Institutional Foundations of Regulation of Banks and Financial markets

- Financial Deepening ⟶ Improved Growth
- Channels of transmission:
  - financial development and the efficiency of investment,
  - financial liberalization

  in increasing savings and, hence, investment.
- Creation and growth of financial institutions lead to a positive relationship between

Why Regulation?

- The twin Pillars of Growth and development:
- Property Rights Protection
- Contract Enforcement
- Asset Shields
- Subsumed in the Walrasian World
- Not guaranteed in the Post-Walrasian approaches
- Market Failures due to Imperfect and Asymmetric Information and High Transaction Costs

- Moral Hazard, Opportunistic behavior and Adverse Selection
- legal institutions, play a crucial role in the overall economic performance of nations.
- **The Nature of the Financial System**
- the future $\longrightarrow$ risk and uncertainty.

- expectations play a major role in the pricing of financial assets.
- limited amount of information available price developments are difficult to predict.

- market parties adjust suddenly and collectively.
- asymmetric information problems arise in financial markets
- adverse selection before the transaction is entered into, and of
- moral hazard after the transaction has taken place.
- financial markets are much more interdependent.

(Systemic risk)

- money, a special commodity with vital transaction functions in the economy, is at the core of the financial system.
- negative macroeconomic externalities from bank failures and financial panics.

- unbridled competition :
- is seen as a major threat to the primary goal of stability of the financial system.
- Increased competition has the benefit of reducing inefficiencies associated with monopoly rents.
- However, increased competition between banks and the financial markets also limits the amount of risk-sharing that banks can provide.
- Competition may cause unwanted effects like suboptimal levels of screening, excessive risk taking or even the break down of the market which need to be counteracted by institutions like supervisory regulations to secure the financial stability of the banking sector.

What Role Does Regulation Play?

- Markets are powerful coordination mechanisms, yet they do not operate perfectly and cannot do so.
- Government replaces the market ?
- traditional public interest view of regulation has been challenged
- by the public choice approach.
- Government must in the first instance have to create a framework for satisfactory market operation,

- in the second instance do they have to prevent and limit the consequences of some negative aspects of the operation of the market mechanism.
- Government measures to protect the consumer such as deposit insurance coverage have in turn created new moral hazard problems. They diminish the incentives for markets to discipline the banks and induce excessive risk taking.

Some specific examples

- Asymmetric information : cannot accurately distinguish good risk applicants from bad-risk applicants before making an investment. Thereby a so-called ‘lemon-premium’ will increase the loan rate, so that only risky projects will be funded.
- The principal-agent relationship of creditors with financial institutions
- depositors lack information regarding the riskiness of the bank’s portfolio.
- Regulation to disclose information

- Financial Intermediaries can help solve the problem but they in turn create similar problems
- In turn these can be solved by rating agencies
- screen and monitor the creditworthiness of bond issuers in the financial market. Because of the public good nature of information and the free rider problem linked to it, financial intermediaries are not able to solve completely these information problems.

- Banks themselves can exercise governance and control and exercise corporate governance over companies.
- The substantive Law governing Corporates is another alternative to regulation.
- Weak legal systems – poor enforcement of Law lead to regulation as the alternative.
- Again who governs the banks?

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- a) enhancing information disclosure systems, creating incentives for private agents to monitor banks, and
- b) Strengthening legal and bankruptcy systems to fundamentally improve the infrastructure of corporate governance (Barth, Caprio, and Levine 2001).
- c) Have regulation and supervisory systems that foster more accurate **information disclosure**, **empower private investor's legal rights**, and **do not offer very generous deposit insurance[1]** substantially boost banking system performance and stability.
- d) permit foreign entry and allow banks to compete along many dimensions (e.g., in securities market activities)

