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**The Role of Central Banks in Driving the Development Agenda**

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The recent global financial crisis that has caused serious dislocation to the economies of the developed countries (DCs) as well as the knock-on effects on the emerging and developing countries (EDCs) has raised a number of serious concerns. First, the role of the regulatory and supervisory agencies in carrying out their tasks has been seriously questioned. Second, the emergence of the shadow banking immune from the oversight indicates a gap in the tool box of the regulatory system. Third, it has been asserted that the financial sector particularly the banks are not performing any socially useful functions or creating any value for development in the EDEs.

Ross Levine, a leading academic researcher has argued that failures in the governance of financial regulations helped cause the global financial crisis. According to him there was a fatal inconsistency between a dynamic financial sector and a regulatory system that failed to adapt appropriately to financial innovation. Levine’s main thesis is that “financial innovations, such as securitization, collateralized debt obligations and credit default swaps, could have had primarily positive effects on the lives of most citizens. Yet, the inability or unwillingness of the governance apparatus overseeing financial regulation to adapt to changing conditions allowed these financial innovations to metastasize and ruin the financial system.

The above questions therefore warrant a re-examination of the Central Banks and the regulators particularly in the emerging and developing countries (EDCs).

Asia region presents a wide spectrum of financial systems with Hong Kong, Singapore, Korea on one extreme, Malaysia, Thailand, Indonesia, China, India, etc. in the middle and Cambodia, Laos, Mynmar, Nepal, Afghanistan at the other. Thus financial regulation cannot be considered in isolation from the larger questions of market structure, financial institutions, financial infrastructure macro-economic frame and overall stage of development of a country. How do these factors impinge upon regulation?

Market structure consists of the degree of competition and interlocking control between financial institutions and business enterprises as well as the degree of specialization within the financial sector. It is influenced by the internal organization, management and governance structure of financial institutions. These, in turn, are affected by the degree of government ownership and control.

A well developed technology driven financial infrastructure such as laws, payment system, accounting and auditing can aid or hinder the efficient functioning of the financial system. The overall macroeconomic framework particularly monetary stability, fiscal prudence and realistic exchange rate is a powerful anchor of the regulations. The higher is the reliance of the government on the banking system the weaker is the effectiveness of the regulatory framework.

The regulatory framework in a particular country has therefore to be designed in

light of the broad development objectives set by the policy makers in addition to the attributes described earlier. This framework should be broad enough to include regulations imposed both for monetary policy as well as prudential purposes and meeting the development objectives. The test of an adequate regulatory framework in this set of conditions is whether it can help ensure financial stability by reducing the probability of bank failures and the costs of those that occur and also contribute to the growth of economic activities that help stimulate equitable and sustainable development.. Regulation is primarily about changing the behavior of regulated institutions because unconstrained market behavior tends to produce socially sub-optimal outcomes. The regulator in the post crisis period has to assume the responsibility to move the system towards a socially optimum outcome. In EDEs with their own development agendas, the Central Bank can help generate such outcomes by playing a more pro-active and facilitative role. In countries where financial inclusion is low, incidence of poverty is high, key economic sectors which help the poor are underinvested, the Central Banks ought to align their regulatory frameworks with other public policies to help achieve the desired goals.

I would therefore take up Pakistan as an illustrative Case Study of a two track tiered approach followed by the regulator. At the top level the strategy followed by the State Bank of Pakistan is to improve the market structure and competition, to strengthen the governance and risk management within financial institutions, to build up an adequate financial infrastructure and to contribute to sound macroeconomic management through monetary and exchange rate policies. At the second tier, the SBP performed a promotional role in nurturing institutions, providing incentives and enabling investments in micro-finance, agriculture finance, SME finance, low cost housing finance, export refinance, infrastructure financing, etc.

The steps that were taken to stimulate competition and improve the market structure consisted of lowering entry barriers, abolishing interest rate ceilings, privatizing government owned banks, promoting mergers and consolidation of financial institutions, enlarging the economies of scope for banks, liberalizing bank branching policy and removing direct credit regulations.

