

Stemming the rot in public banks



SADIQ AHMED

I have written many times in the past about the need to address the governance issues in the state-owned commercial banks (SCBs). This is not because I am a neo-classical economist with unmitigated faith in the market economy, but because of the observed global phenomenon that SCBs anywhere suffer from an inherent governance conflict.

The conflict arises from two characteristics of SCBs. First, since the government owns the banks, the bank managements have no stake in the efficiency or profitability of operations. They keep their jobs and earn their salaries irrespective of performance.

Second, the government of the day is only a transitory owner with little or no real immediate risk. It also has little incentive to manage these banks on a commercial footing because either the losses can be passed over to the citizens through treasury financing based on tax revenues or as continued accumulation of bad loans (also called non-performing loans or NPL).

Instead, there is a strong incentive to use these banks as instruments to finance politically-motivated projects or to distribute polit-

ical patronage to clients in return for financial contributions to the political party or other personal favours. Losses can accumulate and create severe headache at some point in time. But that can usually be passed over to a future government.

This governance conflict has come to a full force in Bangladesh. Over the years, the SCBs and public specialised development banks (SDBs) have shown erratic performance with low or negative profitability, low or negative return on government equity, frequent need for treasury capital injection to stay alive, and a growing burden of NPLs in absolute terms and also as a share of total loans.

The sharply deteriorating performance has become a substantial cause for concern and it is time that the finance ministry does something positive to stem the tide of bad management of public banks. Although national elections are in the horizon that should not be a barrier to taking actions since they will not likely hurt the government and can only be seen as a favourable outcome by the electorate.

One redeeming feature of the Bangladesh banking sector is the emergence of the private banking as a major player. This progress started around 2000 and has gathered momentum since then. Today, the banking market is vastly different from what it was in 2000 in terms of asset ownership, quality and quantity of banking services, the value of deposit mobilisation and the liquidity of the banking sector. This has served Bangladesh well, with better services to deposit holders and bank borrowers.

The cost of bank borrowing has also come down. Importantly, the deposit and lending shares of the poorly performing public banks have come down from 60 percent and 63 percent respectively in 2000 to 30 percent and 16 percent respectively as of March 31, 2017.

Accordingly, the adverse implications of the growing share of the infected portfolio in public banks is somewhat softened by their sharply declining loan market share.

Nevertheless, the downside risks of the large NPLs of public banks for the overall

health of the banking sector are worrisome. Additionally, political interference in private banks has also caused problems for the loan portfolio of some private banks that further weakens the financial health of the banking sector.

The growing incidence of NPLs in public banks is partly due to bad lending decisions but also owing to outright thefts and scams. Irrespective of the reason for the deterioration in the financial health, the fact remains alarming that as of March 31, 2017 some Tk 414 billion of outstanding loans of public banks (SCBs plus specialised banks) were classified as non-performing in the sense that there is little prospect that these loans will be recovered.

The NPL of public banks in FY2009 was Tk 150 billion; it fell to Tk 138 billion in December 2011. The amount of NPLs soared to Tk 424 billion in March 2017, rising by Tk 276 billion over the past six years. This large NPL prevails despite write-offs of some of the bad loans and a restructuring of considerable amount of doubtful assets.

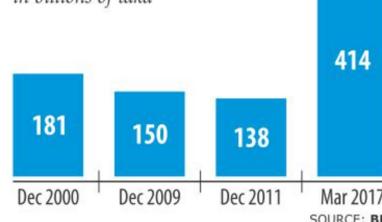
In terms of percentage of total outstanding loans of public banks, the NPL amounts to 29 percent. In the US dollar terms, NPLs of public banks are equal to \$5.2 billion. This value of NPL exceeds by 179 percent the total public spending on health in FY2017 and is equal to 93 percent of the total public spending on education in FY2017. The opportunity cost of NPLs is high. This is indeed a sad state of affairs at a time when Bangladesh needs resources to invest more in health, education and social protection.

On the policy front, the inability of the finance ministry, who owns and supervises these banks, to stem the tide of NPLs is very worrisome. Despite considerable public debate and discussion, the situation continues to deteriorate. On the contrary, the ministry has responded by injecting capital into these public banks to shore up their capital base and keep them in business. An estimated Tk 93.8 billion has been injected so far into these banks between FY2014 and FY2017. This \$1.2 billion diversion of tax payer

money to keep the corrupt, inefficient and financially loss-making public banks into business is a most distressful policy decision. It is not only unethical but also unsustainable. Without first fixing the reasons for the deterioration of the portfolio of the public banks, simply providing funding from the treasury to beef up their capital base with a view to keeping them in business is equivalent to putting bandage on a deteriorating cancerous wound.

