

Effect of banking regulations on financial intermediation

[Finance](#), [Banks](#)



Introduction

Banks have all along played the role of financial intermediaries by channelizing funds primarily from household sector to producing sector and the efficiency and smoothness with which such intermediation is done by banks is one of the prime parameters that determine the economic efficiency and consequent industrial and material progress of a society. Financial intermediation has a cost and that cost is reflected in bank rates and overhead expenditures incurred by banks. Bank rates, however, are not determined in isolation or only from the perspective of profit maximization by the banking sector. These rates are impacted by many other economic and statutory issues pertaining to a particular economy and such issues may vary widely from economy to economy depending upon the administrative attitude towards matters of equanimity in various sectors of the economy, especially the banking sector itself. The general view among experts in this field is that if administrative authorities are in favor of competition, it will lead to the presence of larger number of players in the banking sector that would automatically lead to lower bank rates as competing bankers will vie with each other to attract customers, and will automatically have to become efficient in their functioning in order to stay afloat in such highly competitive environment. So, the economy as a whole would be able to enjoy efficient banking services coupled with comparatively affordable bank rates.

However, if entry in banking sector is strictly regulated, it would result in less competition and might also lead to lesser efficiency and almost certainly higher bank rates as the few banks that would be operating in the finance sector would remain assured of clients as the latter would have no option but

to approach these few bankers for finance. It must be repeated, however, that these statutory regulations differ so widely between countries and regions that the only plausible method of measuring the impact of such biases and restrictions on bank rates and efficiency would be to consider each instance individually and comparing it with the larger and more generic backdrop of financial efficiency. (Demirgüç-Kunt, Laeven and Levine)

Impact of net interest margin and overhead expenditures on Cost of intermediation

Cost of intermediation is substantially impacted by net interest margin and it would be worthwhile to study in a little more detail as to the exact characteristics and features of net interest margin. Put simply, the net interest margin signifies the income of banks and it consists of the interest a bank earns by lending money to borrowers and the interest it has to pay to its depositors. The exact measure of net interest margin is obtained by dividing the difference between a bank's interest earning and interest expenditure by the volume of interest bearing assets. The net interest margin thus is related to the traditional functions of banking industry - accepting deposits at lower interest rates and lending them at higher rates of interest.

The overhead expenditure ratio of a bank is calculated by dividing bank overhead costs by the total assets of the bank. It is but obvious that the more inefficient a bank the higher would be its overhead expenditure ratio. But overhead expenditures are not only dependent on pure operational efficiency of a bank. It also depends on the prevailing market regulations and

freedom or otherwise for players to leave or enter the banking sector as and when the desire to do it arises. The degree of freedom of entry or exit is, quite obviously, determined by the statutory or law enacting authorities of the country. It might be worthwhile to mention at this juncture that though freedom of entry and exit primarily determines the extent of competition in the banking sector, there are other equally important issues that determine the ability of the commercial banks to offer credit to potential customers. It is proper at this stage to take a closer look at these regulatory issues that influence the quantum of credit that commercial banks can offer to customers and the consequent cost of financial intermediation in an economy.

There are two principal instruments to impact the bank regulations and monetary policy that are adopted by central bank of an economy to control the availability of credit in the economy. They are:

Quantitative Instruments and Qualitative Instruments

These instruments, by restricting or allowing commercial banks to offer loans, actually increase or decrease the overhead expenditures of a banking company. It perhaps needs no elaboration that overhead expenditure ratio will get lower and lower as more and more deposits available to the bank are lent outside. The more it can lend from the deposits collected, the higher will be the proportion of interest bearing assets with respect to total assets and quite naturally, the overhead expenses per unit of interest bearing asset will start falling. Thus every banker in his mind wishes for a regime that is very soft on application of these monetary policy instruments.

Quantitative Instruments:

These are those instruments of monetary policy which affect overall supply of money/credit in the economy. These instruments do not direct or restrict the flow of credit to some specific sectors of the economy. Important ones are:

Bank Rate: The bank rate is the minimum rate at which the Central bank of a country (as a lender of last resort) is prepared to give credit to the commercial banks. The increase in bank rate increases the rate of interest and credit becomes dear. Accordingly, the demand for credit is reduced. On the other hand, decrease in the bank rate lowers the market rate of interest charged by commercial banks from their borrowers. Credit becomes cheap; accordingly, demand for credit expands. The Central bank adopts dear money policy when supply of credit needs to be reduced during periods of inflation. It adopts cheap money policy when credit needs to be expanded during deflation.

Success of bank rate policy, however, depends on the following factors:

- Degree of dependence of commercial banks upon Central Bank for loans: If commercial banks have their own surplus funds which they can utilize during periods of high credit needs, their dependence on Central Bank is comparatively less.
- Degree of sensitivity of bank's demand for funds from the Central Bank: Depending on business conditions, commercial banks may or may not be very sensitive to small variations in bank rate. In such situations, bank rate policy may not be a big success.

