Banking Sector Governance: Reforms and Impacts

M. Shahidul Islam

Independent consultant and Research Fellow, IGS, BRACU

Institute of Governance Studies, Brac University

Preamble

- State of Governance in Bangladesh Report 2010-11 explored an unchartered yet integral new dimension – the role of external influence, in shaping Bangladesh's policy making process

- The chapter on economic governance appraised the trajectory of D&DP-driven economic reforms since the mid-1980s; particularly, how these reforms impacted the economy, understanding the roles and interplay of various actors

- Given a mixed bag of results of economic liberalisation, the study explored two cases of banking sector reform and energy price adjustment

Presentation outline

- External influence and economic reforms: Banking sector experience
- Banking sector reform: imperatives, objectives and outcomes
- Governance in banking sector: regulations and supervisions
  - Key initiatives and instruments
- Recent banking scams: regulatory failure or the outcome of rise of “illiberal state”?
- Financial regulations and supervisions: the post-crisis thinking
- Recommendations / What needs to be done?

Rationale and objective of the Study

- Successful economies tend to be those that developed sophisticated financial systems at an early stage (Patrick 1966 and Richard 2003)
- External influence has been relatively higher in this sector
- Political economy of reform in the banking sector is critical to understanding the emergence of the overall architecture of the country's financial system

Three phases of banking reforms

- Financial sector prior to reform: “financial repression” (McKinnon 1973 and Shaw 1973)

- The system operated until the end of the 1980s with the aim to achieve the fiscal objectives of supplying cheap money to the SoEs and a number of priority sectors

- Accumulated problems in the banking sector led to a wide range of reforms

First phase of reform (1980-1990)

Focus: Denationalisation and private participation

- The then government transferred three NCBs to private sector during 1984-86 and four PCBs were granted licenses in the early 1980s

- This round of reform was largely unsuccessful due to the unprecedented influence of vested PCBs and NCBs interest groups, which resulted in **a loan default culture**

Second phase of reform (1991-2000)

- ***Focus: Market based pricing of financial products and private participation***

- Reform measures were undertaken under the aegis of the WB's Financial Sector Reform Project (FSRP) in the 1990s

- Developed a wide range of financial products and services

- The measures have not been successful in addressing the banking sector's key problems, including high NPL ratios, lack of enforcement of the capital adequacy and other regulatory requirement

Third phase of reform (2000s onwards)

- ***Focus: Risk-based regulations and supervisions, private participation***
- Risk-based banking supervision including strengthening of the Central Bank
- The Central Bank Strengthening Project (CBSP) initiated in 2003 focused on effective regulatory and supervisory system for the banking sector
- Implementation of BASEL norms
- A staged withdrawal through divestment and corporatization of a substantial shareholding in the three public sector banks, and divestment of a minority shareholding in the largest SCB
- Discipline in the banking sector was established
- However, weakening of internal governance of SCBs in recent years, rising NPL and liquidity shortages are worrisome

Key reforms

- *Liberalization of interest rates*
- *Introduction of new policies for loan classification*
- *Indirect monetary management*
- *Implementation of capital adequacy requirement of commercial banks*
- *Modernization of the banking sector and introduction of updated accounting system*
- *Revision of the legal structure of financial sector:* New laws been introduced
- *Risk based regulation*
- *Corporate Governance*
- *Strengthening central bank's supervision*
- *Improvement of overall management of the banking sectors with special emphasis on credit management*
- *Capacity building of BB*

Financial development outcome: depth, access, efficiency and stability

	Financial Institutions
DEPTH	**Private sector credit to GDP** Financial institutions' assets to GDP Money (M2 aggregate) to GDP Deposits to GDP Value-added of the financial sector to GDP
ACCESS	**Accounts per thousand adults** (commercial banks) Branches per 100,000 adults (commercial banks) Percent of people with a bank account (from user survey) Percent of firms with line of credit (all firms) Percent of firms with line of credit (small firms)
EFFICIENCY	**Net interest margin** Lending-deposits spread Noninterest income to total income Overhead costs (percent of total assets) Profitability (return on assets, return on equity) Boone indicator (Herfindahl, or H-statistic)
STABILITY	**z-score** (or distance to default) Capital adequacy ratios Asset quality ratios Liquidity ratios Other (net foreign exchange position to capital, etc.)

