Challenges and way forward

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The Bangladesh financial system is dominated by the banking sector, which fundamentally depends on short and medium-term deposits for financing their lending portfolios. The banking sector comprises over 60 percent of the total assets of the financial system, while its share of assets as percentage of GDP is also over 60 percent. The sector is responsible for the intermediation of private financial resources through the banking system. The banking sector has a vital role in achieving the country's investment targets. There are 56 scheduled banks operating in Bangladesh of which 6 are state-owned commercial banks, 2 are government-owned specialized banks, 9 are foreign commercial banks and 39 are domestic private commercial banks, including 31 conventional private commercial banks and 8 Islamic banks.

The past and recent developments in the banking sector, such as structural reforms of 1980s and 1990s, are important catalysts of banking sector performance. Bangladesh's financial system was characterized as a very repressed financial system before the advent of reforms in the 1980s. Both the market and institutions, in the post-independence period faced major structural problems, evident in the money market comprising the banking and other sectors. In order to counter these problems, the first round of financial sector reform was initiated in 1982 with the denationalization of some state owned commercial banks. However, major reforms in the sector were launched much later in the early 1990s.

The reform programs initiated focused on several dimensions, namely privatization of state-owned commercial banks and entry of new private and foreign banks. Other areas the reforms included: recovery of non-performing loans (NPLs); interest rate deregulation; central bank's increased autonomy; strengthened prudential regulation and supervision; rationalization and merger of bank branches; and improvements in the functioning of the money market. In the banking sector performance, Bangladesh has done well overall despite some setbacks in the area of public sector banking.

Banking reforms which started in early 1980s, and gathered momentum in the 1990s and 2000s, have brought about positive changes in most of the indicators of banking performance. Indicators like the broad money (M2) to GDP ratio, which is often used as an indicator of the depth of the financial sector, has risen from 12 percent in 1980 to 52 percent in 2014; total domestic credit as a share of GDP has also grown from 14 percent to 46 percent over the same period. In the absence of a well-developed capital market, the growth in private credit has played a major role in supporting the expansion of the private sector in Bangladesh.

The positive gains in financial deepening notwithstanding, a comparison with regional countries clearly indicate that Bangladesh is still behind most others, except Pakistan. Bangladesh lags behind India in terms of financial deepening and well behind countries like China and Vietnam. Nonetheless, in Bangladesh, competition amongst private banks and between private and public banks caused a massive increase in financial resource mobilization, introduction of new financial products and substantially better service to customers. While still catching up with international standards, intense competition in retail banking has resulted into a huge improvement in banking services, not only in faster turn-around time for transactions but also in access to modern banking facilities such as ATMs, e-banking, credit/debit cards, wire transfers, etc.

Recent setbacks – banking scams and default loans: In 2014 the total default loans of banks rose by Tk 31.83 billion (3,183 crore), with the scam-hit BASIC Bank accounting for almost 64 percent of the rise. The banking sector's total default loans stood at Tk 513,45 billion. The amount is 10.75 percent of the total outstanding loans. Out of the 47 scheduled banks, 23 experienced an increase in their default loans. The default loans of four state-owned commercial banks increased by Tk 10.30 billion in just two months. The default loans of private commercial banks rose by Tk 6.32 billion, with just two banks responsible for 80 percent of the sum. Various experts highlighted the special rescheduling facility that was allowed by the Bangladesh Bank especially due to political turbulence, as the main reason for the increase in default loans. What made this worse were many banks extending this credit facility to even their default borrowers to make their balance sheets look better.

Another reason behind the increase in default loans was that in 2012 and 2013 many loans were given through fraudulent practices, which are now gradually becoming clarified. In an environment of unfinished financial sector reform agenda, the unfortunate scandals involving the state-owned banks (Sonali Bank/ Hallmark Scandal, and Irregularities found in BASIC Bank) and some nonbank institutions raised considerable concerns. In May 2012, a report from the Bangladesh Bank revealed that the Ruposhi Bangla Hotel Branch of the state-owned Sonali Bank, Bangladesh's largest commercial bank, illegally disbursed Tk. 36.48 billion in loans between 2010 and 2012. The largest share, of Tk. 26.86 billion, went to the now infamous Hallmark Group. In the BASIC Bank's irregularities with its loans, the amount of non-performing loans of the scandal-hit bank stood at over Tk. 41.57 billion, or 36.55 percent of the bank's capital. The bank's Gulshan, Dilkusha and Shantinagar branches had disbursed much of the loans violating loan guidelines. In light, serious questions emerged regarding the health of the banking system and the effectiveness of the regulatory regime.