- Structure of interest rates in the money market: If non-banking financial institutions in the market vary their interest rates in accordance with what Central Bank expects from the commercial banks, the bank rate policy may not succeed.
- Overall supply of funds in the market: Bank rate policy may not be a success if non-banking sources of funds are of greater importance in an economy than banking sources.
- Open Market Operations: Open market operations refer to the sale and purchase of securities in the open market by the Central Bank. By selling securities, the Central Bank absorbs cash balances from within the economy. And, by buying securities, the Central Bank contributes to cash balances in the economy. Cash balances are high powered money on the basis of which commercial banks create credit. Thus, through open market operations, if cash balances are increased, flow of credit will increase many times more, and if cash balances are reduced, the flow of credit will decrease many times more.

Success of open market operations depends on some of the following factors:

- Existence of securities market: There must be a well organized and properly functioning market for the sale and purchase of securities. In the absence of it, open market operations would make little impact on the overhead expenditures of commercial banks.
- Reserves with the commercial banks: If commercial banks tend to keep own excess reserves with them, they need not buy securities. This is the standard practice in several developed countries; therefore open

market operations under such market scenario would hardly ever be a success.

Cash Reserve Ratio (CRR): It refers to the minimum percentage of a commercial bank's total deposits required to be kept at the central bank. Commercial banks have to keep with the Central Bank a certain percentage of their deposits in the form of cash reserves as a matter of law of the country. For example, if the minimum reserve ratio is 10% and total deposits of a particular commercial bank is \$100 million; it will have to keep \$10 million with the central bank. If the minimum reserve ratio is raised to 20%, the commercial bank will have to keep \$20 million with the Central Bank. When the cash flow or credit is to be increased in the economy, minimum reserve ratio is reduced, and when the cash flow or credit is to be reduced in the economy, minimum cash reserve ratio is increased.

Statutory Liquidity Ratio (SLR): Every commercial bank is required to maintain a fixed percentage of its assets in the form of cash or other liquid assets called SLR. With a view to reducing the flow of credit in the market, the Central Bank increases this liquidity ratio. However, in instances of expansion of credit, the liquidity ratio is reduced. Success of both CRR and SLR again depends on the amount of excess reserves with the commercial banks. CRR and SLR would be rendered meaningless if banks are used to keeping high excess reserves.

Qualitative Instruments:

These are those instruments of monetary policy that focus on the alternative uses of credit in the economy. These instruments direct or restrict the flow of

credit to specified areas of economic activity. Of course some qualitative instruments may have the shade of quantitative instruments as well, but they are broadly classified in the following manner:

Margin Requirement: The margin requirement of loan refers to the difference between the current value of the security offered for loans and the value of loans granted. For example, a person mortgages an article worth \$100 with the bank and the bank gives the person a loan of \$80. The margin requirement in this case would be 20%. In case the flow of credit is to be restricted for certain specific business activities in the economy, the margin requirement of loan is raised for those very activities. The margin requirement is lowered in case the expansion of credit is desired. It is but natural that those banks that have more exposure to industries where the government of the country is unwilling to forward easy credit, will face lesser demand for loans and thus will be saddled with more idle funds and hence the overhead expenditure ratio for those banks would start soaring.

Credit Rationing: Rationing of credit refers to fixation of credit quotas by Central Bank for different business activities conducted in the economy. Rationing of credit is introduced when the flow of credit is to be checked especially for speculative activities in the economy. The Central Bank fixes the credit quota for different business activities. The commercial banks cannot exceed the quota limits while granting loans.

Direct Action: The Central Bank of a country might initiate direct action against the member banks in case they do not comply with its directives.

Direct action includes withdrawal of banking license of the erring commercial bank and disallowing it to continue with banking business any longer.

Moral Suasion: Sometimes, the Central Bank makes the member banks agree through persuasion or pressure to follow its directives with a view to controlling the flow of credit. The Central Bank has regulatory authority over all commercial banks and hence these banks generally care for and heed to the advices given by Central Bank with regard to expanding or contracting the flow of credit.

If flow of credit is expanded, overhead expenditure ratio of commercial banks comes down and if the flow of credit is restricted, the overhead expenditure ratio of commercial banks goes up. If overhead expenditure ratio goes up, the commercial banks are compelled to increase their lending interest rates in an effort to retain the net interest margin.

Selective Credit Controls: It refers to the discriminatory policy of Central Banks in favor of or against certain sectors of the economy. Flow of credit to certain sectors (priority sectors) may be encouraged with a view to stimulating the level of activity in these sectors. This is a positive application of Selective Credit Control. Also, the Central Bank may decide to restrict the availability of credit to certain (non-priority) sectors. Generally, during periods of inflation, availability of credit for speculative activities is discouraged. This is a negative application of Selective Credit Control. Commercial banks falling within the ambit of negative Selective Credit Control usually find it rather difficult to maintain their net interest margin.

