Nonperforming loans of commercial banks in Bangladesh

Parven, Salena

MBM program, Bangladesh Institute of Bank Management (BIBM), Dhaka -1216, Bangladesh

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Salena Parven
MBM program -2011,
ID-151104

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ACRONYMS

ARA	Artha Rin Ain
BB	Bangladesh Bank
BOI	Board of Investment
BOD	Board of Director
BRPD	Banking Regulation and Policy Department
CC	Cash Credit
CIB	Credit Information Bureau
DFI	Development Financial Institution
GRA	Growth Rate of Advances
GRCL	Growth Rate of Classified Loans
IBP	Inland Bills Purchased
LAD	Loan Accounting Department
LIM	Loan against Import merchandise
LTR	Loan against Trust Receipt
LRP	Loan Repayment Period
NBR	National Board of Revenue
NPL	Non Performing Loan
NPA	Non Performing Asset
OD	Overdraft
PAD	Payment Against Documents
PDRA	Public Demand Recovery Act
STAC	Short Term Agricultural Credit
TL	Total Loan
TCL	Total Classified Loan

Abstract

This paper discusses the magnitude of Nonperforming Loans (NPL) in the banking sector of Bangladesh since the adaptation of prudential norms in the loan classification and provisioning system in 1990. Smooth and efficient flow of saving-investment process is a prerequisite for the economic development of a country. Bangladesh, being a developed country and with an underdeveloped capital market, mainly depends on the intermediary role of commercial banks for mobilizing internal saving and providing capital to the investor. Thus, it matters greatly how well our financial sector is functioning. The process of economic development of Bangladesh has been seriously constrained by the continuing crisis of the accumulation of classified loans. As Loan is the prime asset of a bank, it is essential to know the asset quality of a bank, regulation helps to determine the financial health and efficiency of the banking sector. Besides, a proper loan classification and provisioning system ensures credibility of the financial system that in turn restores trust and confidence in the mind of depositors. Loan classification and provisioning system is also essential for regularizing follow-up, monitoring activities and improving the recovery position. However, the criteria for classifying and provisioning loan portfolios depend on the prudential policies of the central bank.

There are several reasons of classified loans in our banking sector such as flow problem of bad loans, dissatisfactory performance of the courts, having no concrete NPL management strategy equipped with both preventive and resolution measures, having no measurement of the meaningful application of the CRG device in the credit environment etc. For this, there is huge amount of classified loans in our banking sector. The Bangladesh Bank has given the guidelines regarding the provisioning system against classified loans through the BCD and BRPD circulation. Due to increasing default risks of loans, the provisioning system has been revised several times. For protecting the depositor's interest and keeping the bank's financial condition solvent huge amount of provisions are kept against the classified loans. For the causes of classified loans, provision of the banking sector is increasing. As a result the profit of the banks is coming down. Besides government also deprive from current year taxes due to higher rate of provisioning.

So it is needed to maintain a standard asset quality and so need to follow related prudential regulation. Besides, maintenance of an ethical standard in the banking profession from all concerns can be viewed as an important means for making the credit environment credible and vibrant. We have had a two-decade long experience in dealing with the NPLs problem and much is known about the causes and remedies of the problem. So, it is very important for the lenders, borrowers and policy makers to learn from the past experience and act accordingly. It is optimistic that at present the trend of classified loans has begun to decline.

Chapter- One

Introduction

1.1 Background of the Study:

Most of the business is done by banks with the funds which are collected from the public by way of deposits. A non-performing asset in the banking sector may be termed as an asset not contributing to the income of the bank. In other words, it is a zero yield asset when applied particularly to loan and advances. The actual concept of NPA is that it is an asset which ceases to yield income for the bank and that any income accrued from such asset shall not be treated as income until it is actually realized. Classification of an asset as NPA should be a based on record of recovery. Therefore, an asset is to be classified as NPA when there is a threat of loss for the recoverability is in doubt. In spite of wide ranging reform measures initiated in the banking sector, the problem of non-performing assets assumed a central place in issues relating to banking sector.

Lending function of a bank needs to add value to the bank. The lending function comprises origination, funding, monitoring and servicing of loan. Loans are deemed as assets of a bank. To maintain asset to a standard quality various prudential regulation from various angle, issued by central bank such as, loan classification criteria, provisioning requirement, income recognition, write-off policy, risk diversification, directed lending, debt restructuring etc.

In the absence of strong capital market, Bangladesh depends heavily on the banking sector for a smooth financial intermediation. However, for many years Bangladeshi banking sector has been burdened with the crisis of accumulation of huge non-performing loans. All types of domestic banks i.e. NCBs, PCBs and DFIs are facing the daunting amount of non-performing loan. Since 1980s, the central banks of the developing countries, following the practices of the developed countries, have adopted the “prudential norms for asset classification”, with a view to ensuring “transparency” and “quality” of the loan portfolios of the banks. It is a part of Financial Sector Reform Program (FSRP).

Bangladesh, too, has started adopting a number of financial sector reform measures since 1990 as a part of its overall economic stabilization and structural adjustment program. Though privatization (allowing new private commercial banks to operate) and denationalization (selling out government banks to private entrepreneurs) of the financial institutions (as well as other real sector enterprises) started well before (in 1983) the adoption of stabilization and structural adjustment program by Bangladesh Government. However, even if we consider 1990 as take-off year in regard to financial reforms, we have by this time passed 22 years of reforms. The main features of Financial Sector Reforms Program (FSRP) in the context of banking sector of Bangladesh are: liberalization of interest rate policy, abolition of refinance and introduction of rediscounting scheme, introduction of new system of loan classification and provisioning, capital adequacy requirement, strengthening of Central Bank, improvement in the operation of NCBs (recently changed in Ltd company), computerization of banks, development of human resources, reforms in the legal environment, reforms in foreign exchange regime and development of capital market.

After the introduction of explicit loan classification system in 1989, loan classification system has undergone a number of changes from time to time. The present classification system is a little bit relaxed compared to the international norms of classifying the loan. Almost a quarter of the total loans of the banking sector are now classified or non-performing. According to latest BRPD (Banking Regulation and Policy Department, 2012) circular of Bangladesh Bank the latest figure indicated that the 6.59 % of total loan is classified. Although, the ratio was as 26.09% since in 1990 and high as 41.1% in 1999 and it came down gradually to the present level of 6.59%.

It is obvious that non-performing loan (NPLs) reduce banks' profitability, as banks cannot appropriate interest income from their classified loans. NPLs reduce loan-able funds by stopping recycling. Banks need to set aside a portion of their income as loan loss reserve to make up bad debt. A bank with a high percentage of NPLs suffers from erosion of the capital. All those adverse impact of NPLs on banks' financial health such as low profitability and low capital base are clearly reflected in Bangladesh banking sector. The question arises as to why we are unable to solve this problem for such a long time? A number of studies have been undertaken to deal with the problem and to address this 'default culture' phenomenon. Emergence and accumulation of high scale of non-performing loans after independence starting from the nationalization of banks has been well discussed by a number of authors (Islam et al., 1999; Moral et al., 2000).

Several attempts have been made to explain the non-performing loans problem with some theories relating to political economy backed by empirical findings. Islam et al., (1999) in their study on bank loan default offered the idea of 'comprador government' and 'comprador bourgeoisie' developed by Paul Baran as an explanation of the behavior of Bangladeshi capitalists class where trading as opposed to manufacturing becomes the main business of the capitalists and they act as importers, indentors, sales agents, suppliers, etc. The same study also made an effort to explain the process of transfer of economic surplus through international trade based on Emmanuel's theory of 'unequal exchange' which complements Baran's explanation. Ahmad (1997) used three theoretical paradigms in his quest for a socio-political explanation of the bank loan default problem of Bangladesh, the rational actor theory, the pluralist instrumentalist theory and the organizational bargaining theory. Based on an investigation he mentioned some important factors as causes of loan default which includes lack of willingness to pay coupled with diversion of fund, willful negligence and belief that waiver may be available in the future, operational problems, inability to utilize production capacity, power failure, improper credit appraisal, natural calamity, and unfair taxation. Non-professional handling of assets both by the NCBs and the private sector bank was reported as the main reasons for the accumulation of loan default problem in Bangladesh (Alam and Jahan, 1999). It included the Government directed credit for the loss making public sector enterprises and the private sector banks' lending to insiders and connected parties. Prof. Rehman Sobhan (1991) in his study on debt default problem examined the nature and problems relating to poor repayment status of the two DFIs-BSB and BSRS.

Government of Bangladesh has taken some initiative such as tightening up of the regulatory measures to enable banks to recover loans from the defaulters. They have taken some measures on recovery of defaulted loan such as Artha Rin Adalat Ain (Money Loan Court Act 2003) was enacted in 2003 with a view to improving the legal framework for recovery of overdue loans and advances by the banks and financial institutions. In recognition of the importance of an effective risk management system, BB has issued guidelines on managing core risks in banking in October 2003. The five core risks are Credit Risks, Asset and Liability Risks, Foreign Exchange Risks, Internal Control and Compliance Risks and Money Laundering Risks. Now banks are not allowed to approve large loans in favor of any individual or group of borrowers in excess of 50 percent of their total capital. Loans, which have been classified as bad/loss for 5 years or more against which full provision s have been kept are to be written off by the banks to clean their books.

Despite massive injection of loans to the national economy, the contribution of financial sector to the Gross Domestic Product (GDP) remained at dismal level. This laden loan contribution to GDP by the unhealthy and inefficient financial situation. Political connections have played a key role in sanctioning a loan. In such connection, we should realize that what will happen of the confidence of depositors and productive sectors borrower in the domestic financial system? What will happen if the defaulters are not brought to book and soundness of financial institutions are not ensured?

1.2 Objectives of the Study:

Managements of NPA would have the following three specific objectives:

- Improving the quality of NPA to a performing status so that income on such assets is recognized.
- Upgrading the status of the assets so as to reduce the provisioning requirements. .
- To analyze legal aspect to recover loans from the defaulters and the causes and remedies of non-performing loans.

1.3 Methodology of the Study:

The research methodology of the study has been enumerated below:

a. Sources of Data & Data Collection:

Data has been collected from the various secondary sources like research works of individuals, different publications, journal of different institutions, reading materials, books, library sources, Bangladesh Bank, CRG manual etc.

b. Time Preference:

The time preference of the study relates to the period covering the years 1990 to 2011. These 22 years has been taken for different analysis purposes.

c. Data Processing and Analysis:

Data processing has been done manually after checking and editing. Tabular techniques are used to present data in this paper.

1.4 Scope and Limitations of the Study:

Non-performing Loan is very much important for the banking sector. Here the study would be concentrate on laws and regulations and existing legal structure as well as status of NPL of different commercial banks. Problems are always there for any research study. Effort was there to overcome the limitations and to bring a reliable and fruitful result. The limitations of the study are:

- This study did not cover primary and unpublished data.
- The major problem faced while conducting the research was unavailability of relevant data.

1.5 Structure of the Study:

This research report has been divided into seven parts. In the first chapter, introduction of the research has been given. Here the background, Objectives of the study, methodology and scope has been elaborated. In the second chapter, describe the conceptual framework and review of the literature. The third chapter portrays the trend of the loan default problem in Bangladesh. The Fourth chapter illustrates the loan default status of commercial banks. The fifth chapter describes the descriptive analysis of related laws and impact of new regulations. The sixth chapter identifies the causes and remedies of non-performing loans. Finally the seventh chapter contains the findings, challenges and concluding remarks on nonperforming loans.

Chapter- Two

Conceptual Framework and Review of the Literature

2.1 Management of NPL: Meaning, Causes, Objectives and Framework

2.1.1 Meaning of NPA:

The bank being financial intermediaries are in the business of accepting deposits for the purpose of lending and to augment their resources at times they borrow money from other sources and meet the ever increasing borrowing requirements of their customers. However, most of the business is done by banks with the funds which are collected from the public by way of deposits. They are, therefore, answerable to the public at large, who are keeping their funds with the banks by reposing trust in the ability of banks that they will not put the depositors interest to jeopardy.

A non-performing asset in the banking sector may be termed as an asset not contributing to the income of the bank. In other words, it is a zero yield asset when applied particularly to loan and advances. The actual concept of NPA is that it is an asset which ceases to yield income for the bank and that any income accrued from such asset shall not be treated as income until it is actually realized. Classification of an asset as NPA should be a based on record of recovery. Therefore, an asset is to be classified as NPA when there is a threat of loss for the recoverability is in doubt. In spite of wide ranging reform measures initiated in the banking sector, the problem of non-performing assets assumed a central place in issues relating to banking sector.

2.1.2 Causes for growing NPA:

- Improper selection of borrowers, inadequacies of character, capacity and capital at the borrower's level.
- Deficiencies in appraisal, processing, sanction, and release.
- Inadequate/excess sanction of the limit irrespective of the economic size of the unit.
- Scattered financing.
- Unrealistic terms or conditions of sanction and fixing unrealistic repayment schedule.
- Political interference in sanctioning of loans and patronage to defaulters.
- Lack of infrastructural facilities like power, raw materials, fuel, transportation, marketing and technical support.
- Lack of inter-bank co-ordination as well as cooperation with financial institution in exchanging information over list of defaulters.