In the realm of financial institutions strengthening, incentive structure is so designed that the bank owners stand to make substantial losses in the event of insolvency arising from excessive risk taking. Capital adequacy requirements and loan loss provisions fulfill this role. Limiting bank holdings of excessively risky assets, preventing lending to related parties, requiring diversification and making sure those banks have appropriate credit appraisal, evaluation and monitoring procedures in place are all driven by this consideration.

Corporate governance code and best practices have been prescribed for the banks by the SBP. Adverse selection in bank entry is avoided and the individuals likely

to misuse bank do not get bank licenses. Fit and proper criteria and character stipulations, financial back-up and past track record are scrutinized carefully for the controlling shareholders, directors of the boards, chief executives and senior management of the banks.

One of the positive developments in Pakistan’s financial infrastructure has been

the evolution of the payment system from the traditional cash and paper-based modes of payments to a network of more sophisticated, technologically driven systems. Although cash continues to be the dominant mode of settlement of payments especially in rural areas, non-cash modes of payments have increased in volume over time. The banking sector has invested heavily in IT infrastructure in the last decade that has resulted in increased acceptance of e-banking as the preferred retail payment instrument. As of end June 2010, the number of real-time on-line branches constituted 73 percent of total bank branches and 31 percent of total electronic transactions. ATM-based transactions are gaining popularity and now account for over 50 percent of electronic transactions. Similarly, the implementation of the Real Time Gross Settlement (RTGS) system by the SBP has facilitated automation of large value transactions thus reducing the settlement risk. The legal infrastructure in Pakistan however remains weak and is a hindrance to financial sector growth. Reforms and legal infrastructure and enforcement are therefore necessary.

However, the efforts of SBP as a regulatory have not been helped due to persistence of macroeconomic imbalances in fiscal and external accounts over last three years. These imbalances pose system-wide challenge to financial stability in Pakistan. Large public sector borrowing to finance budgetary deficits as well as losses of state owned enterprises have added to the vulnerabilities of the banking system. The banks are making good profits as they charge higher than market prices for activities such as commodity financing and have shifted to low risk weighted assets in their portfolio by lending to the government thus showing preserving capital.

In the period 2000-2008, the SBP however, took some innovative steps as part of its second tier regulatory role. The banks were encouraged to broaden their client base, add new products and to their portfolio, offer new types of services. The banks soon realized that this approach not only help diversify their risks but also resulted in higher returns. The economies of scale and scope facilitated by IT platform made the achievement of these goals quite feasible.

In Pakistan, only 15 percent of the population has access to the formal financial sector and less than 4 percent (5.5 million) are borrowers. Moreover, only 25 percent of total bank depositors and 17 percent of total borrowers reside in rural areas which are home to two thirds of the country’s population. Low level of bank branch penetration has held back the growth of savings and access to credit. The challenge for the SBP was how to design interventions that preserved financial stability , transmitted monetary policy but at the same time spurred financial inclusion. The SBP decided to focus its efforts on Microfinance, SME, agriculture , infrastructure, mortgage but got mixed results.

Pakistan became a pioneer among the EDEs to set up a legal regulatory and supervisory framework for Microfinance. The SBP’s approach for this sector was quite unique and distrust compared to that for the conventional commercial banks. In the case of microfinance it acted more as a promoter and facilitator rather than preventer and wrist slapper. The efforts made by the SBP for mainstreaming Microfinance into the formal financial sector while maintaining its own distinctiveness , flexibility and uniqueness is something can be of interest to other EDEs. This blended and bifurcated regulatory regime for Microfinance has shown impressive results. Eight Microfinance Banks (MFBs) have been established including transformation of three leading Microfinance Institutions (MFIs) and two of the world’s largest MFIs have started operations in Pakistan reflecting private sector participation and institutional diversity. The industry has reached out to 2 million borrowers in the last decade and has grown at impressive rates – among the fastest in the EDEs. But the current outreach has touched less than 10 percent of the potential market and it is a long way before it makes a significant dent in the incidence of poverty. The recent introduction of alternative delivery channels i.e branchless banking and mobile phone banking is likely to yield satisfactory results.

