Are BAB’s demands reasonable?

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Recently, Bangladesh Association of Bankers (BAB), a body representing the owners of private commercial banks, placed a number of proposals

to the Prime Minister seeking relaxation of central bank regulations and guidelines in a number of important areas. BAB’s demands to the PM have come at a time when the financial system in Bangladesh is passing through a period of instability as reflected in the recent collapse of the stock price index, liquidity crisis in the money market and intensifying pressures in the exchange market.

The broad range of demands and the timing of BAB’s intervention, compelled me to prepare a public response to this issue. An attempt has been made in this news analysis to evaluate BAB’s demands objectively to determine whether there is merit in its demands.

Allowing representatives of bankers in the central bank’s policy making body: The policy-making body or the executive board of a central bank is composed of representatives from the Government and eminent citizens with extensive background/experience in macroeconomic and financial sector matters. Since central banks generally regulate the operations of commercial banks to safeguard interests of depositors and maintain macroeconomic stability, representatives of bankers in the Board of a central bank will create conflict of interest. Because of this potential conflict representatives of banks are not allowed to become members of the Board of central banks. In this respect, Bangladesh Bank is no exception. Irrespective of state of development of the banking system, everywhere in the world, banks need tight supervision. The recent global crisis has amply demonstrated the kind of systemic risks a collapsing banking system may cause even to the developed economies of the world.

In less developed economies with questionable governance structure, the conflict of interest issue is even more important. Thus it would certainly not be wise to entertain this kind of inappropriate demand. Consultation with bankers, who are the most important stakeholder, is always valuable. But that should be done in different formats.

Reducing Cash Reserve Requirement (CRR) and increasing the Loan to Deposits Ratio (LDR): Although the main purpose of CRR is to ensure commercial banks liquidity position, on certain occasions, central banks increase the CRR to tighten the stance of monetary policy instead of increasing the interest rate structure. Recently several central banks (Bank of China, Reserve Bank of India) including Bangladesh Bank have increased the CRR to contain the pace of liquidity expansion and dampen inflationary pressures in their economies.

Currently money supply has been expanding at a pace much faster than the target set by Bangladesh Bank in its Monetary Policy Statement (MPS). At the same time the rate inflation in the domestic economy has crossed 9.0% in January. Under these circumstances, the tightening of the monetary stance through the recent increase in CRR was appropriate and reversing that under pressure from the BAB would be inappropriate.

BAB’s demand to increase LDR to 90% is even more unreasonable. Normally the LDR in Bangladesh ranges between 75%-80%, indicating that out of every Tk. 100 in deposits banks lend on average about Tk. 75-80, keeping the balance in liquid assets in compliance with normal banking regulation.

In recent months, banks have been extending loans more aggressively, including for investment in the stock market. This practice on the one hand helped create the stock market bubble and on the other hand contributed to domestic demand pressures as reflected in the surge in domestic imports. The excess lending by banks has already increased the LDR to 86%, well above the historical norm. For some banks the ratio apparently exceeds even 100%. Compared to countries like Pakistan (63%), India (75.1%), Saudi Arabia (80.3%) and Malaysia 81.4%) Bangladesh`s LDR is already the highest and it is a major cause of concern.

Although quite late in the game, Bangladesh Bank is now trying to bring down the LDR to 85% for all commercial banks by end-June 2011. Given the intensifying inflationary and domestic demand pressures, Bangladesh Bank’s efforts may appear modest. However, allowing the LDR to be set at 90% as demanded by BAB would certainly make the already bad situation worse. We have to remember if India can grow at 8.5%-9.0% rate with the LDR at 75%, why do we need anything higher than 80%?

Allowing banks to increase their exposure to the stock market to 20% of their liabilities from the current limit of 10%. BAB also suggested allowing merchant banks to invest 10 times of their capital, which is five times now: Bangladesh Bank’s regulatory limit of 10% is already considered to be lax and may have contributed to the formation of the stock market bubble. Many banks have already crossed the legal limit and are overexposed to the stock market correction. Protecting depositors’ interest is the primary responsibility of Bangladesh Bank and also of the banks themselves.

While banks are supposed to make profits, risk management aspects must not be forgotten and excessive risk taking by commercial banks must be controlled strictly by Bangladesh Bank. Just because banks have overexposed themselves in the stock market and a part of their deposits may be stuck in the stock market does not mean that they should be allowed to invest more in the same sector and potentially go deeper into trouble.

Furthermore, credit demand in the broader economy is already expanding rapidly, with import growing at an all time high pace. This is certainly not the time to allow banks to invest more in the stock market by diverting loans from productive sectors of the economy.

BAB wants to waive 13 percent cap on lending for one year: This longstanding demand of the bankers is legitimate and more pressing under the current circumstances. This lending cap has created excess demand for credit by the private sector pushing up the DLR to 86%, as discussed above. Cheap credit policy of Bangladesh Bank should have been abandoned a long time ago in the face of strong credit demand and inflationary pressures. Recently banks have been competing aggressively for mobilizing deposits to avoid the liquidity crunch and have been offering deposit rates of up to 14% on CDs. The high cost of fund has made the lending cap of 13% impractical and irrational.

It is encouraging that Bangladesh Bank has positively responded to this legitimate demand of the BAB by abolishing the interest rate cap. I would simply add that, the cap on lending rate should never be reintroduced due to its numerous adverse impacts on financial intermediation.

BAB wants to keep the requirement to maintain 9.0 per cent capital against risk weighted assets unchanged in 2011: Bangladeshi banks are generally very small in size and quite weak in meeting their capital adequacy requirements compared with their regional and international counterparts. Although gains have been made, banks are still well behind meeting the capital adequacy requirements established in under the Basel II standards. Although behind its regional counterparts, Bangladesh Bank has adopted the programme to move toward the Basel II requirements in phases and had originally adopted a programme to achieve the 10% capital adequacy requirement target by December 2007. In the event, due to inadequate performance of Bangladeshi banks the target date for achieving the minimum capital requirement of 10% was reset to be July 1, 2011.

Now the banks want this deadline to be deferred once again. Bangladeshi banks have made record profits in 2010 in part due to fabulous gains in their stock market investments. Banks should use a part of these profits to build up their capital base instead of distributing the profits to shareholders in the form of dividends. Given that more challenging time is ahead on the macroeconomic front, it would be imprudent for the banks not to boost their capital base in line with the target set by Bangladesh Bank. It is disappointing that last year the risk-weighted capital adequacy ratio of private banks in Bangladesh declined to 8.7% (as of end-June 2010) from more than 12% at end-2009. In India the corresponding ratio is currently at about 13%.

Concluding observations: BAB is an important and a very powerful organisation. Like in any other country, banking system is critically important for the Bangladesh economy. BAB, as the apex body of the owners of private banks in Bangladesh, needs to understand the importance of a strong and well-functioning banking system for the overall macroeconomic stability and strong economic performance of Bangladesh. The prudential guidelines established by Bangladesh Bank, are aimed at protecting the interest of depositors and ensuring a sound and healthy financial system. Bangladesh's regulatory guidelines are in many respects weaker than the international standards and there is no scope for weakening them further without jeopardizing the integrity and health of our banking system.

Bangladesh Bank bears the primary responsibility for the sound and healthy growth of our banking system in a competitive environment and making it ready for the competitive global economy. Thus it is of paramount importance that Bangladesh Bank is not be pressured into relaxing its prudential guidelines at a time when the guidelines need to be strengthened further. Undue political pressures aimed at compromising the governance structure and operations of Bangladesh Bank will seriously compromise macroeconomic management in the difficult days ahead.

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