


Stopping the plunder of public resources

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In January 2003, I published a paper with co-authors Marilou Uy and S Ramachandaran

entitled “South Asian banking and finance: Growth with festering problems” (South Asia region internal discussion paper IDP-186, The World Bank: Washington DC). We reviewed the progress in the banking sector of the five large South Asian countries — Bangladesh, India, Nepal, Pakistan and Sri Lanka — and reached the following main conclusions about the downside risks. 

1. “Despite some encouraging developments, the overall picture remains worrying... Banks have grown big but not efficient, and the government owns the larger banks with the worst loan portfolios in each of the five countries.”
2. “The inflow of deposits has averted serious liquidity problems that usually presage banking failure; but cannot continue forever. A banking crisis would undo the countries’ many achievements.”
3. “Banking deposits have grown to approach half of GDP, and if the governments were to protect depositors against losses — as it may be forced to in a banking crisis — the fiscal implications are worrying in an environment of already serious fiscal problems of all South Asian countries.”
4. “The current reform approach in all South Asian economies calls for banks to lend more prudently and to strengthen banking supervision. This prescription is sound in theory but could be difficult to implement in substance. For example, supervisors may not be able to rein state-owned or politically well-connected banks. Similarly, laws empowering regulators

are easier to pass than to effectively enforce, frustrating reformers in government. It is difficult to get the major state-owned banks to improve their lending so long as they are under state ownership.”

Looking at the current banking situation in Bangladesh, after over nine years since I published the report that was widely shared with all South Asian governments, it is remarkable how fresh and relevant that diagnostic remains.

The despicable Sonali Bank scam involving some Tk 36 billion or so (equivalent to nearly 10 percent of the 2012 actual Annual Development Programme) is a timely reminder of how little has changed in the area of public banking and how state banks remain a major instrument for plundering scarce public resources.

It is especially hurting public interest at the present time when resource constraints are reducing the ability of the government to implement major public investments in critical infrastructure.

Quite apart from the adverse implications for public resources, this event unless quickly offset poses serious downside risks associated with moral hazard that could threaten the stability of the banking sector. The stakes are large and the government must take swift actions not only to re-establish the rule of law through enforcement of anti-corruption measures but more importantly to eliminate the root cause of the problem facing public sector banking in Bangladesh.

The reform options for eliminating the downside risk presented by state-owned banks remain unchanged now as nine years ago. In that report we had provided detailed analysis based on international experience why public ownership of banks is not a viable long-term option in an environment of poor national governance. I do not wish to repeat that analysis as it is rather detailed to fit the space here, but I will be happy to put a soft-copy of the report on the PRI website for interested readers.

The first best option is to privatise the state-owned banks. Yet we are mindful that privatisation is not a politically palatable option. There are also other practical problems, including union pressure against privatisation and, additionally, finding sound buyers who are

untainted by political favours is a major challenge.

In a political environment where privatisation is not imminent, there is a second-best approach that might work. Public banks tend to have an unfair advantage in mobilising deposits because of the perception of state guarantees and a de facto immunity from effective supervision. Because of these privileges, state-owned banks are able to stay afloat 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. Importantly, the deposits mobilised will be safe and not exposed to risks of the type presented by the recent Sonali bank lending scam.

Such lending restrictions are akin to a “dual banking system” with “narrow banks” that are likely to remain state-owned (and only allowed to gather deposits to invest in government paper) and conventional private sector banks. No new laws are required because the government as owners of the state bank could take this decision.

The idea of narrow bank is not a new one and merits serious attention. At the least the government might ask Bangladesh Bank to review this option carefully and provide a technical proposal.

In the meanwhile the government must adopt the minimum reform of putting immediately all state-banks under the direct supervision of the Bangladesh Bank and require the full compliance by these banks of all prudential regulations, including certification of quality of board and senior management within a tightly stipulated time frame.

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