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The Role of Banks For the Development of the Country

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Abstract: Financial systems in developing countries are typically dominated by banks: bank deposits constitute the most important form of household savings, and bank loans are the most important source of external finance for firms.

Keywords: market, bank system, monetary, credit system, finance.

Introduction. In simple terms, banking is the act of generating, storing, and managing money. It is an economical operation that a banker does to make money available for lending purposes. Banking has various functions like production of money, security of money, deposit operation, investment, and other financial services like international money transfers. The banking sector provides various kinds of financial services through banks. Banks—in both industrial and developing economies—can be distinguished from other financial institutions by a unique characteristic that will be termed here "the franchise value of banks," that is, the special power conferred by the banking charter to issue liabilities that are accepted as a means of payment. In developing countries, the state of the legal and accounting systems makes it difficult for institutions that are not connected to the payments system to issue short-term liabilities such as commercial paper. Hence, banks are the only nongovernment issuers of these liabilities. Because investors require borrowers' liquidity as proof of their solvency, borrowers are restricted to the short-term market, which is dominated by banks.

When investors evaluate the quality of banks in developing countries, they confront the same obstacles that they face in evaluating nonfinancial firms: accounting data are often undependable guides to quality. For example, usual indicators of bank soundness in industrial countries, such as ratios of capital to assets and loan loss provisions to nonperforming loans, are often uninformative because banks are not subject to standard procedures for placing loans on nonaccrual status or deducting defaulted credits from capital and loan loss accounts. Hence, investors in developing countries must look for other ways to assess the quality of bank balance sheets. A bank could convince investors that it is sound and, therefore, able to deliver good funds by holding a large amount of cash assets—cash and deposits at the central bank (reserves)—relative to its deposit liabilities. In other words, a bank could convert itself into a vault. If, however, banks were to act as vaults, they would have less incentive to press borrowers to remain liquid, and they would reduce the amount of credit supplied to borrowers for a given amount of deposits issued. In other words, the liquidity demands of investors would be met by holding cash assets in the central bank rather than by supplying credit to domestic borrowers in a form that forces borrowers to remain liquid. The market discipline imposed by banks on borrowers would be adversely affected. As the evidence presented in the next section demonstrates, when banks do not discipline borrowers, the credit risk in the financial system increases. Some other institution, usually government related, ends up

supplying credit without imposing discipline on borrowers. When borrowers default, bank depositors are often forced to absorb the losses through outright confiscation or through inflation. Hence, one measure of the quality of the bank franchise is the ratio of cash assets to deposit liabilities—a relatively high ratio represents a weak franchise.16 That is, the market discipline exerted by banks on borrowers—by requiring frequent delivery of good funds as a way to prove borrowers' creditworthiness—is reduced. In this connection, exceedingly high reserve requirements may jeopardize the franchise value of banks.

If a central bank lacks credibility in its lending policies, it may find it desirable to signal to the market that it is willing to subject itself to constraints that encourage prudence. One such constraint is to permit the banking system to freely offer loans and deposits denominated in a hard foreign currency, such as the U.S. dollar, a policy known as dollarization. Because the central bank cannot extend credit in the foreign currency without borrowing that currency in the international marketplace, it is more likely to lend funds less carelessly than it would in the domestic currency, which it can create. If banks can maintain high loan and low cash ratios in their foreign currency portfolios, they will have the proper incentives to monitor their borrowers. For example, dollarization of a banking system may not be detrimental to an economy if it is the only means by which loans can be extended in a disciplined manner.

Main part. Banks can complement traditional deposits as a source of funding by directly borrowing in the money and capital markets. They can issue securities such as commercial paper or bonds; or they can temporarily lend securities they already own to other institutions for cash—a transaction often called a repurchase agreement (repo). Banks can also package the loans they have on their books into a security and sell this to the market (a process called liquidity transformation and securitization) to obtain funds they can relend.

A bank's most important role may be matching up creditors and borrowers, but banks are also essential to the domestic and international payments system—and they create money. Not only do individuals, businesses, and governments need somewhere to deposit and borrow money, they need to move funds around—for example, from buyers to sellers or employers to employees or taxpayers to governments. Here too banks play a central role. They process payments, from the tiniest of personal checks to large-value electronic payments between banks. The payments system is a complex network of local, national, and international banks and often involves government central banks and private clearing facilities that match up what banks owe each other. In many cases payments are processed nearly instantaneously. The payments system also includes credit and debit cards. A well-operating payments system is a prerequisite for an efficiently performing economy, and breakdowns in the payments system are likely to disrupt trade—and, therefore, economic growth—significantly.

Literature review. The composition of credit commercial banks and other financial institutions (excluding the stock exchanges) provided to the private sector in a number of Latin American countries indicates a clear bank dominance through the 1980s and early 1990s although the importance of banks varied across countries and across time (Table 1). In this regard, two clarifications of the data are needed. First, owing to a lack of consistent data across Latin American countries, development banks—institutions, typically government owned, established to extend credit to specific sectors of the economy— are included under "other financial institutions."2 Hence, in several countries, a large component of credit extended through other financial institutions is also bank credit.3 For example, assets held by development banks in Bolivia, Guatemala, and Peru accounted for 21, 14, and 47 percent of total assets of financial institutions, respectively, by the end of 1987 (Morris and others, 1990). The importance of development banks, however, declined significantly during the late 1980s and early 1990s, reflecting the privatization programs in many Latin American countries. Mexico is a clear example of the privatization efforts; there, the share of commercial bank credit in total credit to the private sector increased from 76 percent in 1987 to 91 percent in 1992.

Conclusion. The recent developments in the banking sector showed the precise functioning of various segments of the banking sector. Since the introduction of banking, the banking structure in the country has grown leaps and bounds, which is why it is so important for us to understand how it works and what different segments are there. This understanding will go a long way in helping us open our bank account and also help us expand our business through business banking. It is important to know the level of loan that we can avail and other profitable schemes running in the country. Regulations are generally designed to limit banks' exposures to credit, market, and liquidity risks and to overall solvency risk. Banks are now required to hold more and higher-quality equity—for example, in the form of retained earnings and paid-in capital—to buffer losses than they were before the financial crisis. Large global banks must hold even more capital to account for the potential impact of their failure on the stability of the global financial system (also known as systemic risk). Regulations also stipulate minimum levels of liquid assets for banks and prescribe stable, longer-term funding sources. Regulators are reviewing the growing importance of institutions that provide bank-like functions but that are not regulated in the same fashion as banks—so-called shadow banks—and looking at options for regulating them. The recent financial crisis exposed the systemic importance of these institutions, which include finance companies, investment banks, and money market mutual funds.

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