Three decades of banking reforms

M SHAHIDUL ISLAM and RUBAYET HAMID

PRIOR to the initiation of reforms in the 1980s, Bangladesh's financial system constituted typical examples of what economists dubbed 'financial repression'. The system, both the market and institutions, in the post-independence period faced major structural problems, evident both in banking and other components of the money market as well as the capital market.

To overcome these problems, the financial sector reform was initiated in 1982 with the denationalisation of commercial banks, followed by the establishment of the "National Commission on Money, Banking and Credit" in 1984. However, major reforms in the sector were launched in the early 1990s.

Banking is a dominant sub-sector of the country's financial system that underwent massive reforms. The reform programmes initiated under various auspices focused on several dimensions, most notably privatisation of state-owned commercial banks (SCBs), and entry of new private and foreign banks.

The other areas of focus were recovery of non-performing loans (NPL), interest rate deregulations, central bank's increased autonomy, enhancing prudential regulation and supervision, rationalisation and merger of bank branches and improvements to the money market.

Given the changing perspective towards denationalisation and private participation, the initial phase of banking reform (1980-1990) focused on the promotion of private ownership of commercial banks and denationalisation of nationalised commercial banks (NCBs).

While donors supported denationalisation from the very beginning, the compulsion to adopt reform measures was not strong until the mid-1980s. As the weakness of the sector exposed, the government transferred three nationalised commercial banks in the private sector during 1984-86 and four private commercial banks were granted licences in the early 1980s.

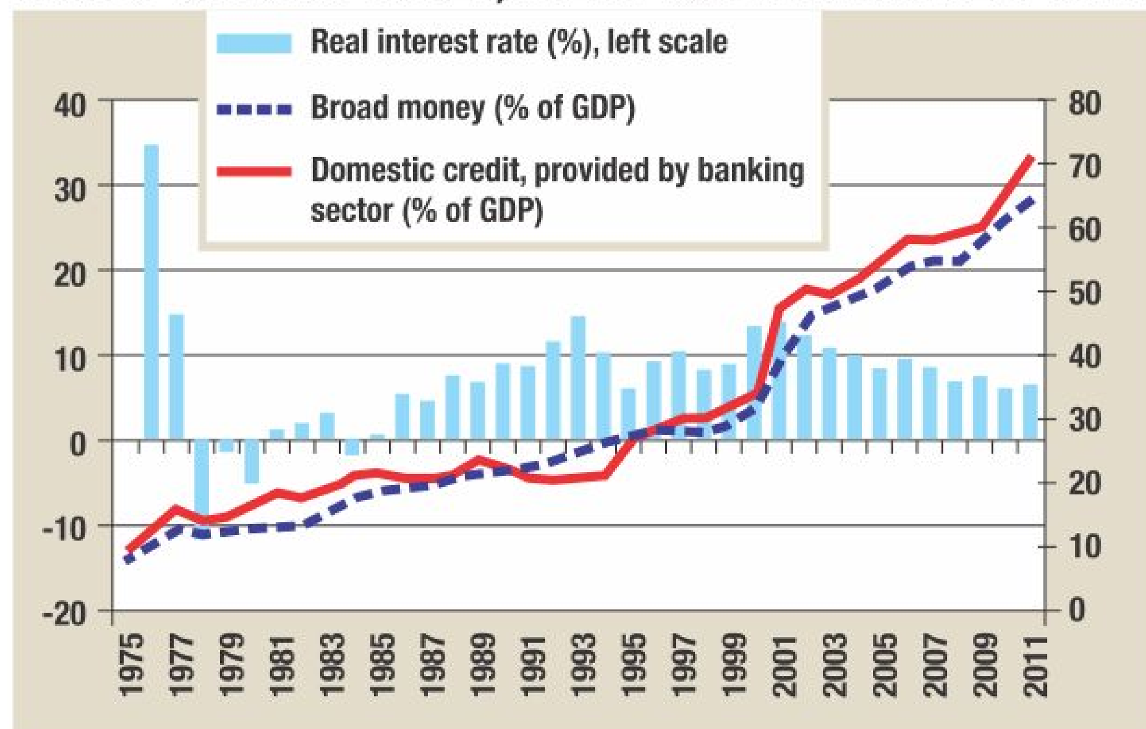
This round of reform, however, was largely unsuccessful due to the unprecedented influence of vested private commercial banks (PCBs) and NCBs' interest groups, which resulted in a loan default culture.