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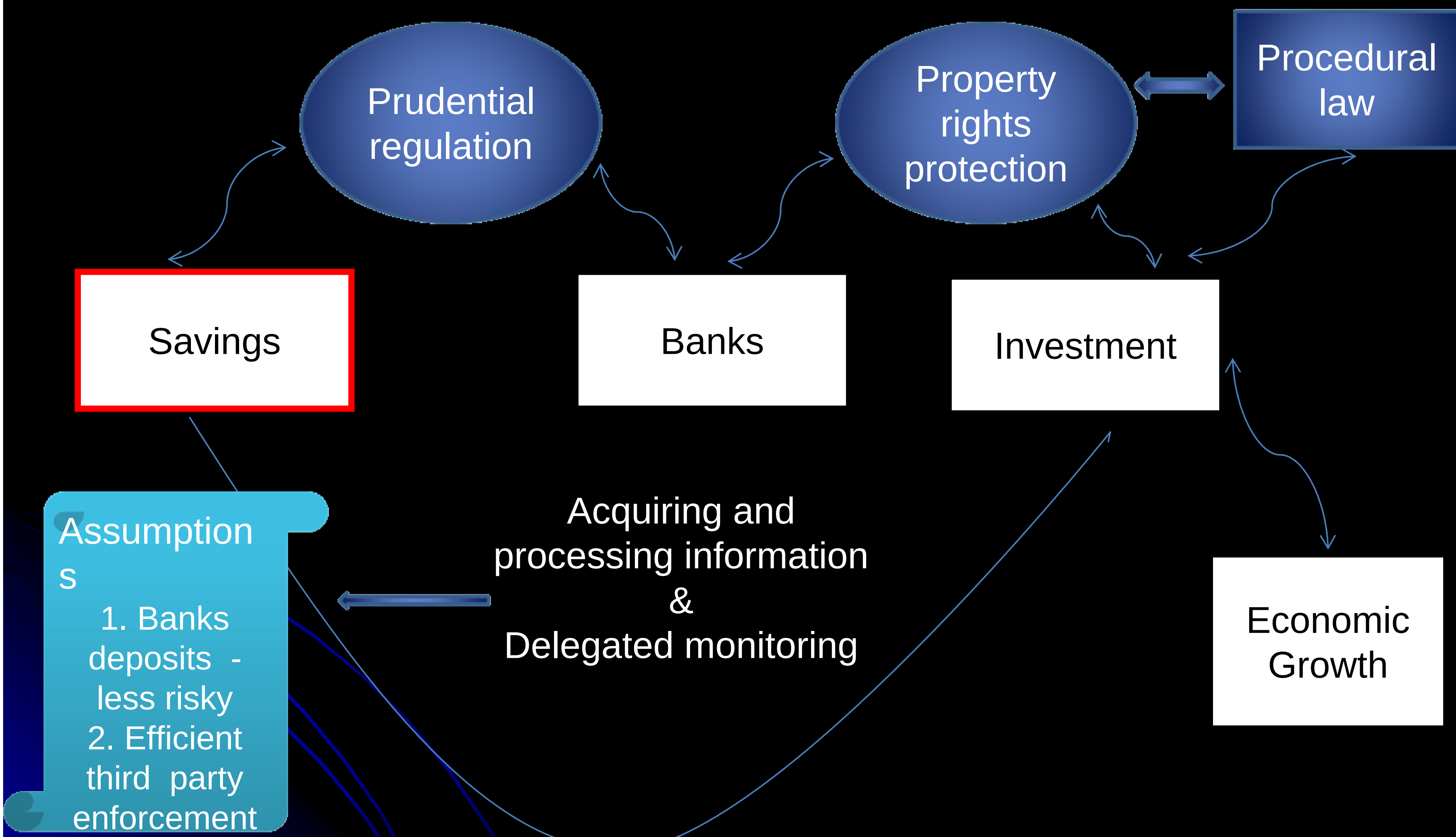
Corporate governance in Capital Markets: The Protection to Minority Share holders:

- ***"Given information imperfection and broader imperfections in market discipline, managers have enormous discretion in diverting resources.... In the absence of effective legal structures, such corporate theft can reach the status of grand larceny--as it did in some of the former socialist economies.... A whole new vocabulary was invented--assets were 'tunneled' out of corporations by the controlling manager, leaving the shareholders with nothing but a shell."***

---Joseph Stiglitz

- protection of outside shareholders (usually, even collectively, minority) shareholders from exploitation by the owner-managers and inside investors.
- agency costs and the inability to implement complete contracts gives the management some discretionary power. Under weak legal systems management discretion can be used to expropriate financiers through various means: Outright expropriation, transfer pricing, or asset stripping.

