

## Institutions matter for development: Role of banking sector

Thursday, Jan 21, 2010

By *Dr. Sadiq Ahmed*

Good governance can be secured by developing institutions. Given the breadth and span of institutions, priorities have to be set. On the economic front, the emphasis needs to be put on key institutions: budget management; banking sector; local governments; and land administration. I wrote in my previous article on January 03 last about the national budget. Today I am going to deal with the banking sector in Bangladesh.

The institutional context of the banking system can hardly be over-emphasized. In today's modern economy confidence in the banking sector is critical for economic and social stability. Lack of confidence and or poor performance can cause economic havoc. The global financial crisis is an important reminder of the damage that can emerge from a poorly managed and supervised financial system. A weak banking system can also be a major source of rent seeking and corruption.

Banking performance and economic growth: Financial sector performance is well recognized as a major determinant of the growth of the private sector in any modern economy. International evidence shows that over the longer term economic development and the maturity of the financial sector are strongly correlated. In today's world of global markets and competition, the cost and efficiency of financial services can often make the difference between a competitive and non-competitive firm. In low income developing economies, the financial sector typically tends to be dominated by banking enterprises. Non-bank financial institutions and capital markets normally tend to be at an evolutionary stage. So, much of the financing for private enterprises is typically provided by the banking sector. This situation is also representative of Bangladesh. For example, as of December 2008, the banking sector accounted for over 80 per cent of the country's financial assets. Consequently, the performance of the banking sector is a key determinant of the growth of the private sector.

Banking and corruption: While the relationship between financial sector performance and economic growth is well understood, the implication of the banking sector for corruption is less well recognized. The corruption problem arises when banks provide large loans to patron-clients promoted by the government in power or through bribe payments by influential business to managers of banks without doing due diligence and non-enforcement of loan servicing provisions. The corruption problem typically emerges from public ownership, but the global financial crisis has shown that private banks, if too large and not properly supervised, can also breed corruption. As well, weak corporate governance and inadequate prudential regulations and supervision could promote corruption in private banks. Public ownership means that bank managers do not have a stake in the bank's performance and the government in power can turn the blind eye in view of short-term political gains. Despite poor financial performance, the banks are sustained through injection of liquidity from the central bank or the Treasury. In the case of large private banks, the "too big to fail" mentality can lead to similar bail outs.

Performance of the banking sector: In Bangladesh, following independence, the banking sector was nationalized. The dominance of these nationalized banks continued well until the late 1990s, even though gradually private banks were allowed entry into the banking business. The combination of public ownership and lack of competition contributed to not only weak performance of the banking sector measured in terms of what is known as the CAMEL indicators, but very importantly, the banking sector became a huge source of rent seeking and corruption. One key indicator of this is the volume of non-performing loans (NPLs). For example, as of 2000, total NPL of the state-owned commercial banks (SCBs) stood at a whopping 39 per cent of total loans (Taka 110 billion or 10 per cent of GDP).

While some of the NPL reflected bad lending decisions, especially those given to weakly performing public enterprises, a large part reflected the non-servicing of loans by politically well-connected private business. This NPL ratio has come down recently based on reform efforts while at the same time the lending share of the SCBs has been sharply cut back by greater competition from private banks, yet the gross NPL of SCBs remains fairly large (24 per cent or around taka billion 200 as of June 2009). In the private sector, NPLs for domestic private banks fell from 22 per cent in 2000 to only 4.9 percent in June 2009.

Progress with banking reforms and remaining challenges: Historically, Bangladesh has

suffered from a poorly performing banking sector due to public ownership, lack of competition, poor governance, weak management, inadequate regulatory framework and lack of central bank's autonomy and capacity. This manifested itself in a sharply deteriorating banking portfolio quality, raising concerns about its viability. Faced with this alarming situation, Bangladesh has launched a comprehensive reform program since 2000. The program has focused on improving prudential regulations, strengthening the oversight capacity of the Bangladesh Bank, improving competition through greater participation by private banks, deregulating interest rates and developing the banking legal system for speedy resolution of loan disputes.