Given the poor outcome of earlier reforms, wide-ranging banking reform measures were undertaken under the aegis of the World Bank's Financial Sector Reform Project (FSRP) in the 1990s. The focus of reforms, among others, has been on gradual deregulations of the interest rate structure, providing market-oriented incentives for priority sector lending and improvement in the debt recovery environment.

Moreover, a large number of private commercial banks were awarded licences in the second phase of reforms. Although second generation banks have addressed many demand side issues, such as, development of a wide range of financial products and services, the measures have not been successful in addressing the banking sector's key problems. These include high NPL ratios both in state banks and private banks and a lack of enforcement of the capital adequacy and other regulatory requirements.

Since denationalisation, greater private participation and market based pricing of financial products did not generate the anticipated results even until the late 1990s, the focus had shifted to risk-based regulations and supervisions in early 2000s. This was largely due to

TRENDS IN BROAD MONEY, CREDIT AND REAL INTEREST RATE



SOURCE: BASED ON WORLD DEVELOPMENT INDICATORS, WORLD BANK

the absence of firm supervision and effective regulations of Bangladesh Bank.

While the issue of regulation and supervision was spelled out in FSRP and the banks adopted Basel I norms (maintaining adequate capital to withstand crisis) in 1996, it was indeed the reforms in post 2000 that had a de facto focus on risk-based banking supervision.

Moreover, the Central Bank Strengthening Project initiated in 2003 focused on effective regulatory and supervisory system for the banking sector, particularly strengthening the legal framework, automation and human resource development and capacity building of the BB.

The Enterprise Growth and Bank Modernisation Project was adopted in 2004 by the WB to help the government achieve a competitive private banking system through a staged withdrawal through divestment and corporatisation of a substantial shareholding in the three public sector banks (Rupali, Agrani and Janata), and divestment of a minority shareholding in the largest state bank, Sonali.

Outcome:

The banking sector reform faced a strong resistance from organised labours, but political support favoured various reforms in the sector as the entry of private players provided them with considerable incentives. The share of nationalised banks' in total banking assets and deposits has declined over the years. Even in the early 2000s, the NCBs/SCBs constituted 47 percent of industry assets and half of the industry deposits. However, the private commercial banks (both local and foreign) emerged as a dominant player in the sector constituting 65 percent of industry assets.

However, the first two phases of reforms did not bring any measurable outcomes, highlighting the fact that wholesale liberalisation without instituting an effective regulatory structure is not the answer to the cumulative problems of bank nationalisation. Nevertheless, the sector turned around in the early 2000s when the focus was shifted to risk-based regulations and supervisions. Moreover, there has also been a strong public opinion against the defaulters, which along with political commitments facilitated enactment of a number of new laws, regulations and instruments to curb NPLs.

That said, financial development outcome of the banking sector is generally judged on its depth, access, efficiency and stability. Key banking sector indicators show that banks' performance, notably private banks, has increased sharply, particularly in the post-2000s.

Depth in banking assets is reflected in rising share of deposits, private sector credit and broad money in proportion to GDP. Access to banking services is on the rise, reflected in branch expansion and firms' access to credit, including BB's financial inclusion programmes. While high interest spread is a drawback, other indicators of efficiency in the sector, such as return on assets and return on equity, are favourable. Finally, asset quality, capital adequacy ratios, probability of default, among others, that indicate banking sector stability suggest that private sector banks in Bangladesh are fairly stable.

