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Saving state-owned banks from government intervention

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A series of financial scams in the past few years have battered the financial system of Bangladesh. It started with stock market crash in 2011. Then numerous multi-level marketing companies swindled millions of taka from the economy. Lately, we have witnessed a number of financial scams in the banking sector, notably in state-owned commercial banks (SCBs).

The scams have affected the SCBs' balance-sheet adversely and exposed acute governance problems in public sector banks. The SCBs still control about 28 per cent of industry assets and 27 per cent of deposits. Moreover, regulatory failure and excessive state intervention in the SCBs have brought independence of the central bank and the future ownership of public sector banks to the forefront of debate.

Before we delve into the two critical questions, it is imperative to check some basic indicators of the SCBs. Financial development outcomes of the banking sector are generally judged on its depth, access, efficiency and stability. The SCBs have made huge contribution to penetration of banking services across the country. The rise in access to financial services, particularly in the rural areas, is largely due to the expansion of the SCBs. Over the years these banks, along with private ones, have also been instrumental in increasing depth of the country's financial sector, reflected by the rise of broad money and credit to the GDP.

However, the efficiency and stability indicators of the SCBs are not favourable. The profitability indicators (that reflects efficiency) of the SCBs, namely return on assets (RoA) and return on equity (RoE) improved in the later half of the past decade. However, their RoA and RoE declined sharply in 2012. Non-performing loans (NPL) and risk-weighted assets (RWA) that indicate stability of financial institutions show similar trends.

The NPL ratios, irrespective of private and public banks, declined in the post- 2000s. However, bad loans increased in 2012. The SCBs experienced the sharpest rise in NPLs between 2011 and 2012 from 11.3 to 17.7 per cent.

The SCBs had a capital shortfall of Tk 19.81 billion at the end of 2012. Most banks except Janata, Sonali and Agrani meet the BASEL II regulatory capital requirements. The rise of NPLs in 2012 has caused a decline in banking sectors' overall surplus capital. This has been partly, if not largely, due to a series of scams that hit the banking sector. While banks are required to raise their capital adequacy ratio (CAR) from the current 10 per cent to 15 per cent by 2015 to meet the BASEL III requirement, the ratio rather declined from 11.4 per cent in 2011 to 10.5 per cent in 2012. An IMF report indicates that the recapitalisation need at the SCBs is estimated to be 1.5 to 2 of Bangladesh's GDP. Despite all these weaknesses, the risky lending in these banks continues to grow faster than other banks.

The banking sector, particularly the SCBs, has come under renewed stress. One has to inquire into what prompted the reversal of the key indicators of bank efficiency and stability. The banking sector's performance is closely associated with overall economic health of the country and the recent downturn could have an adverse impact on their balance- sheets. However, on the governance front there has been some disturbing developments as far as the SCBs are concerned.

To corporatize the SCBs, a host of reform programmes were launched under the aegis of the Enterprise Growth & Bank Modernisation Project (EGBMP). An evaluation of the project 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 the Bangladesh Bank."

However, in 2009 the government created a separate division-the Banking and Financial Institution Division (BFID)- under the Ministry of Finance (MoF) giving it the responsibility to deal with the SCBs. From the very beginning, experts opposed the institution of the BFID fearing that such a move could open an avenue for greater government intervention in the financial sector, especially in the banking sector. This has curtailed the central bank's independence markedly. In fact, the Bangladesh Bank lost its de facto power to regulate the SCBs.

While the major functions of the BFID are, among others, formulation and updating of laws, rules, and policies relating to banking, insurance and the development of capital markets and future markets, we rather have seen a series of regularity failure in the financial system following its inception.

The entity did little to arrest the regulatory failure in several segments of the financial sector, including the stock market manipulation in 2010-11, sucking up millions from small savers by the multi-level companies and the misappropriation of over Tk 50 billion through fictitious loans by various business outfits, including the Hallmark group. An International Monetary Fund (IMF) report suggests that asset quality at the SCBs is expected to worsen considerably once the new and tighter classification and provisioning standards come into full effect and fraud-related loans are classified. It also reports that the number of loss-making branches has increased, following earlier declines.

The SCBs are generally used as an important channel for monetisation of fiscal deficits. While the government faces opposition from the IMF and other donor and development partners to augment fiscal deficits, greater autonomy to the banks has been a bar to automatic financing of deficits. Thanks to the BFID, the government now faces little resistance to borrow from the banking system. For instance, four SCBs have faced severe fund crises as a result of large loans to Bangladesh Petroleum Corporation (BPC), the country's lone fuel importer. The fuel import rise in recent years is to support controversial rental power plants. The BPC's accumulated losses have also resulted in higher NPLs for the SCBs, forcing the government to issue special recapitalisation bonds to allow write-down of some of these NPLs.

Thus, instead of maintaining discipline in the financial sector, the BFID has been an avenue to achieve political goals of the incumbent government.

More worryingly, the institution of the BFID has created dual authorities in banking regulation. The Bangladesh Bank that manages private banks has established itself as a credible institution. This has been possible due to decades of reforms. It has also been fortunate to be guided by some highly educated and competent managers. The BFID is ill-equipped to regulate and supervise banks.

Facing severe pressure from the IMF and think-tanks, the MoF has promised to grant greater autonomy to the central bank to oversee the SCBs. A draft of the Bank Company (Amendment) Bill, 2013 has been placed in the Parliament after a series of consultations with the officials of the IMF, the Bangladesh Bank and the MoF. Apparently, the government is reluctant to allow the central bank's control over the dismissal of state-owned banks' board members but might entitle it to remove the SCBs' chief executive officers. Thus, from political economy perspective, this second best option might appease the central bank but the government's avenue for intervention in these banks will remain open.

Another key question is whether the SCBs should continue to be in the hands of the government. Following over three decades of banking reforms, private banks have emerged as the dominant players in the banking business. Nevertheless, the government still controls over a quarter of banking assets and deposits. Thus, in the long run it is desirable that the SCBs' share continues to decline in line with economic progress of the country. However, at this stage, wholesale privatisation of these banks is not desirable for various reasons.

The SCBs reach the furthest corner of the country where private and foreign banks are reluctant to go. To support the growth of rural economy and broader financial inclusion, their role is of importance. Moreover, experience, including that of India, shows that during financial crisis private and foreign banks become risk averse. Thus, the 'moral suasion' channel of monetary policy transmits better through state-owned banks than private ones. Thus, corporatisation, not wholesale privatisation of SCBs should be a policy priority.

To sum-up, the country's banking sector performed well in the post-2000s, particularly following the adoption of risk-based regulations and supervisions. However, by creating the BFID, the government has created dual authorities in banking regulation that has done more harm than good. The proposed amendment of the Banking Company Act might not stop the government intervening in the banking sector.

Financial sector regulation and supervision are areas where the role of the government is not in dispute; the debate is about how to ensure that the role is carried out well, as observed by the Global Financial Development Report 2013. In the case of Bangladesh, the challenge is to rein in the excessive intervention of illiberal government that represses a quarter of the banking sector.

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