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Financial development outcome

- 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 RoA and RoE, are favourable*
  - *Finally, asset quality, capital adequacy ratios, probability of default, among others, that indicate banking sector stability suggest that most private sector banks in Bangladesh are fairly stable*

- However, the balance sheets of SCBs do not fare well and their internal governance has deteriorated

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Impact on industry assets and deposit shares

- Prior to reforms the sector was overwhelmingly dominated by SCBs

- Even in the early 2000s the NCBs/SCBs constituted 47% of industry assets and half of the industry deposits

- PCBs emerged as a dominant player in the sector constituting 60% of industry asset
- There are currently 47 banks with 8522 branches

	% of industry assets		% of industry deposits	
Bank Types	**2001**	**2011**	**2001**	**2011**
NCBs/SCBs	46.5	27.8	50.93	27.4
DFIs	9.5	5.6	5.64	4.8
PCBs	37.2	60	36.58	61.8
FCBs	7.8	6.6	6.85	6.0
Total	100	100	100	100

Impact on Profitability

	2007	2008	2009	2010	2011	2012
Return on Equity (ROE)						
ROE (all banks)	19.8	25	19.5	21	16.8	13.5
SCBs	-9.4	35.6	24.9	18.4	18.5	11.7
PCBs	26.7	24.3	18.9	20.9	15.7	12.4
Return on Assets (ROA)						
ROE (all banks)	1.1	1.6	1.4	1.8	1.5	1.2
SCBs	-0.3	1.2	1.0	1.1	1.3	0.7
PCBs	1.9	1.9	1.6	2.1	1.6	1.2

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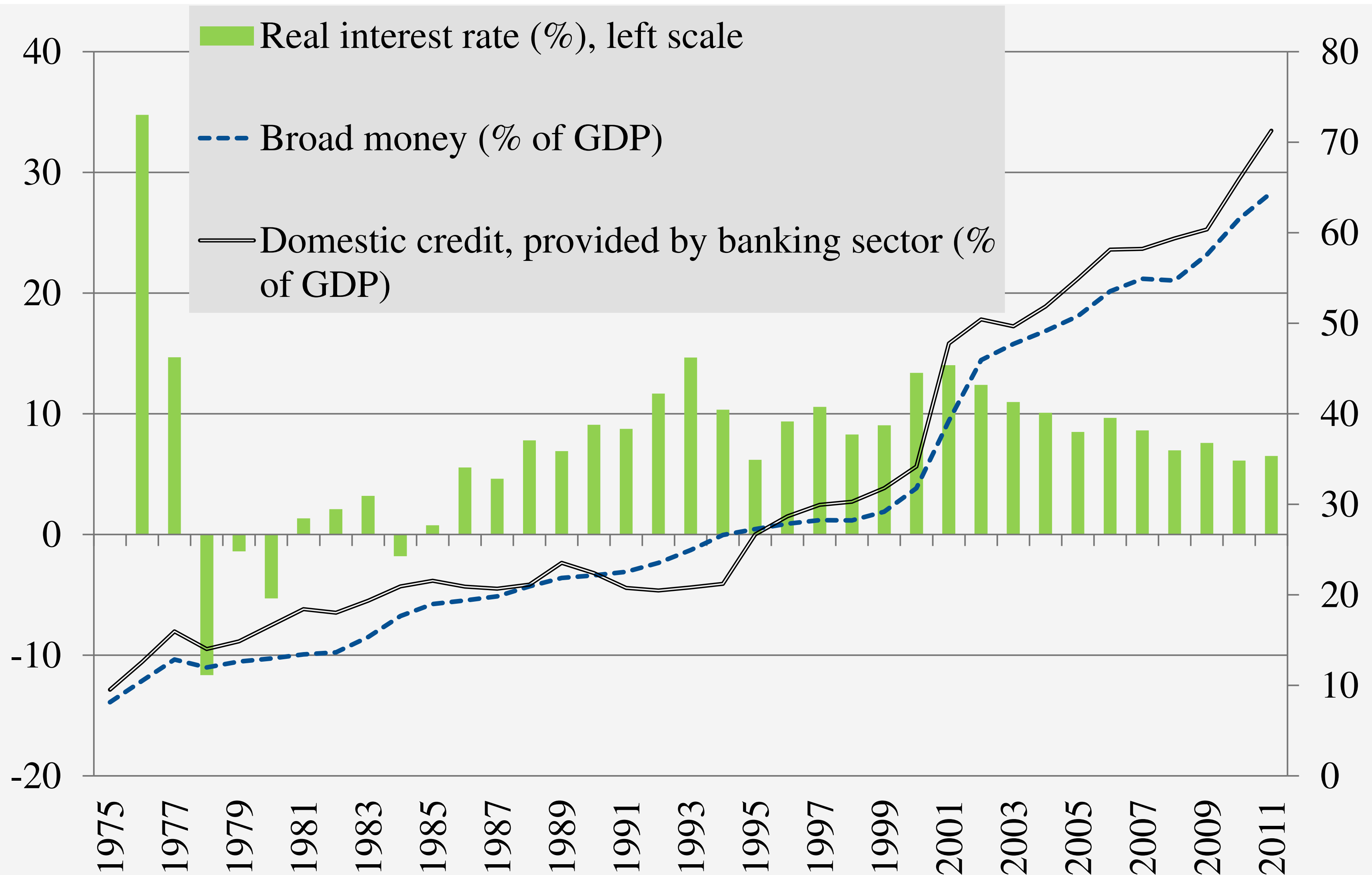
Impact on Broad Money, Credit and Real Interest Rate



