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OP-ED

In defence of Bangladesh Bank's independence

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There is growing apprehension between the ministry of finance and the donors and development partners regarding the central bank's supervisory and regulatory roles in state-owned commercial banks (SCB). The governor of Bangladesh Bank (BB) is asking for more autonomy to oversee the SCBs. This has been particularly apparent following the central bank's unearthing of the biggest scam ever in the history of country's banking sector involving Sonali Bank and a little-known business outfit.

This does not bode well for the banking sector as SCBs still constitute approximately 28% of the total banking industry assets and deposits. It also brings in the debate on central bank independence to the forefront.

While the ownership of SCBs belongs to the state, regulatory and supervisory functions are de jure in BB's portfolio. However, the central monetary authority does not have de facto power to oversee them. This is largely due to the reluctance of the ministry of finance to grant greater, if not full, autonomy to the central bank.

To understand the issue better one needs to explore the recent developments with regards to SCBs and central bank reforms. The latest round of reform in the sector, particularly in the post-2000s, was undertaken under the aegis of the Central Bank Strengthening Project (CBSP) and the Enterprise Growth & Bank Modernization Project (EGBMP).

The CBSP laid greater stress on the strengthening of effective regulatory and supervisory systems for the banking sector, particularly focusing on the legal framework and capacity building of BB. The EGBMP's objective was to achieve a competitive private banking system by a staged withdrawal through divestment and corporatisation of a substantial shareholding in three public sector banks (Rupali Bank, Agrani Bank and Janata Bank), and divestment of a minority shareholding in the largest SCB Sonali Bank.

The Independent Evaluation Group (IEG), a unit within the World Bank Group, which evaluated the EGBMP in December 2011, observed that "during project implementation it became apparent that the original target of privatisation of nationalised commercial banks could not be achieved. The four nationalised commercial banks were corporatised, brought under the Banking Companies Act and, therefore, regulated by Bangladesh Bank."

What is interesting to note is that even a few months back the finance ministry favourably documented BB's roles in its Letter of Intent (dated March 27, 2012) to the International Monetary Fund (IMF) when it sought a loan from this multilateral entity. It assured the Fund that necessary measures would be undertaken to increase operational independence of SCBs, strengthen their finances, broaden their capital bases with a view to corporatising their operations, minimise fiscal risks, and reduce the government's effective ownership, with BB anchoring the process.

According to the Letter, it was supposed to submit an amended Bank Companies Act before the Parliament by September 2012, aimed at establishing a clear supervisory mandate for BB.

However, in the recent past, the actions of the ministry of finance have been markedly different from what it committed to the IMF. The autonomy of BB has been curtailed by instituting the Banking and Financial Institution Division (BFID) in the ministry in 2009 through a cabinet decision, which has been an obstacle in monitoring of SCBs by the central bank.

In a recent meeting with IMF, the finance minister said that there was no consensus over reforms in the Banking Companies Act allowing full control to the BB over the SCBs. He even criticised the central bank for its failure to address some recent regulatory failures in the financial system.

The question then arises whether the central bank is capable of regulating all banks, private and public. BB currently enjoys greater autonomy to regulate private sector banks -- both local and foreign -- that account for nearly 67% of banking industry assets.

Financial development outcome of the banking sector is generally judged on its depth, access, efficiency and stability. Key banking sector indicators show that banks' performance, notably private banks, has increased sharply, particularly in the post-2000s.

Depth in banking assets is reflected in rising share of deposits, private sector credit and broad money in proportion to GDP. Access to banking services is on the rise, reflected in branch expansion and firms' access to credit. While high interest spread is a drawback, other indicators of efficiency in the sector, such as return on assets and return on equity, are favourable. Finally, asset quality, capital adequacy ratios, probability of default, among others, that indicate banking sector stability suggest that private sector banks in Bangladesh are fairly stable.

Nonperforming loan ratios in private banks are now much lower than in state-owned ones. Almost all the private banks meet the global norms on capital adequacy (known as BASEL norms).

Nevertheless, this is not to say that BB has all the instruments to regulate and supervise the banking sector. At the same time, there is no other entity, including the BFID of ministry of finance, which has better infrastructure and capacity to regulate SCBs. It is almost a global norm that banking regulation falls under the purview of central banks.

Then why is the government reluctant to provide greater autonomy to the central bank that has managed private banks well? Further independence of BB was constrained, inter alia, by the government's fiscal constraints, largely owing to some flawed policies of the government.

The SCBs have been channelled to monetise fiscal deficits, particularly to finance politically motivated projects that do not get alterative funds owing to governance concerns. These banks are also an avenue to benefit political cronies and businesses, leading to deterioration of the quality of financial intermediation, as we noticed in the case of the Hall-Mark scam.

The recent adverse developments in SCBs have also sent another wrong message to the market. Following the Hall-Mark scam, some analysts opined that privatisation was the only way forward to solve the problems accumulated in these banks. This is a flawed argument for several reasons. My own research on the Indian financial system showed that during financial crisis private sector banks become risk-averse, leading to credit constraint.

The role of the SCBs, apart from the state's social goals, is critical during economic stress. Central bank's "moral suasion" as a monetary policy tool works better in public banks. Corporatisation of SCBs under the central bank guidance seems to be a better solution.

To sum-up, successive governments have delegated autonomy to the central bank over the years in line with banking reform. The reform in the banking sector is broadly successful thanks to the changing focus on risk-based regulation where central bank's role is critical. Thus, BB should be allowed to oversee all the banks, and BFID should be dismantled. The proposed amendment to the Banking Companies Act should ensure its greater independence.

On the finance ministry's concern regarding the problem of "guarding the guardians," what the great Greek philosopher Plato observed in The Republic about half a millennium ago is still insightful, that "one should be able to trust them to behave properly; that it was absurd to suppose that they should require oversight." BB has traditionally been served by competent governors and boards, transforming it into a credible entity. Let the right guardian guard the banking sector.

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