Financial regulation in low-income countries: balancing growth with stability

Dr Stephen Spratt, ISSER Conference Centre, University of Ghana. 10-11 September 2013.
Presentation

- Research questions and approach
- Methods
- Specification of questions for review
- Review results
- Key findings
- Main research gaps and questions for discussion
Research question and approach

The primary question to be addressed is: How does financial regulation in low-income countries (LICs) affect growth and financial stability?

Two parts to this ‘causal chain’:
1. How do the different components of the financial system impact upon growth and stability?
2. How does regulation impact effect these components of the financial system?

- Direct effects: where regulation influences the day to day behaviour of financial actors
- Indirect effects: where regulation influences the ‘architecture’, or structure of the financial system, which affects growth and stability outcomes.
How might approach to regulation differ in LICs?

“...for many low income countries, especially in Africa, financial regulation policies constitute the foundation basis for the mechanisms through which financial development exerts a positive impact on economic growth and poverty reduction.” (Murinde, 2012)

- Growth and poverty reduction a more pressing imperative
- FSD at an early stage (e.g. Regulation needs to reflect this, but also adjust dynamically as the system evolves)
- Fewer, more systemically important institutions
- Economic structures different (more concentrated and volatile. Agriculture; SMEs, informal sector more important)
- Greater need to manage external sector due to potentially large effects on domestic financial systems and real economies
Methods

- First step was to develop a conceptual framework to capture causal channels from regulation to growth and stability, both directly and indirectly.
- This resulted in 7 research questions to be addressed, 4 address direct impacts, 3 indirect.
- Given the complexity of issues, the research questions were then further organised in sub-questions,
- Keywords and phrases were developed for each sub-question and used to search main academic databases.
- 14,000 titles/abstracts. Subsequently screened to leave approximately 1,000 papers
- Criteria: LIC focus; relevant to research question minimum quality threshold,
- 1,000 full papers obtained, organised by question and sub-question, and reviewed for evidence/insight
7 Research questions

RQ1: What constitutes sustainable access to the financial system, and how should financial regulation be structured to achieve this?

RQ2: What is the appropriate level and form of financial provision to government, and how should regulation be structured to achieve this?

RQ3: What is the appropriate level and form of banking sector flows to the private sector, and how should regulation be structured to achieve this?

RQ4: What is the appropriate level and form of non-bank investment flows, and how should regulation be structured to achieve this?

RQ5: What is the best financial sector architecture to facilitate sustainable financial inclusion, and how should regulation be structured to achieve this?

RQ6: What is the best banking system architecture for growth and stability, and how should regulation be structured to achieve this?

RQ7: What are the best capital market and insurance sector architectures for growth and stability, and how should regulation be structured to achieve this?
Purpose of ‘pre-systematic review’

- To provide a conceptual framework for the relationships between regulation, the financial sector, and growth and stability in LICs.
- To identify the primary channels through which these relationships work: i.e. regulation to finance, and finance to growth and stability.
- To map these channels onto research questions, and to prioritise these questions in an LIC context: e.g. what role could public banks play in maximising growth with stability; how should they be regulated to facilitate this?
- To (within the limits of what is feasible) obtain and assess the existing evidence on each of these questions in an LIC context.
- To summarise the existing evidence, and provide an assessment of what this tells us about the primary research question to be addressed: How does financial regulation in LICs affect inclusive growth and financial stability?
- To identify and prioritise the most important research gaps.
Results
RQ1: What constitutes sustainable access to the financial system in LICs?

<table>
<thead>
<tr>
<th>Sub-questions</th>
<th>Results</th>
<th>Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1 What basic financial services are needed and how much should they cost in LICs?</td>
<td>71</td>
<td>5.01</td>
</tr>
<tr>
<td>1.2 What is a sustainable level of personal debt in LICs?</td>
<td>11</td>
<td>5.66</td>
</tr>
<tr>
<td>1.4 How can the supply of third party credit bureaux be increased in LICs?</td>
<td>4</td>
<td>4.5</td>
</tr>
<tr>
<td>RQ1</td>
<td>86</td>
<td>5.04</td>
</tr>
</tbody>
</table>
RQ1 Findings and gaps

- The costs of providing services such as basic bank accounts far too high. Solutions well understood:
  - Increase competition (reduce entry barriers)
  - Reduce information asymmetries
  - Use innovative approaches to lower transaction costs (e.g. Mobile and branchless banking)
  - Prioritise 3rd party agencies (information sharing requirements may be needed, and public bodies)

Gaps

- More research needed to identify financial products needed/wanted by the poor
- Should these be packaged (bundled?), to reduce transaction costs
- How does the use to which debt is put influence debt sustainability (e.g. Demand for MFI funded goods)?
RQ2: What is the appropriate level and form of financial provision to government?