2.1.3 Objectives of NPA:

Management of NPA would have the following three specific objectives:

- Improving the quality of NPA to a performing status so that income on such assets is recognized.
- Upgrading the status of the assets so as to reduce the provisioning requirements.
- Cleansing balance-sheet of loss assets and also unsecured portion of doubtful assets.

2.1.4 Framework of NPA:

Risk is inherent in all aspects of a commercial operation; however for banks and financial institutions, credit risk is an essential factor that needs to be managed. Credit risk is the possibility that a borrower or counter party will fail to meet its obligations in accordance with agreed terms. Credit risk management needs to be a robust process that enables banks to proactively manage loan portfolios in order to minimize losses and earn an acceptable level of return for shareholders. And NPL management must be thought of as an integral part of overall credit risk management. It implies that NPL management is not an independent event, that stats with conversion of a performing loan into non-performing loan. In fact a robust NPL management must start before a loan becomes non-performing. It is much better to prevent an NPL, rather than curing or nursing an NPL.

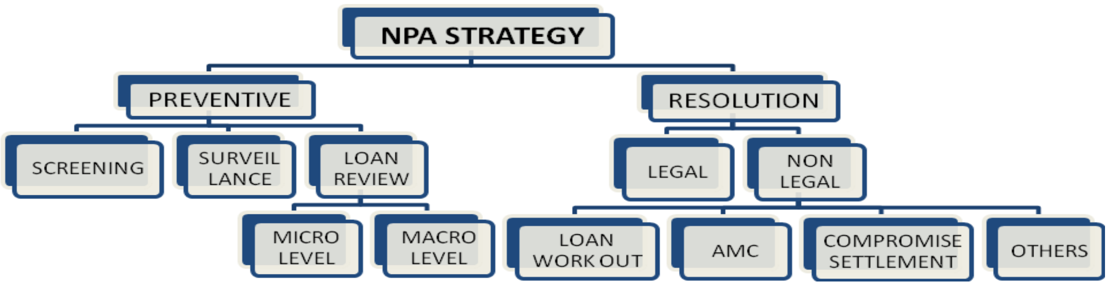

Figure 1: NPL Management Strategy

NPL Management Strategy, in figure 2, explains that the incidence of non-performing advances (NPAs) is affecting the performance of the credit institutions both financially and psychologically. The successful banker-client relationship in the credit function of banks involves three important and interlinked phases viz.:

- The right type and the right amount of credit are given to the right type of client.
- The borrower's makes proper use of the amount received from the bank.
- The borrower repays the outstanding loan along with the interest in time.

Management of NPAs shall rely upon the following basic principles:

- Recovery of normal loans and advances
- Recovery of NPAs

- Compromise should be a negotiated settlement under which banks should ensure recovery of maximum dues with minimum expenses.
- Proper distinction needs to be made between willful defaulters and borrowers who defaulted due to circumstances beyond their control.
- In settlement cases the banks should promptly recycle the fund with advantage instead of resorting to expensive recovery proceedings spread over a long period.

When the bank is entering into compromise settlement the following points need to be remembered:

- Maximum recovery with minimum cost.
- Distinction needs to be made between willful defaulters and defaulters on account of conditions beyond their scope.
- Where security is available, proper weightage needs to be given location, marketability conditions, possession thereof.
- Fund recycling to maximum advantage instead of opting for lengthy, expensive recovery process.
- All compromise proposals should be reported to the next higher authority for scrutiny so as to prevent fraudulent activities.
- Before presenting the compromise proposal before the Settlement Advisory committee, the proposal needs to be examined by the top executive.
- Special recovery cells needs to be set up to monitor recovery and prevent fresh generation of NPA.
- Adequate attention should be given and appropriate action initiated for upgrading substandard assets to standard assets.

As a Preventive measure there should have proper screening before disbursement of the Loans and surveillance such as:

- To select right borrowers.
- To identify viability of project.
- To ascertain credit environment.
- To assess credit need.
- To timely supply of credit.
- To obtain proper securities.
- To prevent defective documentation.
- To maintain credit discipline.

Recovery of credit largely depends on effective follow-up. By supervision we mean to have a proper control over the borrowers operation to ensure the end-use of funds. Supervision keeps track of the end-use of fund lent. Supervision and follow-up function in banks has assumed considerable significance due to increasing trend of sickness in industrial units.

Loan Review:

Loan review is not luxury but necessary for a sound bank lending program. The structure of credit review process would have to periodically examine the assumptions on which every loan was appraised and granted, and whether these assumptions have changed materially enough to endanger the debt-servicing capacity of the borrower. Typically, all or most of the following aspects are reviewed for every loan till it is repaid in full.

- Developments in the economy that may have an impact on the industry in which the borrower operates.
- Developments in the industry or sector in which the borrower operates.
- The borrower's payment record in this and other loans so far.
- The quality, condition and value of the prime and collateral securities.
- The completeness of loan documentation, and developments in law governing the instruments effecting credit delivery.
- Some borrowers may default on debt service due to factors out of their control. In such cases, the bank may have to reschedule the debt requirements and alter some of the covenants, if necessary.

Central banks of most countries have devised country-specific definitions and control systems to tackle 'sick' borrowers. There are three categories of sickness that could afflict borrowers:

a) Sickness at birth- the project itself has become infeasible either due to faculty assumptions or a change in environment.

b) Induced sickness- caused by management in competencies or willful default.

c) Genuine sickness-where the circumstances leading to sickness are beyond the borrower's control, and has happened in spite of the borrowers sincere efforts to avert the situation.

Key Steps for Loan Workout:

- Always keep the goal of loan workouts firmly in mind: to maximize the banks chances for full recovery of its funds.
- The repaid detection and reporting of any problems with a loan are essential; delay often worsens a problem loan situation.
- Keep the loan workouts responsibility separate from the lending function to avoid possible conflicts of interest for the loan offer.
- Bank workout specialists should confer with the troubled customer quickly on possible options, especially for cutting expenses, increasing cash flow, and improving management control.
- Develop a preliminary plan of action after determining the banks risk exposure and sufficiency of loan documents especially any claims against the customer's collateral other than that held by the bank.

- Estimate what resources are available to collect the trouble loan including the estimated liquidation values of assets and deposits.

Loan review helps in the following:

- Continuously checking if the loan policy is being adhered to.
- Identifying problem accounts even at the incipient stage.
- Assessing the bank's exposure to credit risk.

2.2 Objectives and Importance's of Loan Classification and Provisioning:

According to **BRPD Circular No. 19 dated December 27, 2012,** Bangladesh Bank has, over the last several years, positioned the banks on a path towards higher regulatory capital ratios and a more precise calculation of each individual bank's need for capital, through a gradual implementation of internationally recognized capital standards. The enforcement of a stricter regulatory capital regime also requires measures to improve the accuracy of financial data which are used internally, stated in the audited financial statements and reported to Bangladesh Bank as per rules. For both the banks managerial and Bangladesh Bank's supervisory purposes, as well as for accurate valuation of a bank's capital in all of its financial reports is necessary.

An accurate valuation of capital relies, in turn, on an accurate valuation of assets. Loan loss provisioning – the recognition that some or all of the required payments on a loan may never be made – is the single most important aspect of asset valuation to bankers and bank supervisors. It is important because loans typically make up 50% or more of the total assets of the bank. Basel II and Basel III devote a great deal of attention to the distinction between "expected losses" and "unexpected losses" on the bank's loan portfolio. The purpose of provisioning is to take into account expected losses. Expected losses can be assigned to loans based on a loan classification system, which has been utilized in Bangladesh for many years and is being updated with this circular.

Bangladesh Bank also wishes to stress that it is the responsibility of bank management to adopt and implement proper accounting and reporting, and that correct classification and provisioning is a part of that responsibility. Loan classification and provisioning must be a key component of a regular internal loan review process that looks at the current likelihood that the borrower will repay. The value of the formed allowance that results from the provisioning process should reflect all expected losses resulting from credit exposures.

Bangladesh Bank has established requirements for general loan loss provisions, in certain percentages, for certain categories of loans that are unclassified or in the Special Mention Account. As the name suggests, general provisions are assigned to take into account the expected losses on pools of loans that are thought to have similar characteristics. The characteristics of each individual loan are not analyzed. Put differently, it is not known or even assumed which loan or loans in the pool are going to result in loan losses; it is simply taken as given that in such large pools, even those currently unclassified, there will undoubtedly be individual loans that in the future will not be repaid. Ideally, the percentages of provision that are applied to each pool are determined based on historical loss experience of similar loan pools. Banks are encouraged to calculate these historical loss experiences on the loan pools for which Bangladesh Bank has indicated general provision percentages, and use these data if they result in higher provisions than are required in this circular. Because general provisions are not formed based on expectations of loss on any individual loan, they are allowed to be included in the calculation of Tier 2 capital, subject to some restrictions. In contrast, specific provisions (established on loans that are classified as Sub-standard, Doubtful or Bad/Loss) are set up on a loan-by-loan basis after careful analysis of each individual loan's probability of repayment. For loans placed into any of these classification categories, weaknesses have been identified that cast doubt on the borrower's ability or intent to make all contractual payments in a timely manner. For this reason, specific provisions are not allowed to be included in the calculation of Tier 2 capital.

Loan classification is the act of grouping or arranging of loans and advances according to their status like unclassified, sub-standard, doubtful and bad or loss based on given criteria. Provisioning means setting aside certain fund from the current year profit against possible loan losses. In Bangladesh, Bangladesh bank prescribes the loan classification and provisioning criteria through **BRPD Circular No. - 1 dated June 05, 2006; BRPD Circular No. -7 June 14, 2012; BRPD Circular No.-14 dated September 23, 2012 and BRPD Circular No. 19 dated December 27, 2012**. As part of this program, a new system of loan classification and provisioning against potential loan losses for advances was introduced in November 1989. Before 1989 no specific guidelines were followed by the commercial banks for this purpose. This process is continued to date. The title of the circular was ***"Master Circular: Loan Classification and Provisioning"***. The introduction of this program was aimed at to bring loan loss provisioning and classification in line with international standards by the end of 2012.

Loan classification means giving each and every loan case a status like unclassified, sub-standard, doubtful and bad or loss through verification of borrowers' repayment performance on a particular date while provisioning means setting aside fund from the profit (profit before provision and taxes) against possible loan loss. This is obviously essential for determining the financial health and efficiency of the banking sector. Besides, a proper loan classification and provisioning system ensures credibility of the financial system that in turn restores trust and confidence in the minds of the depositors.

Loan classification makes two pronged attacks on the activities of banks. **First,** interests applied on loans are not taken into account because such interests are to be taken into account only on its realization. **Second,** banks have to make provisions on classified loans *as per guidelines by Bangladesh Bank* from out of the income earned by them on performing loans.

Objectives of Loan Classification:

- Find out net-worth of a bank.
- Help for assessing financial soundness of a bank.
- Help for determining required provision and the amount of interest suspense
- Put the bank on sound footing in order to develop sound banking practice in Bangladesh.

Importance of Loan Classification:

- Strength credit discipline,
- Improve loan recovery positions and
- Make future planning of loan

2.3 Categories of Loans and Advances:

For the purpose of loan classification, loan and advances have been grouped into four categories:

(a) Continuous loan: The loan which is sanctioned without specific repayment schedule but there is a specific expiry date for repayment and credit limit can be treated as continuous loan. For examples: O/D, CC, PC, LIM, LTR, etc.

(b) Demand Loan: When loan is sanctioned on the basis of repayment depends upon the demand of bank can be treated as demand loan. Contingent or other liabilities which are converted into forced loan are also to be treated as demand loan. For examples: Forced LIM, PAD, FBP, IBP, etc.

(c) Term Loan: The loan which has a specific expiry date for repayment and for which repayment is schedule through specific repayment schedule is treated as fixed term loan. For example: Project finance, industrial finance, and tec.

(d) Short-Term Agricultural Credit and Micro-Credit: Short-Term Agricultural Credit means the credit which is enlisted as short term credit under the annual credit program announced by Agricultural Credit Department of Bangladesh bank. Credit in agriculture sector repayable within 12 months is also included in this category. On the other hand, Short-Term Micro-Credit means the credit which have loan limit less than TK. 25000.00 and repayable within 12 months. Micro-credit may be even non-farm credit, self-employment credit, loom-loan or any forms of credit under the own credit program of the banks.

2.4 Basis for Loan Classification:

If any uncertainty or doubt arises in respect of recovery of any Continuous Loan, Demand Loan or Fixed Term Loan, the same will have to be classified on the basis of qualitative judgement be it classifiable or not on the basis of objective criteria. If any situational changes occur in the stipulations in terms of which the loan was extended or if the capital of the borrower is impaired due to adverse conditions or if the value of the collateral decreases or if the recovery of the loan becomes uncertain due to any other unfavourable situation, the loan will have to be classified on the basis of qualitative judgement .