Value of public bank NPLs

in billions of taka



There are much better policy options than self-defeating capital injections. As I have indicated in my previous write-ups, the first best solution is to privatise the public banks. Private banks cannot afford to run excessive NPLs as they will go out of business. In most cases, the owners will come down hard on management and will likely replace them on account of poor performance. There is no such accountability in public banks.

It is known that in the current political environment, privatisation is not a viable option. So, a second best option is to convert the SCBs into "narrow banks" and either fold out or drastically reform the SDBs. The idea of narrow banks is that SCBs 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 SCBs will become safe banks with a zero risk for accumulating additional NPL.

Regarding SDBs, a full diagnostics of

their operational problems should be done. The development function 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 that is financed upfront through the budget. This way the fiscal cost of running the SDBs will be transparent, the SDBs can strive to remain financially solvent within the framework of their mandate, and the management of SDBs can be held accountable for performance.

A third best option is to drastically reform the SCBs in the same spirit as the SDBs. Unlike the SDBs, 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 SCBs must be managed by professional bankers; be fully supervised by the Bangladesh Bank; should be subject to all penalties of the Bangladesh Bank for any violation of prudential norms as their private bank counterparts are; be required to earn a profit; and be held fully accountable by the owners (government) for performance.

It is only as a part of a business decision to run these SCBs commercially and earn a profit that the government could justifiably provide one-time budgetary resources to recapitalise the SCBs. 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 SCB management, who will also have the flexibility to hire and fire staff members and decide on remuneration based on financial profits. In summary, except for government ownership, the SCBs will behave like private commercial banks.

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Fed rate hike remains uncertain after Harvey, Irma



The US Federal Reserve building in Washington, DC.

AFP, Washington

TWO hurricanes slammed into the United States within two weeks, taking a bite out of economic growth, and adding to doubts about the potential for a third interest rate hike this year.

The Federal Reserve is widely expected to leave interest rates untouched after the two-day policy meeting this week, but economists are split on whether the impact of Hurricanes Harvey and Irma will create enough uncertainty to delay the next tightening move until 2018.

After inflation at long last posted a sizeable uptick in August, markets saw an increased probability of a move in December that would push rates up a notch from the current range of 1.0-1.25 percent.

But Satyam Panday, senior economist at Standard & Poor's, told AFP this one-off pop in the Consumer Price Index should not obscure the larger reality.

"We don't expect any rate hike in September or December," he said. "The underlying trend of inflation still is well below the inflation target of two percent."

CPI rose 0.4 percent last month, and the index for the latest 12 months accelerated to 1.9 percent.

As a result, market odds for a December hike jumped, with futures markets showing the probability above 54 percent on Friday, up from 31 percent the week before. But the August increase in consumer prices was in large part driven by volatile energy prices. Excluding food and energy, 12-month core CPI held steady at 1.7 percent, the same increase seen every month since May.

Fed policymakers have for months downplayed stubbornly low inflation as the result of temporary factors, but core CPI has not risen above 2.3 percent in six years.

And the Fed's preferred inflation measure, the Personal Consumption Expenditures price index, has been steady at 1.4 percent, while the core measure has

been below the central bank's two percent target for more than five years.

Meanwhile, the Fed is expected this week to announce the start of a plan to reduce the multi-trillion dollar investment holdings built up to support the economy in the wake of the 2008 financial crisis.

While the Fed has said the process will be very gradual, to avoid upsetting financial markets, it will act as a slight tightening of monetary policy akin to an interest rate hike.

The double-whammy of Irma and Harvey could shave as much as 0.5 percent off of US GDP in the third quarter, as businesses are disrupted, energy prices rise and hiring weakens.

But economists and Fed officials say the storms will not affect the underlying trend in growth, which has been steady at around two percent in recent years, and activity should rebound later in the year due to reconstruction efforts.

Mark Zandi, chief economist at Moody's Analytics, said central bankers will "look through the economic impacts of Harvey and Irma, because they know they're temporary."

Economist Tim Duy agreed. "I think that they will still on average lean toward hiking in December," he told AFP, noting there are a "sufficient number" of officials who believe low inflation is due to temporary factors.

In a speech early this month, influential New York Fed President William Dudley said while he was surprised that inflation had been so low, steady growth of the economy should eventually push wages higher, allowing the Fed to continue to raise rates "gradually."

