

Federal Reserve Bank of Cleveland

Legal Systems and Bank Development

by O. Emre Ergungor

What promotes economic development? The question has puzzled economists for years. Recent research suggests that a country's financial system plays a key role in its growth (see King and Levine 1998 and Levine 1999). In some countries—France and Germany, for example—most firms borrow the money they need from banks. In others—like the United States and the United Kingdom—firms most often turn to credit markets to raise capital. Some anecdotal evidence suggests that in the latter half of the 1990s, economies with market-based financial systems grew more rapidly than bank-based systems. But research shows that over long periods, countries with large banking industries do as well as those with large financial markets. The important factor is how well developed a financial system is, not its type (see Demirguc-Kunt and Maksimovic 1998 and Levine and Zervos 1998).

If that is so, why do some countries have market-oriented financial systems while others are oriented toward banks? One strand of research suggests that a country's financial system is influenced by the path its industries took during the industrial revolution. Another strand traces countries' differences in financial structure to differences in their regulatory environments. But neither approach satisfactorily explains why banks predominate in some countries and markets predominate in others. The missing piece of the puzzle seems to be a country's legal traditions, which determine the structure of its financial system. Countries that follow common law (based on the law of England) are market-oriented, while those that follow

civil law (based on the law of France) have a marked preference for banks.

This *Commentary* examines the role of legal systems in determining the type of financial system a country develops. It describes the differences in how judges interpret and enforce contracts under civil law versus common law and how those differences affect a country's financial system. Where civil law prevails, the courts' literal interpretation of contract language makes writing one-time, bilateral contracts problematic and requires involving a financial intermediary such as a bank in the contracting process. The wider discretion enjoyed by common law judges in interpreting contract language reduces the cost of writing contracts and favors market-oriented financial systems. On the whole, differences in how countries make and apply laws (that is, their legal traditions) may be the most important factor shaping their financial systems.

■ Civil Law versus Common Law

Judges' power to issue opinions that go beyond the literal interpretation of statutes is an important difference between civil and common law. Civil law's tradition of strict interpretation of statutes and contracts dates to the French Revolution. Accusations that corrupt judges were betraying the people by systematically ruling in favor of the aristocracy led to the enactment of Article 5 of the French Civil Code of 1804, which forbade judges to lay down general rules in deciding cases. Continued mistrust of judges strongly influenced the organization of the courts, which were eager to

In some countries, banks are firms' key source of financing. In others, firms look mainly to credit markets to meet their financial needs. Why should this be so? New research suggests that a country's legal tradition strongly influences which financial system becomes dominant there.

show their submissiveness to the new order. The result—complete obedience to the word of the law—became an integral part of the civil law tradition.

Under civil law, the judge's duty is strict application of the law as laid down in codes and enactments. But no legislation can be applied in a purely mechanical way, so civil codes contain explicit directions for interpreting texts. The most famous of these interpretive directives is Article 1 of the Swiss Civil Code of 1907, which instructs the judge that if he can find no rule in enacted law, he must decide in accordance with customary law and, failing that, in accordance with the rule that he as a legislator would adopt, consistent with approved legal doctrine and judicial tradition. But during the years the Swiss Civil Code has been in force, Article 1 has rarely been invoked. Swiss judges almost always prefer to follow more traditional methods of interpretation, which involve logical and grammatical torture of the code in search of a section that applies to the issue at hand.

In the common law tradition, however, judges sometimes are required not only to apply the law but also to interpret and, to a degree, even create it. This creation process has been described as “the discovery of the old unwritten custom of the land” (in the declaratory theory of common law). Some legal scholars compare common law to Newton’s laws of nature, which had always existed; Newton, they say, did no more than discover and label them (see Greenberg 1986). Judges’ rulings often rely on precedents that were established by past decisions; that is, judges can base their decision on more than the specific terms of existing laws, they can apply other judges’ arguments and interpretations, and they can extend the general principles underlying previous decisions to situations they view as similar. In *Law and Society*, Steven Vago claims the practice has several strengths. Vago says it is often much easier and less time-consuming to follow precedents than to search all over again for solutions that have already been found by applying pre-existing laws. Precedents also enable the judge to draw on wisdom accumulated by earlier generations outside of legal statutes. Applying precedents is argued to minimize arbitrariness and make it easier for less experienced judges to issue fair decisions. More important, it enables individuals to plan their conduct, secure in the expectation that past decisions will be honored in the future.

