



## Financial development, institutions and banks



Isaac Marcelin <sup>a,1</sup>, Ike Mathur <sup>b,\*</sup>

<sup>a</sup> School of Business, Management and Technology, University of Maryland Eastern Shore, Princess Anne, MD 21853, USA

<sup>b</sup> Department of Finance, Southern Illinois University Carbondale, Carbondale, IL 62901, USA

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### ABSTRACT

This paper presents a framework for understanding the interactions between political and legal institutions, property rights protection, and their implications for financial development. Whereas the literature has answered questions on why some countries lag behind in terms of financial and economic development, the current study suggests how to get around some institutional attributes to spearhead financial intermediation and economic growth through a set of institutional, information, and banking reforms. It finds little support that common law legal heritage is more suitable than French civil law for some key features of financial development. It concludes that types of institutional and market reforms are more relevant to financial intermediation than legal systems. It proposes some ways forward to increase financial intermediation; and expects, over the long run, the proposed approach to financial development to be beneficial for a number of developing countries.

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### 1. Introduction

Both the law and finance and the financial development threads of literature underscore that trends in financial intermediation have been diverging for some time and the likely cause is the quality of the institutions across countries. If there have been improvements in intermediation in some countries, in others, firms are faced with momentous challenges to access external finance to upgrade and deepen their industrial capability in order to contribute to overall economic growth. Cross country variations in institutional quality, as well as their effect on financing options, may explain firms' inability to access finance. In many countries, political institutions may be a catalyst to external finance by easing market tensions and facilitating greater access to finance, while in others, they may contribute to erecting barriers to finance.

Financial disintermediation, coupled with poor institutions, may exacerbate fear of bank runs should savers suspect that liquidity in the system is in jeopardy and the likelihood of recovering their money is low. When banks are the sole securities brokers, sellers of many types of assets may find it difficult to find buyers should these assets become

highly illiquid; especially, when the banking system is outdated. Reversing this situation requires long-term fixes involving improvements and sometimes the creation of an institutional environment that encourages risk-taking and innovation for new forms of intermediation and investment vehicles to emerge.

Whereas the channeling of funds from risk averse economic agents to entrepreneurs is the fundamental role of financial intermediaries, this function is also a reflection of the existing level of financial development in a country, and may be hindered by the type of institutional arrangements prevailing in that economy. The ability of financial intermediaries to resolve issues of information asymmetries, agency and adverse selection problems – ubiquitous in financing contracts – is a reflection of a country's overall institutional quality, financial system, and subsequently, its level of financial development.

The debate on differences in ease of access to finance, across countries, has been mostly concentrated on distinctions between bank and market based financial intermediations (see Allen & Santomero, 1999). Another focus has been on the civil and common laws divide (see La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1998; Levine, 1997; Levine, 2005; Rajan & Zingales, 1998). In the first case, the discussion has been largely dominated by the proliferation of new financial products and ways for intermediaries and regulators to learn and adapt to new forms of risks. In the second case, the discussion has focused mostly on financial intermediation, the ease of access to finance, and institutions. Either way,

\* Corresponding author. Tel.: +1 618 581 1613; fax: +1 618 453 5626.

E-mail addresses: imarcelin@umes.edu (I. Marcelin), imathur@business.siu.edu (I. Mathur).

<sup>1</sup> Tel.: +1 410 651 7719; fax: +1 618 453 2717.

a large array of financial products remains undeveloped and often very limited in less developed economies due in part to the inability of these countries to develop an institutional framework suitable to the development of new financial products and to handle their underlying contracts.

Financial development is not a natural upshot of the interplay of free market forces. Rather, a reverberation of political and property rights of institutions ensuring sound macroeconomic policies and strong legal protection for stakeholders in financing contracts. Understanding the likely causes of the lack of finance and low level of financial development across countries and regions requires the analysis of views outside of the realm of traditional financial intermediation theories. This compels us to ask the question of why financial markets are still undeveloped in many countries while so many (developing) countries appear to have been relatively quite successful in implementing institutions more conducive to financial development by lowering country systemic risks so that firms might have easier access to external finance. More importantly, why have so many countries managed to increase intermediation despite institutional weaknesses.

The law and finance literature posits that unlike French civil law countries, British common law countries have been very successful in implementing institutions conducive to property rights protection and thereby financial development. Despite this, many civil law countries have circumvented their legal heritage to devise a framework that allows firms to have relatively better access to external finance while many common law countries have failed to capitalize on their legal heritage to set in motion institutions conducive to financial development and growth. In fact, as illustrated in Fig. 1, the theory is at odds with recent data on the spread of financial services around the world. New data, over the period of 2004–2011, extracted from the International Monetary Fund's (IMF) database show that countries with French civil law heritage have increased the scope of financial services and have done so substantially more than their British common law counterparts. In a broader sense, to comprehend why many developing countries have been lagging behind in terms of advances in intermediations for so long, one needs to first grasp the conditions under which intermediations have thrived. This requires us to bring into perspective the role of the formal and informal institutions in devising financial contracts.

