DIGITISATION AND INCLUSIVITY: TAKING EVERYONE ALONG

Financial inclusivity and the banking sector

CONTINUED FROM PAGE 33

Measures were adopted for tightening loan classification and establishing provisions more in line with international practices. Key provisions in the Bank Companies Act were amended in 2013 to provide the BB full regulatory and supervisory control over the SCBs. The financial reporting of bank branches was automated in 2014. Banks implemented Risk Based Capital Adequacy guideline formulated in line with Basel-II and started adopting Basel-III.

NPL reduction was achieved through provisioning and write-offs and by a sharp reduction in new NPLs. Enhanced legal powers of the banks to collect problem loans and better screening of new loans improved the NPL ratio. NPL recoveries improved significantly after 1999, leading to steady decrease in the NPL ratio to 6.1 percent in 2011. Greater legal powers of the banks to recover problem loans through the money loan courts and better screening of new loans by the Credit Information Bureau contributed.

THE SLIDE BACK

Bangladesh's financial system deepened notably in the past decade, with private sector credit increased from 30.9 percent of GDP in 2009 to 39.8 percent of GDP in 2019. The improvements came mainly from banks, driven by better access and improved operating efficiency. Good access reflects a relatively wide network of ATMs and bank branches per 100,000 adults. Bangladesh's strong economic performance has been historically supported by rapid private sector credit growth. However, the correlation between the change in the private credit to GDP ratio and real activity is diminishing. The degree of co-movement of financial and real variables has weakened while the credit intensity of growth is on the rise. NPLs rebounded to 10 percent in 2012 and further to 12 percent in September 2019. This indicates growing resource misallocation. The deterioration of credit quality, with NPLs significantly increasing in recent years in the context of weakly capitalised banks, raises concerns about the capacity of the financial sector to continue supporting economic growth.

Increased regulatory forbearance of the kind seen recently in Bangladesh compounded the problem of NPLs. The fundamental causes of resurgence of NPLs include weak corporate governance practices, risk management systems and regulatory failures. Country experiences have shown that moral hazard thrive where the owners of undercapitalised banks have little shareholder capital to lose from risky investments. Weakening asset quality has undermined the intermediary role of banks. So far, the regulator's strategy for resolving the NPLs problem has been to allow the defaulters an exit route by relaxing the application of regulatory codes and repeated rounds of re-capitalisation of public sector banks. Neither strategy has paid any dividend yet. Almost all of the loans rescheduled in 2015 defaulted one year after they were rescheduled. Similarly, indiscriminate re-capitalisation of public sector banks without a credible commitment to improve governance and disinvest over time, created a vicious cycle of moral hazard and weak micro-prudential regulation. Although re-capitalisation plans have been linked to performance targets of the state-owned banks in theory, the links have not been enforced due to various intervening forces.

Two amendments of a dubious nature were made to the Banking Company Act in 2018 undermining the cause of good governance. The tenure of banks' board of directors increased from six years to nine years, while up to four family members were allowed to be on the board, instead of two. Repeated violations of bank policies have led to their current dilapidated state.

In the context of a remarkable history of reform success, how do we make sense of the reform reversals seen in recent years? These reversals demonstrated the key vulnerabilities of the financial sector and the regulatory architecture governing it with the government invoking both formal and informal mechanisms to issue directions to the BB. We know that elites have a disproportionate influence on any reform process and associated outcomes. The elites are also not a homogenous group. The functioning of the financial sector affects different elites differently. Some benefit directly from blocking financial sector inclusion. However, the elites controlling financial institutions have a direct interest in expanding their activities.

Similarly, large manufacturing firms need significant external finance and thus a developed financial sector. When the banking system is in part controlled by the State, elites can use it as a powerful economic lever in their political competition. The bureaucracy plays their part in determining who gives and receives credit, and at what price, offering various rationales for maintaining such a system. What is in the interest of one class of elites is not necessarily in the interest of others.

What determines which group wins the battle of the elites? Raghuram G Rajan and Luigi Zingales (2005) observe from their extensive research that in intermediate regimes of partial democracy, the balance of power tilts towards some economic elites who are able to "capture" the government with greater ease and adopt policies that simply maximise the interests of the same elites. Acemoglu and Robinson (2008) defined these regimes as "captured democracy". Such privileged elites may block reforms in specific areas, while reforms can still proceed in areas where they have no strong vested interests or where they in fact gain from reforms.

WHAT MAKES ELITE CONTROL A PROBLEM?

If accountability of institutions is weak, elite capture can happen even under limited government where the authority of public officials is constrained. Such institutions can be subject to elite capture and favour connected interests. Connected individuals inevitably

CONTINUED ON PAGE 39