Table 5. RQ2 sub-questions, results and quality

<table>
<thead>
<tr>
<th>Sub-questions</th>
<th>Results</th>
<th>Quality</th>
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</thead>
<tbody>
<tr>
<td>2.1 What level/maturity of government debt is most supportive of inclusive growth?</td>
<td>39</td>
<td>4.63</td>
</tr>
<tr>
<td>2.2 When does government borrowing start to crowd out the private sector in LICs?</td>
<td>3</td>
<td>5.3</td>
</tr>
</tbody>
</table>
RQ2 Findings and Gaps

- Distinguish between domestic and external channels
- Domestic: main issue is crowding out of private sector credit; may be less of an issue in LICs due to concessional finance, but low integration into global markets may offset
- External: main issue is currency mismatch and debt sustainability
- Both need to be rigorously reassessed for LICs

Gaps

- What is a sustainable level of domestic currency debt in LICs? How is this influenced by sector where debt invested?
- How can borrowing differentials between external and domestic currency be reduced? (In February 2013, a 10-year international currency bond in Ghana yielded 4.5%; a 5-year domestic currency bond, in contrast, yielded 20%)
- Post Rogoff-Reinhart + post-2007/8 crisis + post macro and fiscal instability in LICs, does ‘debt intolerance’ still hold, and what is a sustainable level of external debt?
RQ3: What is the appropriate level and form of banking sector flows to the private sector?

Table 7. RQ3 Sub-questions, results and quality

<table>
<thead>
<tr>
<th>Sub-questions</th>
<th>Results</th>
<th>Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Appropriate provision of credit to the private sector</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.1 What role should public finance institutions play in addressing market failures in LICs?</td>
<td>50</td>
<td>5.12</td>
</tr>
<tr>
<td>3.2 How should microprudential regulation be structured to positively influence the supply of credit and the terms of credit in LICs?</td>
<td>149</td>
<td>5.46</td>
</tr>
<tr>
<td>3.3 Which macroprudential mechanisms are likely to have a net positive effect on bank stability in LICs?</td>
<td>34</td>
<td>5.1</td>
</tr>
<tr>
<td>3.4 What is the best balance between home and host bank supervision to balance growth and stability in LICs?</td>
<td>11</td>
<td>5</td>
</tr>
<tr>
<td><strong>Banking crises: determinants and solutions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.5 What are the determinants of banking crises, and what measures are best suited to preventing them?</td>
<td>86</td>
<td>4.92</td>
</tr>
</tbody>
</table>

** Most important category; largest number of results
RQ3.1: What role should public banks play in addressing market failures in LICs?

“...allocation of financial resources purely by market forces is far from ideal. It leaves without access precisely those that need it most. Some examples are: poor household in need of financing for education or housing; micro enterprises that need access to working capital at reasonable interest rates; SMEs with good investment projects; local governments that must satisfy the needs of their inhabitants for clean water or education.” (Agostin 1999)

- Market failures undisputed, as is the case for public banks
- Largely negative experience in LICs led to view that ‘government failure was inevitable and worse than market failure
- Confirmed by seminal empirical work (La Porta et al.2002)
- 2007/8 crisis changed perceptions: public banks do things private bank don’t (e.g. perform valuable counter-cyclical functions)
- Successful banks (e.g. BNDES) gained more attention
- New econometric work = institutional quality that matters
- Public banks neither good nor bad: good public banks are good, and vice versa
- Gap: how to design and regulate to **fulfil development mandates**, while avoiding the well-documented failures of the past.
RQ3.2: How should the microprudential regulation and supervision of banks be structured in LICs?