Despite the probability of any loan being affected due to the reasons stated above or for any other reasons, if there is any hope for change of the existing condition by resorting to proper steps, the loan, on the basis of qualitative judgement, will be classified as 'Sub-standard '. But even after resorting to proper steps, there exists no certainty of total recovery of the loan, it will be classified as ' Doubtful ' and even after exerting the all-out efforts, there exists no chance of recovery, it will be classified as ' Bad/Loss ' on the basis of qualitative judgement. For incorporating qualitative judgment, banks must focus on the likelihood that the borrower will repay all amounts due in a timely manner, using their own judgment and the following assessment factors:

(1) Special Mention:

a) Assets must be classified no higher than Special Mention if any of the following deficiencies of bank management is present: the loan was not made in compliance with the bank's internal policies; failure to maintain adequate and enforceable documentation; or poor control over collateral.

b) Assets must be classified no higher than Special Mention if any of the following deficiencies of the obligor is present: occasional overdrawn within the past year, below-average or declining profitability; barely acceptable liquidity; problems in strategic planning.

(2) Sub-standard:

a) Assets must be classified no higher than Sub-standard if any of the following deficiencies of the obligor is present: recurrent overdrawn, low account turnover, competitive difficulties, location in a volatile industry with an acute drop in demand; very low profitability that is also declining; inadequate liquidity; cash flow less than repayment of principal and interest; weak management; doubts about integrity of management; conflict in corporate governance; unjustifiable lack of external audit; pending litigation of a significant nature.

b) Assets must be classified no higher than Sub-standard if the primary sources of repayment are insufficient to service the debt and the bank must look to secondary sources of repayment, including collateral.

c) Assets must be classified no higher than Sub-standard if the banking organization has acquired the asset without the types of adequate documentation of the obligor's net worth, profitability, liquidity, and cash flow that are required in the banking organization's lending policy, or there are doubts about the validity of that documentation.

(3) Doubtful:

Assets must be classified no higher than Doubtful if any of the following deficiencies of the obligor is present: permanent overdrawn; location in an industry with poor aggregate earnings or loss of markets; serious competitive problems; failure of key products; operational losses; illiquidity, including the necessity to sell assets to meet operating expenses; cash flow less than required interest payments; very poor management; non-cooperative or hostile management; serious doubts of the integrity of management; doubts about true ownership; complete absence of faith in financial statements.

(4) Bad/Loss

Assets must be classified no higher than Bad/Loss if any of the following deficiencies of the obligor are present: the obligor seeks new loans to finance operational losses; location in an industry that is disappearing; location in the bottom quartile of its industry in terms of profitability; technological obsolescence; very high losses; asset sales at a loss to meet operational expenses; cash flow less than production costs; no repayment source except liquidation; presence of money laundering, fraud, embezzlement, or other criminal activity; no further support by owners.

2.5 Maintenance of Provision:

a) General Provision: Banks will be required to maintain General Provision in the following way:

(1) @ 0.25% against all unclassified loans of Small and Medium Enterprise (SME) as defined by the SME & Special Programmes Department of Bangladesh Bank from time to time and @ 1% against all unclassified loans (other than loans under Consumer Financing, Loans to Brokerage House, Merchant Banks, Stock dealers etc., Special Mention Account as well as SME Financing.)

(2) @ 5% on the unclassified amount for Consumer financing whereas it has to be maintained @ 2% on the unclassified amount for (i) Housing Finance and (ii) Loans for Professionals to set up business under Consumer Financing Scheme.

(3) @ 2% on the unclassified amount for Loans to Brokerage House, Merchant Banks, Stock dealers, etc.

(4) @ 5% on the outstanding amount of loans kept in the 'Special Mention Account'.

(5) @1% on the off-balance sheet exposures. (Provision will be on the total exposure and amount of cash margin or value of eligible collateral will not be deducted while computing Off-balance sheet exposure.)

b) Specific Provision: Banks will maintain provision at the following rates in respect of classified Continuous, Demand and Fixed Term Loans:

(1) Sub-standard: 20%

(2) Doubtful: 50%

(3) Bad/Loss: 100%

c) Provision for Short-term Agricultural and Micro-Credits:

(1) All credits except 'Bad/Loss' (i.e. 'Doubtful', 'Sub-standard', irregular and regular credit accounts): 5%

(2) 'Bad/Loss' : 100%

To Sum up:

The base for provisions on non-performing loans was the balance outstanding in the loan ledger for the loan, less any interest taken in an interest suspense account. However, the base for provision shall be further reviewed towards closer convergence with international best practice standards.

Loans	Duration of overdue	Required Provision (% of outstanding loans)
Unclassified	Less than 1 year	1
Substandard	1 year < 3 years	10
Doubtful	3 years < 5 years	50
Bad	5 years or more	100

Source: BRPD circular no. 07 / 2012

In latest **BRPD circular no. 19 dated December 27, 2012**, an amended and revised loan classification and provisioning procedure was introduced by the Bangladesh Bank to bring it in line with the international standards. This was implemented in five phases, the last of which ended in December 2012. In the revised policy, the duration for loans to be classified under various categories was drastically reduced, while the frequency of classifications was increased. For classification and provisioning under the revised procedure banks were instructed to classify the loans in following procedure:

Loans	Duration of overdue	Required Provision (% of outstanding loans)
Unclassified	Less than 3 months	1
Substandard	3 months< 6 months	20
Doubtful	6 months < 1 year	50
Bad	1 year or more	100

Source: BRPD circular no.19/December 2012

According to **BRPD circular no. 19 dated December 27, 2012** either of these continuous, demand and fixed term loans will be classifying and provisioning by following procedure:

Loans	Duration of overdue	Provision (% of outstanding loans)
Unclassified	Less than 6 months	1
Substandard	6 months< 9 months	20
Doubtful	9 months < 1 year	50
Bad	1 year or more	100

Source: BRPD circular no. 19/December 2012

2.6 Loan Rescheduling:

Latest **BRPD circular no. 19 dated December 27, 2012**, Bangladesh Bank recognizes that in some cases, a legitimate banking practice may allow for the renewal of a continuous loan or line of credit. Occasionally, even a term loan is renewed or extended under unfortunate circumstances that are beyond the control of the borrower and do not signify that the borrower's willingness or ability to repay has deteriorated the loan. However, Bangladesh Bank is concerned that rescheduling (also known as "prolongation" or "evergreening") may sometimes result in an overstatement of capital, when loans that have a low probability of repayment are carried at full value on banks' balance sheets. Bangladesh Bank is hereby issuing this circular in order to communicate its policy stance that rescheduling should be done only in limited circumstances and under restrictions.

2.6.1 Time Limit for Rescheduling:

Banks shall comply with the following instructions while considering application for loan rescheduling of non-performing loan (loans classified as Sub-standard, Doubtful and Bad/Loss) and the rescheduling shall be for a minimum reasonable period of time. Time limit for rescheduling of different categories of loans will be as follows:

a) Time limit for rescheduling Continuous Loan:

The loan account in which transactions may be made within certain limit and have an expiry date for full adjustment will be treated as Continuous Loan:

Frequency	Classified as Sub-standard	Classified as Doubtful	Classified as Bad/Loss
First Rescheduling	Maximum 18 months from the date of rescheduling	Maximum 12 months from the date of rescheduling	Maximum 12 months from the date of rescheduling
Second Rescheduling	Maximum 12 months from the date of rescheduling	Maximum 09 months from the date of rescheduling	Maximum 09 months from the date of rescheduling

Third Rescheduling	Maximum 06 months from the date of rescheduling	Maximum 06 months from the date of rescheduling	Maximum 06 months from the date of rescheduling

Conditions: During the rescheduled period all required principal and interest payments must be made. Rescheduled amount should be repaid in monthly installments. If the amount of defaulted installments is equal to the amount of 3(monthly) installments, the loan will be classified as Bad/Loss.

b) Time limit for rescheduling Demand Loan:

The loan which becomes repayable on demand by the bank is treated as Demand Loan. If any contingent or any other liabilities are turned to forced loan (i.e. without any prior approval as regular loan) those too will be treated as Demand Loans

Frequency	Classified as Sub-standard	Classified as Doubtful	Classified as Bad/Loss
First Rescheduling	Maximum 12 months from the date of rescheduling	Maximum 09 months from the date of rescheduling	Maximum 09 months from the date of rescheduling
Second Rescheduling	Maximum 09 months from the date of rescheduling	Maximum 06 months from the date of rescheduling	Maximum 06 months from the date of rescheduling
Third Rescheduling	Maximum 06 months from the date of rescheduling	Maximum 06 months from the date of rescheduling	Maximum 06 months from the date of rescheduling

Conditions: During the rescheduled period all required principal and interest payments must be made. Rescheduled amount should be repaid in monthly installments. If the amount of defaulted installments is equal to the amount of 3(monthly) installments, the loan will be classified as Bad/Loss.

c) Time limit for rescheduling Fixed Term Loan:

The loan which is repayable within a specified time period under a prescribed repayment schedule is treated as Term Loan.

Frequency	Classified as Sub-standard	Classified as Doubtful	Classified as Bad/Loss
First Rescheduling	Maximum 24 months from the date of rescheduling	Maximum 18 months from the date of rescheduling	Maximum 18 months from the date of rescheduling

Second Rescheduling	Maximum 18 months from the date of rescheduling	Maximum 12 months from the date of rescheduling	Maximum 12 months from the date of rescheduling
Third Rescheduling	Maximum 12 months from the date of rescheduling	Maximum 09 months from the date of rescheduling	Maximum 09 months from the date of rescheduling

Conditions: During the rescheduled period all required principal and interest payments must be made. Rescheduled amount should be repaid in monthly/quarterly installments. If the amount of defaulted installments is equal to the amount of 6 monthly or 2 quarterly installments, the loan will be classified as Bad/Loss.

d) Time limit for rescheduling for Short-term Agricultural and Micro-Credit

First Rescheduling	Repayment time limit for rescheduling should not exceed 02 years from the date of rescheduling.
Second Rescheduling	Maximum 01 year from the date of rescheduling.
Third Rescheduling	Maximum 06 months from the date of rescheduling.

e) If the loan becomes default after third rescheduling, the borrower will be treated as a habitual loan defaulter and the bank shall not consider for further loan rescheduling.

f) Approval of loan rescheduling cannot be made below the level at which it was originally sanctioned. A detailed appraisal report including implications of such loan rescheduling on the income and other areas of the bank must be placed to the approving authority at the time of placing the rescheduling proposal.

Bangladesh Bank through its BRPD circulars issued at different times, have announced various **Policy for Rescheduling of loans**, to commercial banks at warning about non-performing loan. The purpose of this Policy **for Rescheduling of loans** is to encourage commercial banks to accelerate growth by providing loans to these priority sectors. Policy guidelines and instructions have also been circulated to Commercial Banks for their adoption. Instructions of, **2006 BRPD Circular No. 02 dated February 14** hereby stand superseded by this circular.

The issue has been reviewed and it has been decided that the borrowers whose credit facility has been rescheduled will get new loan facility subject to fulfilment of the following conditions:-

a) The defaulting borrower who has availed interest waiver must settle at least 15% of the compromise amount (excluding the down payment on rescheduling as per present guidelines) to avail any further credit facility from any Bank.

b) In case of borrowing from other Banks, the same rule will be applicable, i.e. the borrower will have to settle at least 15% of compromise amount (excluding the down payment on rescheduling as per present guidelines), then, will be allowed to take regular facility from other Banks subject to the submission of NOC (No Objection Certificate) from the rescheduling bank.

c) If there is any Principal waiver, no fresh facility will be allowed till the full settlement of compromise amount.

d) Export borrowers may be granted further credit facility (after being identified as not a willful defaulter), if required, subject to settle at least 7.5% of the compromise amount (excluding the down payment on rescheduling as per present guidelines) being paid.

e) Prior approval of Bangladesh Bank shall have to be obtained if the loan is related to the director/ ex-directors of a Bank Company.

f) If any such issue is already there (such fresh facility has already been allowed after allowing waiver), the same will not fall under purview of this circular.

06. Information on the loan accounts rescheduled shall be reported to the Credit Information Bureau (CIB) of Bangladesh Bank. While reporting to the CIB, such rescheduled loans/advances may be shown as RS 1 for first rescheduling, RS 2 for second and so on. Interest waivers given to the entity should be mentioned as RSIW & Principal waivers granted should be designated as RSPW.

2.7 Review of Literature:

Nonperforming loans ("NPLs") refer to those financial assets from which banks no longer receive interest and/or installment payments as scheduled. They are known as non-performing because the loan ceases to "perform" or generate income for the bank. According to Choudhury et al. (2002), the nonperforming loan is not a "uniclass" but rather a "multiclass" concept, which means that NPLs can be classified into different varieties usually based on the "length of overdue" of the said loans. NPLs are viewed as a typical byproduct of financial crisis: they are not a main product of the lending function but rather an accidental occurrence of the lending process, one that has enormous potential to deepen the severity and duration of financial crisis and to complicate macroeconomic management (Woo, 2000). This is because NPLs can bring down investors' confidence in the banking system, piling up unproductive economic resources even though depreciations are taken care of, and impeding the resource allocation process. In a bank-centered financial system, NPLs can further thwart economic recovery by shrinking operating margin and eroding the capital base of the banks to advance new loans. This is sometimes referred to as "credit crunch" (Bernanke et al., 1991). In addition, NPLs, if created by the borrowers willingly and left unresolved, might act as a contagious financial malaise by driving good borrowers out of the financial market.[1] Further, Muniappan (2002) argues that a bank with high level of NPLs is forced to incur carrying costs on non-income yielding assets that not only strike at profitability but also at the capital adequacy of a bank, and in consequence, the bank faces difficulties in augmenting capital resources. Bonin and Huang (2001) also state that the probability of banking crises increases if financial risk is not eliminated quickly. Such crises not only lower living standards but can also eliminate many of the achievements of economic reform overnight. The economic and financial implications of NPLs in a bank-centered financial economy can be best explained by the following diagram.

