

## The debate on new banks revisited

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In a recent article published in The Daily Star (Safeguarding citizen's money, published on August 18, 2011),



Tellers work at a bank. The financial health of the state-owned commercial banks is fragile and a number of private banks are vulnerable, owing to exposure to the declining stockmarket. Photo: Amran Hossain

I provided a fairly detailed review of the pros and cons for the licensing of new banks.

I had basically argued against granting new banking licences during this present economic and financial environment of Bangladesh. In summary, I made the following arguments:

- 1) The number of banks at present providing services in urban areas adequately meet the needs of the urban population.
- 2) With 47 banks in place, there is sufficient competition to ensure the quality and pricing of services provided.

3) While the efficiency and profitability of banks have increased, there is still an unfinished reform agenda for the banking sector. The financial health of the state-owned commercial banks is still fragile and a number of private banks are vulnerable, owing to exposure to the declining stockmarket. A few banks are fully compliant with Basel II standards.

4) The supervision of Bangladesh Bank has improved but remains constrained by a lack of autonomy in hiring skilled and professional staff.

5) In the present environment of high inflation, growing budget deficit and the need for monetary tightening, the liquidity situation in the banking sector will be tight and requires careful management of banking sector portfolio and associated risks.

6) In this economic and financial situation, adding new banks will create pressure on existing banks that could well lead to difficulties and a liquidity crisis in vulnerable banks. This in turn could jeopardise the stability of the banking sector.

7) The presumption that the treasury and Bangladesh Bank would bail out vulnerable banks is inconsistent with macroeconomic stability that is already under strain. Any attempt to bail out vulnerable banks through pumping additional liquidity in the economy will contribute to even higher inflation, destabilise the balance of payments and add pressure on the nominal exchange rate.

I also provided my views on the criteria for giving licences to new banks when the time is right. Drawing on good international practices, I suggested the need to further increase the capital adequacy requirements than is presently the case.

I had provided my views as a technocrat. In the real world, governments are run by politicians and often technical considerations come in conflict with political imperatives. It will be naive to ignore those political imperatives even though I do not believe political considerations should come in the matter of granting new licences. This is especially because banking, unlike other business, involves dealing with other people's money and without adequate safeguards, bank owners would not hesitate to take undue risks in a bid to make profit.

The government has a moral and social responsibility to safeguard citizen's interests. The political party in power also has a commitment to promote the interests of its constituencies, especially those who provide the financing of political parties. How a government balances its social commitments to the citizens with its private commitments as a political party to its financiers and other supporters is an art rather than a science. A government succeeds or fails as a political power depending upon ability to properly balance these often conflicting and competing claims. The case of giving licences to new banks is an important example of this art of proper policy making.

The present government is firm in its decision to move ahead with the licensing of new banks, despite sound technical advice against this policy. So, now we are in the second best world involving possible trade-off between safeguarding citizen's interest with profit making by political allies. A number of considerations might guide the government in securing the proper balance between these two conflicting considerations.

First, it is imperative that the long list of applicants must be properly evaluated against the announced criteria and guidelines for bank licensing.

Second, a short-list of prospective banks that fully meet the criteria should be prepared and presented to the Bangladesh Bank board for review, debate and discussion.

Third, depending on the short list, the Bangladesh Bank board will need to evaluate the prudent number of new banks that might be given licences at this time. While there is no scientific way of establishing the number of new banks, prudence requires keeping this list to a small number and certainly no more than three-four.

Fourth, if the shortlist is more than four, the board might want to select the four best new proposals based on the following two considerations: (a) the amount of own capital in excess of the minimum required; and (b) the quality of the business plan, past banking experience, and the quality management and proposed staffing.

The alternative approach of licensing as many banks as politically desired is fraught with serious downside risks as noted earlier. It also serves to undermine the institution of the central bank and its board. International experience suggests that long term development

requires strong institutions. This is already a serious constraint in Bangladesh. The few good economic institutions that still remain including Bangladesh Bank, the finance ministry and the National Board of Revenue must not be weakened through excessive political pressure.

This may also be an opportune moment to reflect and learn from the stockmarket crisis. Unbridled competition for profit taking combined with poor regulations, weak regulatory institution (Securities and Exchange Commission) and excess liquidity played havoc on the stockmarket. Everybody enjoyed the profit taking game when the going was good. The inability of the policy makers to anticipate the inevitable downturn and the likely havoc led to inappropriate or inadequate interventions at the right time. In hindsight, the stockmarket crisis could have been prevented through proper regulations, by having a strong regulatory body and by managing liquidity properly.

The situation is now similar in the case of the licensing of new banks. Fortunately, however, the regulatory body (Bangladesh Bank) is a strong institution and has adequate regulatory policy in place (the criteria for new banks) to implement the government's decision to introduce new banks. This institution must be allowed to do its due diligence and not be swept under the political rug. The country and the citizens would be the loser.

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