Selected Banking indicators of key economies of South Asia, 2009-10

	Bank Deposits/ GDP	Bank Credit/ Bank Deposits	Bank Concentra tion	Bank ROA	Bank ROE	Bank Z-Score
India	69	70	0.34	1.3	20.2	8.75
Bangladesh	52	74	0.45	1.8	21.7	8.2
Pakistan	35	70	0.51	0.2	1.0	5.28
Sri Lanka	31	98	0.61	0.1	14.5	14.5

*z-score, a variable that explicitly compares buffers (capitalization and returns) with the potential for risk (volatility of returns). A higher z-score implies a lower probability of insolvency

Increasing focus on risk based regulatory and supervisory reforms

- One of the key lessons of banking reform is *"Liberalization without regulation can do more harm than good"*

- The post-2000s reform placed increasing focus on regulation

- CAMEL framework, which involves analysis and evaluation of the five crucial dimensions of banking operations, namely capital adequacy, asset quality, management soundness, earnings, and liquidity

- Early Warning System (EWS) to streamline the BB's supervision of banks under threat of incipient crises

Increasing focus on risk based R&S reforms

- Loan classification and provisioning
- Money Laundering Prevention Act
- Deposit insurance scheme (although has proven inadequate to prevent banks' taking excessive risks)
- Risk based supervisions
- BASEL II implementation
  - Operational and market risks are manageable. However, credit risk that constitutes 85% of RWA is a major challenge for risk managers
  - Stress testing results- cautious optimism

Impact on capital adequacy (in %)

	2006	2007	2008	2009	2010	2011	2012
Risk-weighted assets (adjusted)	5.6	4.0	6.5	8.8	7.6	10.1	9.7
State owned banks	-2.1	-21.6	-15.1	-7.6	-0.1	5.3	3.7
Risk-weighted assets (unadjusted)	5.6	9.3	10.4	11.7	9.3	11.3	10.9
State owned banks	-2.1	7.3	7.9	9.0	8.9	11.7	9.7
Private banks	9.0	10.4	11.2	12.1	10.1	11.5	11.3
NPL to regulatory capital	280	411	193	110	69	48	74

