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Exploring the nexus between financial sector reforms and the emergence of digital banking culture – Evidences from a developing country

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ABSTRACT

Several financial and banking sector reform programs were instituted in different countries over the last three decades. The underlining purpose of these reforms was largely to improve banking sector supervision and regulation, introduce bank privatization mechanism, introduce clearance and settlement systems, infuse competition and to stimulate financial innovation. The objectives of this study are to 1) review the relevant published literature and market survey reports on the financial & banking sector reforms undertaken in Pakistan and elsewhere, 2) analyze how these reform programs develop digital banking culture and increase financial inclusion in the country and 3) guide future research by putting forward a research agenda. The findings of the study suggest a link between the financial and banking sector reforms and the stimulation of financial innovation; the promotion of digital banking culture; and the infusion of financial inclusion in Pakistan. We discuss managerial/policy implications of the study, limitations and presents recommendations for future research.

1. Introduction

Over time, the expected benefits from an increased centralization of the financial system and an excessive government regulations and restrictions did not materialize (Bertrand et al., 2007) and resultantly, the financial sector undergone radical reform programs in many countries around the world. As banking is an integral sector of the financial system, the majority of those reforms were fundamentally directed towards the banking sector. According to Barth et al. (2001), since early 1980s more than 130 countries have experienced banking and financial problems that impede growth, have been costly to resolve, and considered disruptive to economic development. This troublesome situation had led to calls for financial & banking sector reforms by national governments, regulators and international financial institutions such as the World Bank and the International Monetary Fund (IMF).

The focus of these reform programs was largely placed on regulators and financial institutions and the underlining purpose of these reforms was likely to chart out the process to make the financial sector more productive, vibrant, and efficient. Similarly, improving banking sector supervision and regulatory mechanism, introducing bank privatization mechanism, establishing efficient clearance and settlement systems, deregulating interest rates, infusing competition, and enhancing financial developments and innovations ware also the underline purposes of these reform programs (Ağca et al., 2013; Edirisuriya, 2007).

In addition to developed countries such as the United States, many transition countries located in Eastern Europe have pursued reform programs during the last few decades. In South Asia region, Sri Lanka, India and Pakistan were among the forerunners of these

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reform programs (Edirisuriya, 2007). Consequent to these reforms the financial sector in India and Pakistan become relatively less state-directed, more efficient, more competitive, and open to foreign banks and non-banking financial institutions (Ataullah et al., 2004).

Consistent with the interest in reform programs, a great deal of banking, financial and economic research started exploring the relationships or links between reform programs and bank competitiveness, efficiency and economic growth (Sehrawat and Giri, 2015; Mwenda and Mutoti, 2011), income inequality (Christopoulos and McAdam, 2017), bank competition (Lee and Hsieh, 2014), output growth (Levine, 2005), employment growth (Boustanifar, 2014), profit and cost productivity of the banking sector (di Patti and Hardy, 2005) and so forth. In some cases, these reforms became necessary due to the destabilization effects of global financial crises in regional markets such as ASEAN (Gimet and Lagoarde-Segot, 2011) and African countries (Senbet, 2009).

These research trends suggest that there has been barely any research that has analyzed the nexus between financial sector reforms and the emergence of digital banking culture. Moreover, a small amount of empirical literature exists that have examining the reform programs in developing countries (Iimi, 2004) as compared to transition (Kyrgyzstan), emerging (China, India, Brazil) and developed countries (USA, EU). This paper is, therefore, motivated by the lack of empirical studies that examine the impact of reforms in developing country and their role in promoting digital banking culture.

In order to fill this gap in the literature as well as after considering the importance of the reform programs in making the financial sector more productive and efficient, this study is important on three accounts. *First*, our study contributes to the on-going debate concerning financial and banking sector reforms especially in the context of a developing country. Pakistan as a case example can be considered 'representative' of fast emerging developing economies and, therefore, findings of this study can be transferred to investigate the similar financial sector reform programs instituted in other developing and emerging countries. The study was done by examining a host of individual datasets. These datasets are published by the banking companies in Pakistan and the State Bank of Pakistan since late 1980s when Pakistan undertook the first program of financial sector reforms. *Second*, unlike majority of the related studies, there is a striking paucity of empirical studies that have explicitly documented the impact of deregulation and financial sector reforms on the emergence as well as the growth of digital banking culture in a developing country and how do these reforms improve the quality and variety of banking services as well as promote financial innovation. *Third*, this study also add to knowledge accumulation and creation in the banking & finance literature by summarizing what we know about the global financial crises, the reform programs, and their impact on digital banking domain.

The objectives of this study are *first* to review the relevant published literature and market reports on the reforms program instituted in Pakistan and elsewhere. *Second* to document and describe the reform programs in Pakistan as well as the state of digital banking and financial inclusion by focusing on various reform periods including early phases of reforms instituted in the late 1980s as well as the latest period during 2000 and onwards. *Third* to analyze how these reform programs promote digital banking culture and increase financial inclusion for the poor in Pakistan, and *fourth* to put forward a research agenda for future research.

This paper begins with a debate on global financial crises and how the financial sector reforms were initiated (Section-2). Thereafter, led the authors conveniently to the major research question of how the financial sector reforms were instituted in Pakistan (Section 3). Next the authors provide a detailed status of digital banking, branchless banking and financial inclusion in Pakistan before and after the reforms program (Section 4). Final section (Section 5) summarizes and concludes with a discussion on the primary contributions of this research as well as the theoretical and managerial implications, and limitations that arrant additional investigation.

2. A debate on global financial crises and financial sector reforms

According to Fohlin (2016), a financial system consists of a set of banking and microfinance institutions and markets that gathers excess cash or funds from savers and allocates financial capital to entrepreneurs, industry, and others in need of credit. Whereas, 'strengthening the financial systems' means cooperating to promote principles and sound practices for financial stability through development of well-functioning financial systems and market discipline (Bossone et al., 1998, p.1). Given the importance of banking and financial sector in influencing the other sectors of the economy, many countries over the last three decades introduced reforms into the supervisory architecture of their financial sector (Doumpos et al., 2015). These countries, for instance, include European Union member countries, North America, Korea, Nigeria, China, Egypt, Bangladesh, India and Pakistan.

Research uses various terms to refer to reform programs, including "Financial system reforms" (McKinsey and Co., 2006), "financial sector liberalization" (Bandiera et al., 2000), "financial sector transformation" (Ağca et al., 2013), and so forth. According to Obienusi and Obienusi (2015), financial (and banking) sector reforms focus on restructuring financial sector institutions including the regulators and commercial banks, microfinance institutions via institutional and policy reforms. Moreover, the banking and financial sector development is important for developing economies such as Pakistan since a bank-based system exerts a greater impact on growth at the early stage than does a market oriented financial system (Iimi, 2004). Another common terminology used interchangeably with financial sector reforms is: 'financial liberalization'. It is widely recognized that financial liberalization is an important part of financial sector development (Ang and McKibbin, 2007).

Especially with regard to the global financial crises, prior research (e.g., Benedikter, 2011) has largely identified two economic and financial 'bubbles'. The first bubble known as the 'real estate bubble' and the second was the 'derivative bubble' that was triggered by a liquidity shortfall in the United States banking system. By mutually influencing and aggravating each other, these bubbles created severe banking and financial crises during the period 2007–2010 which led to economic crisis globally (Benedikter, 2011). Since banking companies and other financial institutions as well as services are closely interconnected in this globalized era, the resulting crisis on one hand sprung new challenges for the governments, regulatory authorities and the financial institutions and