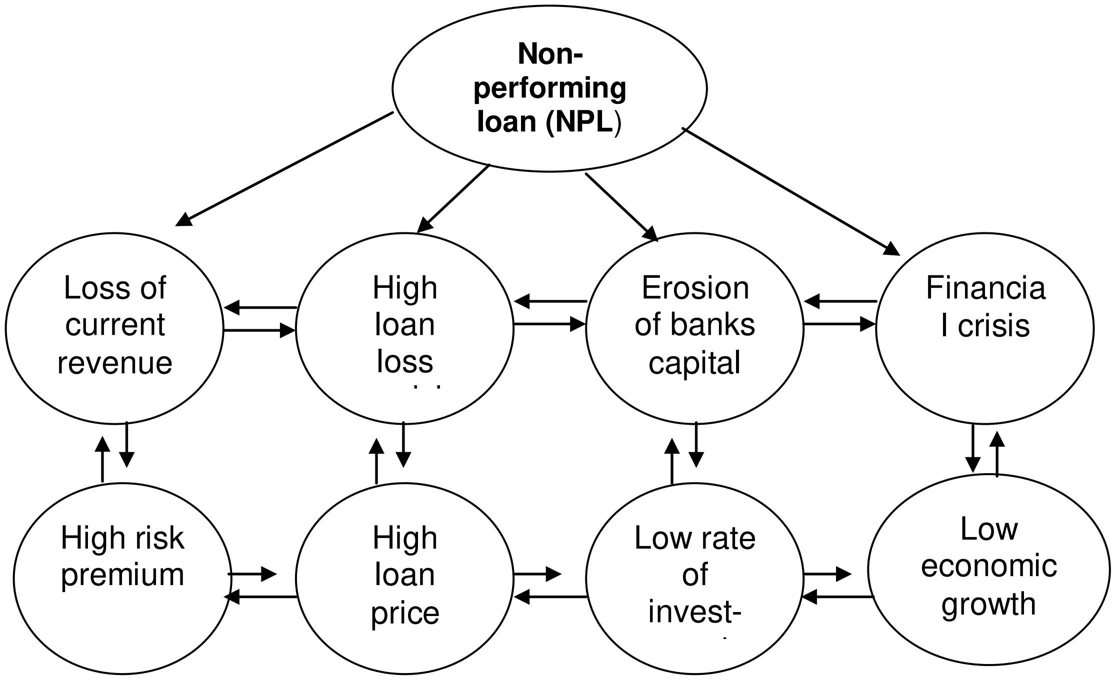

Fig. 2: Economic and financial implications of NPLs

This figure illustrates the catastrophic effect of NPLs in a bank-centered financial system. Having such a system, Bangladesh needs to study the condition of NPLs on a routine basis in order to augment investible capital in the productive sectors as well as to ensure sustainable economic growth.

The issue of nonperforming loans in Bangladesh is not a new phenomenon. In fact, the seeds were cultivated during the early stage of the liberation period (1972-1981), by the government's "expansion of credit" policies on the one hand and a feeble and infirm banking infrastructure combined with an unskilled work force on the other (Islam et al., 1999). Moral et al. (2000) argue that the expansion of credit policy during the early stage of liberation, which was directed to disbursement of credit on relatively easier terms, did actually expand

[1] If NPLs are not properly addressed, bad borrowers can create a negative psychological impact on good borrowers to prolong their payments. This situation becomes worse in an economy where enforcement status of laws is seen as very weak.

credit in the economy on nominal terms. However, it also generated a large number of willful defaulters in the background who, later on, diminished the financial health of banks through the "sick industry syndrome".[2] Islam et al. (1999) add that despite the liberalizing and privatizing of the banking sectors in the 1980s with a view to increasing efficiency and competition, the robustness of the credit environment deteriorated further because of the lack of effective lenders' recourse on borrowers. Choudhury et al. (1999) find that Government direction towards nationalized commercial banks to lend to unprofitable state owned enterprises, limited policy guidelines (banks were allowed to classify their assets at their own judgments) regarding "loan classification and provisioning"[3], and the use of accrual policies of accounting for recording interest income of NPLs resulted in malignment of the credit discipline of the country till the end of 1989.

In the 1990s, however, a broad based financial measure was undertaken in the name of FSRP[4], enlisting the help of World Bank to restore financial discipline to the country. Since then, the banking sector has adopted "prudential norms" for loan classification and provisioning. Other laws, regulations and instruments such as loan ledger account, lending risk analysis manual, performance planning system, interest rate deregulation, the Money Loan Court Act 1990 have also been enacted to promote sound, robust and resilient banking practice. Surprisingly, even after so many measures, the banking system of Bangladesh is yet to free itself from the grip of the NPL debacle. The question thus arises, what are the reasons behind such a large proportion of nonperforming loans in the economy of Bangladesh? Is it because of "flexibility in defining NPLs" or lack of effective "recovery strategies" on the part of the banks? Alternatively, is it due to poor enforcement status of laws related to nonperforming loans? The present study has concentrated on the above issues mainly with a view to assisting policymakers to formulate concrete measures regarding sound management of NPLs in Bangladesh.

2.8 Base for Provisioning and Accounting Treatment of NPLs:

2.8.1 Base for Provision:

For eligible collaterals of the following types, provision will be maintained at the stated rates on the outstanding balance of the classified loans less the amount of Interest Suspense and the value of eligible collateral:

a. Deposit with the same bank under lien against the loan,

b. Government bond/savings certificate under lien,

c. Guarantee given by Government or Bangladesh Bank.

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[2] This phenomenon was observed in the mid-1980s. This is not a sunset industry but created by borrowers willfully.

[3] Loan classification refers to the process banks use to review their loan portfolios and assign loans to categories or grades based on the perceived risk and other relevant characteristics of the loans (Finance Forum, 2002). Provisioning is a method that banks use to set aside funds against possible loan loss.

[4] Financial sector reform project (FSRP) was launched under financial sector adjustment credit of the World Bank in early 1990s.

For all other eligible collaterals, the provision will be maintained at the stated rates on the balance calculated as the greater of the following two amounts:
i. outstanding balance of the classified loan less the amount of Interest Suspense and the value of eligible collateral; and
ii. 15% of the outstanding balance of the loan.

2.8.2 Accounting of the Interest of Classified Loans:

If any loan or advance is classified as 'Sub-standard' and 'Doubtful', interest accrued on such loan will be credited to Interest Suspense Account, instead of crediting the same to Income Account. In case of rescheduled loans the unrealized interest, if any, will be credited to Interest Suspense Account, instead of crediting the same to Income Account.

As soon as any loan or advance is classified as 'Bad/Loss', charging of interest in the same account will cease. In case of filing a law-suit for recovery of such loan, interest for the period till filing of the suit can be charged in the loan account in order to file the same for the amount of principal plus interest. But interest thus charged in the loan account has to be preserved in the 'Interest Suspense' account. If any interest is charged on any 'Bad/Loss' account for any other special reason, the same will be preserved in the 'Interest Suspense' account. If classified loan or part of it is recovered i.e., real deposit is effected in the loan account, first the interest charged and accrued but not charged is to be recovered from the said deposit and the principal to be adjusted afterwards.

“Making provision stemmed from the credit transactions such as credit sales. Sales on any basis other than for cash make possible the subsequent failure to collect the account. An uncollectable account receivable is a loss of revenue that requires, through proper entry in the accounts, a decrease in the asset accounts receivable and related decrease in income and stockholders’ equity. Recording the bad debt expense recognizes the loss in revenue and the decrease in income. Of the two methods of recording uncollectible accounts receivable, the allowances method is appropriate in situation where it is probable that an asset has been impaired and that the amount of the loss can be reasonably estimated since the collectability of receivables is considered a loss contingency. A receivable is a prospective cash inflow, and the probability of its collection must be considered in valuing this inflow (Kieso et al, 2001).”

On the other hand, an uncollectable loan/advance for the banking business is not only a loss of revenue, but also a loss of capital. The uncollectible interest receivable is the loss of revenue and the uncollectable principal is the loss of capital. An analogy between the uncollectable account receivable and the uncollectable interest can be drawn as:

Sales price= Cost+ Mark up fir risk premium and profit expectation (spread)

So, the provision against the interest receivable can be treated as a normal business expense since it reflects the probable loss of revenue. The conflict may arise that the nature of banking business is different from the nature of other business and banks are not utilizing the capital directly to generate revenue-generating goods whereas other business do. But the banks take the collateral against the loans and advances mainly to create pressure for timely repayment of loans and advances. From this it is evident that the loss of a capital is the fault of either of the legal system or of the political system of management system but neither of the shareholders nor the depositors. Under protectionist banking systems like Bangladesh there is less chance that the depositors will be deprived in case of a bank failure. So, the loss is of the owners (shareholders).

Now a day the bank managers of Bangladesh deduct the amount of interest suspended and the value of "eligible securities"[5] from the outstanding amount in order to determine the base for provisioning to NPLs. For unclassified loans, however, they keep a general provision (1%) against the outstanding amount and include it in the capital to determine the capital adequacy of the bank (at present 9%). With regard to income recognition, as the banking sector follows IAS 30[6] for preparing financial statements, bank managers do not consider the amount of interest on substandard and doubtful loans as income for the bank, but rather keep it separately in an "interest suspense account". However, if any amount is received against sub-standard and doubtful loans, the said amount is deducted from the total interest suspense amount. In the case of a bad/loss loan, the interest on such loan is also kept in the interest suspense account if a suit is filed in the court. Seemingly, with regard to substandard and doubtful loans, this interest is also excluded from the income of the bank. These accounting measures have made the banking sector more transparent and credible than they were in the past.

[5] Eligible securities include certificate of deposits, gold and gold ornaments, government bonds / savings certificates, easily marketable goods and land & buildings.

[6] IAS stands for International Accounting Standard. IAS 30 deals with the preparation of the bank's financial statement. Bangladesh adopted this standard in 2000.

Chapter- Three
Trend of the Loan Default Problem in Bangladesh

3.1 Nature of the Problem:

The basic function of commercial banks is financial intermediation between savers and borrowers. Banks are financial intermediaries that mobilize funds from surplus economic units and allocate those funds to deficit economic units. Bank mobilizes fund mainly through collecting deposits and allocate those funds by providing loans. Bank credit is the principal sources of loanable fund for millions of households and the government. Agricultural, commercial, and industrial activities of a nation are often financed by bank credit. Without adequate financing there can be no growth or maintenance of stable output. Thus, the bank credit influences total macroeconomic environment by affecting money supply, investment, total output, and employment.

This process is an ongoing one that begins when a loan application is made and screened (origination) and continues until the loan is repaid. As unpaid loans are incomplete transactions for lenders this incomplete transaction will not add any value rather destroy it. And this unpaid or default loan causes constraints on the process of economic development.

3.2 Emergence of Default Loans:

As banking remains the main intermediary vehicle of harnessing investible capital for accelerating the growth of the productive sectors in Bangladesh, the continuing crisis of accumulation of non-performing and defaulted bank loans has emerged as one of the most serious constraints in the path of economic development of our country. Now we will discuss how the loan default problem has emerged in our country by year wise.

3.3 Pre Liberation Periods:

Before the liberalization of Bangladesh , the economic development policies of Pakistan was centered around growth –oriented ‘modernization paradigm ’,wherein industrialization was assigned the top priority in the allocation of investible funds from the institutional credit sources in the name of providing employment to the vast multitude of the so-called ‘disguisedly unemployed labour force ’.This attempt of development of an industrial entrepreneurial class in Pakistan miserably failed to provide adequate quantum of formal industrial employment even in West Pakistan. This is regarded as one of the main factors behind the rapid growth of ‘’regional economic disparity’’ between the two Pakistan. Then banking was blamed as a principal mechanism of siphoning –off capital from the East Pakistan and, therefore, nationalization of the banks and insurance companies, became one of the most popular issues in the election manifesto of the Awami League during the 1970 election of Pakistan.

3.4 Post Liberation Period:

After the liberation of Bangladesh, the Awami League Government's decision to nationalize the banks and insurance companies operating in Bangladesh should be considered a logical step but the task of re-organization of the nationalized banks in the chaotic, war-ravaged and crisis-ridden post-liberation years and a very rapid expansion of banking network in rural Bangladesh created some problems for the banking sector. There was no time after nationalization as the most corrupt, indisciplined, overmanned, and mismanaged concerns mired in a sea of recurrent losses in the backdrop of the political and administrative inexperience of the post liberation regime.

In this scenario, the nationalized banks were involved in two sorts of pressure situations, firstly, the almost insatiable demand for credit from the loss making state-owned enterprises kept the banks under constant pressure due to a shortage of adequate liquidity and secondly the newly emerging so called "briefcase business man" with connection with politics and politicians, top bureaucrats and top bankers, and retired military and civil bureaucrats were constantly lobbing for access to bank credit and in the process were vitiating the work atmosphere in the banks by alluring a section of the bankers to indulge in corruption and malpractices. It is now widely recognized that today's millionaires of Bangladesh came mostly from the Ranks of those "briefcase business man" and the groups mentioned, who could successfully establish and maintain this types of patron client relationship with the bankers and in the process created a host of millionaires from amongst those bankers themselves, who had actively connived and harvested the illicit margins in exchange of the favours rationed out to those fortunate loanees.