Capital adequacy/Risk-weighted assets : the minimum amount of capital that is required based on a percentage of assets, weighted by risk

Impact on asset quality, non performing loans (NPL)

	2006	2007	2008	2009	2010	2011	2012
NPL to total loans	12.8	14.5	11.2	9.0	7.3	6.1	8.8
SCBs	22.8	29	28	20.1	15.7	11.3	17.7
PCBs	4.9	5.4	5.1	4.0	3.1	2.9	4.9

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Agrani
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One
Premier
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Mercantile
Mutual Trust
Exim
Al Farah
BRAC
Social Islami
City
Standard
AB
NCC
Dutch-Bangla
EBL
Pubali
Uttara
Jamuna
IBBL
National
Prime
Bank Asia
Trust

0 2 4 6 8 10 12 14

BASEL II requirement

Capital Aqequacy Under BASEL II

Janata, Sonali and Agrani have shortage of regulatory capital

Weakening of governance in recent times

- Some back-sliding in asset quality in the first nine months of 2012 across most types of banks (IMF 2013)

- SCBs that accounts for 2/5th of all bank branches and ¼ total banking assets of in particular have come under renewed stress

Recent scams and stress in the banking sector: What went wrong?

- SCBs resulted better results reflected by higher CAR and lower NPL, following corporatization efforts, supporter by WB
- Asset quality of SCBs has deteriorated, profitability indicators showed weakness and internal governance weakened in 2012-13
- Liquidity pressures and capital shortfalls poses serious concern
- Managing credit risk is the key challenge for the risk managers
- Despite all these weaknesses in their balance sheets risky lending continues!

Governance in SCBs: What went wrong?

- *Institution of Banking and Financial Institution Division (BFID) in the Ministry of Finance in 2009 threatens the stability of banking system*
- *Such a move reversed the success of banking reforms*
- *The major functions of BFID include, formulation and updating of laws, rules, and policies relating to banking, insurance and the development of capital markets and future markets*
- *Instead institution of BFID has created greater government intervention in the financial sector*

Governance in SCBs: What went wrong?

- Creation of BFID impedes the banks' independence, including the Central Bank- one of the hard-earned successes of the three-decade long banking reforms

- BFID: an avenue to achieve political goals of the incumbent?

  - *Automatic monetisation of Fiscal deficit*
  - *Finance rental power plants*
  - *Politically motivated credit allocation*
  - *Appointment of broad of directors, top managers on political considerations*

- The activities BFID are doing more harm than good

- Dualism in bank regulation

- BB's actions: too little too late?
  - Early Warning System proven inadequate

Regulations & Supervisions (R&S): the post-crisis thinking

- Strengthening and expanding the scope of regulation and supervision (R & S)
- Controlling leverage of financial institutions
- Dampening pro-cyclicality of capital requirements
- Reducing costs of financial failures
- Devising market incentives for prudent behavior

Scope of R&S

- R&S has not only to be strengthened but that its scope also needs to be extended considerably

- A1. Entrusting a special regulatory authority (either an existing one or a newly constituted one) with an explicit financial stability mandate
  - *In the case of Bangladesh there is no special regulatory authority. Bangladesh Bank and Securities and Exchange Commission regulate and supervise the financial system. In India the BFS (Board for Financial Supervision) had already been established as early as in 1994.*

Scope of R&S

- A2. Ensuring coordination between different regulatory authorities
  - *Coordination between the three major regulators BB, SEC and IDRA is weak*

- A3. Expanding the scope of regulation to include credit rating agencies and private pools of capital (including hedge funds) via a system of registration, disclosure requirements and oversight
  - *No move in this direction is in sight*

Leverage of financial institutions

- An important amplification factor for the recent global crisis has been not only the high degree of leveraging of many financial institutions but also the fact that this leveraging has very often been quite opaque

- B1. A stronger focus by regulators on loan-to-value ratios
  - loan to value (LTV) ratio ranged 50-80% (LTV- Valuation of collateral/mortgage)