- **Who** should supervise, **what** they should supervise, and **how** this should be done?
  - **Who**: strong case for unified approach to supervision with strong central bank involvement
  - **What**: everything, but not in the same way. Stringency of regulation linked to complexity and systemic important of institutions – banks vs. MFIs. Case for regulatory forbearance in new and innovative areas, particularly where they reduce transaction costs (e.g. M-Pesa in Keny)
  - **How**: regulators and supervisors in LICs have retained a far more diverse ‘toolkit of instruments than is the case in developed countries. Should be retained and used flexibly

Gaps

- To what extent should Basel 2-3 be implemented, as much of is not applicable in LICs?
- How can finance be channelled to the most developmentally important sectors that may not be the most profitable?
RQ3.3: Which macroprudential mechanisms are likely to have a net positive effect on bank stability in LICs?

- Debate in developed economies pre-dated by a considerable literature on counter-cyclical policy in developing countries.
- Considerable body of research to draw upon. Both in terms of key indicators, and the appropriate tools to employ (e.g. Various Ocampo publications).

**Gaps**

- Does the imperative of financial sector development in LICs require a different approach to macroprudential policy, with a greater emphasis on growth than stability than in developed economies?
- When are booms good? (i.e. Leading to financial deepening and positive for long-term growth)
- How can a macroprudential framework incorporate and balance both domestic and external factors?
RQ3.4: What is the best balance between home and host bank supervision in LICs?

- Supervisory questions are distinct from arguments for and against foreign bank participation in developing countries - the most important questions relate to the responsibilities and control of home and host supervisors.
- Branches = home supervision
- Subsidiaries = host supervision
- Generally, more control over banks operating in a jurisdiction better than less.
- Therefore subsidiaries are preferable to branches (in general terms)
RQ3.5: What are the determinants of banking crises in LICs, and how can they be prevented?

- Plenty of evidence on the determinants of banking crises, but much of it is contradictory (e.g. Too much competition vs. not enough competition) – methods poor + context specific
- Liberalisation clearly associated with greater crisis risk. Particularly the case with volatile (short-term) capital inflows.
- Bank ownership: public banks have been associated with crises; recent research reverses findings on foreign banks – may increase crisis risk (depending on home market)
- Crisis drivers seem deeply rooted in human psychology. Not a question of if they will occur, but how to reduce risks
- In LICs at an early stage of financial development, the risk of future booms and crises very high, and external capital flows are very important in this regard.

**Gaps**

- How to regulate banks (and external flows) to reduce crisis risk while not stifling finance for growth and development
- How should deposit insurance be designed in LICs?
RQ4: What is the appropriate level and form of non-bank investment flows in LICs?

<table>
<thead>
<tr>
<th>Sub-questions</th>
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<th>Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1 Which sectors in LICs are most suited to (which types of) non-bank, finance (domestic and external)?</td>
<td>72</td>
<td>3.2</td>
</tr>
<tr>
<td>4.3 Which sectors are most susceptible to bubbles, and create most damaging economic effects in LICs?</td>
<td>68</td>
<td>4.6</td>
</tr>
</tbody>
</table>
RQ4: Findings and gaps

- Questions on the best forms of non-bank financing in LICs are significantly under-researched.
- Potential to expand existing institutions into new sectors (e.g. microfinance), and to develop institutional forms (e.g. private pensions, and venture capital/private equity firms).
- We know little about the best ways of achieving this, or the role that regulation could play.
- External capital should be attracted into sectors with the greatest development potential such as infrastructure (these may not be the sectors that external investors wish to invest in though – and returns expectations may be excessive)
- Property sector particularly associated with asset price bubbles
- Natural resource sector may be source of instability and ‘hot’ inflows.
- May be wise to restrict the types of external finance that has access to these sensitive sectors
RQ5: What is the best financial system architecture for financial inclusion?

Table 10. RQ5 sub-questions, results and quality

<table>
<thead>
<tr>
<th>Sub-question</th>
<th>Results</th>
<th>Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 What is the optimal size/composition of the financial sector in LICs for financial inclusion?</td>
<td>61</td>
<td>4.9</td>
</tr>
</tbody>
</table>
RQ5: Findings and gaps

- The main finding for this question is that **diverse financial systems**, where a range of institutions compete for overlapping sections of the market are likely to be most positive for financial inclusion.

- E.G. Rural banks should face competition from commercial banks employing innovative approaches in rural areas, as well as from MFIs and Savings and Credit Cooperative Organisation (SACCOs).

- Regulation should be sufficient but avoid creating high entry barriers and be tailored to the complexity of institutions: a small, local cooperative should be regulated differently to a large, commercial bank.