Evidence shows that good progress has been made in deregulating interest rates, strengthening prudential regulations, enhancing the capacity of the central bank and allowing more competition through greater entry of private banking enterprises. Less progress has been made in reforming state owned banks, preparing them for privatization, and developing institutions for speedy resolution of loan recovery disputes.

The outcomes show this policy progress. Thus, there has been a significant growth in banking deposits and credit relative to GDP, a sharp increase in the private sector banking activities from a low base, interest rates now better reflect market forces, and there has been significant improvement in the quality of banking portfolio in terms of better capital adequacy ratios and lower share of NPLs. The performance improvement is mostly concentrated in private banks, including domestic private banks. The private banks now have a greater share of the banking deposits and loans than the public banks. Their NPLs are substantially lower than found in public banks. This encouraging progress with the transformation of banking system within a relatively short period is a truly commendable outcome.

Not surprisingly, private banks also show stronger performance in terms of CAMEL indicators. Despite some improvement, the quality of public banks remains of major concern. Evaluation of CAMEL ratings suggests that the performance of most public banks is rated as marginal. When compared internationally, despite the substantial progress over the past few years, the average banking performance in Bangladesh is weaker than in other large South Asian countries of India, Pakistan and Sri Lanka. This performance ranks even more poorly when compared with East Asian countries, particularly regarding banking portfolio quality and capital adequacy.

The Way Forward: The experience with banking reforms in Bangladesh suggests two important lessons going forward. First, prudential regulations matter a lot for improving the efficiency and soundness of the banking institution. This is also the most important lesson emerging from the global financial crisis. So, further progress with instituting prudential regulations and oversight/supervision responsibility/capacity of the central bank is very important. Secondly, competition and ownership matter a lot in strengthening the quality of the banking system.

Greater competition by allowing new entry of private banks is fast changing the quantity and quality of banking services in Bangladesh. Yet, the slow and hesitant move with privatizing the state owned commercial banks (SCBs) is constraining this progress. The continued vulnerability of the banking sector is largely explained by this weaker progress in privatizing the SCBs. While reforms have helped improve performance in SCBs, this performance remains substantially weaker than in private banks, thereby sharply pulling down the industry average. The continued high NPL ratio for SCBs is of particular concern. Although some progress has been made in recovering loans, the prospects for major recovery do not appear bright.

Regarding prudential regulations and capacity of the Bangladesh Bank, past progress has served Bangladesh well. This progress needs to be consolidated with an even greater move to ensure the independence of the Bangladesh Bank. International experience suggests that countries with an independent monetary authority tend to perform better with regulating the financial sector and managing inflation. On the regulatory front, in addition to implementation of measures for strengthening the soundness of the banking sector (e.g. implementation of Basel II Framework), a careful review of the state of corporate governance and the points of vulnerabilities would be helpful to assess progress on this important dimension and to design appropriate measures.

Concerning progress with privatization, this agenda seems to have taken a back seat and needs to be revived. The poor performance of many large private banks in OECD countries and their contribution to the recent global financial crisis has raised doubts in some quarters about the need for bank privatization. This concern needs to be properly evaluated.

The failures in the private banks are reflective of inadequate regulations and supervision

rather than a case for public ownership. In Bangladesh, the continued weak performance of the public banks over a 38-year period should be an adequate basis for considering these banks for privatization. In particular, care has to be taken that the SCBs do not revert back to old-style instruments for political favors.

Even if privatization is not on the cards in the immediate future, there must be a sound time-bound strategy for improving their performance with similar standards of performance targets as in private banks. Regulatory oversight of the Bangladesh Bank in the operations of SCBs must not be compromised by any type of political interference in the name of government ownership. (The writer is Vice Chairman of Policy Research Institute of Bangladesh)