- B2. Higher loan-loss provisioning norms
  - Loan loss provisioning (an expense set aside for bad loans) varies depending on type of Banks. For SCBs the required ratio is 73%

- B3. Stress testing exercises to be conducted periodically to monitor leveraging on an on-going basis
  - All banks and FIs are mandated to carry out stress testing on half yearly basis (June 30 and December 31) each year

- B4. Improved disclosure requirements for complex structured products
  - Complex derivative products such as synthetic securitization ha
    permitted so far

Pro-cyclicality of capital requirements

- C1. Requiring financial institutions to build-up capital buffers during economic expansions, which could then be unwound in times of recession to forestall the adverse impacts of *fair valuation*, leverage and maturity mismatches
  - pro-cyclicality is sought to be mitigated via risk weights adjustments

- C2. Imposing higher capital requirements on *systemically important* financial institutions
  - In India the systemically important non-bank financial intermediaries are subject to a higher CRAR (capital to risk-weighted assets ratio) of between 12% to 15% as opposed to the regularly applicable CRAR of 9% for banks. In the case of Bangladesh the rate is flat 10%

Reducing cost of financial failures

- The welfare costs of financial shocks are generally severe and fall disproportionately on disadvantaged groups in any society
- D1. An early warning diagnostic system can contribute considerably towards containing collateral damage
  - *An early warning system is in place, but not adequate proven following the scams of SCBs.*
  - *In India the RBI introduced the Prompt Corrective Action (PCA) scheme in December 2002. Under the PCA, the RBI will initiate certain structured as well as discretionary actions in respect of banks, which have hit certain trigger points in terms of capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and return on assets (ROA).*
- D2. The instituting of orderly closure rules for important financial institutions (as prevalent in the U.S. for banks under the FDIC (Federal Deposit Insurance Corporation) Improvement Act & Competitive Equality Banking Act).
  - *No such provision exists*

Devising market incentives for prudent behaviour

- Unregulated corporate compensation framework, which provided perverse incentives for excessive risk taking resulting in a serious moral hazard syndrome

- E1. Prudential oversight of financial executive compensation schemes
  - *Such rules do not exist*

- E2. Better separation of ratings and consultancy activities of credit rating agencies
  - No formal legislation to this effect, but safeguards exist to prevent "cherry picking" credit assessments by banks.

What needs to be done?

- **Banking sector is at crossroads**
  - Banks' surplus capital decreased markedly in the second half of 2012 due to the rise of bad loans in SCBs, economic and political uncertainties could increase bad loans in private banks as well
- **Disintegrating (illiberal) state from directly controlling finance**
  - Financial sector regulation and supervision are areas where the role of the state is not in dispute; the debate is about how to ensure that the role is carried out well
- **Dismantling of BFID**
- **Greater autonomy to BB**
  - Amendment of Banking Company Act is the key in this regard

What needs to be done?

- **Corporatization not wholesale privatization of SCBs is a solution**
  - Lending by state-owned banks can play a positive role in stabilizing aggregate credit in a downturn, but it also can lead to resource misallocation and deterioration of the quality of intermediation

- **SCB reform should focus on asset quality, liquidity management, internal audit**

- **Increasing role of BB in appointing board members and senior managers**

- **Continued focus on risk-based R&S**

- **Making SCBs BASEL II complaint and raising adequate regulatory capital to meet the BASEL III requirement**

- **Special focus on credit risk management**

What needs to be done?

- **Deposit insurance reform**
  - The prevalent flat-rate deposit insurance premium does not deter banks from taking unreasonable risks as they do not incur any additional premium expense in doing so
  - An ideal deposit insurance premium pricing system should embody (a) banks paying premium indexed to their own levels of risks, and (b) a premium level that ensures a continually solvent insurance fund (see e.g. Demirguc-Kunt and Huizinga, 2004)

- **Greater cooperation between various regulatory authorities**

- **Need for a "super regulatory" authority?**
  - Akin to the Financial Stability and Development Council of India to maintain financial stability, enhance inter-regulatory coordination, beef-up macro prudential supervision and coordinate the country's international interface with financial sector.