Policy Brief

CDRF 8/07

8

Financial Services Regulation
Perspectives in Banking from India and Bangladesh

Efficient and well functioning banks form the backbone of a modern economy. Due to the unique nature of banks (provider of both producer and consumer services), their impact on growth and development and their role in ensuring financial inclusion in an economy, putting in place an appropriate regulation on the banks is of high importance for policy makers.

This policy brief describes the link between regulation, corporate governance and competition in banking with illustration from India and Bangladesh. It analyses two different aspects of banking regulation: introduction of competition in India; and the state of corporate governance in Bangladesh.

The Need for Banking Regulation

Why Regulation?

There are several definitions of regulation. It can be defined as a systematic effort to affect the behaviour of the agents based on rules, which give clear and strict directives and permit further negotiations among agents. In emerging economies, regulation offers a stable environment for market players useful for reducing uncertainty, promoting innovation, boosting investment and providing efficient factor markets. Balanced and effective regulation not only ensure consumer welfare but also provide a continuous workable environment to firms operating in the market.

There are several reasons for adopting banking regulation. Banking regulation is important for the growth and development of an economy. It facilitates growth of a strong financial network resulting in efficient allocation of resources. Banks have an even greater role in developing countries in terms of a broader extent of claimants on the bank assets and funds. Lately, competition is seen to be a facilitator of effective regulation.

This also has an effect on trends in regulation of the financial sector, making it more elaborate and bringing international convergence. These trends are reflected in the latest proposals from Basel Committee on Banking Supervision (commonly known as Basel II). The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face.

One of the most important banking regulations relates to prudential measures: stipulation of capital requirements and strengthening of risk management processes to achieve and maintain financial stability, which has always been the overriding objective of financial regulators. Tendency to excessive risk taking by commercial banks is curbed mainly through stipulating minimum regulatory capital. Basel II permit banks to use their internal risk rating models to compute capital requirements provided banks satisfy the regulators about suitability and accuracy of these models. Norms for information disclosure are helpful in monitoring by depositors and/or equity investors.

While the relationship between regulation and competition is well recognised it is not clear whether government ownership would facilitate either competition or regulation of the financial system. Government ownership in financial sectors is broadly a developing country phenomenon.

Corporate Governance

It is important to discuss corporate governance in this context since it can be seen as a form of self-regulation. There is a trend towards enhancing corporate governance mechanism in banks, which also introduces an element of competition among them to win confidence of customers and investors. The issues of high leverage, greater need of public confidence and disparity in the maturity of assets and liabilities make governance issues in banks more special than many other firms.

25 years CUTS International 1983 2008

Ownership and Competition

The issue of ownership is discussed here because it has an impact on the effectiveness of regulation and competition. The issue of ownership (public versus private or domestic versus foreign) is also important in banking reforms since often deregulation and enhanced competition is considered necessary to improve efficiency and stability of banks. Competition helps to maintain high standards of corporate governance.

The Financial Services Authority (FSA), UK considers competitive financial services industry helpful in achieving its objectives of maintaining market confidence, public awareness, consumer protection and reduction of financial crime. In developing countries, the banking sector tends to be at a greater risk (than in developed countries) of misappropriation/abuse as a result of heavy government ownership, lack of prudential regulation, weak legal protection and presence of special interest groups.

In several developing countries, statutory/legislative mechanism to preserve competition has been implemented recently and is still evolving. The issue of competition in sectors such as financial, in many developing countries including India, is linked with government ownership.

Whether or not to continue government ownership is a contentious political economy issue because of the possible impact of a change of ownership on bank employees and on inclusiveness of financial system, i.e. easy access to finance for small agriculturists and entrepreneurs particularly from weak and poor sections. The rationale for having government ownership has always been to achieve certain social objectives, such as providing finance to preferred and under served sectors, regions or group of borrowers.