All this could lead us to suppose that common law courts are more effective in resolving conflicts than civil law courts because they are freer to create and interpret the law when the statutes are incomplete and do not address a particular situation. However, this argument may seem too strong because Western European and North American countries are known to have very efficient judicial systems. But the most commonly used measures of judicial efficiency include factors like the speediness with which a case is resolved in court or judges’ susceptibility to bribes. In our context, “efficiency” is not measured by the number of cases heard or the amount of time and money expended per case. Nor does it concern judges’ integrity. It refers to the interpretive power of judges to go beyond the letter of the law and the fact that codes in civil law countries constrain judges far more powerfully than those in common law countries (see Glaeser and Shleifer 2001).

■ Legal Systems and Financial System Development

One way to characterize a country’s financial system is to look at the ratio between loans by deposit-taking banks and market capitalization. As this ratio goes up, so does the importance of banks in the economy. By this standard, figure 1 shows that in 1994, markets were more important than banks in economies like those of the United States (with a ratio of 1.33), the United Kingdom (1.22), Nigeria (0.85), Zimbabwe (0.78), Malaysia (0.68), and South Africa (0.43). Banks were the key players in France (ratio of 6.57), Austria (22.67), Egypt (5.50), the Philippines (4.50), Indonesia (3.20), and Argentina (4.14).

The crucial point in figure 1 is that countries whose legal systems are based on common law have market-oriented economies (with a low bank/market ratio), and countries with legal systems based on civil law are bank-oriented (with a high bank/market ratio). Why is there a relationship between legal systems and financial systems when neither factor in itself seems to affect a country’s per capita GDP (horizontal axis of figure 1)? The answer may lie in differences in the way contracts are written and enforced.

We know that it is practically impossible for any contract to include a clause that covers every contingency. Then how do you settle disputes that arise when an uncovered contingency becomes a reality? You can go to court. This is a viable alternative in common law countries because judges are not strictly bound by the clauses of the contract but feel free to interpret them (or the laws for that matter) to determine whether the parties acted in accord with the spirit of the contract. One good example is contracts’ penalty clauses, which specify sanctions for a party’s failure to abide by the terms of the agreement. In the U.S. (common law) legal system, penalty clauses are generally inapplicable because the judge determines whether a contractual promise has been broken and, even if it has, can alter the contractual penalty. But in civil law countries, contracts, including penalty clauses, are strictly enforced. Another good example is the code that governs the distance between buildings and trees in a community. In civil law countries, a slight violation, although reasonable and harmless to a