There is much less research into what types of institutions – property rights or contracting rights – are more conducive to financial development and what types of new institutions are most needed to stem disintermediation. This delineation may shed some light on how to leapfrog some institutional weaknesses to framing systems that allow private parties to contract with each other and achieve greater redeployment of assets through enhanced intermediation. The law and finance literature, while highlighting the importance of institutions for financial

development, is rather thin on the types of institutions that lead to better financial outcomes. It concentrates on the importance of formal institutions, bureaucratic capacity, government stability, law and order, and private sector organization. However, explanations of why and how private parties leap over their weak judicial system to enforce financial contracts are vague and under-developed.

Are property rights institutions more relevant to financial development than contracting rights institutions? Are formal institutions more conducive to financial contracting than informal institutions? Aggarwal and Goodell (2009) surmise that since all optimal contracts are incomplete, and the efficacy and efficiency of overcoming contracting costs depend not only on the legal environment, but also on ethical and other informal conventions, industrial structure, and social and cultural values. Understanding the effects of property and contracting rights, formal and informal institutions on financial contracting, enforcement mechanisms may be of great importance for multinational and portfolio investors as well as policymakers.

This paper presents a framework for understanding the kinds of institutions necessary for successful financial development. It brings in insights from law and finance as well as other bodies of literature on institutions, financial development, private contracting, and government-firms and private citizens interactions. It expressly concentrates on property and contracting rights, formal and informal institutions, and how do they affect financial outcomes. It underscores the institutional, information and larger banking reforms that are needed for sustained growth in intermediation. By focusing on informal institutions and contracting rights, it adds to the ongoing debate on financial development by exploring other facets of private monitoring and access to finance. Overall, it feeds the debate regarding the relations between political institutions and finance, and the linkages between habits, customs, traditions and credit flows to the private sector. As a consequence, it has implications for finance, economics, politics and sociology.

The remainder of the paper is organized as follows. The next section presents a review of the relations between various forms of institutions and financial development. Section 3 summarizes our argument and presents some perspectives along with some policy issues related to institutional choices and their implications to financial development. Section 4 concludes with a set of reforms needed to increase financial intermediation and access to external finance.

## 2. Financial development and legal institutions

This study brings together different strands of related literature on institutions and financial development. The first thread, the law and finance literature, is regrouped under a series of studies by La Porta et al. (1997, 1998). This branch of literature relates country legal heritage and institutional infrastructure to investor protection and minority rights. The second thread, the institutions literature, which is substantiated by Acemoglu, Johnson, and Robinson (2001, 2005), relates more to property rights protection. The third thread of literature, dominated by a series of research by Levine (1997), Rajan and Zingales (1998), and Levine (1999), offers a broad view of the financial development literature.

This latter thread of literature analyzes the differences in countries' level of financial development as a reflection of their formal legal system. The current study transposes this strand of literature by relating the theories of institutions or property rights of institutions and contracting rights of institutions to the level of financial development, and the ease with which firms within a certain institutional framework have access to external finance even when they have to use informal channels to enforce financing contracts.

### 2.1. Institutional differences and external finance

Financial development hinges around the issue of how well a country's institutional arrangement allows for optimal allocation and redeployment of investible resources. The effective implementation of

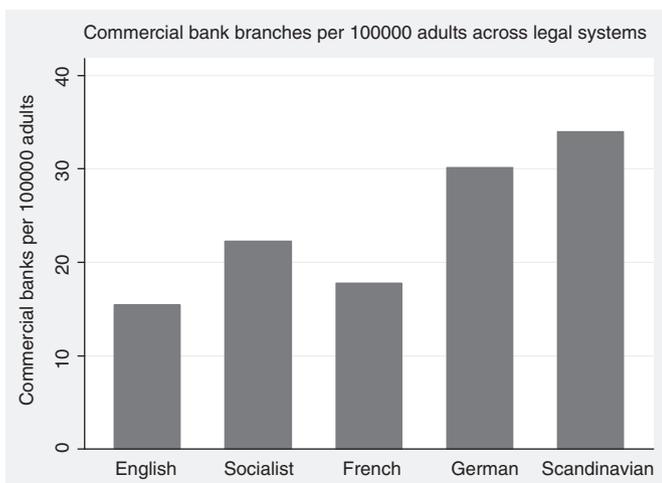


Fig. 1. Commercial bank branches per 100,000 adults across legal systems.

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