Market structure-Competition in the banking sector and stability of commercial banks

The traditional view is of 'competition-fragility' where it is stated that increased number of players in the banking sector reduces market share of each player and negatively impacts both the net interest margin and overhead expenditure ratio. If such an unrestricted entry in the banking sector is coupled with a spate of deregulation of this sector; banks are handed in a platter the opportunity of taking risks that are at times too high and purely speculative. At times banks have been able to manage such risks, but more often than not, such rash risk taking has ended in a spate of bank failures in countries where simultaneous relaxation of entry norms in banking sector coupled with deregulation of banking activities have taken place. Thus proponents of 'competition-fragility' concept argue against allowing unrestricted entry of willing entrepreneurs in the banking sector.

However, of late there has been another school of thought that has gained considerable ground and it takes a contrary stand of 'competition-stability'. The second school of thought does not negate in totality the perceptions of the older school of thought in the sense that it does admit that additional competition indeed reduces market equity that leads to greater degree of risk taking by commercial banks by lending at higher rates of interest to potentially risky borrowers in an effort to shore up the steadily declining net interest margin that gets battered by increased competition in the lenders market. But the new school of thought differs in how the commercial banks would brace themselves against such potential high risk customers. The new theory states that the banks will try to cover their high exposure to risk by

opting for more equity capital, sale of loans or credit derivatives or opting for a leaner loan portfolio or some other risk mitigation techniques that are easily available. The dominant refrain in this school of thought is that when the banks are aware of the additional risk exposure on account of increased market competition, they will most certainly undertake risk mitigation measures instead of closing their eyes to the impending danger and pray for a miracle or feel smug under the misleading impression that they are too big to fail.

The other observation of experts is that prevailing deposit rate controls are essentially strong and act as sufficient disincentives to banks to try and corner a sizeable number of customers by offering irresistibly attractive rates of interest. These deposit rate controls never allow the commercial banks to cross all limits and behave in a totally imprudent manner irrespective of the extent of competition in the banking sector. The other equally important issue is that a bank can hope to increase its franchise power only if it remains in business for a sufficiently long period of time. Surely no commercial bank would risk its long term future, indeed its very existence by dealing in high risk loans and be out of business before getting any real chance of building up a substantial goodwill. Those in favor of 'competition-stability' theory also attempt to view the issue from an opposite perspective. They argue that if there is less competition in the banking sector the established players, secured in their sizeable volume of market share might get tempted to take irrational risk in an attempt to earn excess profit. The perception that they are too secure and, more importantly, too big to fail

may make them a trifle reckless and over adventurous while taking loan risks. These apparently inconsequential loan risks may snowball into crises that may put the entire bank in financial jeopardy. (Berger, Klapper and Turk-Ariss)

Recent improvisations in financial intermediation market

With the recent emergence of financial futures and options there has been a sea change in the market for financial intermediation which was till recently dominated by banking firms that mobilized deposits or issued insurance policies and channelized resultant funds to producer sector. The financial markets have undergone a complete transformation with an unprecedented growth of bonds and stock markets and the emergence of completely novel financial products as various mortgage backed securities and other securitized assets, as well as derivative instruments such as swaps and complex options. One important observation made by experts in this regard is that these new financial products have almost completely been used by financial intermediaries with households showing practically no interest in dealing with these new entrants in financial market.

In fact, there has been a dramatic reduction in the participation of individuals and almost corresponding increasing in the level of participation of intermediaries in financial markets. There has also been a silent but thorough change in the nature of players in finance markets. The market shares of traditional banks and insurance companies have fallen while market shares of mutual funds and pension funds have increased phenomenally. A completely new type of non-banking or non-insurance

financial intermediary like GE Capital, that has raised capital entirely by issuing security and not taking any deposits, has emerged on the financial scene. In a natural reaction, banks and insurance companies have also brought in certain perceptible changes in their operations. Banks have discovered that by securitizing loans it becomes possible to remove them from the liability side of their balance sheets. Insurance companies have also started shifting from actuarial functions to providing newer and more growth oriented products.

It has been observed that a dramatic reduction of individual participation has been almost simultaneous with an increase in better opportunities for individuals to operate in market. This nails earlier theories that financial intermediaries prospered as it is difficult and expensive for an individual to conduct activities in financial market. The truth perhaps lies in the idea that financial intermediaries have actually evolved in becoming really efficient risk managers of both individuals and corporate entities and have an extremely important role to play in economies of future. (Allen and Santomero)

Conclusions

The Bank regulations can explain the cost of financial intermediation. It has the statute of limitations and regulations on banking activities. These rules can regulations the freedom of bankers to conduct business, and improve the bank's net interest margin. From the bank stability, firm's access to external finance, bank valuations and financial development. From these

points to shows the characteristics centralized control of banking sector and the inflation rate.

The more important is the Institutional rules and regulations, market structure. Government's ownership and business cycle fluctuations both these factors can impact the Cost of Financial Intermediation. The impact of market structure is from the competition. Lowering the price to increase the market share and reduce the Cost of Financial Intermediation.

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