Table 1: Ownership and Performance in Banks

The Issue	Description
Effect of Ownership on Performance	If the objects pursued by public and Public Sector Banks (PSBs) are different their measured performance would understandably be different. It is generally recognised that government-owned entities do not try to maximise profits but seek to achieve other multiple objectives, which are stated in very general terms.
Deposit Mobilisation and Portfolio Quality	Impact of government ownership on depositors is particularly significant as it has been seen as an additional security, over and above the safety net in the form of deposit insurance. Such security can come about without imposing any burden on taxpayers. This may put privately owned banks at a disadvantage but there are issues, such as access and service quality in which private players may get an edge.
Risk Management	Banks' ability to earn decent return from their portfolio depends, among others, on the manner in which risks are assessed and managed. Risk management becomes more important and to some extent difficult when a domestic economy is opened up to foreign competition. PSBs may be more static than private banks – their inputs or procedures link and accord importance to pre-set conditions on acceptable risk profile. In such a situation, private banks are likely to be quick in identifying new profitable lending opportunities, exploit them early and take quick exit decisions to maintain better portfolio risk profile.
Incentives	Traditionally public sector enterprises have been operating in business environment devoid of competition. In such situations the public sector may operate in such a way that implicit incentives like career concerns may become important. Attracting people who value or share higher institutional goals may also prove useful for the PSBs. Several sectors where public monopolies traditionally operated, due to technological advances, have both private and public entities. In such situations providing appropriate incentives becomes important, as attracting and retaining talent is important in a competitive environment.
Human Resource Policies and Practices	The state of human resource (HR) practices is another channel through which the ownership could impact the PSB's commercial performance. HR policies through employee motivation have an impact on portfolio choice and risk management.

Ownership and Performance

The relationship between ownership (that is whether government or private-owned) and performance in the banking sector is described in Table 1. The difference arises from the fact that public and private sectors often pursue different objective functions, e.g. the public sector may not concentrate on profit maximisation but could have other social objectives (e.g. priority sector lending) in their functions. For depositors there may be a choice between two types of banks. While PSBs offer security, private banks provide better service. Private banks may also be better at managing risks. In a new competitive environment after the introduction of private players issues such as incentives and HR practices have assumed significance.

Empirical evidence on this subject is mixed. State-owned banks are associated with poor a financial operating system, though they could overcome informational problems and allocate scarce funds to more productive projects/sectors. Another study did not find much difference between public and private banks regarding input/output efficiency though differences existed as regards profit/income efficiency. One study found that public sector banks have shown higher cost efficiency than private banks whereas it has been the other way around in the case of profit efficiency.

The experience of two divergent South Asian countries with banking regulation including the impact of change in ownership and self regulation (or corporate governance) is explained in the following sections.

Reforms in the Indian Banking Sector

Prior to 1991, the Indian banking sector was strictly controlled as illustrated in Table 2. Most commercial banks were Government-owned and there were controls over interest rates and banking operations. The rates of interest were also quite high. Some of the effects of the regime were ineffective regulation, absence of competition among banks, weakened banks, low profitability and poor level of technology etc. Banking reforms were introduced in India in 1991. Some of the measures adopted in the reforms have also been described in Table 2.

Impact on Banks in India

Reforms in the banking sector led to decontrol, competition and stricter prudential regulations. This has also resulted in declining market share of PSBs. Overall performance of banks improved in terms of asset quality, credit growth and profitability. The booming economy led to increased demand for bank credit. Though all banks have benefited from this boom, banks that have moved quickly to spot new business opportunities have benefited the most. Continuing restriction on voting power (capped at maximum 10 percent) has restricted the expansion of foreign banks at present. As per a Reserve Bank of India (RBI) roadmap, foreign banks would be given greater market access by March 2009.