Other challenges to the banking sector: Although the banking sector has had its share of success and noted scams, there are a number of structural concerns which are likely to intensifying if remained unattended.

First, there are sharp differences in the performance of banks, especially between private and public banks. For example, the non-performing loans (NPLs) of private banks in mid-2015 were 5.7 percent, but it was 22 percent for public commercial banks and 25 percent for public specialized development banks. Furthermore, the reported NPL numbers have portfolio quality problems because they do not account for the scams, the losses incurred by the merchant banks due to the bursting of the stock price bubble, the reluctant quality of regulatory standards, and the below par quality of accounting standards.

Second, the definition of non-performing loans (NPLs) used in Bangladesh is not in line with the international norms. The standard international definition for NPLs was scheduled for adoption from July 2012. This move has contributed to the deterioration of the NPL ratios beginning 2013. It is therefore likely that the true NPL of the banking sector is under-stated while the capital adequacy is over-stated.

Third, there are concerning issues relating to the corporate governance of banks. Due to political influences some private banks are able to bypass standards relating to optimal criteria for bank board and management. Importantly, public banks are not within the purview of the supervision of the Bangladesh Bank. As such, there are serious concerns about the quality of the board and top management of these banks.

Fourth, the capacity and flexibility of Bangladesh Bank to supervise the banking industry and implement prudential measures are often constrained. Owing to lack of autonomy, Bangladesh Bank cannot withstand political pressure that compromises prudential management. Similarly its operational flexibility is inadequate. For example, it does not have wage setting flexibility and as such cannot hire quality-skills. As a result, quality of bank supervision suffers in myriad ways.

Fifth, there is widespread allegation from the business community that bank interest rates and charges are too high. These high interest rates have adversely impacted investment and domestic economic activity. This economic policy issue will require careful review of several aspects of Bangladesh economy before making an informed policy intervention.

Sixth, the lack of autonomy of the Central Bank is constraining in regards to sound monetary policy and the granting of licenses for new banks. Monetary policy was overtly expansive during FY10-12, partly owing to pressures from the Government to pump liquidity in the stock market and the finance of treasury operations. Under government pressure the Bangladesh Bank was forced to issue several new licenses to new private banks at a time when new banks were not needed.

Finally, corrective monetary policy actions tended to offset some of these adverse effects. In the area of new bank licenses, the Bangladesh Bank approached the political challenge as professionally as possible, by laying down stricter performance criteria for the selection of new banks. Yet, the risks of political interventions in the functions of the Central Bank must be averted to establish a healthy banking system.

Reform agenda for the banking sector: At the very top of the reform list is the need for autonomy of the Bangladesh Bank. The government should carefully review the issue of independence of the Bangladesh Bank and the amount of autonomy it wants to convey. A fully autonomous regulator that can hire quality staff it needs, procure the technology it requires, and implement prudential norms, without the fear of political influence, is essential to prevent recurrence of Hallmark and Basic Bank type scams. An autonomous central bank is also necessary to conduct sound monetary policy management and to exercise utmost prudence in such matters as the licensing of new banks.

The government should also rethink the strategy for the supervision of public banks. The weak performing public banks with a huge amount of infected portfolio are a serious threat to the soundness of the banking sector. In addition to efforts to improve their performance, these banks must be brought fully under the regulatory supervision of Bangladesh Bank and must be required to comply with all prudential norms, including certification of the bank boards and senior management as per the approved criteria. The government must understand that it cannot both be a producer of banking services (as owner) and also a regulator of these services. It is a serious conflict of interest.

Over the longer term, the Government should also reassess whether it really needs be in the business of providing banking services. There is plenty of international evidence that publicly owned banks do not perform well in an environment of weak governance. The quality of portfolio inevitably gets tainted owing to political interventions that are inconsistent with sound banking decisions. The first best option is to privatize the state-owned banks. Unfortunately, this is not a politically palatable option in Bangladesh.

