness of lobbying activities. Vice versa, Goldman, Rocholl and So (2008), using data of 500 S&P companies in the US, show that stock prices increase abnormally following the announcement of the nomination of a politically connected individual to the board.

Cultural capture

Finally, the recent financial crisis has also provided an alternative explanation for why the financial sector has succeeded in cooperating with the regulatory community: not simply by appealing to material self-interest, but also by convincing them that financial deregulation was in the public interest. Lord Adair Turner (2010), chair of the UK Financial Services Authority, has referred to a "cognitive capture" to describe the tendency of financial regulators to engage in industry-friendly problem-solving together with the regulated institution itself. When the regulators share strong social ties to the industry and are more sympathetic to the industry's understandings about the world, she is able to shape the regulators' belief (Kwak 2013). As a result, she can induce them to identify with their interests, and the regulatory community can make "conflict-free" decisions because her conception of the public interest has been colonized by industry.

Conclusion

What insights can we now obtain by applying the grabbing hand approach to the arena of banking regulation? We have effectively seen that the history of banking regulation is full of rules directing banks to fund activities to which the political system wishes to give preference, most importantly the government itself. Over the last century virtually every country has erected a risk-inviting safety net to "protect" the financial system from the social costs of a banking crisis. Debtor-oriented laws allow bank owners to reduce the cost of taking risks, while bailouts and deposit insurance help them to raise funds and formalize the process of how losses are covered. The key question for economists is to what extent the grabbing hand works under the guise of seeking financial stability. One reason for concern is the fact that co-evolving, the financial sector was incentivized to grow and to interconnect itself to a point where it now dominates an economy and is able to capture the regulator to remain the banks' subsidy that is manifested in today's financial safety nets. However, the techniques of capturing have changed and now include subtle forms of informational lobbying where, as a result of the heightened complexity, regulators rely on industry expertise, or forms of cultural capture where regulators are influenced, even unknowingly, by the industry through a combination of social, cultural and intellectual currents (Kwak 2013).

From a policy standpoint, the grabbing hand behavior is, at least at the margin, preventable through persistent regulatory innovation. Transparency-rules (i.e. lobby-registers) or accountability laws can advance the public interest by mirroring the mechanisms that draw lobbyists into the policy-making environment. In recent years, the media has also been an effective weapon against lobbyism: Dyck, Moss and Zingales (2008) argue that "profit-maximizing media firms can play an important role in reducing power vested interests have on policy making. By informing voters, the media help to make elected representatives more sensitive to the interests of their constituencies and less prone to being captured by special interests." Moreover, it has been argued that consumer empowerment programs as a countervailing voice to banks' interests should be politically supported and scholars like Magill (2013) point out that the judicial system has a unique ability to prevent capture by constraining a regulatory action ex-post (see also the Marquette decision in Box 1). Therefore, it should be clear that lobbying by the financial sector is not a constant barrier to stability and regulatory effi-

ciency, but merely a symptom of a grabbing hand government that is controllable.

References

Acemoglu, D., S. Johnson, A. Kermani, J. Kwak and T. Mitton (2010), "The Value of Political Connections in the United States", *MIT Working Paper.*

Acemoglu, D. and J. Robinson (2001), "A Theory of Political Transitions", *American Economic Review* 91, 938–63.

Admati, A. and M. Hellwig (2013), *The Bankers' New Clothes*, Princeton University Press, Princeton.

Barth, J., G. Caprio Jr. and R. Levine (2006), *Rethinking Bank Regulation. Till Angels Govern,* Cambridge University Press, Cambridge.

Bagehot, W. (1873), *Lombard Street: A Description of the Money Market*, H.S. King, London.

Becker, J. and G. Morgenson (2009), "Geithner, Member and Overseer of Finance Club", *New York Times* April 26, 2009; available at http://www.nytimes.com/2009/04/27/business/27geithner.html?pagewanted=all&_r=0.

Benmelech, E. and T. Moskowitz (2010), "The Political Economy of Financial Regulation: Evidence from US State Usury Laws in the 19th Century*", Journal of Finance* 65, 1029–73.