Schematic Overview of the Literature



When there is no information asymmetry and no transaction costs

Recent Banking Reforms in India and their impact

- One of the most protected and regulated sectors in the past
- The Narasimhan Committee (1991) proposed deregulation of interest rate, reduction of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) limits and reduction of compulsory lending to priority sector
- Legal and Judicial factors affecting banking performance:

  -- procedure of asset liquidation (Visaria, 2006) and

  - court delay (The Law Commission of India, 1988)
- Changes in Procedural Law:
- Debt Recovery Tribunals and SRFAESI Acts
  - Asset restructuring companies
  - Credit rating Agencies

Data & Methodology

Measure of financial sector development

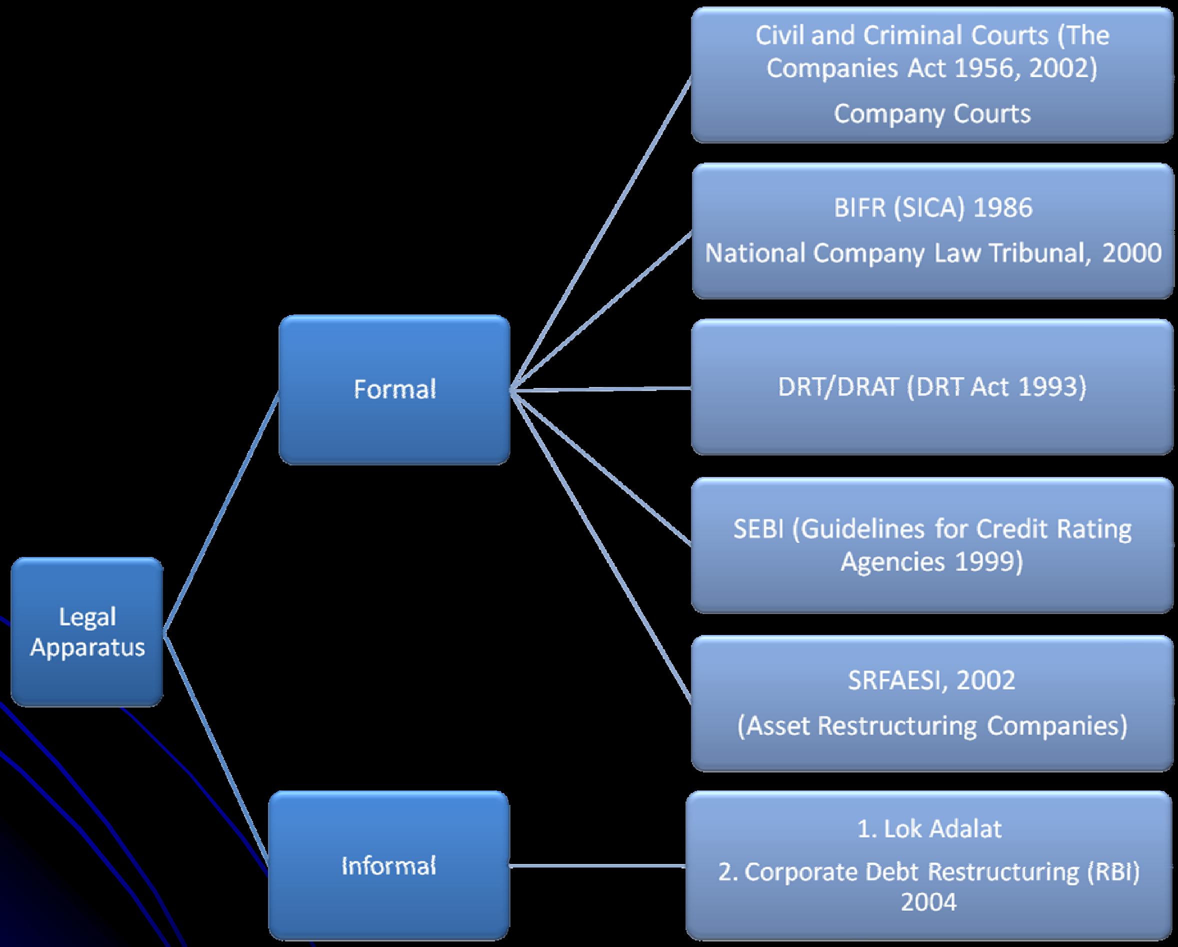
- Ratio of bank credit to the private sector to nominal GDP (CR)

