

Do we really need more banks?

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In recent weeks controversy has flared press reports that government has decided to grant new banking licences for fourth generation banks to start operations. Arguments have been made by both opponents and proponents in favour or opposing this decision on various economic grounds. In some cases proponents and opponents are also divided along political party lines, making the issue political. The statement of the Finance Minister “banking license would be issued because of political reasons”, may be factually correct but has made the whole issue much more controversial. In this analysis I would like to objectively look at arguments put forward by both sides on this dividing issue.

On the issue of coverage: Currently Bangladesh has 48 commercial banks which are operating on 7,095 branches (as on December 2009). The number of bank branches can be easily increased if the banks are allowed to do so. But this number is strictly controlled by Bangladesh Bank (BB) through limiting the approval of new bank branches. The existing banks may easily increase their countrywide network much faster and are more likely to serve the unbaked areas of the country, since most of the major urban or semi-urban areas have been covered by extensive networking of existing banks.

Table: Financial Access Indicators (2010)

	Bank branches per 1,000 km ²	Bank branches per 100,000 adults	ATMs per 1,000 km ²
Bangladesh	58.89	6.89	16.46
India	29.14	10.91	
Pakistan	12.16	8.76	6.12
Vietnam	6.96	3.33	36.87

Source: IMF

Bangladesh is proud to have strong rural financial system comprising of financial services of the postal department (with around 10,000 branches), non-governmental organisations (NGOs) and microfinance institutions (over 20,000 branches). These institutions mainly cover the areas where traditional commercial banks have not been able to penetrate.

The question is: can newly established commercial banks increase the coverage of financial sector by operating in the unbanked areas? I do not think granting more bank licenses will be of any help in this regard. First, experiences show that microfinance institutions and banks with concentration on small and medium enterprises' (SMEs') banking services are better suited compared to traditional private commercial banks, to operate in the rural areas. Second, there will be a natural tendency for new banks to operate in the major urban business centers initially. It is unthinkable if a new bank willing to open its first five or ten branches will ever go for underserved rural areas. Third, a closer look at the development of the banking sector of Bangladesh will reveal that older and strong private sector banks (First generation Islami Bank, for example) have gone on to operate in the economically less developed areas, not the third generation banks. So coverage of banking sector in the rural areas will depend on the level of economic activities in those areas, innovation of financial products by the banks and strength of individual banks instead of total number of banks operating in sector. Moreover, the extensive network of micro finance institutions and institutions with greater focus on SMEs will always be better suited for the purpose.

Strength of banks: In Bangladesh currently some banks are strong and others are weak both in terms of deposit base and capital. Many of the bank's letters of credit (LC) coverage are not accepted by the global counterparts. In many cases they do not have any correspondent bank in major global financial centers of interest for Bangladesh. The small capital and asset base of Bangladeshi banks makes them look like lilliputs compared to giant international banks against whom our banks would need to compete in future.

Weak bank management: The banks of Bangladesh are already suffering from acute shortage of professional personnel to conduct financial and treasury operations. Most prominent local banks rely on Bangladeshi nationals trained by international banks like Standard Chartered, HSBC or Citi. Even as of today many of the banks do not know how to conduct treasury operations efficiently and manage risk in proper ways. This fact is reflected in the systematic volatility of bank profits and frequent tensions in the short term money market. Here the problem is lack of skilled bank professionals and that's why we see domestic banks

competing for a few quasi-trained Bangladeshi staff from the international banks. The problems associated with weak bank management staff is likely to continue for some time.

Supervisory stress on Bangladesh Bank (BB): BB is responsible for both off-site and on-site supervision of the commercial banks. BB already has less than adequate capacity for extensive supervision of banks. Recent experience with banks' investment in the capital market and the surge in the credit to deposit ratio beyond the prudential/permissible limit are testimonies of the weakness in BB's supervision capacity. BB needs to strengthen its own supervision quality and they are rightly focusing on this issue with technical support from competent organizations like the IMF. Opening of new banks with questionable political background will create additional headache for BB's supervision team.

Interest rate spread and profitability: It is often argued that because banks are generally earning high profits there is scope for greater competition in this sector. I certainly agree with the argument that banking business is profitable in Bangladesh. But the real question is whether adding more banks will solve the problem?

First we need to look at monopoly behaviour, if that exists in the banking system. In this regard I would point out the recent decision of Bangladesh Association of Banks (BAB) to fix deposit interest rate ceiling at 12%. By letting the lending rate depend on market forces and by capping the deposit interest rate at 12%, BAB has essentially acted as a monopolist to widen the spread between lending and deposit rate (exactly as monopolist fixes its profit margin unilaterally in the absence of competition). This is certainly a monopoly behaviour and government and BB have not done anything about that.

With existing more than 40 private commercial banks, one would expect Bangladesh's banking sector to be very much competitive, but unfortunately that is not the case if they follow the dictation from the BAB. How would allowing new banks, which would also become members of BAB, change the situation? I wonder! Theoretically and in practice even with a fewer number of firms there could be a competitive market. Bangladesh's telecom sector with four major players in the mobile segment is such an example. Certainly we would not be able to stop monopoly situation if BAB's behavior is not tackled head on by the government and BB.

Economies of scale: Large-sized banks enjoy some economies of scale by reducing overhead cost and increased efficiency through strong management team. In a market with too many firms with large fixed cost there may be a situation where no firms can operate in most efficient scale and thus the overall market can become inefficient. Because of this reason, countries like Singapore deliberately adopted policies to reduce the number of banks to less than half through mergers and acquisitions.

If we ever want to establish an internationally competitive, recognized and respected commercial banking system in Bangladesh, we need to engineer a consolidation of the banking sector with fewer but stronger banks. This should be the objective of the government. One approach that the government may consider is to encourage economically weak and smaller banks with low capital base to accept new sponsors with strong financial backing and/or technical skills.

Whether Bangladesh needs more banks or not, should be determined by objective criteria, instead of political criteria. The initiative taken by Bangladesh Bank regarding conditions for granting license for new banks, backed by its Board of Directors, is appropriate under the circumstances and needs to be strictly adhered to. In particular, a number of requirements are very important for strong and sound management of the new banks which include: a minimum paid up capital of Tk 4.0 billion (400 crore); sponsors' contributions to the paid-up capital coming out of net worth declared to the tax authorities and not borrowed from other banks; and sponsor directors' competence, integrity and qualifications including qualifying the "Fit and Proper" criteria applicable for Bank Directors.

It is, however, disconcerting to hear from press reports that strong pressures are being exerted on Bangladesh Bank from different quarters to weaken the terms significantly in these important areas. Bangladesh Bank management and Board of Directors must stand firm against such unhealthy pressures in the greater interest of the country's banking system. Bangladesh really does not need new commercial banks and if we really have to have some, those should be economically strong and managed by technically qualified people with personal integrity.

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