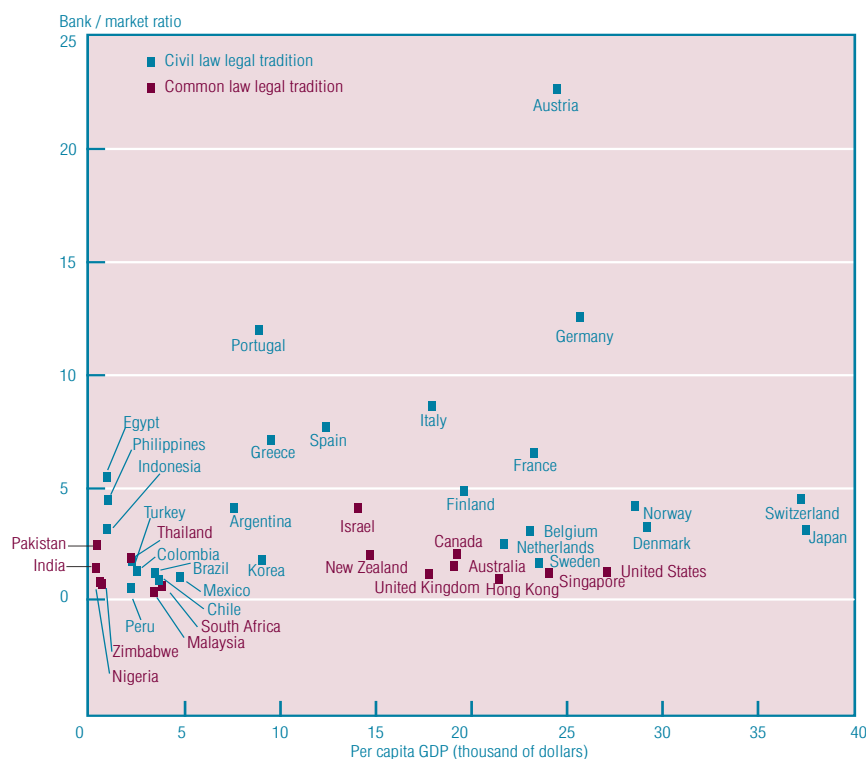
neighbor, compels destruction of the building or eradication of the offending tree. In common law countries, a standard of reasonableness guides the judge’s decision (the second example is from Mattei 2000).

Recent research shows that, in the civil law tradition, restraints on judges’ interpretive powers affect the way contracts are written and enforced. When a country’s civil law courts are not effective in settling disputes between credit market participants, banks emerge as institutions that can resolve conflicts and enforce contracts without a court’s intervention (see Ergungor 2001 for a full discussion).

To see how banks mitigate contractual problems, imagine that a borrower has devised a fraudulent way to transfer assets or profits. The lender has been damaged, but a civil law court cannot remedy the situation because the borrower’s technique is not specifically covered in the statutes. In other words, the borrower’s actions are *immoral* but not necessarily *illegal*. Civil law courts do not function this way because they are negligent or incompetent but because, unlike their common law counterparts, they put more emphasis on the word of the law than on fairness. This allows insiders in civil law countries to structure unfair transactions that conform to the letter of the law. Johnson et al. (2000) confirm this behavior of civil law courts in conflicts between minority and controlling shareholders when controlling shareholders transfer the assets and profits out of the firm.

The economic effect of civil courts’ limitations is that would-be borrowers cannot convince lenders that they will not exploit them, so they cannot borrow from capital markets. What advantage does a bank have in these circumstances? It can make a credible commitment to provide borrowers with a service in the future that individual investors cannot offer. For example, a bank can promise to lend a customer money in the future at a predetermined rate (a contract known as a loan commitment). For reasons similar to those that weaken promises made by individual borrowers, promises by individual lenders would lack credibility: Individual lenders are more inclined to opportunistic behavior because even though they put their reputation and future business opportunities at risk, they collect all the benefits of their action. In contrast, shareholders

FIGURE 1 RATIO OF BANK LOANS TO STOCK MARKET CAPITALIZATION VERSUS PER CAPITA GDP, 1994



SOURCES: Levine (1998); and La Porta et al. (1997).

of an institution would have to share those benefits with all the other shareholders, while each individual shareholder has his entire reputation at risk (see Boot, Thakor, and Udell 1991).

The ability to offer services that markets cannot offer gives banks superior bargaining power. Banks can restrain borrowers' opportunistic behavior with a credible threat to withhold unique, valuable services. All market participants anticipate that a borrower who has a relationship with a bank will honor his obligations in order to preserve that relationship. Thus, banks prevent credit market failure.

Conclusion

The orientation of a country's financial system seems to be influenced by that country's legal system: Firms in common law countries are more likely to use credit markets, and firms in civil law countries prefer banks. This *Commentary* examines the reasons for this difference and argues that banks can mitigate a legal system's ill effects on financing. Banks can use both carrot and stick to restrain opportunistic borrowers from exploiting legal loopholes; in doing so, banks allow credit markets to function properly. This ability gives banks a crucial role in the economy in addition to their traditional role as liquidity providers.

