The Role of Banking Sector Regulation

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Developed and many developing countries have experienced spectacular progress in financial services though there have been a number of painful crises both in real and financial sectors, particularly in some emerging market economies in recent years. While the banking sector is crucial to an efficient allocation of resources and hence to economic growth, Turkey's performance in this regard is far from satisfactory. Following severe economic crises in recent years, the Banking Sector Restructuring Program was introduced to create a strong banking sector. Although important milestones have been achieved so far, there is still a need for further progress.

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Introduction

Developed and many developing countries have experienced spectacular progress in both scale and diversity of financial services in recent years. A huge number of statistical indicators confirm this worldwide tendency, evidence of the fact that there is a close association between financial sector development and economic growth. On the other hand, a number of emerging market economies have suffered from serious financial turbulence at the same time. Several East Asian countries, Russia, Brazil, Argentina and Turkey are some examples, where painful crises in the real sector were triggered by a serious crisis in the financial sector. Given the existing structural problems, the cost of these financial crises put a heavy burden on public and private institutions, and consequently decreased the possibility of catching up with advanced economies, which is the principal goal of developing countries.

This paper analyses the role of the banking sector in economic growth with particular emphasis on the importance of regulations and supervision on the effective functioning of the overall economy.

The Banking Sector and Economic Growth

When it comes to fostering economic growth and ensuring a sustainable development, it is widely recognized that the financial sector plays a crucial role. Globalization and the changing role of the state in the last three decades, particularly in developing countries, in line with the requirements of the market economy, served to further intensify the need for a strong financial sector. Increases in both internal and external competitive pressures on the one hand, and confining the state's direct involvement in the economy, abolishing direct support of the private sector via subsidies, low interest rate credits, etc. on the other, has left domestic firms, especially small and medium sized ones, in need of financial resources. Weak capital markets and dominance of Small and Medium Size Enterprises (SME's) in economic activities made this a crucial issue for developing countries. Consequently, reorientation of economic policy in favor of the market economy and the prevalent economic environment, namely the trend towards globalization, dictate the creation of a strong financial sector, particularly true for the banking sector, if we are to attain stable and high growth performance.

Together with the potential risks the financial sector posed with regard to destabilizing the overall economy, the crucial role of this sector in the growth and development process led to a rise in interest regarding the role of the sector with respect to designing an appropriate development strategy. With financial services playing an increasingly larger role in economic activities and with the growing complexity of the financial system, it has been generally accepted that the sector requires special treatment, which of course reveals the sector's unique characteristics. Among these, the intermediary and integrating role of financial institutions, which is a pre-condition for effective functioning of the overall economic system, and the incomparable opacity and complexity of the system need to be emphasized. In effect, these mean that the financial sector poses the primary risk to the system due to its integrating nature, and has the potential to trigger a market failure due to information asymmetry arising from the opacity and complexity of the financial institutions. Obviously, these are the characteristics of the financial systems that form the rationale behind the establishment of independent regulatory and supervisory public authorities. By focusing on building transparency, improving incentives, and setting limits and standards in a market friendly manner, these authorities fulfill a vital task for maximum or rational utilization of scarce physical and non- physical resources with a view to realization of society's potential. As a matter of fact, this task is of utmost importance in developing countries like Turkey, where structural problems accumulated over a long period of time and the need for a structural break is obvious and inevitable.

The banking sector forms an important component of the financial system and the role of the sector in the process of economic growth has been examined extensively in the literature. Existing empirical findings show a strong relation between banking sector development and economic growth (King and Levine (1994), Levine and Zervos (1998), Demirgüç-Kunt and Maksimovic (1998), Rousseau and Sylla (2001), Fisman and Love (2002)). The basic link between banking sector development and economic growth can be understood in at least in three ways. More specifically, development of the banking sector could improve:

- capital accumulation,
- total factor productivity growth, and
- private saving rates.