The political changes of 1975 ushered in an era of political culture, where in corruption gradually became institutionalized, the economics of rent seeking took firm roots in the body politic of Bangladesh. In the process, sanctioning of bank loans became one of the prime victims of the buying and selling process afflicting the political party affiliation process, and a popular mechanism for doling out financial favors to party leaders as well as political cadres. This politicization of the banking practices has seriously hampered the institutional disciplines of the banks, where professional expertise, integrity and ethical values have become exceptions to some extent rather than rules. Ex-bankers emerged as financiers as the newly floated private banks, but there was no mechanism to make them accountable or to know about the sources of their cash. Defaulters of bank loans taken from nationalized banks or state owned development finance institutions swelled the rank of directors of the newly established private banks, but nobody intervened on behalf of the loan-giving banks caught in the middle with defaulted loans. The laws, rules and regulations relating to banking remained mostly in the books; and the judicial process utterly failed to take the willful defaulters to task, thereby making the process of lender's recourse on borrowers almost a mockery in Bangladesh. Therefore, we surmise that behind all these malaises, the nature of the state and of politics played the real villainous role by patronizing and developing a class of 'comprador bourgeoisie' in Bangladesh, created, nursed and constantly nourished by state-patronage. And, in this nursing process, bank loans were rampantly used as lucrative doles.

In the eighties, the rapid liberalization of Bangladesh's import regime has created the so-called 'sick-industry syndrome', which provided a potent excuse for some, and created genuine hardships regarding repayment of bank loans for the others. The domestic industries have been bearing the burnt of this ill advisedly too rapid pace of liberalization of Bangladesh's international trade without appropriate preparatory policy measures. The political doldrums of the late-eighties provided additional excuses to these swelling groups of defaulters. The BNP government of 1991-96 tried to stem the rot in this field in the initial years of its term. They repeated the blunders of its predecessor of providing lavish encouragements to bank managements to ease and expedite the process of term lending, especially according to its own political exigencies at the later stages of its rule, which added a massive amount of fuel to the fire of the so-called 'default-culture'. And earlier lending sprees continues to haunt the banking sector even today by sustaining the momentum of the build-up of the defaulted loans of the earlier two decades.

3.5 The Present Status of Loan Default Culture in Bangladesh:

As loans comprise the most important asset as well as the primary source of earning for the banking financial institutions and on the other hand also the major source of risk for the bank management so a prudent bank management should always try to make an appropriate balance between its return and risk involved with the loan portfolio. But Banking sector's recent involving activities, guidelines and their concentration in that is not satisfactory.

The prudential guidelines also call for making adequate "provisions" against classified loans in order to protect the financial health of the banks are prepared but which is meaningless as by making provision the number of willful defaulters are increasing day by day. The economic implications of the non-performing / default loans are not only stoppage of creating new loans but also the erosion of banks profitability, liquidity and solvency, which might sometimes leader towards collapse of the banking financial system. It has, therefore, become sine qua non for policy makers to study the loan default scenario of the banking sector of a routine basis for estimating classified loan, making appropriate provisioning, adopting effective recovery strategy and thus ensuring soundness and efficiency of the banking sector.

Before privatization and liberalization this banking activities were thus directed to disburse credit, according to the Government's economic priority, and hence little attention was placed to identify the problem loans and making provisions thereon, although there was a significant amount of hidden default loans. After 1982, the banking sector of Bangladesh underwent a rapid denationalization and privatization process. The out of six nationalized commercial bank (Uttara Bank and Pubali Bank) were denationalized in 1983 and 1984 respectively with a view to increasing the efficiency of the banking sector. Henceforward, private banks were allowed to conduct banking operations (banking sector books 60 private banks having 628 branches, and 7 foreign banks having 14 branches at the end of 1984) in order to increase, competition, reasons, the efficiency and productivity of the banking sector. But due to various reasons, the efficiency of the banking sector did not increase rather the credit discipline was further eroded.

The most important aspect of this study is to measure the magnitude of loans classified substandard, doubtful and bad/loss since the adoption of criteria for overdue loan classification in 1990. In connection to this, it must be mentioned that the banking system in Bangladesh (as of December, 2011) comprises four types of scheduled banks – 4 State commercial banks (SCBs), 5 government-owned development financial institutions (DFIs), 30 private commercial banks (PCBs) and 10 foreign commercial banks (FCBs) – for catering to the credit needs of the economy. Therefore, data on classified loans in both the banking sector as a whole and in different clusters of banks are taken into account to gain a clearer picture of the NPL issue.

Chapter- Four
Loan default status of commercial Banks

4.1 Bangladesh Bank's Guidelines as per Latest BRPD Circular for Loan Classification

In order to get rid of default loans and to protect the bank capital from this engulfing crisis the government also formed a committee in 1986 in the name of National Commission on Money, Banking and Credit for providing suggestions on non-performing loans so as to improve the efficiency of the banking system. The Word Bank also, at this time started making an in-depth study on the financial sector of Bangladesh.

Regarding the default loans, Bangladesh Bank, however, asked the commercial banks to use their own subjective criteria for the identification of problem loans and to maintain provisions against it. Therefore, it appears that the banking sector as a whole simply neglected the identification of problem assets as well as maintenance of proper provision on it. At that time banking community used to believe that they would be able to realize the time bared loans in full after selling the security kept against it. And as such, they used to deem accrued interest on the non-performing loans as their income following the accrual principles of accounting. Hence, both the profit and loss account and the balance sheet did not reflect thee actual position and both dividend and taxes were paid from the overstated income. This practice seriously eroded the capital bases of the banks till the end of 1989, as before that there were hardly any policy guidelines by the central bank regarding classification of loans and maintenance of provisions against it. Of course, there was also an absence of appropriate laws relating to recovery of default loans.

In order to curb continuing financial distress and to arrest increasing growth of default loans, Bangladesh Bank formally introduced BCD Circular No-34 on November 16, 1989 on loan classification and making provisions thereof. The circular states that henceforth the banks themselves will carry out the classifications of their loans at least once in a year on the basis of the position existing on December 31 (annual closing date) in accordance with the guidelines given in the **BRPD Circular No. 07 on June 14, 2012: Loan Classification and Provisioning**. It also states that except for agricultural short-term loans, all loans are to be classified as either classified' or unclassified'. Classified loans are to be considered as those loans that have a reduced chance of repayment and are to be further classified as substandard, doubtful and bad/ losses. It further states that the bank will use both overdue and qualitative judgment criteria to deem a loan classified or unclassified.

We know proper assessment of the probable losses o revenue is required to make proper provision and to determine the net realizable asset position: "There is always a requirement for banks to systematically and realistically identify their problem assets and provide adequate reserves for possible losses. To accomplish this, Bangladesh Bank issued guidelines in 1989 (vide BCD Circular No. 34, dated 16.11.89) regarding classification and provisioning procedure. Subsequently, a revised policy as introduced in 1994 (vide circular No.20, dated 27.12.94) to be implemented by banks in five phases commencing 31st December 1994. The introduction of this program as aimed at bringing loan loss provisioning and classification in line with international standards by the end of 1998. Prior to 1989, there were no clear cut policy guidelines to enforce adequate provision by the banks. In the majority of cases, banks simply did not identify problem assets, establish realistic provisions for potential losses or suspend interest on non-performing assets. As a result, the balance sheet did not reflect the banks actual condition and the income statement overstated profits upon which dividends and taxes were paid. However, during the mid-eighties a norm was fixed by Central Bank to raise the level of provisions by 0.5% of the total loans each year till it reached 4%. Obviously, it had no relation to loans classified. Interestingly, the banks on the whole did not comply with this requirement. The situation ultimately led to unreasonable developments regarding keeping of provisions by the banks (Choudhury et al, 1997, pp.43-44)".

It implies that the Central Bank policy of raising provision does not cover the fluctuation in classified loan. Besides the commercial bank on the whole did not comply with this requirement may be due to luck of Central Bank supervision, lack of sufficient profit before provision and taxes. This expanse of the borrowers is the interest against the loans and advances. For sometimes it is an unavoidable issue that banks charge higher interest rate that become difficult for the borrowers to repay and the banks (specially the PCBs) defend themselves by saying that they have to pay a higher rate against deposits and borrowings, and they have to add a higher proportion for risk, which actually results from their anticipation of loan loss. Whatever might b e the attack and counter attack, on principle the bank can lose at most a portion of the interest since interest is the additional amount the borrowers are paying to the banks for the services they are getting from the banks. How far the reduction of interest spread, that is, the difference between the interest received and the interest paid will improve the present bad loan situation is not certain because willful defaulters are indifferent to such steps.

4.2 Current Loan Classification and Provisioning System as per Latest BRPD Circular in Bangladesh:

Since 1989, Bangladesh follows both "overdue criteria" and "qualitative criteria" to deem a loan classified or unclassified. According to overdue criteria, as suggested by Bangladesh Bank, bank managers usually divide all loans into five categories (continuous loan, demand loan, term loan payable within five years, term loan payable in more than five years and short-term agricultural credit / micro credit), and then observe periods elapsed for repayments. All troubled loans are then further reclassified as special mention account (SMA)[7], substandard, doubtful and bad/losses to comply with international norms of loan

[7] The special mention account (SMA) classification was introduced in Bangladesh from the beginning of the year 2006.

classification. Further, in order to keep the management up to date about the status of loans, bank managers review the loan quality on a quarterly basis. With some exceptions, the banking sector at present follows a norm of six months overdue for deeming a loan nonperforming. The rate of provision on classified loans follows norms of 5%, 20%, 50% and 100% against special mention accounts, substandard, doubtful, and bad/loss loans respectively. The current loan classification and provisioning system (in a summary form) in use in Bangladesh is shown below in table 2.

Table 2: Current loan classification and provisioning system as per latest BRPD in Bangladesh

Type of Loan	Period overdue	Status of classification	Rate of provision
Continuous Loan (OD/CC, PC, LIM, LTR etc.). Overdue period will be counted from the day following the date of expiry of such loan.	➢ Less than 6 months ➢ 3 months or more but less than 6 months ➢ 6 months or more but less than 9 months ➢ 9 months or more but less than 12 months ➢ More than 12 months	Unclassified SMA Sub-standard Doubtful Bad/Loss	1% (except SE&CF) 2% (for SE&CF) 5% 20% 50% 100%
Demand Loan (Forced LIM, BLC/ PAD, IBP, FBP etc.). Overdue period will be counted from the day following the date of expiry of such loan.	➢ Less than 6 months ➢ 3 months or more but less than 6 months ➢ 6 months or more but less than 9 months ➢ 9 months or more but less than 12 months ➢ More than 12 months	Unclassified SMA Sub-standard Doubtful Bad/Loss	1% (except SE&CF) 2% (for SE&CF) 5% 20% 50% 100%
Term Loan Payable Within 5 Years Overdue period will be counted from the day following the expiry of the due date of payment of installment of such loan.	➢ Less than 6 months ➢ If the default amount of installment is equal to or more than the installment payable in 3 months ➢ If the default amount of installment is equal to the installment payable in 6 months ➢ If the default amount of installment is equal to the	Unclassified SMA Sub-standard Doubtful	1% (except SE&CF) 2% (for SE&CF) 5% 20%

Type of Loan	Period overdue	Status of classification	Rate of provision
	installment payable in 12 months ➢ If the default amount of installment is equal to the installment payable in 18 months	Bad/Loss	50% 100%
Term Loan Payable in More Than 5 Years Overdue period will be counted from six (6) months following the expiry of the due date of payment of the installment of such loan	➢ If the overdue amount of installment is equal to or more than the installment payable in 3 months but less than 12 months. ➢ If the default amount of installment is equal to the installment payable in 12 months ➢ If the default amount of installment is equal to the installment payable in 18 months ➢ If the default amount of installment is equal to the installment payable in 24 months	SMA Sub-standard Doubtful Bad/Loss	5% 20% 50% 100%
STAC / Micro Credit Overdue period will be counted from six (6) months following the expiry of the due date of payment of the installment of such loan	➢ Less than 12 months ➢ 12 months or more but less than 36 months ➢ 36 months or more but less than 60 months ➢ More than 60 months	Unclassified Sub-standard Doubtful Bad/Loss	5% 5% 5% 100%

Source: Banking Regulation & Policy Department circular no. 8,15,7, 34, 16, 9 and 14. Financial Sector Review, (various year), Bangladesh Bank.

Note: SE & CF: Small Enterprise and Consumer Financing.

According to the qualitative judgment criteria, bank managers classify any loan if it forecasts the uncertainty of recovery of the loan due to the following reasons:

- Credit extended without approval of competent authority or without any logical basis (under pressure).
- Incomplete documentation.
- Insufficient security or drastic fall in the value of security.
- Borrower sustains heavy loss in capital due to natural calamity or business condition.
- Frequent overdraw of limit
- Rescheduling terms are not maintained.
- Borrower cannot be traced or death of the borrower.
- Filing a suit against the borrower for recovery of credit.