The second-best approach may be adopted. Public banks tend to have an unfair advantage in mobilizing deposits because of the perception of state guarantees and de-facto immunity from effective supervision. Because of these concessions, state-owned banks are able to stay float even with very poor loan portfolios. The adverse implications of these improper privileges for efficient lending decisions could be tackled by taking away the lending functions of these banks. If such banks are allowed to only hold government paper, their deposit growth would be indirectly limited and sounder banks would intermediate more flows. The deposits mobilized will be safe and not exposed to risks of the type of Sonali Bank and Basic Bank type scams.

Such lending restrictions are akin to a “dual banking system” with “narrow banks” that are likely to remain state-owned and conventional private sector banks. No new laws are required because the government as owners of the public banks could take this decision. The idea of narrow bank is not a new one. The government can ask Bangladesh Bank to review this option carefully and provide a technical proposal.

Regarding the implications for the adequacy of banking safeguards, there are two inter-related issues. First is the adequacy of internal controls within the Sonali Bank and other public banks. And second is the adequacy of the supervisory efforts of Bangladesh Bank. The transfer of taka 36 billion from a small Sonali Bank branch (Sonali Bank/Hallmark Scandal) is a mind-boggling event. The Basic Bank scam is also equally disturbing. These scams give rise to huge concerns about the lack of internal controls. There is an urgent need for Bangladesh Bank to do a full review of the internal control mechanisms of all the public banks and ensure that all loopholes are immediately plugged.

The recent performance of state owned banks calls for a fundamental change in the manner the state-owned banks operate in Bangladesh. Since the government is opposed to privatization of the state-owned banks and management of these banks are not likely to improve significantly as has been demonstrated time and again over the last 46 years, their activities should only be limited to “narrow banking” which allows state-owned banks to gather deposits but limit their direct lending. Any surplus fund of the state-owned banks can be placed in the interbank market for on-lending by the private banks.

There has been a proliferation of branch network by the state-owned banks and specialized agricultural credit banks, without regard to commercial opportunities. Such branch expansion has also contributed to manpower expansion and a rapid increase in overhead costs. Since commercial activities of these public banks can easily be covered by private banks, expansion of branches and operations of public banks should be strictly limited.

Strategy for lowering lending rates in Bangladesh: Bangladesh is also facing strong demand from the private sector for reducing interest rates on domestic lending, especially to boost domestic investment by the private sector. The reduction of interest rates should be on the basis of a medium term market based process that involves reducing inflation, reducing the cost of doing banking operations, and lowering loan loss provision. Any lowering of interest rates on an ad hoc basis will not work in a sustainable manner. Systematic efforts to reduce the loan losses provisioning, continued lowering of domestic inflation, would need to be taken by Bangladesh Bank under a market-based strategy in order to reduce interest rates.

Bangladesh Bank has been relatively successful to create competitive pressures within the banking system by liberally allowing the domestic private sector to borrow from abroad in dollar terms at much lower interest rates. The resulting supply of funds from external sources is putting pressure on domestic banks to lower their lending rates and as a result the whole structure of interest rates has come down significantly by at least 1 – 2 percentage points. For the lending rates to come down to single digit levels two more things must happen. First, the banks must strengthen their loan management capacity to reduce the amount of nonperforming assets and the consequent provisioning requirements. Second, the inflation rate should also come down further to about 4.0 per cent level so that depositors are not subjected to financial repression and the depositors are not deprived from receiving modestly positive real interest rates on their financial savings. A combination of lower inflation and lower spread in a competitive market environment would bring down lending rates to single digit levels in a sustainable manner. In particular, the spread between lending and deposit rates should not be more than 3.5 – 4.0 per cent range.

Concluding observations: Banking system in Bangladesh already plays the most important role through intermediation of financial resources for productive investment and trade financing. Given the state of development of the bond market and the insurance sector and the lack of public confidence in the stock market, the banking sector will continue to serve as the dominant source of financing for investment and trade. An efficient and strengthened banking system, offering funds at lower interest rates for trade and investment would go a long way to the future development of Bangladesh. Bangladesh Bank should help sustain the competitive environment and strengthen its oversight on the banking system for the banks to become more competitive and financially strong and serve the economy better. The government must empower Bangladesh Bank through greater autonomy for it to exercise its authority without political intervention.