Growth of Non-banking Institutions

The concept of non-banking institutions were to introduce competition among banks through permitting new entrants but not through

Table 2: Reforms in the Indian Baking Sector

Prior to 1991	Reforms in 1991
Ownership: Government-owned most commercial banks	More competition: new private banks were permitted; banks entered into funds management, broking, insurance, primary dealership in government securities etc. through subsidiaries to diversify business activities.
Restrictions: Banks were subjected to elaborate operational controls of RBI besides it also stipulated their lending rates & deposit rates. A large proportion of deposits were blocked due to high levels of statutory liquidity ratio (SLR) and cash reserve ratio (CRR) stipulated for banks 40 percent of the credit was earmarked for certain priority sectors	SLR and CRR progressively reduced from peak levels of 38.5 and 15 percent respectively; deposit and loan rates deregulated; more operational freedom; cap on maximum voting rights by individual shareholders increased. Improved disclosures in bank balance sheets; minimum capital prescribed for credit and market risks; banks required to be compliant with elaborate capital standards under Basel II over a period of time.

privatisation of existing banks. Therefore, the government directly or indirectly owned these new entities. Several PSBs have entered into new activities such as fund management, primary dealership in government securities, capital market related services etc. where specialised skills such as bond or foreign exchange trading, are required. Such new private banks and non-banking institutions have been relatively successful largely due to the fact that they were granted more operational freedom.

Banking Sector in Bangladesh

The state of affairs and quality of governance in the banking sector in Bangladesh has been a matter of concern. Some of the problems in the banking sector are decreasing profitability, increasing non-performing assets, provision and capital shortfalls, eroded credit discipline, corruption, low recovery rate, poor asset quality, managerial weakness, excessive Government interference, weak regulatory and supervisory structures etc. Many of these problems have been attributed to lack of sound corporate governance in the banks.

Looking at corporate governance from the point of view of banks, it is the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management. It involves the following activities in banks:

- setting of corporate objectives;
- running day-to-day operations;
- considering interests of recognised stakeholders;
- alignment of corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and
- protecting the interests of depositors.

Flawed Structure

As Table 3 explains there are problems in the structure of Bangladeshi banks, which are not favourable to ensuring effective corporate governance system. To illustrate, audit and disclosure mechanism is not transparent enough and very few banks disclose internal audit reports to their shareholders and to the public.

Regulatory Agencies in Bangladesh

Weak corporate governance structure in Bangladeshi banks can perhaps be explained by the problems in the regulatory framework related to the financial sector. Table 4 shows that the regulators are plagued with various problems, such as poor human capital, excessive government interference, lack of other relevant regulations, corruption etc.

Many corporate governance problems in banking were due to the relatively weak nature of practices followed by Bangladesh Bank (BB) on prudential regulation and monitoring till late 1990s.

Measures have been adopted to improve the system. For example, since mid 1990s, BB established a Credit Information Bureau where

Table 3: Structure and Functioning of Bangladeshi Banks

Ownership/ Shareholding Structure	The banks in Bangladesh are closely held corporations; the majority of the banks are not publicly listed companies. On an average, 20 percent shares are publicly available; a majority of shares are owned by a small number of sponsor shareholders. The number of executive shareholding is minimal.
Boards	Board members are dominated by the non-executive members representing sponsor shareholders. In Private Commercial Banks, 9 out of the 10 members of the boards are shareholder directors. The remaining person is the Chief Executive Officer (CEO).
Management, Contracts and Incentives	Shareholders have total control over executives. In 82 percent banks, CEOs are accountable to the respective boards. In remaining banks they are accountable to owners; in foreign banks, which are fewer in numbers, accountability is to seniors.
Audit and Disclosure Findings	95 percent banks in Bangladesh have internal audit departments. Under banking laws, all banks need to appoint external auditors, who must be from an accounting firm, and banks should have a board audit committee. Only a small percentage of the banks disclose internal audit reports and board audit committee's report to the shareholders and to the public.