4.3 International Standard of Loan Classification and the Status of Bangladesh:

Being a member country of the World Bank, Bangladesh needs to compare its loan classification and provisioning system with the international standard. In order to facilitate the same, the standard international system of loan classification and provisioning is shown below in table 2.

Table 3: Loan classification system (international standard)

Period overdue	Status of classification	Rate of provision	Frequency of classification
Less than 3 months	Unclassified	1% - 5%	At least quarterly, usually monthly.
Loans overdue for 3 months but less than 6 months	Substandard	10% - 25%	
Loans overdue for 6 months but less than 9 months	Doubtful	50%-75%	
Loans overdue for 9 months or more	Bad/loss	100%	

Source: Studies in Bangladesh Banking: Series 1, Page 67.

In comparison to the international standard of loan classification and provisioning, it is found that the banking system of Bangladesh follows 4 stages (SMA, sub-standard, doubtful, bad and loss) to define the status of a classified loan, as opposed to three stages (sub-standard, doubtful, bad and loss) used in the international standard. While the international standard provides the norm of 3 months overdue for terming a loan substandard, this period is used in Bangladesh as the norm for terming a loan a "special mention account". In addition, Bangladesh shows more flexibility than the international standard in the classification of long-term loans. However, in the case of provisioning and frequency of classification, Bangladesh follows the international standard to a great extent. In the final analysis, it can be concluded that the present loan classification and provisioning system in use in Bangladesh is similar to a great extent to the international standard, although it is yet to adopt the international standard completely.

4.4 Trend of Growth of Total Loans and Classified Loans in Bangladesh:

Table 4: Trend of Growth of Total Loans and Total Classified Loans of all banks (1990-2011)

YEAR	TL	Growth Rate of TL	TCL (NPL)	Growth Rate of TCL
1990	177.12		46.21	
1991	185.6	4.787714544	46.54	0.71413114
1992	214.36	15.49568966	65.74	41.25483455
1993	244.28	13.95782795	85.16	29.54061454
1994	262.88	7.614213198	91.56	7.515265383
1995	310.29	18.0348448	99.42	8.584534731
1996	351	13.11998453	110.54	11.18487226

1997	462.27	31.7008547	173.32	56.79392075
1998	527.32	14.07186276	214.37	23.68451419
1999	580.83	10.1475385	238.79	11.39151934
2000	654.42	12.66980011	228.51	-4.305037899
2001	749.49	14.52736775	235.99	3.273379721
2002	851.73	13.64127607	238.57	1.093266664
2003	914.9	7.416669602	203.2	-14.82583728
2004	1079.71	18.0139906	190.03	-6.481299213
2005	1292.51	19.70899593	175.14	-7.835604904
2006	1528.58	18.26446217	200.98	14.75391116
2007	1710.44	11.89731646	226.2	12.54851229
2008	2108.9	23.29576016	224.8	-0.618921309
2009	2439.8	15.69064441	224.82	0.008896797
2010	3110.96	27.5088122	227.1	1.014144649
2011	3699.01	18.90252527	243.8	7.353588727

Source: Banking Regulation & Policy Department, Bangladesh Bank; Annual Reports of Bangladesh Bank, (various years)

on:
TL=Total loans (Taka in billions)
TCL=Total classified loans (Taka in billions)

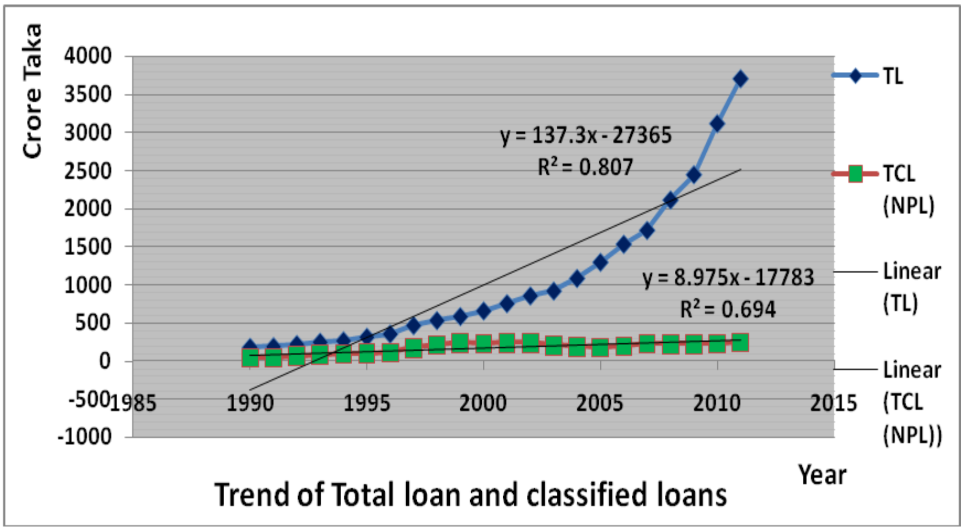

Chart 1: Trend of total loan and classified loans as a whole represents that banking sector, 1990-2011

Total loans, total classified loan and growth of classified loan for all banks from 1990 to 2011. The trend of total loans and total classified loan and trend of growth of total loan and classified loan for all banking system in Bangladesh has shown a sliding downtrend since the year 2000. The growth of total loan 15.49% in 1992, 18.03% in 1995, 12.66% in 2000, 19.70% in 2005 and 18.90% in 2011, that is, shown before 2000 downward trend of growth of total loan and after 2000 steady state trend of growth of total loan. The growth of total classified loan 41.25% in 1992, 8.5% in 1995, -4.3% in 2000, -7.83% in 2005 and 7.3% in 2011, that is, shown before 2005 drastically downward trend of growth of total classified loan and after 2005 upward trend of growth of total classified loan at table 4.

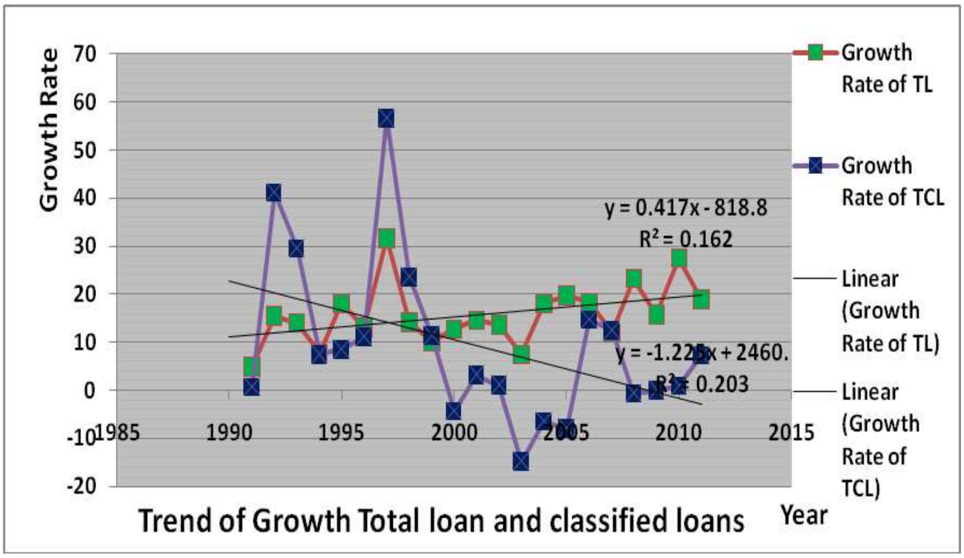

Chart 2: Trend of growth of total loan and classified loans, as a whole represents that banking sector is growth of classified loan, though a slight improvement has been observed 1990-2011.

4.5 Present Status of Default Loans in Bangladesh:

Status of total loans, total NPLs and NPLs as a percentage of total loans for all banks from1990 to 2011. The ratio of NPLs to total loans in the banking system in Bangladesh has shown a sliding downtrend since the year 2000. After increasing steadily from 26.09% in 1990 to a peak of 41.11% in 1999, the ratio of NPLs to total loans fell to 31.49% in the year 2000, 13.56% in 2005 and 6.59% in 2011 shown in table 5.

Table 5: Status of Total Loan and Total Classified Loans: sub-standard, doubtful and bad/loss loans of all banks (1990-2011)

YEAR	TL (Taka in billion)	TCL (Taka in billion)	CL as % of TL	SL as % of TCL	DL as % of TCL	BL as % of TCL
1990	177.12	46.21	26.09	N.A	N.A	N.A
1991	185.6	46.54	25	N.A	N.A	N.A
1992	214.36	65.74	30.67	N.A	N.A	N.A
1993	244.28	85.16	34.86	N.A	N.A	N.A
1994	262.88	91.56	34.85	19.22	17.6	63.19
1995	310.29	99.42	32.04	13.08	12.36	74.56
1996	351.0	110.54	31.49	13.42	12.27	74.31
1997	462.27	173.32	37.49	7.88	11.7	80.42
1998	527.32	214.37	40.65	4.26	7.21	88.53
1999	580.83	238.79	41.11	5.26	8.27	86.47

2000	654.42	228.51	34.91	4.82	6.33	88.57
2001	749.49	235.99	31.49	7.93	5.48	86.6
2002	851.73	238.57	28.01	8.56	5.09	86.35
2003	914.9	203.2	22.1	10.24	8.75	80.97
2004	1079.71	190.03	17.6	7.2	6.6	86.19
2005	1292.51	175.14	13.56	8.66	6.96	84.37
2006	1528.58	200.98	13.14	13.13	7.15	79.72
2007	1710.44	226.2	13.2	9.75	7.51	82.74
2008	2108.9	224.8	10.8	9.43	9.42	81.14
2009	2439.8	224.82	9.2	12.24	8.35	79.41
2010	3110.96	227.1	7.3	13.44	8.44	78.11
2011	3699.01	243.8	6.59	14.43	9.08	82.61

Source: Banking Regulation & Policy Department, Bangladesh Bank; Annual Reports of Bangladesh Bank, (various years)

Notations:

TL=Total loans (Taka in billions)
TCL=Total classified loans (Taka in billions)
CL=Classified loans as % of total loans
SL=Sub-standard loan as % of TCL
DL=Doubtful loans as % of TCL
BL=Bad/loss loans as % of TCL

In contrast, the sub-standard loan as a percentage of total NPLs increased by 1.4% in 2005 as compared to 2004, marking the end of a declining trend since 1997, with the exception of the year 2003, but again upward trend from 2008 to 2011 as 14.43%. However, in the case of doubtful loans, a longer declining trend has observed since the adoption of prudential norms in 1990, except in the years 2003 and 2005, but again upward trend from 2008 to 2011 as 9.08% shown in table 5.

In 2005, doubtful loans increased by 0.36% as opposed to 6.6% in 2004 and now 9.08 in 2011. A more alarming picture is observed in the case of bad/loss loans, which account for more than 80% of NPLs since the year 1997 but in 2011, 82.61%. Unfortunately, this trend has not shown any improvement over the period 1990 to 2011. NPLs still account for 6.59% of all loans in Bangladesh. This staggering rate of bad loans in fact reflects the incapability of the banking sector to arrest the growth of NPLs, although an encouraging trend of declining NPLs has been noticed recently.

The loan classification and provisioning system have already been discussed and it is found that they are followed different overdue and qualitative judgment criteria for giving the various statuses to a non-performing loan. Therefore, it is very difficult to make a uniform status about the status of the non-performing loans .The status of all types of NPL have been presented here, and data on classified loans of the banking sector of Bangladesh are shown in the Tables 5.

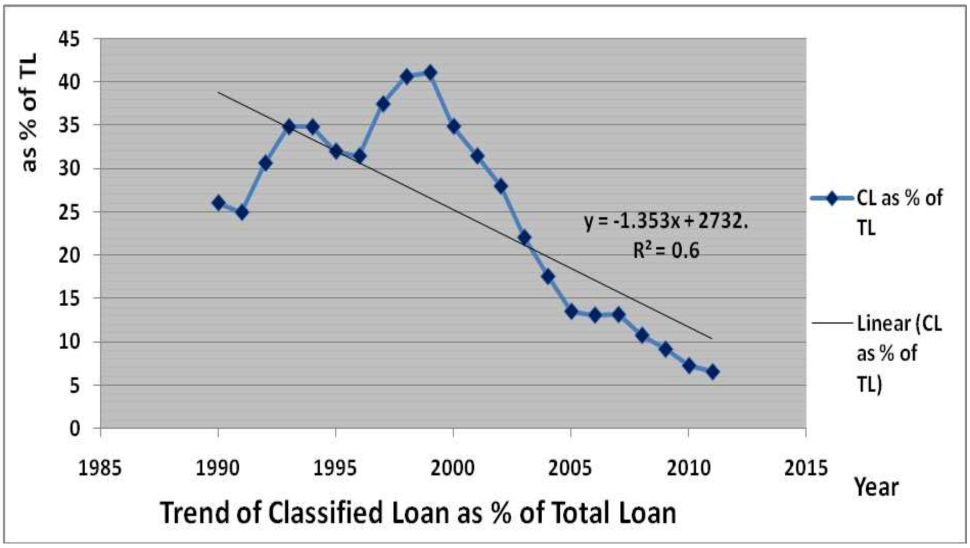

Chart 3: Trend of classified loans as a percentage of total loans of all banks, 1990-2011

4.6 Present Status of Nonperforming Loans for Different Types of Banks in Bangladesh:

An analysis of the aggregate NPLs in clusters of banks and types of loans in 1999 indicates that the highest ratio of NPLs is in the category of loans of SCBs (45.62%) and DFIs (65.02%). This is followed by term loans over a maturity of 5 years (42.68%) for DFIs and (25.3%) for SCBs in 2004. However, in the case of continuous loans and demand loans, SCBs and DFIs have the largest ratios of NPLs (14.01% and 21.8% respectively) among the bank clusters in December 2011 (table 6). Therefore, it can be concluded that non-performing loans in the sector of micro and agricultural loans, as well as term loans of SCBs and DFIs, are aggravating the NPL situation of Bangladesh.