Zandi said with the unemployment rate "falling dramatically" and nearing four percent, inflation eventually will follow.

"It's just a matter of time."

Along with the policy statement Wednesday, Fed members will release their forecasts for the economy and the course of interest rates, which could give a clearer picture of the sentiment in the central bank.

China expresses concern over EU push to curb foreign takeovers

REUTERS, Beijing

CHINA expressed concern on Monday over a proposal by European Commission chief Jean-Claude Juncker to limit its ability to buy up European companies in the infrastructure, hi-tech manufacturing and energy industries.

In the European Union's equivalent of a US president's State of the Union address last week, Juncker presented proposals for an investment screening framework.

It aims to give EU members a tool to intervene in cases of foreign direct investment in strategic assets, in particular if carried out by state-controlled or state-financed enterprises.

Chinese Foreign Ministry spokesman Lu Kang said the EU had for a long time been promoting free trade and making investment easier, which have brought real benefits to European nations.

Closing the door will not achieve lasting development, he added. "Practicing trade and investment protectionism for short-term interests, from a long-term perspective, the losses will outweigh the gains," Lu told a daily news briefing.



European Commission President Jean-Claude Juncker addresses the European Parliament in France.

REUTERS/FILE

He urged the European Union to respect World Trade Organisation principles, especially non-discriminatory principles, in any measures it adopted.

It must "avoid putting out wrong, confusing and negative information to the outside world," he added. In June, French President Emmanuel Macron urged the

Commission to build a system for screening investments in strategic sectors from outside the bloc.

In July, Germany became the first EU country to tighten rules on foreign corporate takeovers following a series of Chinese deals giving access to Western technology and expertise.

France already has national

legislation in place to block such deals in certain sectors, such as energy and telecoms.

Last year's purchase of German robotics maker Kuka by Chinese company Midea raised concerns that China was gaining too much access to key technologies while shielding its own companies from foreign takeovers.

Google launches digital payments service in India

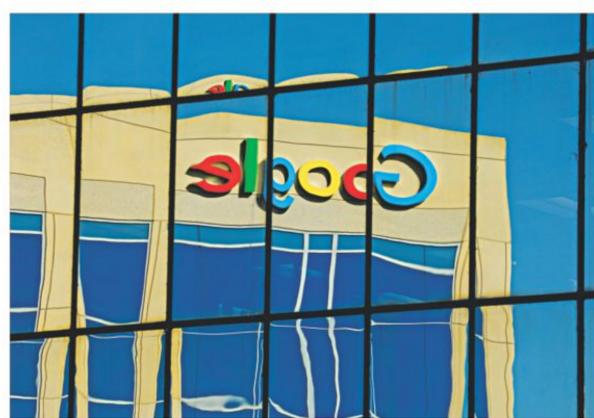
REUTERS, New Delhi

ALPHABET Inc's Google on Monday launched a localised payments app for India as it tries to gain a foothold in the country's rapidly-growing digital payments space.

India's crowded digital payments market, expected to grow ten-fold to \$500 billion by 2020, received a shot in the arm after Prime Minister Narendra Modi banned old high-value notes last year, forcing people to use e-wallets and card payments.

A state-backed payments system, Unified Payment Interface (UPI), has also helped banks enter the fray, forcing wallet players to actively partner with lenders or adopt the platform in the world's fastest growing internet services market.

Google's payments app named Tez, meaning fast in Hindi, uses UPI and allows users to connect their bank accounts to the service.



The Google logo is shown reflected on an adjacent office building in California, US.

REUTERS

Google has partnered with State Bank of India, the country's biggest lender, HDFC Bank, ICICI Bank and Axis Bank for the service.

Tez will compete, among oth-

ers, with Paytm which is backed by SoftBank and Alibaba. Paytm is the country's largest e-wallet with more than 225 million users.

Finance Minister Arun Jaitley

who launched Tez in New Delhi said Google was keen on joining India's transformation into a digital economy, especially after the demonetization.

"The Google team was extremely keen because they saw a great potential, both in the economy and the businesses in India."

Google has increasingly stepped up its efforts to reach deeper into the Indian market. It provides free wifi at several rail-ways stations across the country and launched a version of its video platform YouTube that runs on a slower network.

Bharti Enterprises-backed Hike launched a UPI-linked wallet within its messaging platform earlier this year, while Facebook's popular WhatsApp instant messaging service is also mulling foraying into digital payment services in India, its biggest market and home to 200 million of its billion-plus users.