Table 4: Features of the Regulatory Agencies in Bangladesh				
Agency	**Bangladesh Bank (BB)**	**RJSC (Registrar of the Joint Stock Companies)**	**The Securities and Exchange Commission (SEC)**	**Institute of Chartered Accountants (ICAB)**
Activity	The central bank of Bangladesh, formed in 1972, regulates banking companies	Custodian of company laws; registers limited companies	Responsible for ensuring that listed companies abide by capital market regulations; has discretion over some activities of publicly listed banking companies	Monitors and regulates the accounting profession and practice; governed by the Ministry of Commerce but works as an autonomous body
Problems	Poor human capital; government interference	No evidence of compliance with their requirements; RJSC does not have the authority to investigate into company affairs; no electronic system of maintaining the database or records; shortage of staff	Exclusion of most banking companies from the SEC Act; shortage of staff and lack of appropriate training and qualifications and corruption	Many ICAB requirements not ensured by other relevant regulations; ICAB has very rarely taken action against problem accountants

every bank had to submit specific detailed information. It also established a new division called the Offsite Supervision Unit to analyse different data submitted by the banks and evaluate banks' position in terms of operating and financial results and monitor changes in key risk indicators. The BB stipulated that all PSBs should regularly report on loans and deals involving the board members and sponsor shareholders. In 2004, the BB developed a set of guidelines for core banking risk management, which every bank must implement in their operational measures.

Conclusion and Policy Recommendations

Banks need to be regulated because of their vital role in an economy. In a developing country, their role is more significant as they also take it on themselves to ensure efficient resource allocation and financial inclusion. Banking regulation is mostly prudential in nature. Although in recent times promotion of corporate governance in banks has been touted as a means to achieve effective regulation. The relationship between ownership and performance is discussed in this context since the ownership and presence (or absence) of competition also determines the efficacy of the regulatory mechanism. It can be concluded that ownership has a significant influence on performance of banks, the main reason being difference in objective functions between public sector and private banks.

The discussion on the change in ownership and introduction of competition after the adoption of banking reforms in India in 1991 gives rise to the following conclusions and policy recommendations:

- Government ownership *per se* does not lead to poor performance but absence of competition makes a regulatory regime ineffective. Therefore, policymakers should adopt measures to promote competition.

- Change in ownership and introduction of competition has improved the performance of banks. More reforms measures need to be adopted for continued improvement in performance of the Indian banking sector.

- Improvement of performance of banks in India is also partly due to the economic boom and banks that have moved quickly to spot new opportunities have performed better. Thus, it is important to synergise overall economic growth strategy with policies for further developing the banking sector.

- The experience of non-banking institutions in India demonstrates the importance of granting more operational freedom to banks. Thus, the Government should explore promotion of such alternative institutions as well for overall growth and consumer welfare.

- The process of opening the Indian market for foreign banks will not be complete before March 2009, and the Indian Government and regulators have been proceeding on this issue cautiously. While such prudence is required in an economically diverse country such as India, the Government and regulators should also align their strategy for liberalisation with their plan for making Mumbai as an International Finance Centre.

The section on Corporate Governance in Bangladeshi banks gives rise to the following conclusions and policy recommendations:

- Banks in Bangladesh have been suffering from various problems including troubles in the regulatory framework and weak corporate governance. To make the banking sector competitive, these problems should be addressed first.

- Measures have been adopted recently to improve the regulatory framework and should be sustained to improve the performance of Bangladeshi banks.

- A number of problems are due to political economy including excessive Government interference, corruption and trade unionism and thus will have to be tacked at the political level.

- There are also problems of inadequate legislation and regulation and need to be corrected for improving effectiveness of regulation.

This Policy Brief is published as a part of the Competition, Regulation and Development Research Forum (CDRF) project with the support of Department for International Development (DFID), UK and International Development Research Centre (IDRC), Canada. It is based on inputs from papers entitled *Regulation, Competition & Government Ownership: A case study of the Banking Sector in India* by M. K. Datar and *Regulation, Corporate Governance and the Banking Sector – the Case of Bangladesh* by Thankom Arun and Masrur Reaz. The views expressed herein are those of the authors and do not necessarily reflect the views or position of CUTS International, CUTS Institute for Regulation & Competition or the CDRF project and its associated advisers.