Berglöf, E., H. Rosenthal. and E.-L. von Thadden (2001), "The Formation of Legal Institutions for Bankruptcy: A Comparative Study of the Legislative History", Background Paper for the World Development Report.

Blau, B., T. Brough and D. Thomas (2013), "Corporate Lobbying, Political Connections, and the Bailout of Banks", *Journal of Banking and Finance* 37, 3007–3017.

Buck, F. and U. Maier (2013), "The Political Economy of Financial Repression", *CESifo Working Paper*, January 2014.

Calomiris, C. (1995), "The Costs of Rejecting Universal Banking: American Finance in the German Mirror, 1870-1914", in Lamoreaux, N. and D. Raff, eds., *Coordination and information: Historical perspectives on the Organization of Enterprise,* University of Chicago Press, 257–315.

Calomiris, C. and S. Haber (2013), *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit,* forthcoming Princeton University Press, Princeton.

Calomiris, C. and C. Kahn (1991), "The Role of Demandable Debt in Structuring Optimal Banking Arrangements", *American Economic Review* 81, 497–513.

Calomiris, C. and E. White (1994), "The Origins of Federal Deposit Insurance", in *The Regulated Economy: A Historical Approach to Political Economy,* University of Chicago Press, 145–88.

Carr, J. and F. Mathewson (1988), "Unlimited Liability as a Barrier to Entry", *Journal of Political Economy* 96, 766–84.

Demirgüc-Kunt, A. and E. Detragiache (1998), *Financial Liberalization and Financial Fragility*, International Monetary Fund.

Dewatripont, M. and J. Tirole (1994), *The Prudential Regulation of Banks*, MIT Press, Cambridge.

Diamond, D. and P. Dybvig (1983), "Bank Runs, Deposit Insurance, and Liquidity", *Journal of Political Economy* 91, 401–19.

Dyck, A., D. Moss and L. Zingales (2008), "Media versus Special Interests", *NBER Working Paper* 14360.

Ehrenberg, R. (1928), *Capital and Finance in the Age of the Renaissance: A Study of the Fuggers and their Connections,* Harcourt, Brace and Company, New York.

Eisert, T. and C. Eufinger (2013), "Interbank Network and Bank Bailouts: Insurance Mechanism for Non-insured Creditors?" *SAFE Working Paper* 10.

Fohlin, C. (2007), *Finance Capitalism and Germany's Rise to Industrial Power,* Cambridge University Press, New York.

Friedman, M. and A. Schwartz (1963), *A Monetary History of the United States 1867–1960*, Princeton University Press, Princeton.

Gerschenkron, A. (1962), *Economic Backwardness in Historical Perspective,* Harvard University Press, Cambridge.

Gibson, R. and M. Padovani (2012), "The Determinants of Banks' Lobbying Activities", *Working Paper.*

Goldman, E., J. Rocholl and J. So (2008), "Do Politically Connected Boards Affect Firm Value?", *Review of Financial Studies* 22, 2331–60.

Griffith-Jones, S. and A. Persaud (2008), "The Pro-cyclical Impact of Basel II on Emerging Markets and its Political Economy", in Ocampo, J. and J. Stiglitz, eds., *Capital Market Liberalization and Development,* Oxford University Press, 262–88.

Grossman, R. (2010), *Unsettled Account – The Evolution of Banking in the Industrialized World since 1800,* Princeton University Press, Princeton.

Hakenes, H. and I. Schnabel (2013), "Regulatory Capture by Sophistication", *Working Paper.*

Hellwig, M. (2010), "Capital Regulation after the Crisis: Business as Usual?", *CESifo DICE Report* 8 (2), 40–6.

Herring, R. (2011), "The Capital Conundrum", *International Journal of Central Banking* 7, 171–87.

Igan, D. and P. Mishra (2011), "Three's Company: Wall Street, Capitol Hill, and K Street", *IMF Working Paper.*

Jensen, M. and W. Meckling (1976), "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *Journal of Financial Economics* 3, 305–60.

Kane, E. (1989), *The S&L Insurance Mess: How Did it Happen?*, The Urban Institute Press, Washington.

