Consolidating gains in the banking sector

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Bangladesh can take some satisfaction that it has been progressing

well with the establishment of a modern banking sector. A series of reforms starting in early 1980s but gathering momentum in the 2000s has paid off handsomely in terms of most indicators of banking performance. Broad money (M2) to gross domestic product (GDP) ratio, which is often used as an indicator of the depth of the financial sector, has risen from 12% in 1980 to 59% in 2011 (November); bank credit as a share of GDP has grown from 14% to 60% over the same period; and the share of private credit to total credit has similarly expanded from 36% to 77%.

The quality and stability of the banking sector has improved as reflected by the sharp decline in the share of non-performing loans (NPLs) from a high of 41% in 1999 to only 7.1% in 2011 (June). Improvement was made in meeting capital adequacy requirement under Basel I standards although the progress falls short under Basel II guidelines. Profitability of banks measured against rate of return on assets and equity has substantially increased, especially in the private sector.

The coverage of the banking sector also compares favourably with neighboring countries even though Bangladesh is a significantly smaller economy. The number of banks has grown from 17 in 1980 to 47 in 2010 and the number of branches expanded from 4067 to 7700 over the same period. There are 53 bank branches per 1000 square kilometer in Bangladesh as compared with 10 in Pakistan and 24 in India. There is one bank branch for every 20,000 people in Bangladesh as compared with 20,340 people per branch in Pakistan and 14,485 people in India. Efforts are now underway to enhance coverage of banking in unserved rural areas through mobile phones.

The three main factors that contributed to this improvement are greater competition, better regulations and improved supervision. The opening up of the banking sector to private enterprise is perhaps the most dominant factor. This changed the character of the banking industry as competition amongst private banks and between private and public banks caused a massive increase in financial resource mobilisation, introduction of new financial products and substantially better service to customers. While still catching up with international standards, nevertheless intense competition in retail banking has caused a huge improvement in banking services not only in terms of faster turn-around time for transactions but also in terms of access to modern banking facilities such as ATMs, e-banking, credit/debit cards, wire transfers, etc.

As a result of this competition, the share of private banks in total assets grew from 42% in 2001 to 65% in 2010; commensurately, its share of total deposit expanded from 43% to 66% over the same period. Much of the improvement in non-performing loans (NPLs) also happened due to the rising share and much better portfolio quality of the private banks. Within private banks, foreign banks performed better in terms of NPLs. Furthermore, foreign banks have substantially surpassed the Basel II risk weighted capital guidelines, making them the safest banks in the industry.

Banking regulations have been progressively tightened. Full implementation of Basel II guidelines will be of further significance in this regard. Similarly, progress has been made in improving the supervision capacity of the regulator, the Bangladesh Bank (BB).

Notwithstanding this progress, a number of concerns remain in the banking sector.

First, there are sharp differences in the performance of banks, especially between private and public banks. For example, the NPL of private banks is only 3.1% for foreign banks and 3.5% for domestic private banks. As compared to these, it is 14.1 % for public commercial banks and 21.8 % for public specialized development banks. This high share of infected portfolio of the public banks is a serious problem. Even if one were to ignore the potential threat to banking stability because of implicit government bailout, it poses a major fiscal risk.

Second, the banking sector as a whole is not fully compliant with the capital adequacy requirement of Basel II. As of June 2011, foreign commercial banks substantially exceeded

this requirement (17.1% as compared to the required 10% under Basel II). Private commercial banks on average had a risk weighted capital asset ratio of 10.4%, which means basic compliance with the required 10% under Basel II. However, public commercial banks had a risk weighted capital asset ratio of only 1.5% (properly adjusted) while this was negative 7.1 % for public specialized development banks.

Third, the accounting standards for loan classification and provisioning are not in line with international best practices. As such the reported indicators of financial health might mask somewhat the true picture.

Fourth, there are some emerging macroeconomic concerns that need to be managed better to avoid a potential risk to weak banks. One such risk is the exposure to stock markets. While the BB has taken steps to reduce future exposure, some banks remain vulnerable to previous exposure that requires careful watch. Second, the housing price bubble can create difficulties for exposed banks down the line that also needs careful observation and management. More generally, the evolution of the banking sector in an environment of tighter monetary management and rising interest rate needs proper surveillance including exposure monitoring and stress tests.

Fifth, there are important issues relating to the corporate governance of banks. Due to political connections and influences, some private banks are able to bypass prudential norms as well as standards relating to fit and proper criteria for bank board and management.

Sixth, public banks are not within the purview of the supervision of the BB. As such, their compliance with prudential regulations is weak. This is a serious risk to the stability of the banking system and ought to be corrected quickly.

Finally, not withstanding progress, the BB’s capacity to supervise the large number of banks is constrained. As a result, erring banks are often able to bypass prudential standards for liquidity ratios, compliance with credit/deposit ratios, exposure to stock markets, compliance with capital adequacy and accounting standards.

This brief review suggests that the banking reforms have generally progressed well and have yielded good results in terms of the quantity and quality of banking services. Nevertheless,

there is an unfinished agenda. The main reforms are in three broad areas.

First, there is a constant need to upgrade the quality and health of the banking sector by ensuring that reporting and accounting standards follow the international best practice. The BB must continue to monitor this progress. It should ensure the full implementation of BASEL II guidelines for all banks and initiate the implementation of BASEL III guidelines.

Second, the BB's monitoring and supervisory capacity is limited by the lack of full autonomy to implement prudential regulations as well as its inability to hire competent staff owing to tight control of the government on its compensation package. Political interference in the implementation of the BB's work including in the conduct of monetary policy as well as supervision of banks should be avoided. The government may want to rethink the degree of autonomy it wishes to convey to its central bank. A strong and autonomous central bank with high quality professional management and technically sound staff will strengthen this key institution and serve the interests of the country much better than a weak central bank with political interventions to serve short-term vested interests.

Third, the government should also rethink the strategy for supervision of public banks. The weakly performing public banks with a huge amount of infected portfolio and inadequate capital base are a serious threat to the soundness of the banking sector. In addition to efforts to improve their performance, these banks must be brought under the regulatory supervision of the Bangladesh Bank and must be required to comply with all prudential norms in a time-bound manner. (Sadiq Ahmed is Vice Chairman of the Policy Research Institute of Bangladesh. He can be reached at sahmed1952@live.com.)