There is no doubt that a well-developed financial system particularly a banking sector is crucial to an efficient allocation of resources and hence to economic growth. In this respect, the main functions of the banking sector include contributing to the mobilization of resources and increasing the rate of savings by offering alternative means of saving and investment, allocating capital funds for productive investment, monitoring managers to ensure the funds are used in line with the loan agreement, directing funds to different sets of activities to mitigate risk and acting as a pool for small pieces of savings to finance large scale investments. Perhaps more importantly, recent empirical findings indicate that a well-developed financial sector plays a role in reallocating resources from lower growth opportunity industries to higher growth opportunity industries leading to the emergence of global opportunities particularly of a technological nature (Fisman and Love (2002). In this sense, financial sectors could be regarded as an important tool for increasing the long-term growth rate and substantially improving the well being of nations.

The facts related to the structure of Turkish financial and real sectors can be stated as poor performance in capital accumulation and inefficient use of existing resources, which includes a low level of productivity, a high share of banking activities with limited development of alternative financial instruments, and widespread dominance of SME's which are not sufficiently capable of internal financing. In view of these, it is reasonable to argue that an independent regulatory and supervisory authority for the banking sector is the key to achieve a satisfactory economic performance.

The Turkish Experience

Analyzing the growth performance and the contribution of the banking sector to economic growth during the last three decades, it is possible to state that Turkish economic performance is far from satisfactory. While the rate of growth was moderate, the high volatility in the growth rate and prices were the main macroeconomic problems. When the structure of the Turkish banking sector is compared to the European Union countries, the sector's limited size, poor capital base and asset structure, the low level of financial intermediation and the high degree of state involvement in the sector were the principal structural concerns.

In an attempt to solve the structural problems of the banking sector amplified after the crises in late 2000 and early 2001, Turkey implemented an extensive restructuring program of the sector. In this context of severe financial and economic crises which eroded the banks' capital base and led to bank failures, the Banking Sector Restructuring Program which was announced on May 15, 2001, can be considered the major turning point in the effort to create a strong banking sector to assist formation of a stable macroeconomic environment. The basic objective of the program was to eliminate distortions in the financial system and adopt regulations to promote an efficient, globally competitive and sound banking sector. The program had four main pillars: restructuring of the state banks, resolution of the Saving Deposit Insurance Fund (SDIF) banks, strengthening of the private banks, and improving the regulatory and supervisory framework. The primary goals of the program were financial and operational restructuring of the state and the SDIF banks (strengthening of capital base, elimination of overnight liabilities, reducing the number of branches and personnel, etc.), introduction of a recapitalization scheme for private banks to ensure transparency and enhancing confidence in the banking sector. A special emphasis was put on restoring market discipline, improving banks' capital base, encouraging mergers and acquisitions, and adopting international standards in the regulatory and supervisory framework. Application of the Istanbul Approach was the other important element of the program designed to improve the relations between the financial and real sectors through restructuring the outstanding risks of viable companies.

Important milestones have been achieved so far. The main achievements of the program have been consolidation in the banking sector, decline in the share of the state and the SDIF banks, reduction of financial risk to manageable levels, improvement in transparency and profitability and strengthening of the capital structure of banks. The adoption of a strategy to improve the legal and regulatory environment played a crucial role in this success. In accordance with international standards, the strategy involves imposing measures or standards concerning minimum capital requirement, risk management, lending limits and loan loss provisioning, related party exposure, accounting standards and independent auditing, and finally contributing to mergers and acquisitions by tax incentives. Furthermore, the Banking Regulation and Supervision Agency (BRSA), also took an important step by signing the Memorandum of Understandings with other countries' supervisory authorities to improve cross-border supervision. Most recently, the BRSA has introduced risk-based supervision and tighter prudential supervision.

As a result of the program implemented, significant steps have been taken in order to ensure that the banking sector has a stronger and more competitive structure. Accordingly, the asset volume of the banking sector had increased to USD 151.4 billion in July 2003 from USD 117.7 billion as of the end of 2001. The banking sector's profitability performance has also improved as indicated by the USD 1.1 billion in profit achieved in 2002, following a huge loss of USD 8.2 billion recorded in 2001. As a result of the consolidation process, the number of banks declined to 51 as of August 2003 from 79 in 2000.

As in many other countries, the restructuring of the banking sector led to a heavy burden on public finance. Excluding the case of Imarbank, the cost of restructuring has been USD 24.6 billion, or 16.9 % of GDP, with USD 2.9 billion spent on restructuring the state banks (excluding duty losses) and USD 21.7 billion for the resolution of the banks transferred to the SDIF. Duty losses of the state banks amounted to USD 19 billion, which corresponds to 12.8 % of GDP.