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Gaps

- Improve understanding of how regulation could be structured to encourage the development of a diverse financial system.
RQ 6: What is the best banking system architecture for growth and stability?

Table 11. RQ6 Sub-questions, results and quality

<table>
<thead>
<tr>
<th>Sub-questions</th>
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<th>Quality</th>
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</thead>
<tbody>
<tr>
<td>6.1 How large and diversified should the banking sector be to best balance growth and stability?</td>
<td>57</td>
<td>4.6</td>
</tr>
<tr>
<td>6.2 What is the best composition of banking - e.g. geographic; sectoral; SMEs; universal banks?</td>
<td>84</td>
<td>5.2</td>
</tr>
<tr>
<td>6.3 What is the right balance between domestic and foreign banks' market share?</td>
<td>65</td>
<td>4.9</td>
</tr>
</tbody>
</table>
RQ6: Findings and Gaps

- **RQ6.1**: recent suggests that, beyond 80-100% of GDP, FSD becomes negative for growth. More chance of (bigger) crises + misallocation of assets

- **RQ6.2**: some argue that LICs should primarily rely on small, local banks (e.g. Justin Lin). Others argue for a mix of small and larger banks. (*Gap: what is the correct balance + how to prevent consolidation process?*)

- **RQ6.3**: opinion shifted considerably after 2007-8 crisis. Foreign banks can be destabilising, particularly where they dominate the financial sector. Also bring benefits, however: aim should be to obtain these benefits while not allowing foreign banks to take too large a market share (*Gap: what is the optimal market share for foreign banks?*)
RQ 7: What are the best capital market and insurance sector structures for growth and stability in LICs?

<table>
<thead>
<tr>
<th>Sub-questions</th>
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<th>Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1 What is the optimal capital market architecture for growth and stability in LICs?</td>
<td>93</td>
<td>5.1</td>
</tr>
<tr>
<td>7.2 What is the optimal insurance sector architecture for growth and stability in LICs?</td>
<td>24</td>
<td>4.4</td>
</tr>
</tbody>
</table>
RQ7: Findings and Gaps

RQ7.1: developing efficient capital markets, particularly domestic bond market important long-term objective for LICs. Making progress on creditor rights and contract enforcement are important generally and should remain a priority. For now the banking sector will remain pre-eminent: preparatory work for capital markets should not distract from reforms to improve the banking sector.

RQ7.2: while insurance sectors in LICs also small, a range of innovative, practices are emerging as microinsurance. While these are promising, important questions remain. Key gaps: - how can insurance products be made available to those who need them most (i.e. the poorest)? - how can the ‘bottom-up’ microinsurance sector be linked to the ‘top-down’ sector that focuses on trade-related activities to fill the ‘missing-middle’ in insurance provision in LICs?
Key findings

- Stability is vital, but more as a precondition for growth than an end in itself: emphasise how finance can boost growth.

- If this growth is to be ‘inclusive’ a more proactive approach to FSD is needed. Market failures are endemic and financial exclusion will continue without effective intervention to:
  - understand better what financial services are needed by different sections of society, particularly poorer groups
  - encourage innovation to drive down transaction costs
  - foster a diversity of financial institutions, which have different goals and compete to serve overlapping sections of the market

- Use public funds strategically, and public banks to channel funds to developmentally important but not necessarily lucrative sectors

- Regulation should be unified not uniform: diversity & competition need low entry barriers and regulation tailored to the circumstances of different institutions.

- Regulators in LICs should chart their own path

- External finance needs to be actively managed for this to be possible
Key gaps & questions for discussion

How to do most the previous things in practice...there is a pressing need for more research on finance in LICs.

Specific questions:
- What products and services are needed by different groups in society, and can these be delivered in affordable ‘bundles’?
- How can FSD with a diverse range of financial institutions be fostered and maintained, when finance tends towards consolidation and returns to scale?
- To what extent can the lessons from successful public development banks (e.g. In Brazil) be translated to LICs?
- How should regulation be structured to be a) unified and b) non-uniform? (i.e. How to avoid local cooperatives being crushed by regulation suited for large banks?)
- How can regulators retain sufficient autonomy, only adopting (and adapting) relevant international standards?
- How should external finance be managed to support domestic FSD, rather than undermine it?