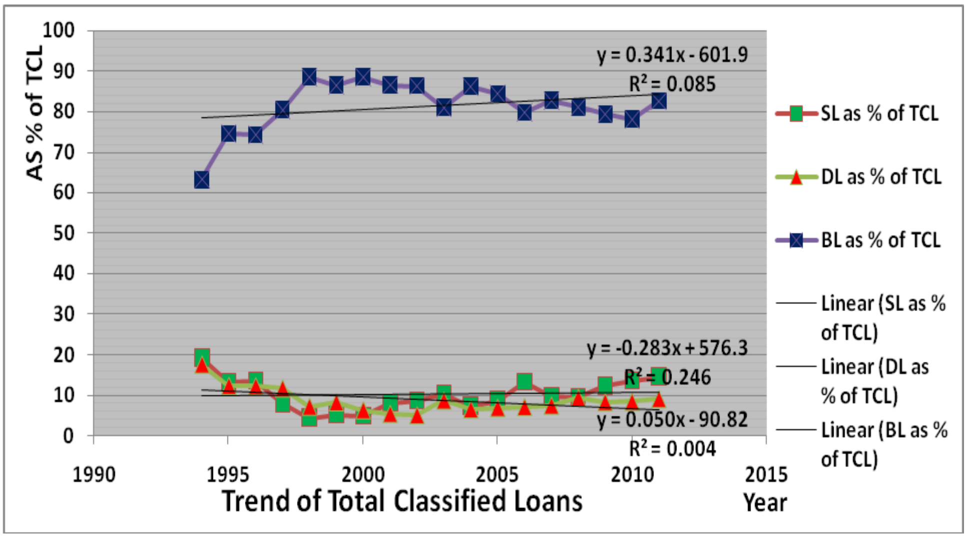

Chart 4: Trend of classified loans: SL, DL and BL as a percentage of total loans of all banks, 1990-2011

It is evident that in 2011, the growth rate of advances is the highest in SCBs (14.1%), followed by FCBs (3.1%). Prior to 2011, however, PCBs played a leading role for a number of years (Table 6). SCBs also show an increasing trend in advances since 1999, whilst DFIs show a declining rate of growth, except for the years 2001 and 2011. In order to compare the growth rate of classified loans to the growth rate of advances, it is observed that the growth rate of classified loans of SCBs up to the year 1999 was higher than the growth rate of advances, with the exception of a few cases. However, after 1999, a declining trend is found for all clusters of banks, PCBs, FCBs and DFIs, except in a few cases (table 6). Presently in 2011, the growth rate of classified loans is found to be lower than the growth rate of advances for all clusters of banks in general and in total. Therefore, it can be said that the banks belonging to different clusters have made progress with respect to the arrest of classified loans since the year 2000.

Table 6: Trend of nonperforming loans as a percentage of total loans for different clusters of banks (1990-2011)

Year	SCBs	PCBs	FCBs	DFIs
1990	27.59	23.73	20.65	NA
1991	26.3	34.2	11.87	NA
1992	31.86	31.1	12.64	NA
1993	32.23	44.42	10.46	NA
1994	32.12	44.53	8.89	NA
1995	31	39.43	5.4	NA
1996	32.55	34.77	4.72	NA
1997	36.57	31.42	3.58	65.72
1998	40.38	32.72	4.14	66.7
1999	45.62	27.09	3.8	65.02
2000	38.56	22.01	3.38	62.56
2001	37.02	16.98	3.32	61.8
2002	33.73	16.38	2.61	56.19
2003	29	12.4	2.7	47.4
2004	25.3	8.5	1.3	42.8
2005	21.35	5.62	1.26	34.87
2006	22.94	5.54	0.81	33.68
2007	29.9	5	1.4	28.6
2008	25.4	4.4	1.9	25.5
2009	21.4	3.9	2.3	25.9
2010	15.7	3.2	3	24.2
2011	14.1	3.5	3.1	21.8

Source: Banking Regulation & Policy Department and annual report (various years) Bangladesh Bank.

With regard to the flow of classified loans, it is observed that among the new outstanding loans disbursed in the year 2001, the rate of classified loans on 31 December 2011 was much lower for all banks than in any periods. In the case of SCBs, the proportion of classified loans in relation to total loans disbursed in the year from 2000 to 2011 was gradually lower. However, the flow of NPLs for FCBs and DFIs has also shown a declining trend over the period 1990 to 2011, with some exceptions.

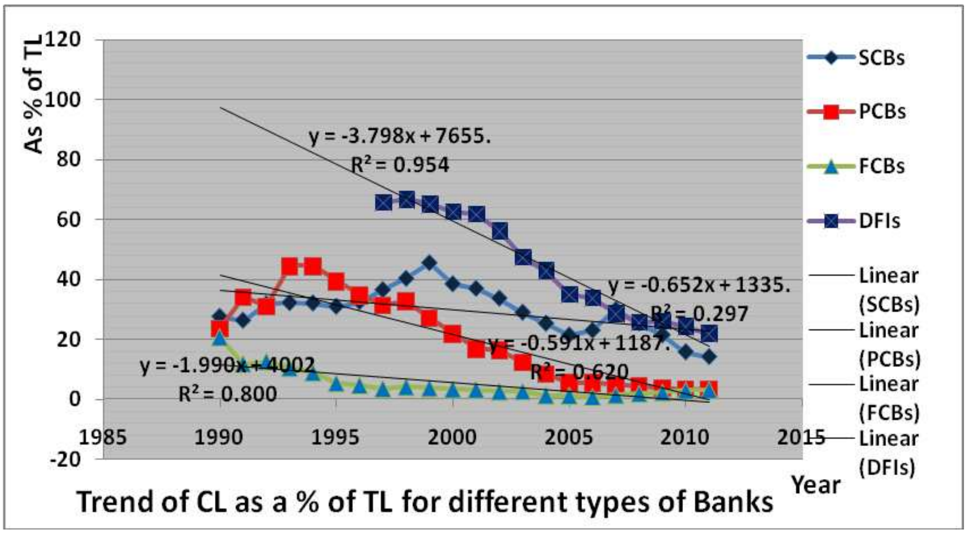

Chart 5: Trend of classified loans: SL, DL and BL as a percentage of total loans of all banks, 1990-2011

4.7 Provisioning Surplus / Shortfall:

One of the important aspects of the prudential norms of banking is the requirement of maintaining provisions against default loans. An analysis of the loan loss provisions of different clusters of banks reveals that each cluster of banks, excepting FCBs, has failed to book the required level of provisions since the adoption of prudential norms in 1990. At present 2011, the provisioning shortfall of SCBs is found to be 14.1% followed by PCBs at 3.5%. For both SCBs and PCBs, provisioning shortfalls have reached alarming levels in the last couple of years, although a slight improvement is observed in case of PCBs (table 7). This provisioning shortfall position depicts erosion of banks' capital, one of the inherent weaknesses of the banking system in Bangladesh.

Table 7: Status of provisioning surplus/ shortfall as a percentage of total required provision for all banks (2003-2011)

Year	NPL	RP	PM	E(+)/S(-)	PMR= PM/RP*100
2003	203.2	92.5	37.3	-55.2	40.3
2004	190.03	87.8	35.9	-51.9	40.9
2005	175.14	88.3	42.6	-45.7	48.2

2006	200.98	106.1	52.9	-53.2	49.9
2007	226.2	127.2	97.1	-30.1	76.3
2008	224.8	136.1	126.2	-9.9	92.7
2009	224.82	134.8	137.9	3.1	102.3
2010	227.1	149.2	142.3	-6.9	96.92
2011	243.8	158	152.3	-5.6	96.4

Source: Banking Regulation & Policy Department, Bangladesh Bank, 2003-2011

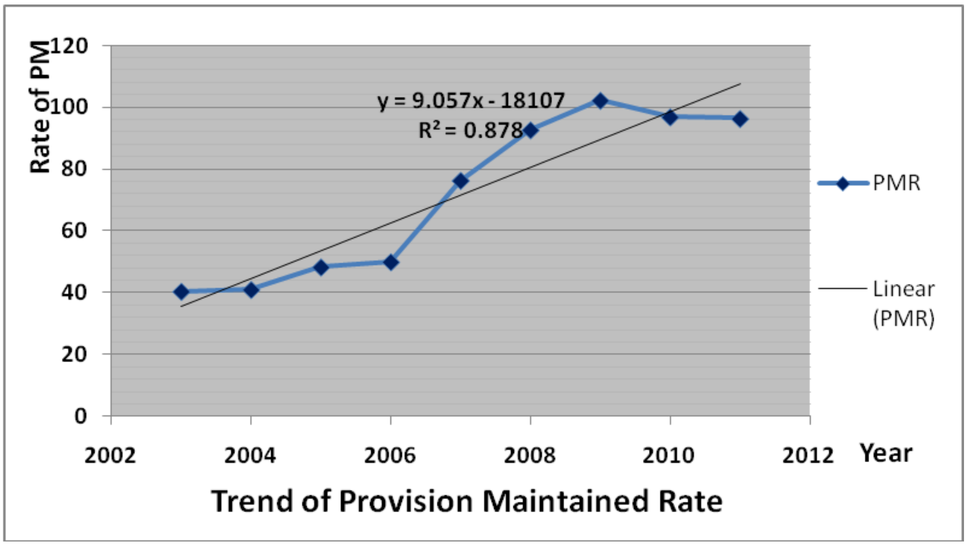

Chart 6: Trend of provisioning surplus/ shortfall as a percentage of total required provision for all banks, 2003-2011

Chart 6 shows that each cluster of banks, excepting FCBs, is having provisioning shortfall. In case of SCBs it is 14.1% while in case of PCBs and DFIs it is 3.5% and 21.8% respectively in the year 2011. Over the years, SCBs, PCBs, FCBs and DFIs are maintaining surplus provision.

Chapter- Five

Legal measures to recover the default loans

5.1 Enforcement Status of Laws Relating to the Default Loans in Bangladesh:

There is a famous maxim “justice delayed is justice denied”. This can be applied to banks, especially in developing countries like Bangladesh, owing to the presence of corruption and opaqueness in the settlement process as well as poor enforcement of laws that usually create a fertile ground for the willful defaulters. In the case of Bangladesh, although several laws have been enacted and amended with a view to ensuring the safety and soundness of the banking system, the banking sector still witnesses an alarming amount of NPLs. Therefore, it would be meaningful to measure the actual performance of different courts in terms of number of suits filed, rate of settlement and rate of recovery of NPLs over the years.

One aspect of the study in to evaluate the enforcement status of different lenders recourse related laws. In fact, Bangladesh has initiated legal reforms relating to banking since 1972. Since then, amendments have been made in some laws like Bangladesh Bank Order 1972, Bangladesh Banks (Nationalization) Order 1972, Negotiable Instruments Act 1881, etc. Again, some new laws with prudential regulations like Banking Companies Act 1991 and lenders recourse related laws like the Artha Rin Adalat Ain 2003 and the Bankruptcy Act 1997 have been enacted and amended further with an objective to ensuring the safety and soundness of the banking system. Therefore, it will meaningful to have a look at the performance of different courts in terms of number of suits filed, rate of settlement and rate of recovery over the years.

5.2 The Performance of Artha-Rin-Adalat:

The Artha Rin Adalat Act was enacted in 1990 to address separately all issues related to NPLs, with the objective of ensuring the safety and soundness of the banking system. An analysis of the performance of this court reveals that the number of suits filed, amounts claimed and number of settled suits have all increased considerably from 1991 to 2011 (table 8). It is also encouraging that the percentage of settled suits has increased considerably from 11.59% in 1991 to 37.71% in 2001, 46.36% in 2004 and 71.69% in end of 2011. Unfortunately, the recovery rate is seen to be very slow and is confined to 3.65% in 1991, 8.65% in 2001 and 19.00% in 2011, ultimately 3%-19% only during the last twenty years. Thus, the slow execution of the decrees in Bangladesh can be seen as the main factoring contributing to very low recovery of NPLs.

Table 8 (chart 8) shows the overall picture of suits filed and settled in the Artha Rin Adalat during 1991 to 2011. If we focus our attention to the bank group wise, it is observed that number of cases under trial is highest in the SCBs (33796), followed by DFIs (12758), PCBs (10542) and FCBs (179) in 2001 .Though DFIs and PCBs have nearly same number of cases under trial, the amount of suits under trial in PCBs is much higher than DFIs. In terms of settled cases, SCBs, DFIs and PCBs all are having almost equal percentage (about 43%) of cases settled while FCBs are far ahead of all other groups; the percentage of their settled cases is 70.39% as on June 30, 2000. The recovery of FCBs is much higher (44.30%) as compared to SCBs (8.10%) and PCBs (10.09%). As FCBs operate under the same legal framework for loan recovery their far better performance indicate the potential of attaining a more effective enforcement than what is so far achieved in regard to SCBs, DFIs and PCBs.