However, it should be underlined that despite the achievements of the last two years and a heavy burden of restructuring, there is still a need for further progress to eliminate the fragility of the banking sector in the short and medium term. High proportion of nonperforming loans, the short-term maturity structure of deposits, the dominance of the share of government bonds in the balance sheet and an improved but low level of free capital are the primary concerns that need to be addressed.

Basic Policy Perspectives

Based on past experience, it is apparent that more effective regulation and supervision requires new measures and standards on a variety of issues ranging from good corporate governance to new organizational structures of financial firms, namely financial holding companies. In this regard, in the medium and long term, our ultimate goal is to create a sound and competitive financial sector that has a high adaptive capacity in the changing domestic and global environment. In order to achieve this goal, we have to address issues, such as further improvement in market discipline and transparency, ensuring a level playing field among banks, introducing measures to improve corporate governance culture and risk management practices, reducing intermediation costs, increasing diversity in financial services and ensuring efficient supervision. In order to reach the goals of the BRSA, the supervision and surveillance framework must be strengthened by the establishment of financial holding companies, conducting studies toward Basel-II and preparation for risk-based supervision.

In a broader sense, the BRSA will provide the necessary infrastructure of legal rules, practices and timely and accurate information conducive to a more efficient utilization of market forces to shape the behavior of banks, which will, in turn, contribute to a better use of resources. To this end, the regulatory and supervisory arrangements could be used as effective means to provide constructive incentives for the market agents. Regarding more effective regulatory and supervisory arrangements, the recent experience of the BRSA reflects the need for a new set of measures. Licensing is the most important phase and requires clear, healthy and strong rules. On-site supervision must be enhanced and particular attention should be paid to more intensive and effective use of information technologies (IT). Apparently, effective coordination with other public authorities is an important pre-condition. Of course, the nature and functioning of the overall legal structure has a decisive impact on effective regulation and supervision carried out by the BRSA, and hence the role played by this complementary but also critical factor should not be underestimated.

However, it should also be pointed out that effective regulation and supervision is necessary but not a sufficient condition for a sound banking system, and hence for efficient allocation of resources and consequently for strong economic growth. Macroeconomic stability is a necessity for a healthy banking sector. The uncertainties related to the macroeconomic environment damage expectations and lead to short-termism in banks' decision-making process. This is the biggest challenge that we have to cope with and the success of the ongoing stabilization program is crucial for a sound banking sector.

Conclusion

There is no doubt that achieving an efficient and secure financial market environment will provide a window of opportunity in the transition to "real banking". The maintenance of macroeconomic stability, and effective regulation and supervision in accord with international standards will inevitably result in an increasing consolidation in the banking sector and better integration with world financial markets which could bring foreign banking activity in Turkey to a remarkable level. There is no question that Turkey's perspective on full-integration with the European Union will speed up this progress substantially. In an environment of macroeconomic stability complemented with orderly market discipline and competition, the cost efficient and large-scale provision of banking services will provide an opportunity for banks and real sector firms to develop expectations with a long-term perspective in which both the decision-making process and allocation of resources will be more efficient. This progress, will lead to a bust in capital accumulation and productivity dimensions of economic growth that involves allocation of resources in favor of more productive areas such as education, health, and high value-added industrial and service sectors.

It would not be an exaggeration to claim that the success in this process will lead to stabilization of the economy around a higher long-term growth path. A rise in access to a bigger pool of financial resources by different segments of the society, coupled with better monitoring and risk management methods in the banking sector, and development of new financial instruments, such as venture capital, will result in an increase in economic interactions or activities including more efficient investment. While limiting the excessive risk-taking and fraudulent behavior in both the banking and real sector, channeling the resources to credible and innovative entrepreneurs who act in accordance with long-range perspectives will transform the composition of output and spur the rate of growth. Consequently, this process could ignite a virtuous circle era leading to a sharp decline in unemployment and poverty and lead to dynamic growth performance, which also implies reaping the potential of the Turkish economy, and most importantly, limiting the possibility and extent of future financial crises.

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