Recommended Reading

Allen, Franklin, and Douglas Gale. 1999. "Diversity of Opinion and Financing of New Technologies." *Journal of Financial Intermediation*. 8 (1-2), pp. 68-89.

Allen, Franklin, and Douglas Gale. 2000a. "Comparing Financial Systems." In *Comparing Financial Systems*, Cambridge: The MIT Press.

Allen, Franklin, and Douglas Gale. 2000b. "The Historical Development of Financial Systems." In *Comparing Financial Systems*, Cambridge: The MIT Press.

Boot, W. A. Arnoud, Anjan V. Thakor, and Gregory F. Udell. 1991. "Credible Commitments, Contract Enforcement Problems, and Banks: Intermediation as Credibility Assurance." *Journal of Banking and Finance*. 15 (3), pp. 605-32.

Demirguc-Kunt, Asli, and Vojislav Maksimovic. 1998. "Law, Finance, and Firm Growth." *Journal of Finance*. 53 (6), pp. 2107-137.

Ergungor, O. Emre. 2001. "Market- vs. Bank-Based Financial Systems: Do Investor Rights Really Matter?" Federal Reserve Bank of Cleveland, Working Paper, no. 01-01.

Glaeser, Edward L., and Andrei Shleifer. 2001. "Legal Origins," Harvard Institute of Economic Research, Discussion Paper, no. 1920.

Greenberg, Donald W. 1986. "United States." In Alan N. Katz, ed., *Legal Traditions and Systems: An International Handbook*. Westport, Conn.: Greenwood Press, pp. 415-35.

Johnson, Simon, Rafael LaPorta, Florencio Lopez de Silanes, and Andrei Shleifer. 2000. "Tunneling," Harvard Institute of Economic Research, Discussion Paper, no. 1887.

King, Robert G., and Ross Levine. 1993. "Finance and Growth: Schumpeter Might Be Right." *Quarterly Journal of Economics*. 108 (3), pp. 717-37.

LaPorta, Rafael, Florencia Lopez de Silanes, Andrei Shleifer, and Robert Vishny. 1997. "Legal Determinants of External Finance." *Journal of Finance*. 52 (3), pp. 1131–50.

Levine, Ross. 1998. "The Legal Environment, Banks, and Long-run Economic Growth." *Journal of Money, Credit, and Banking*. 30 (3), pp. 596–620.

Levine, Ross. 1999. "Law, Finance, and Economic Growth." *Journal of Financial Intermediation*. 8 (1–2), pp. 8–35.

Levine, Ross, and Sara Zervos. 1998. "Stock Markets, Banks, and Economic Growth." *American Economic Review*. 88 (3), pp. 537–58.

Mattei, Ugo. 2000. *Comparative Law and Economics*. Ann Arbor: The University of Michigan Press.

Vago, Steven. 2001. *Law and Society*. Upper Saddle River, N.J.: Prentice Hall.

O. Emre Ergungor is an economist at the Federal Reserve Bank of Cleveland.

The views expressed here are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland, the Board of Governors of the Federal Reserve System, or its staff.

Economic Commentary is published by the Research Department of the Federal Reserve Bank of Cleveland. To receive copies or to be placed on the mailing list, e-mail your request to 4d.subscriptions@clev.frb.org or fax it to 216-579-3050. Economic Commentary is also available at the Cleveland Fed's site on the World Wide Web: www.clev.frb.org/research, where glossaries of terms are provided.

We invite comments, questions, and suggestions. E-mail us at editor@clev.frb.org.

**Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101**

Return Service Requested:
Please send corrected mailing label to the above address.

Material may be reprinted if the source is credited. Please send copies of reprinted material to the editor.

**PRSRT STD
U.S. Postage Paid
Cleveland, OH
Permit No. 385**