The most important development in 2000s has been the banks, notably private banks' commitments towards the implementation of Basel II, in which banks are required to maintain a Capital to Risk-Assets Ratio (CRAR) of 10 percent.

Governance challenges:

While the reforms' success, notably in the post-2000s, is largely due to better performance of private sector banks that account for nearly 65 percent of banking industry assets, nearly a third of the sector (SCBs and development finance institutions) is ailing. The SCBs' performance has not improved in line with reform objectives, largely owing to political interventions. Moreover, the autonomy of BB has been curtailed by instituting the Banking and Financial Institution Division in the finance ministry in 2009, which has been an obstacle in monitoring of SCBs by the central bank.

As the public banks are not within the de facto purview of the supervision of the BB, their weak compliance with prudential regulations is a serious risk to the stability of the banking system. The recent SCB scams indicate that the success of reform could be reversed if politicians and their aligned business groups find room to channel the outcome entirely in their favour.

The reform experience in the banking sector also offers a broad lesson for other segments of the financial system that without instituting an effective regulatory architecture, market based reforms could do more harm than good -- the lesson thousands of investors learnt, albeit painfully, during the two episodes of stockmarket crashes.

Going forward, the banking sector needs to address a number of challenges with regards to high interest spreads, money market volatility, balance sheet problems of SCBs, central bank's autonomy, political interference in allocation of credit and overall governance problems. Moreover, the sector still has much to catch up with regard to financial innovation. The immediate challenge nevertheless is to reestablish BB's greater control over SCBs, dismantling the Banking and Financial Institution Division.

The writers are research fellow and research assistant, respectively, at the Institute of Governance Studies, BRAC University. They can be contacted at imonsg@gmail.com

Can mobile phones improve factory fire safety?

TRIPTI LAHIRI, *The Wall Street Journal*

IN the wake of the fire at a Bangladesh factory that killed at least 112 garment workers on November 24, US and European retailers who buy from the South Asian country have said they will drastically improve safety checks at the factories they use.

The plans in the works include carrying out extensive fire assessments at vendor factories, in the case of one retailer, and hiring an engineer to check fire safety, in the case of another.

But few of the plans being considered by retailers seem likely to address issues that labour groups have raised with regard to the present safety audit system that they don't allow workers a way to alert retailers to issues that crop up when the brands' representatives are not around. Another complaint is that information on fire safety is generally kept confidential and rarely shared in a comprehensive way with the workers most likely to be at risk.

Indian-American entrepreneur Kohl Gill is hopeful that cellphones, which are now widespread in exporting countries like Bangladesh and China, could help.

Through his two-year-old company LaborVoices, Gill has been developing a voice-activated system that workers can call to leave messages about workplace conditions.

"We anonymise that and we provide views on that information to other workers and to local organisations and to brands," he said. "Eventually we'll provide views to consumers as well so consumers can know how brands are being made."

The information would be free to workers, and available by mobile phone; retailers would have to subscribe to the service, and then would have access to the information online. Callers will not be identified to retailers using the system, Gill said.

Gill said he's working with a US clothing retailer to implement the system at its factories in Bangladesh by early 2013, but declined to name the company. The system has been previously tested at an electronics factory in China, and at factories in southern India, he said.

In a January pilot, with about 20 garment factories in Bangalore and covering about 300 workers, employees left as many as 90 messages about work conditions.

Gill said he developed the phone service as a way to plug the gap in information that can be left even where inspection regimes are in place.

"Everybody we talk to knows inspections are broken," said Gill, who previously worked on global labour relations at the US State Department. "You can't have an inspector going to every factory every month. It's very expensive and there aren't enough inspectors."

AFP/GETTY IMAGES

The Tazreen Fashions plant after the fire in Savar near Dhaka on November 26.

When a fire at a Pakistan factory in September this year killed at least 283 people, the reliability of social auditing used by retailers was sharply questioned. The factory there had been certified as meeting standards developed by Social Accountability International, a leader in social compliance certification.