The SME sector faces a host of both demand and supply side constraints that impede credit delivery. On the demand side, lack of planning and entrepreneurial skills remain major hindrances while on the supply side banks perceive financing these entities as high risk in the absence of credit history and collateral. The SBP, therefore, introduced a separate set of prudential regulations for the SME sector which based the credit risk appraisal on expected cash flow of the enterprises rather than on credit history and collateral. The banks were also encouraged to set up program based lending to SMEs. The share of SME credit in total outstanding rose to 17 percent before declining to 12 percent because of energy shortages and demand contraction arising from a slowing economy. SBP is helping banks in designing specific products, developing a credit scoring system and a financial reporting for SMEs. The number of borrowers still remains around 12 – 15 percent of the potential eligible borrowers in the sector.

Agriculture lending particularly to small farmers received a big boost through liberalization of interest rates and removal of mandatory credit limits imposed upon the banks. Rather than lending to small farmers at below-the-market prices up to the limits prescribed by the Central Bank the banks found they were better off by paying the penalties for non-compliance of the targets. The SBP in the year 2000 removed the interest rate ceilings for lending to agriculture sector and also abolished the mandatory credit limits. As a result, the banks margins on demand-constrained agriculture lending shot up and their earnings from the segment went up significantly. Consequently, agriculture lending by the banking sector multiplied eight fold in eight years, i.e. from Rs.30 billion in 2000-01 to Rs.250 billion in 2008-09. But despite such spectacular expansion in the volume the current flow of credit meets only 50 percent of the sector’s credit requirements. The number of borrowers has reached 2 million while three million potential borrowers remain outside the formal banking sector. Some innovative measures have been taken by the SBP to fill in this gap. A revolving three year credit scheme under which farmers can borrow for one year and continue to borrow without providing documentation each year has been successfully introduced by the SBP. In view of the growing importance of livestock, dairy farming, fisheries and horticulture new guidelines have been issued for lending to these subsector which had remained untouched by the banks so far.

The traditional mode of financing infrastructure projects only through Public Sector Development Program (PSDP) has resulted in congestions, shortages and bottlenecks. The experiment with a dedicated fund for Independent Power Producers (IPPs) was successful but a number of lessons were also learnt from it. An Infrastructure Fund Facility (IFF) has to complement an Infrastructure Development Fund (IDF) that attracts private sector either on stand alone basis or in partnership with the public sector to set up long gestation infrastructure projects in the country particularly hydropower, dams, electric power stations, railways, etc. The Contractual Savings Institutions (CSIs) are looking for opportunities to invest in long term instruments and a match between the supply of funds by CSIs and the demand of funds by IFF would lead to a socially optimal solution to the problem being faced by the country in meeting its infrastructure needs.

Mortgage financing particularly for low cost housing has not yet taken off in Pakistan. Unlike countries such as Malaysia where the commercial banks and other financial institutions such as Contractual Savings Institutions have played a key role in provision of housing Pakistan has lagged far behind. Mortgage financing accounts for less than 1 percent of GDP and the recent slump in economic conditions has further slowed down housing construction. Demand for mortgage financing is therefore subdued. The regulators have allowed setting up Real Estate Investment Trusts (REITS) but only such REITS have actually been formed. The scope for mortgage finance remains large and untapped as the middle income class is growing rapidly.

In the end, let me make it quite clear that the two tiers of regulatory regime which I have discussed above are closely interlinked and intertwined. If the Central Bank is weak in performing top level regulatory functions it is highly likely that taking up the second tier responsibilities would only do harm to financial and monetary stability. It would be inadvisable to engage in developmental activities until such time as the capacity to undertake primary regulatory functions and perform them effectively and efficiently is strengthened.

1. Lead speaker at 2nd OIC Experts’ Group Workshop on Central Banking and Financial Sector Development held at Bank Negara Malaysia, Kuala Lumpur on November 13-14, 2011 [↑](#footnote-ref-1)