DIGITISATION AND INCLUSIVITY: TAKING EVERYONE ALONG

Financial inclusivity and the banking sector

CONTINUED FROM PAGE 37

use it to obtain preferential access to capital, in particular from, but not limited to, the state-owned banks. The consequent weak financial regulation and enforcement limit access to finance for less established competitors.

The financial sector contains a number of very large institutions organised into powerful banking associations. They can afford lobbying through well-prepared participation in public debate on regulatory measures. Finance is necessarily characterised by asymmetric information between banks and their clients, and by systemic effects. Risk is an inherent feature of the industry. Confidence effects among banks and between banks and their creditors create various forms of externality. Other externalities arise because of competition. The competitive behaviour of banks varies depending upon their financial condition. Sound banks have lower funding costs and weak banks compete more aggressively. The regulations favoured by the key players may promote financial stability and largely coincide with what would promote overall efficiency if they perceive such regulation is in their self-interest. Often, they are not so perceived.

Politicisation of entry and excessive forbearance of risky lending lead to inefficiency and stability risks. Political influence led to allowing new banks without extensive scrutiny in recent years. Several of these fourth-generation banks suffered a severe liquidity and capital adequacy crisis. These had to be bailed out by the government. The costs are borne largely by a subset of institutions whose interests diverge from the users of financial services and those seeking financing who have less ability to exercise influence over regulators. The ability of just a few business interests to capture the regulator may be enough to undermine the public's confidence in the competence of the banking regulator.

When people lose trust in formal financial systems, they keep their savings in un-regulated or under-regulated investment avenues, making them more vulnerable to fraud. Anecdotal evidence suggests a number of weak PCBs are plagued by insider lending and other owner abuses.

The political capture of the regulatory entity prevents proper resolution of failing banks. While there is an explicit deposit insurance scheme, it has never been used. BB has de facto extended an implicit guarantee to all banks. Over the past years, no domestic bank has been allowed to fail. Weak banks are referred to the Problem Bank Monitoring Department within BB where they are subject to special supervisory oversight, certain regulatory restrictions and regulatory forbearance. These produce systemic inefficiencies. Larger loan loss provisions of weak banks drive up the spread between lending and deposit rates, allowing other healthy banks to enjoy rents in the form of higher profits.

THE DRIFT TOWARDS EXTRACTIVE INSTITUTIONS

In their "Why Nations Fail: The Origins of Power, Prosperity and Poverty", Daron Acemoglu and James Robinson, suggest that countries can be bedevilled by economic institutions "structured to extract resources from the many by the few and that fail to protect property rights or provide incentives for economic activity." The banking sector has historically been a target for extractive elites in many economies. The wealth of the financial industry gives them enormous lobbying power, including as contributors to political campaigns or to ruling parties. A narrow elite seizes control of bank regulation to prevent broad based financial inclusion.

Sustained economic reform

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requires a framework of long-term policy to which the government can credibly commit itself. But the backsliding in the reform process is eroding most of the structures of institutional insulation of long-run economic management decisions against the wheeling-dealing of day-to-day politics. There are very few assurances that commitments made by the government will be kept even by itself under pressure. The pressure comes from insiders who have a strong incentive to block or reverse financial reform as financial development improves the conditions for entry of new players, thus challenging rents of the insiders through increased competition.

CAN WE STILL HOPE?

Bangladesh's financial sector development lags those of peer economies. Dealing with symptoms of a financial crisis before the crisis becomes full blown requires swift action to maintain stability and confidence in the banking system. Within Bangladesh's political elites, the leadership at the top plays a decisive role in shaping the policy. A leadership committed to reforms faces resistance from three quarters: opponents within and among the supporters of the government, those in the opposition, and the vested interests that expect to lose from the policy change. A determined leadership can often overcome resistance from all three sources.

The focus on regulation and corporate governance of banks is important given the prevailing dominant role of banking institutions as a source of finance for the corporate sector and the SMEs. Improved board structures, administrative procedures and disclosure requirements could result in better governed banks, which are more likely to allocate capital efficiently. The evolving discourse on financial regulatory reforms recognises that the motivation for state intervention in finance must be guided by an understanding of the sources of market and regulatory failures. The government has been taking on a very active role in the financial system to enhance savings mobilisation, direct credit to priority sectors, and make financial services affordable to larger parts of the population. Through interest rate controls the government is hoping to reduce lending costs for borrowers, while credit quotas are reportedly under consideration to guarantee that financial resources flow to priority and underserved sectors.

Government solutions to overcome market failures have not worked. Bureaucrats have limited expertise to run financial institutions and they are subject to political and regulatory capture. Bureaucrats as bankers have failed almost everywhere, but especially in developing countries. Being owner, borrower and regulator of an institution at the same time, the Financial Institutions Division under the Ministry of Finance face obvious conflicts of interest.

Experience in Bangladesh has shown once again that government-owned banks are often used by politicians to finance commercially unviable government projects or state-owned enterprises. Present approach to financial regulatory reform has been limited to addressing the symptoms. This approach relies on the government to enable and develop markets.

The role of government has to be redefined to make Bangladesh's financial system more efficient and investment friendly. Beyond ensuring macroeconomic stability and providing an effective and reliable contractual and informational framework, the government should move from the role of an operator and arbiter in the financial system to the role of enabling and creating markets.

Yes, the financial sector suffers from the general governance problems in the economy and the society at large. This actually strengthens the case for putting financial sector reform at the centre of governance reform, since it is here that the money and thus the temptation is. The depoliticisation of financial sector regulation and supervision can send an important signal to the rest of the economy and society and be an important catalyst for governance reforms in other areas.

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