The organisation has said it will publish a report on its findings about how the Pakistan factory was able to gain certification early next year. Labour groups have criticised SAI for not releasing the audit report of the factory. SAI has said that as part of the certification process, accredited certifying agencies sign contracts with factories that require confidentiality.

In an email interview, SAI founder Alice Tepper Marlin, said that confidentiality serves a purpose in the audit process.

"Confidentiality of the audit itself protects workers and promotes a greater willingness of factory owners and others to engage positively to improve working conditions for workers," said Marlin. "Specifically, workers who speak out during audits, as well as other stakeholders with information about working conditions that can benefit workers, must be able to share that information freely, confidentially, and without fear of retribution."

But in a new report on factory safety in the wake of the Bangladesh fire, the International Labour Rights Forum questions how well confidentiality truly serves workers. The reporters expressed concern about the fact that audit report findings are kept confidential, shared only with the clients that commission them and factory owners. Audits conducted of a factory for one supplier may not even be shared with other suppliers a retailer uses in that country.

Audits of Tazreen Fashions, the Bangladesh factory where the fire occurred, had highlighted fire safety problems such as blocked exits and the lack of sufficient firefighting equipment over a year before the fire, according to documents found at the factory site and verified by executives of the factory's parent group. One supplier stopped using the factory; others did not, later citing unauthorised subcontracting as the reason production ended up there.

"Because audits are confidential, companies' and auditors' knowledge of problems is their private intellectual property," said the labour rights group's report. "In this case, doing the right thing-- sharing factory lists and audit reports -- might have saved lives."

India's wait for rate cut

DH PAI PANANDIKER, *for Reuters*

AT its mid-quarter review on Jan. 18, the Reserve Bank of India (RBI) did not cut the repo rate and also left the CRR unchanged. But it raised hopes that policy easing can follow in the fourth quarter.

The firm message the RBI has been sending all along is that it is entrusted with the singular objective of "maintaining price stability and ensuring adequate flow of credit to productive sectors". Surely, price stability does not necessarily mean static prices but allows for a gentle rise not exceeding 6 per cent. This level of inflation the consumer can take in his stride and is really good for investment because it reduces the real rate of interest.

That has been so with most other central banks though their tolerance limit for inflation is generally low. But since the financial crisis of 2008 there has been a radical transformation in outlook. It is no longer inflation but growth that is the target.

US Federal Reserve Chairman Ben Bernanke recently redefined the monetary policy objectives. The interest rate, he said, will remain at zero until the level of unemployment comes down to 6.5 per cent. Presently it is 7.7 per cent. It has also been indicated that the rate may not be increased even after unemployment drops to the target level. That is a necessary but not a sufficient condition for tightening the policy. The Fed expects that it would not be before 2015 that unemployment will be less than the target level. Hence it will keep the rate in check with quantitative easing (QE).

The same anxiety is revealed by many other central banks even from emerging market economies. The People's Bank of China cut interest rate twice in 2012 because the rate of growth had dropped to 8.1 per cent. The Brazilian central bank has cut interest rate 10 times since July 2011 to a record low to revive economic growth.

The new mantra obviously is growth whether it is a developed country like the US or emerging economies like China and Brazil. It is much easier to curb growth than to revive it. Hence the priority should be to prevent growth from falling. The RBI tried exactly its reverse. It aimed to bring down growth 'temporarily' in order to check inflation. The result? Growth dropped but inflation did not.

It is time that the RBI re-looks at its monetary policy objectives. If at all there is choice between reasonable inflation and possible growth it is the latter that should have priority. For, growth is not for its own sake. It means employment, it means more money with Government for poverty alleviation, it means lower budget deficit and consequently lower inflation.

The RBI has held out hope that the repo rate will be revisited in the last quarter. But minor changes don't make an impact. What are called for are cuts in quick succession, as the RBI did in 2008, when the economy was in a similar chaotic state.

The writer undertakes research on current macroeconomic issues of interest, mainly to industry, as president of RPG Foundation, a private think tank in India.