- Real GDP per capita (PGDP) is used as our measure for economic development
- The possible channels considered are Per capita gross domestic savings (PGDS), per capita gross domestic fixed investment (PGDFI), per capita gross domestic fixed capital formation (PGDFC), the measure of trade openness (OPEN) and Total factor productivity (TFP)
- All the data are taken from National Accounts Statistics of India: 1950–51 to 2005-06

Index of Procedural Law and Enforcement (LD)

- India fares well in the index of investor and creditor protection (LLSV, 1997, 1998)
- Weak procedural law (Visaria, 2007; Law Commission Report, 1988)
- A number of procedural law initiatives pertaining to credit recovery
- Our index contains those provisions in law and regulatory reforms that matter for the speed and the quality of redress
- The index gets a value of one if a specialized board or tribunal is constituted to resolve insolvency and debt recovery matters for the period 1960 to 2006

Formal and Informal Legal Developments Pertaining to Debt Recovery Matters



Causality Test Results: Procedural law development (LD)

•There is a significant reverse causality from economic growth to financial sector development measured by private credit (CR) is not well pronounced

•Procedural law development (LD) significantly causes financial development.

•Causality from law to economic growth without any feedback effect.

- We analyze the procedural aspect of judicial efficiency on bank performance
- staggered introduction of DRTs to capture the causal effect of procedural innovation on the lending behavior of banks that were exposed to DRT (treatment group) vis-à-vis the banks that were not (control group).

Data

- The data on banks are taken from PROWESS database of CMIE for all the banks that have a national commercial presence
- Short listed 32 scheduled banks
- Data on commercial banks include advances to commercial sector in India (LADV), total advances including priority sector (LADVT), profits (LPROFIT) and banks' investments in India (LINV) for the years before and after the introduction of DRT i.e. for the years 1993 and 1995.
- Control for bank specific fixed effects we introduced number of employees and number of branches
- Control for state specific effects, we introduce output per worker and investment per worker taken from Annual Survey of Industries (ASI).

Results and Interpretation

- Highly significant and positive sign for DRT (POSTDRT) indicates that introduction of DRT had increased the advance (LADV)
- When investment per worker and output per worker to capture state specific information were introduced along with bank specific information measured by the number of employees and branches, DRT remains positive and highly significant
- The impact of DRT is significant and robust across different specifications
- Introduction of DRT has positive impact on other bank performance measures such as total advances made in India (LADVT), investment (LINV) and banks' profit (LPROFIT).
- Even after controlling for bank and state effects the impact of DRT is highly significant for total advances made and investment made within India.
- Results show that total advances made in India (LADVT) is higher by 1.3% (antilog of 0.263), investment (LINV) is higher by 1.5% (antilog of 0.393) and banks' profit (LPROFIT) is higher by 1.6% (antilog of 0.493) vis-à-vis the banks did not have access to DRT.

- Our study reveals that the phenomenal growth in Indian financial sector could be in part attributed to legal developments and positive changes in regulatory environment.

- Financial sector reforms/ regulation must be formulated not as an ad hoc measure whenever necessary but must reflect the overall analytical basis from which it is drawn.
- There is a need to study the features of the Indian Financial sector in a much more detailed manner.
- Study the Substantive Law
- And put together the correct procedural laws in place which lend support to the substantive law.
- The Institutional Approach seems to be by far the most effective way of analyzing the problems.

THANK YOU