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Does business regulation matter for banks in the European Union?

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ABSTRACT

This paper provides a comprehensive analysis of the impact of business and financial specific regulations on banks in the EU-27 over the 2004–2010 period. We employ a dataset of a wide range of business regulation indices from the "*Doing Business*" project of the World Bank. Results for the credit regulation indices show that the strength of creditor rights is negatively related to bank performance as measured by cost efficiency, although this effect subdues during the recent crisis period (2008–2010). On the other hand, credit information sharing improves efficiency, a result that is further strengthened during the crisis. Tax-compliance costs and entry regulation constrain bank efficiency. More stringent regulation of labour, in terms of minimum wage and dismissal costs, and insolvency regulation are positively associated with efficiency. Furthermore, regulation that protects investors from management expropriation, such as the extent of director liability, exerts a positive impact on bank efficiency and more so in the crisis years. Finally, we use interaction terms between the business regulation variables and institutional quality as measured by the rule of law and control of corruption. Results show that there are cases that institutional quality influences the individual effects of specific types of business regulation on bank efficiency.

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1. Introduction

Business regulations are central to policy making as setting them right would foster competitiveness and boost economic growth, whereas excess regulation could prove harmful to the economy. Another important focal point of policy makers is the performance of the banking sector, as this is of major significance to the well-functioning of financial markets in particular and the economy in general. Moreover, the recent financial crisis demonstrated that poor bank performance asserts a negative effect on the overall economy due to the systemic financial stability implications and credit constraints. Given the prominence of both regulation and bank performance is not surprising that there has been an extensive literature (Demirgüç-Kunt and Detragiache, 1998; Barth et al., 2004, 2013; Beck et al., 2006a,b; Pasiouras, 2008; Pasiouras et al., 2009; Delis et al., 2011; Delis and Staikouras, 2011),[2] in particular regarding bank-specific prudential and supervisory regulation. However, to the best of our knowledge the impact of wider regulations that could affect the day-to-day bank operations has not been examined thoroughly in the literature. To this end, we fill a gap by studying the impact that wider business regulations, targeting to improve competitiveness, could have on bank performance, whilst we also focus on bank-specific regulations.

In early empirical studies on bank performance, variables that reflect the quality of institutions such as bureaucratic quality or law observance serve as proxies for regulation and supervision that is specific to the banking sectors. Demirgüç-Kunt and Detragiache (1998, 2002) provide evidence that improved institutional quality is negatively related with the probability of banking crisis and reduces the effect of moral hazard due to deposit insurance regulation. The availability of data for regulation specific to the banking sector steered research that use these data as main regulatory variables while general country-level institutional quality measures serve as control variables. A proliferation of research that examines the impact of bank supervision and regulation on bank performance has not reached yet an agreement on how specific types of bank regulation affect bank performance or what in general is a good regulation for the financial sector.

Furthermore, extant research of the impact of non-financial regulation on bank performance is limited although banks operate within the wide spectrum of regulations of the country they are located. This is so despite that some studies have demonstrated the importance of the non-financial institutional and regulatory framework in explaining cross-country differences in bank performance (Demirguc-Kunt et al., 2004, 2008; Lensink et al., 2008; Hasan et al., 2009a,b; Claessens and Van Horen, 2012).

Overall, the literature that links regulation to bank performance is dominated by bank-specific regulation, while institutional quality measures serve as control variables. Furthermore, the limited literature that focuses specifically on how non-financial regulation and institutional quality could affect bank performance uses wide measures, as for example law observance, making it harder to derive specific policy implications in order to prioritise efforts to improve the regulatory framework.

In the light of the above, this paper provides a missing link by examining a wide range of country and bank-specific business regulation on bank performance as measured by cost efficiency. In particular, we examine how several types of business regulation derived from the "*Doing Business*" project of the World Bank affect bank cost efficiency in the EU-27 economies over the 2004–2010 period. To this end, we employ models that account for business regulation in the following categories: *starting a business; getting credit; protecting investors; enforcing contracts; paying taxes; resolving insolvency* and *employing*

[2] Barth et al. (2004) find that private monitoring regulation has a positive and significant effect on bank performance. In the same study official supervisory power and regulation for capital requirements are found not be significantly related with the performance of financial institutions. Beck et al. (2006a,b) confirm the importance of private monitoring regulation for the banking sector. In a study of 2500 banks across 37 countries they find that enhancing private monitoring of banks by obliging them to reveal truthful information to the private sector has as a result to decrease the level to which corruption of bank staff posits a hurdle for companies to access finance. In another study, Pasiouras et al. (2009) investigate the impact of the three pillars of Basel II and restrictions on bank activities on efficiency. They find that market discipline regulation and the supervisory authority is positively related with bank efficiency. On the other hand, restrictions on bank activities increase profit efficiency but reduce cost efficiency, while stricter capital requirements have the reverse impact. Other studies that examine the impact of financial regulation on bank performance include Pasiouras (2008), Delis et al. (2011), Delis and Staikouras (2011), and Barth et al. (2013).

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