Kennedy, P. (1989), *The Rise and the Fall of Great Powers*, Vintage Books, New York.

Kindleberger, C. (1996), *Manias, Panics and Crashes: A History of Financial Crises,* Macmillan, Basingstoke.

Kroszner, R. and P. Strahan (2013), "Regulation and Deregulation of the US Banking Industry: Causes, Consequences and Implications for the Future", in *Economic Regulation and Its Reform: What Have We Learned?*, University of Chicago Press, Chicago.

Kroszner, R. and T. Stratmann (1998), "Interest-Group Competition and the Organization of Congress: Theory and Evidence from Financial Services' Political Action Committees", *American Economic Review* 88, 1163–87.

Kwak, J. (2013), "Cultural Capture and the Financial Crisis", in D. Carpenter and D. Moss, eds., *Preventing Regulatory Capture: Special Interest Influence and How to Limit it*, Cambridge University Press.

Laeven, l. (2004), "The Political Economy of Deposit Insurance", *Journal of Financial Services Research* 26, 201–24.

Laffont, J.-J. and J. Tirole (1991), "The Politics of Government Decision-Making: A Theory of Regulatory Capture", *Quarterly Journal of Economics* 106, 1089–127.

La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1998), "Law and Finance", *Journal of Political Economy* 106, 1013–155.

Lall, R. (2012), "From Failure to Failure: The Politics of International Banking Regulation", *Review of International Political Economy* 19, 609–38.

Leitner, Y., (2005), Financial Networks: Contagion, Commitment, and Private Sector Bailouts, *Journal of Finance* 60, 2925–53.

Magill, E. (2013), "Courts and Regulatory Capture", in D. Carpenter and D. Moss, eds., *Preventing Regulatory Capture: Special Interest Influence and How to Limit it*, Cambridge University Press.

Mian, A., A. Sufi and F. Trebbi (2010), "The Political Economy of the US Mortgage Default Crisis", *American Economic Review* 100, 1967–98.

North, D. and B. Weingast (1989), "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in 17th Century England", *Journal of Economic History* 44, 803–32.

Nunez, S. and H. Rosenthal (2004), "Bankruptcy Reform in Congress: Creditors, Committees, Ideology, and Floor Voting in the Legislative Process", *Journal of Law, Economics, & Organization* 20, 527–57.

Pagano, M. and P. Volpin (2005), "The Political Economy of Corporate Governance", *American Economic Review* 95, 1005–30.

Perotti, E. and E.-L. von Thadden (2006), "The Political Economy of Corporate Control and Labor Rents", *Journal of Political Economy* 114, 145–74.

Rajan, R. and R. Ramcharan (2011), "Land and Credit: A Study of the Political Economy of Banking in the United States in the Early 20th Century", *Journal of Finance* 66, 1895–931.

Rajan, R. and L. Zingales (2003), "The Great Reversals: The Politics of Financial Development in the 20th Century", *Journal of Financial Economics* 69, 5–50.

Roe, M. (2003), *Political Determinants of Corporate Governance: Political Context, Corporate Impact,* Oxford University Press, New York.

Sinn, H.-W. (1982), "Kinked Utility and the Demand for Human Wealth and Liability Insurance", *European Economic Review* 17, 149–62.

Thornton, H. (1802), *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain,* Allen and Unwin Ltd, London.

Turner, A. (2010), Interview with Financial Crisis Inquiry Commission Staff, November 30.

Shleifer, A. and R. Vishny (1998), *The Grabbing Hand – Government Pathologies and Their Cures,* Harvard University Press, Cambridge.

Webb, S. (1982), "Agricultural Protection in Wilhelminian Germany: Forging an Empire with Pork and Rye", *Journal of Economic History* 42, 309–26.

White, E. N. (2011), "Implementing Bagehot's Rule in a World of Derivatives: The Banque de France as a Lender of Last Resort in the Nineteenth Century", in G. Wood, T. Mills and N. Crafts, eds., *Monetary and Banking History: Essays in Honor of Forrest Capie,* Routledge.