Risks from recapitalising the state banks

Sunday, Aug 25, 2013

By *Dr. Sadiq Ahmed*

I am delighted to learn that the finance minister has finally expressed

his unhappiness and concern about the financial health of the public banks. The specialised development banks were always problematic largely because of the nature of their business. But the sharp deterioration in the portfolio of the four state-owned commercial banks has raised alarm bells because a large part of this deterioration involves corruption. The most notorious of these corrupt practices is the well-known Hall-Mark scandal that involved the swindling of some Tk 36 billion from Sonali Bank. Unfortunately it seems that there are a number of other corruption incidences involving the state banks and development banks that are not in the public domain.

Irrespective of the reason for the deterioration in the financial health, the fact remains alarming that as on March 31, 2013 some Tk 321 billion of outstanding loans of public banks (state banks plus development banks, including BASIC Bank) were considered as non-performing in the sense that there is little prospect that these loans will be recovered. This amounts to 27 percent of the total loans of the public banks. This is equal to $4.1 billion, which exceeds by 28 percent the total estimated cost of the Padma bridge ($3.2 billion); is equal to 61 percent of the FY2013 development budget; and amounts to 107 percent of the FY2013 budgetary spending for education and health. This is indeed a sad state of affairs at a time when Bangladesh needs these scarce resources to build critical physical infrastructure and invest more in health, education and social protection.

Much of the discussions I have seen in the newspapers centre on the need to recapitalise the state banks with a view to allowing them to acquire adequate capital base in order to lend more. This is precisely the wrong policy choice. Without first fixing the reasons for the deterioration of the portfolio of the state banks, simply providing funds from the treasury to beef up their capital base is equivalent to putting bandage on a cancerous wound.
The main theme of this article is to argue that using taxpayer money to cover the holes in the state banks owing to corruption and inefficiencies is not only unsustainable, it is also unethical. It will suggest better policy options that avoid these major pitfalls in policy making.

I will start with the sustainability argument. The table shows the outcome of the non-performing loans (NPLs) of the four state banks. It shows the situation as of end-March 2013 and the position that existed in December 2009.

First, there has been a rapid increase in NPLs of the state banks over the three and quarter years since December 2009. NPLs grew from Tk 118 billion in December 2009 to Tk 244 billion in March 2013, which amounts to a whopping 107 percent increase.

Second, NPLs have grown at a faster rate (107 percent) than lending (64 percent).
Third, as a share of total loans, the NPLs have increased from 21 percent to 27 percent.
Fourth, the portfolio of all the four state banks has deteriorated. In relative terms, the Janata Bank's portfolio has worsened most (113 percent). In absolute terms (taka amount), the portfolio of Sonali Bank performs the worst (Tk 47 billion addition to NPL).

These results are quite alarming. While the portfolio of the state banks was worrisome to start with in 2009, instead of improving, it has further deteriorated sharply. A full diagnosis of the underlying reasons at the individual state bank level can provide the answers to the factors that account for this weakening of the respective portfolios. Nevertheless, two well-known factors are corruption (for example the Hall-Mark scandal and other wrongdoings) and poor lending decisions. Regardless, the cost to the economy is huge.

In the absence of a full diagnosis at individual state bank level and action programme to plug all holes, a policy decision to recapitalise simply to allow them to lend more will lead to the disastrous consequence of further losses through NPLs. As evidence suggests, the NPLs are growing much more rapidly than new lending. Unless this trend is arrested and reversed, it is possible that the NPL hole could become so big that these banks will simply fail to honour their liability to the depositors.

The national budget does not have the fiscal space to fill the already yawning hole left by the NPLs of the state banks and development banks ($4.1 billion, which is 3.1 percent of FY2013 GDP). A further increase in this hole could lead to insolvency in the public banks. Clearly, the present lending operations of the public banks are not sustainable and must be reformed first before any recapitalisation.

It is morally wrong and unethical that in a poor country like Bangladesh, where some 47 million people live below the poverty line and 40 percent of the labour force does not have any education, scarce budget resources are diverted away from social programmes relating to poverty, social protection, agriculture and human development to fill the NPL gaps left by corruption and poor lending decisions of the state banks. By and large, most of the beneficiaries of these NPLs are the rich and the powerful that are well-connected to the power-base and are, therefore, able to get away with these scams.

There are much better policy options. As I have indicated in many of my previous write-ups, the first best solution is to privatise the public banks. It is not accidental that the average NPLs of foreign banks are a mere 3 percent of their total lending and that of local private banks only 4-5 percent. Private banks cannot afford to run excessive NPLs as they will go out of business. The owners will come down hard on management and will likely fire them on account of poor performance at the very first red light signal. There is no such accountability in public banks.

I can understand that privatisation is not a politically palatable option. So, a second best option is to convert the state banks into narrow banks and either fold out or drastically reform the development banks. The idea of narrow banking is that these banks will no longer have a lending function. They can collect deposits and perform treasury functions including funding of budget deficits by holding T-bills. By taking away lending decisions, the state banks will become safe banks with a zero risk for accumulating additional NPL.

Regarding the development banks, a full diagnosis of their operational problems should be done. The development need that these banks are playing should be properly identified based on a solid review of the market failure that is being addressed by these banks, and a system of subsidy introduced transparently that is financed upfront through the budget. This way the fiscal cost of running the development banks will be transparent, the development banks can strive to remain financially solvent, and the management of these banks can be held accountable for performance.

A third best option is to drastically reform the state banks in the same spirit as the development banks. Unlike the development banks, the case for subsidisation due to market failure does not exist. So, whatever the government's reasons to own banks, it must let them be run on a commercial basis. This means these state banks must be managed by professional bankers; be fully supervised by Bangladesh Bank; should be subject to all penalties of the BB as their private bank counterparts are; and be held full accountable by the owners (government) for performance.

It is only as a part of a business decision to run these state banks commercially and earn a profit that the government could justifiably provide one-time budgetary resources to recapitalise the state banks. In this environment, there will be a new management team who will be subject to performance rewards as well as penalty. The government will not intervene in lending decisions or in the matter of loan rescheduling and recovery. These will be normal business decisions of the new state bank management, who will also have the flexibility to hire and fire staff and decide on remuneration based on financial profits. In summary, except for government ownership, the state banks will behave like private commercial banks.