Financial Deregulation, Bank Performance and the Need of Prudential Regulation for Developing Countries: Evidence from the Banking Sector of Bangladesh

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Abstract

Starting from the 1970s, the paradigm shift to financial deregulation from financial repression to accelerate financial deepening by intensifying the banking sector competition has been commonly observed initially in developed countries and later on in developing countries. However, from the developing countries' perspective, this issue still remains debatable for a number of reasons depending primarily upon their country specific conditions and requirements; which requires some further studies to identify the appropriate banking regulation in accordance with the relationship between country specific requirement and required financial deregulation in their developing stage. The banking sector of Bangladesh is in no exception as it has initiated the adoption of financial deregulation in 1980s by targeting the Anglo-American mode of financial intermediation. Consequently, the financial sector has experienced moderate level of financial deepening, financial disintermediation to socially desirable sectors, abolition of the demarcation between banking and non-banking activities in the form of stock market activities of banks, and stock market bubble and its eventual bursting. In this regard, this thesis aims at evaluating the adoption of financial deregulation in the banking sector of Bangladesh by using both theoretical and empirical analyses. By doing this, this study generates a number of policy lessons not only for Bangladesh but also for other developing countries where similar changes have taken place. The theoretical analysis is conducted by critically assessing the adoption of the Anglo-American mode of financial deregulation from a developing country's perspective. On the other hand, the empirical analyses are conducted to identify the impact of various direct and indirect changes made by financial deregulation on the banking sector of Bangladesh as a whole. To be specific, it attempts to assess bank performance by using return on assets and Data Envelopment Analysis grounded efficiency, to identify the impact of commonly observed dimensions of financial deregulation on each of the performance indicators, to demonstrate the significant changes in deposit and lending structures, to ascertain the changes in banking sector competition by using eight structural measures of competition, to portray the impact of the changing competition level on bank performance, and to highlight the causes and consequences of the recent accelerated stock market activities of banks. According to the findings, various changes made by financial deregulation possess a statistically significant negative impact on bank performance, although these changes have been successful in intensifying the banking sector competition to a great

extent. However, this intensified level of competition not only negatively affects the banking sector performance but also shrinks the spread margin from regular banking activities, which in turn, provides ill incentives for banks to involve in stock market activities as non-banking activities and discourages banks to engage in financing to risky but socially desirable sectors like agriculture, small and medium enterprise, and export. In addition, allowing banks to establish subsidiaries for stock market operations hinders the stability of the financial sector including the banking sector by amplifying the fundamental principal-agent and moral hazard problems between central bank and commercial banks, by creating substantial conflict of interest between Securities and Exchange Commission and central bank due to the bubble and its bursting in an underdeveloped nature of the stock market, by eroding the regulatory structure of the central bank, and by hampering the objective of financial deepening under liberalization. Based on the theoretical and empirical evidence, this thesis argues that the naive adoption of the Anglo-American mode of financial deregulation is less contributing for a developing country like Bangladesh; rather, a modified version with necessary country specific prudential regulation instruments for meeting the country specific requirements and conditions along with various commonly accepted changes can be an alternative mode of transformation form financial repression to financial deregulation for the developing countries. Specifically, banking sector competition has to be restricted and stock market operations through subsidiaries have to be separated from regular banking activities. These are needed to be followed by the adoption of control on the deposit rates so that banks, particularly private banks, have the incentive to sustain their improved bank performance, to refrain from risky non-banking activities, to finance socially desirable sectors, to encourage rural deposits, and to extend financial deepening by establishing adequate branches in the rural areas of the country.