Challenges for new banks - By Reaz Islam

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Over the past decade, Bangladesh economy enjoyed favourable economic environment and grew at approximately 6 percent with tolerable inflation. Major economic indicators like GDP, exports and imports have tripled in the last 10 years; industrialisation and trade have soared to unprecedented heights.

Growth in the “real” economy has fuelled the growth of the country's banking sector which has seen an increase in deposits by over 400 percent and assets by around 500 percent in the last 10 years. Simultaneously, per capita GDP has more than doubled and yet more than half the population is still unbanked.

The central bank's decision to allow licences to nine new banks has the merit. Regardless of political motivations, a logical argument can be made beyond the unbanked population argument that more competition will improve service quality and ultimately benefit the consumers.

From the sponsors standpoint, a logical argument can be made about the potential economic benefit for the sponsors based upon past record, which is estimated to be 25 percent+ over 10 years from inception of a bank approximately 15 percent higher than the risk free rate in Bangladesh.

Past performance do not guarantee future returns

These all sound great theoretically but the ground reality is different, and challenges faced by the management and shareholders of new banks cannot be minimized. The banking industry is already highly competitive. Therefore, unless these new banks get their act together fast, shareholders could suffer a major setback and even some could face extinction.

Show me the money

Let us refresh our memory about how banks make profit. Banks make money primarily in three ways. Firstly, from the spread between the deposit and lending rates; Secondly, from the fees they charge for various products and services, and thirdly from proprietary investments.

This is obviously overly simplified; however, all these modes of earnings potential are possible to some extent provided that the demand is growing, banks are well capitalized and have the proper human resource; and the rest happens automatically. So what are the challenges?

It is all about people

At present, the banking sector is suffering from an acute shortage of skilled and adept professionals.

Except for a few foreign and local banks, unfortunately the quality of staff beyond the CEO, managing director and DMD levels drops drastically. Depth and breadth of knowledge unfortunately is poor. This is an ominous sign for the industry since professional human resource is essential for the growth and development of the industry. These weaknesses obviously facilitate frauds, mismanagement, and value destruction for shareholders and encourage and breed substandard corporate governance culture in the financial sector.

The first challenge for new banks will be attracting the right leadership. It will not be easy to attract talents for a newly established entity. The most likely outcomes are - either you end up recruiting an unqualified team due to budget constraints or you end up paying a significant premium for talents.

If you recruit weak managers, then they end up attracting even weaker subordinates and we all know how that works.

Attracting deposits

While most banks offer similar commodity type products, they are combating with each other in most cases on price/yield, realistically, the new entrants can gain an initial advantage and capture market share by offering higher deposit rates.

Falling deposit rates at present driven by recent political uncertainty, risk averseness, lack of demand for loans and recent spike in demand for short-term government securities provide a lower rate environment, nevertheless provide no relative advantage to the new banks.

Lending to the right clients

Contrary to popular believe that aggressive marketing or in this case aggressive lending may help quickly capture market share and drive banks' profitability, in reality success of these new banks in the long-run depends on ensuring that they lend to the right clients. Most of us are aware of the result of aggressive growth in the lending portfolios.

As a lender, you only get the stated interest and the principal within the maturity date at best and you have no upside like equity investors. This is why one must wonder why many banks even today lend to entities with no real capital or a sliver of capital created from revaluation and other financial engineering.

If the new banks fall into this temptation, this could be the first nail in the coffin. Chasing yield and risking principal is the fastest way to go bankrupt.

Tapping the untapped

With around half the population unbanked, the biggest opportunity for new banks exists for targeting unbanked rural populations with the right products and services. Opening cost-efficient branches and nimble service centres in suburban and rural areas can substantially boost asset size and simultaneously, bring the much-needed diversification that every lender requires to spread-out its risk.

Last mover advantage

Despite the challenges, new banks have some vantage points comparing to the existing banks. Currently the industry maintains NPL of 8.93 percent+, which is similar to the levels back in 2007. While all the other government and private commercial banks have been working hard to clean their books, new banks have the luxury to formulate carefully thought-out strategies for market penetration.

It is a well-established fact that many of the existing players are required to recapitalisation to maintain minimum capital adequacy. It is a daunting challenge to concentrate both on business expansion and recapitalisation effectively.

For the past 10 years, in the backdrop of consistent economic growth driven by export and remittance, balance sheets of banks have inflated due to aggressive lending, stock market and real-estate bubble and finally the head-wind; the sector is now facing serious challenges due to poor balance sheet. All these incidents provide a road map of do's and don'ts for a new bank.

Embracing new technology

The biggest advantage for a new bank is the opportunity to embrace technologies to get an edge over the existing players. We expect disruptive technologies to impact banking globally and also, to some extent, in Bangladesh.

For instance, mobile technology now provides the plumbing for delivering products and services unthinkable even a few years back. In Bangladesh, more than 70 percent of the population lives in rural areas, where financial services are generally inaccessible. Furthermore, with the advent of 3G technology in Bangladesh, internet penetration promises to grow exponentially in the coming years.

Lessons can be learn from organisations such as bKash, which has proven how financial services can be delivered conveniently and at a low-cost. We believe this is just the beginning and more game-changing technologies are expected.

As a proponent of a free market, increased supply of banks is generally good for the consumers. However, the road to success is not smooth at all and expected to be even more challenging in the future. Now it is not an option but essential to invest in intellectual capital, attracting deposits at competitive rates, focusing on unbanked population, selecting right clients, learning from past mistakes, embracing new technology, and most importantly developing effective leadership.

How well these banks execute on these dimensions will finally determine the fate of these banks in the future.

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