Table 8: Statement of Suits Filed and Settled in the Artha Rin Adalat

Year	No. of suits filed	Amount claimed (Tk. in Crore)	No. of settled suits	Amount recovered (Tk. in Crore)	% of settled suits	Recovery rate
1991	23010	1479.18	2667	54.06	11.59	3.65
1992	28524	2262.77	4418	85.12	15.49	3.76
1993	33961	2802.21	6144	127.2	18.09	4.54
1994	38995	3444.49	7854	181.82	20.14	5.28
1995	42789	4071.12	9726	237.5	22.73	5.83
1996	45777	4838.72	12647	313.94	27.63	6.49
1997	51802	5765.34	14862	387.21	28.69	6.72
1998	56304	6936.87	17181	492.6	30.51	7.1
1999	60190	8270.06	19857	575.37	32.99	6.96
2000	65569	9373.92	22025	717.72	33.59	7.66
2001	69014	10562.07	26024	934.62	37.71	8.85
2002	74073	11027.58	29834	1163.01	40.27	10.55
2003	79367	14185.37	35412	1398.16	44.61	9.86
2004	91491	20064.1	42417	1994.4	46.36	9.9
2005	94897	21756.8	49116	2380.7	51.75	10.94
2006	99000	24861.8	55908	2996.95	56.47	12.05
2007	102340	26577.4	61586	3426.9	60.18	12.89
2008	104832	29454.8	67336	4200	64.23	14.26
2009	108840	31814.9	72068	5081.6	66.21	15.97
2010	111348	35486.7	75513	5942.1	67.82	16.75
2011	114564	38423.2	82130	7300.8	71.69	19.001

Source: Banking Regulation & Policy Department, Bangladesh Bank; Annual Reports of Bangladesh Bank, (various years)

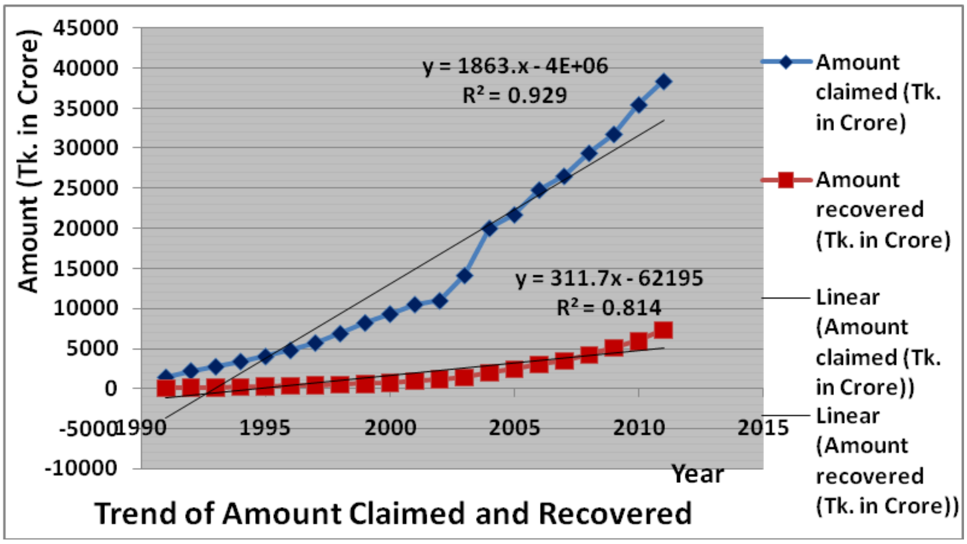

Chart 7: Trend of amount claimed and recovered for all banks, 1990-2011

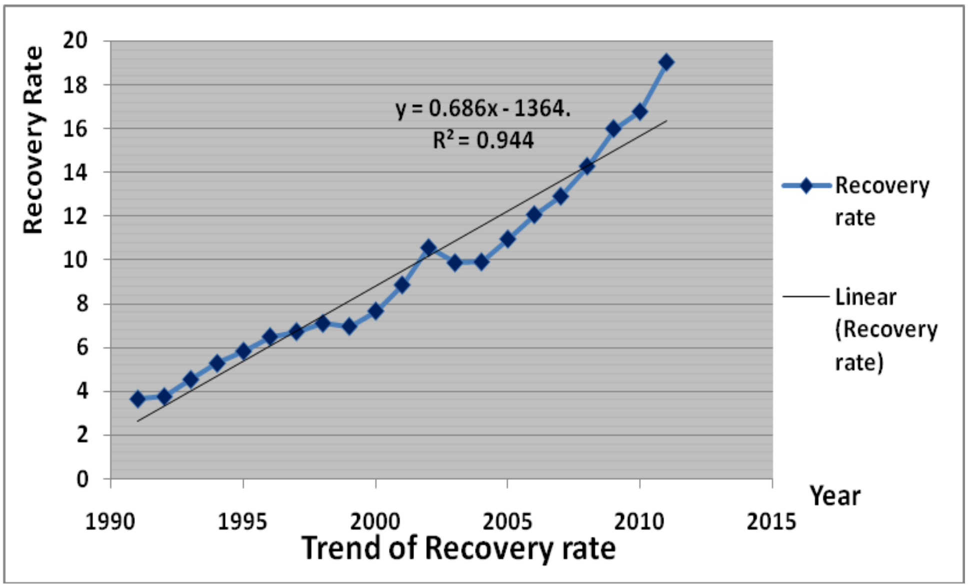

Chart 8: Trend of recovery for all banks, 1990-2011

5.3 The Performance of the Bankruptcy Act and the PDR Act:

The Bankruptcy Act of 1997 was formulated in order to assist the recovery environment and to enable speedy recovery of NPLs in Bangladesh. An analysis of the performance of the bankruptcy act June, 2011 shows that the recovery rate is only 12.96% against Tk. 2618.6 crore in 2005 in table 9. The recovery rate of cases settled through the PDR act June, 2011 is also seen to be unsatisfactory recovery rate 52.19% in table 10, although it trends shows positive inclined that is better performance than other courts.

Table 9: Status of Suits Filed and Settled in the Bankruptcy Act, as June 2011

Year	No. of suits filed	Amount claimed (Tk. in Crore)	No. of settled suits	Amount recovered (Tk. in Crore)	% of settled suits	Recovery rate
2005	443	2493.7	155	32.8	34.99	1.32
2006	451	2505.7	163	116.7	36.14	4.66
2007	456	2533.99	185	131.5	40.57	5.19
2008	467	2608.7	200	141.5	42.83	5.42
2009	469	2618.4	211	142.9	44.99	5.45
2010	481	2641.8	237	315.8	49.27	11.95
2011	485	2618.6	255	339.5	52.58	12.96

Source: BRPD and annual reports, Bangladesh Bank, 2011.

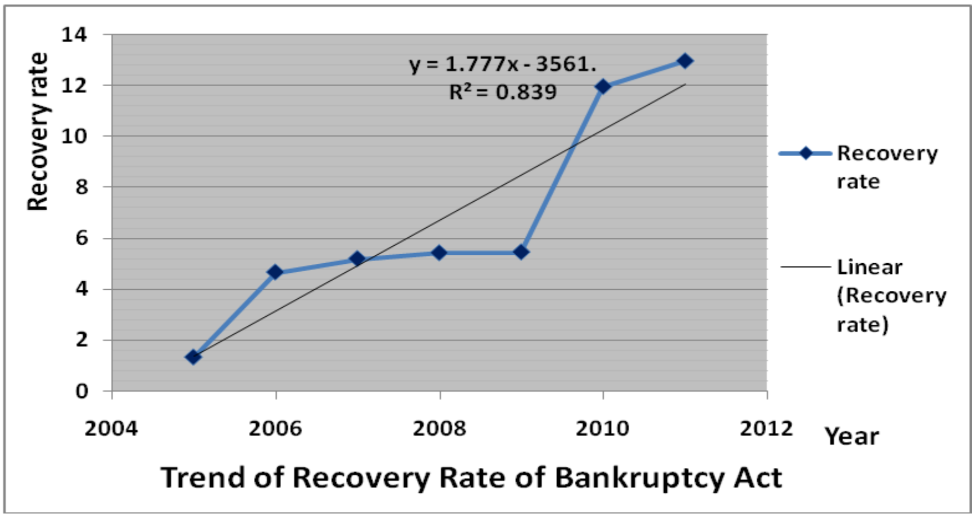

Chart 9: Trend of recovery rate of bankruptcy act, 2005-2011

Table 10: Status of Suits Filed and Settled in the PDR Act June 2011

Year	No. of suits filed	Amount claimed (Tk. in Crore)	No. of settled suits	Amount recovered (Tk. in Crore)	% of settled suits	Recovery rate
2005	651783	977.43	475300	476.77	72.95	48.78
2006	669688	1021.61	497763	517.71	74.33	50.67
2007	695350	1107.86	518571	564.53	74.58	50.97
2008	719500	1211.16	538945	605.80	74.90	50.01
2009	744709	1249.16	558127	639.15	74.94	51.17
2010	754364	1291.52	572662	688.59	75.91	53.32
2011	781760	1372.02	593817	716.08	75.96	52.19

Source: BRPD and annual reports, Bangladesh Bank, 2011

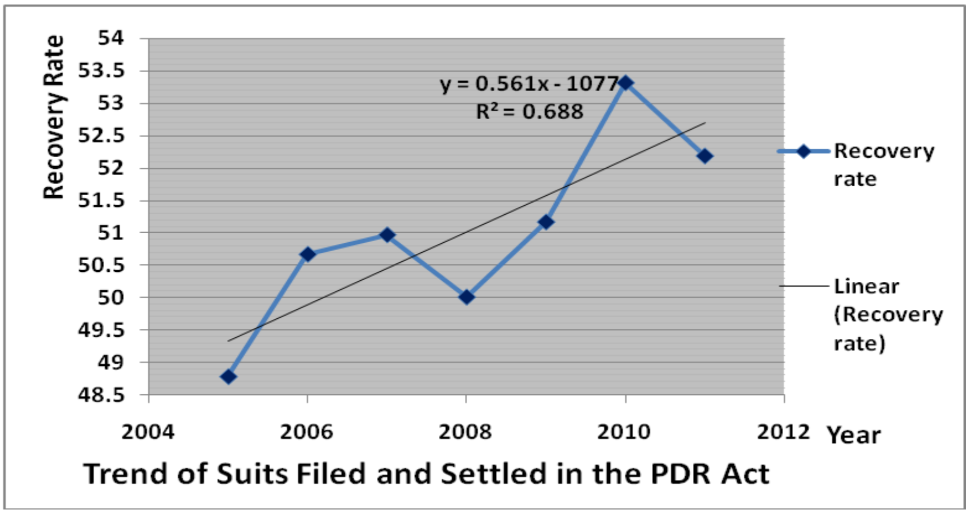

Chart 10: Trend of suits filed and settled in PDR act, 2005-2011

The main hindrance, therefore, relating to the recovery of default loans at this moment seems to be the poor enforcement status of laws and slow execution of decrees. In this connection, it must be mentioned that the law itself is not solely responsible for delay in settlement of cases related to NPLs; rather, a number of parties such as plaintiffs or complainants, defendants, lawyers and judges are also involved in the process.

5.4 Measures Adopted for Reduction of NPLs in Bangladesh:

Bangladesh has adopted many punitive measures to curb and recover nonperforming loans. Hence, it is important to discuss all these measures adopted for better policy framework and effective management of NPLs. The measures are summarized in table 11, below.

Table 11: Measures Adopted for reduction of NPLs in Bangladesh:

Name of Measure	NPL Management Guidelines
National Commission on Money Exchange and Credit, 1986	• Suggests administrative and judicial steps for overcoming problems of overdue loans of DFIs and NCBs. • Measures undertaken: setting of recovery targets for NCBs and DFIs, prohibiting defaulters from access to further credit, linking loan recovery measures with the central bank.

Name of Measure	NPL Management Guidelines
Financial Sector Reform Project (FSRP), 1990	• Suggests an overall improvement in the debt recovery environment. Enacts different laws and regulations for enabling speedy the settlement processes. • Measures undertaken: enacting a number of new laws, regulations and instruments[8] to improve the credit quality of the banking system; fixing targets for collection and resolution of legal cases for the hundred largest defaulters; publishing list of the hundred largest defaulters through different media.
Banking Reform Committee, 1996	• Suggests formulating a concrete "recovery policy" for the NCBs to address their huge NPLs and to verify the feasibility of forming one Asset Management Company (AMC) for resolving the problem of default loans. • Measures undertaken: formulating recovery cells and recovery camps in NCBs to speed up the process of recovery of default loans • Introduction of incentives to bank officials for the recovery of default loans.
Structural Adjustment Performance Review Initiative (SAPRI), 2000	• Focuses on improvement of the loan screening and monitoring standard of individual banks for curbing default loans. Also proposes wide economic deregulation in an environment of feeble and weak enforcement status of prudential laws and regulations relating to default loans. • Measures undertaken: improving the supervision and regulation of banks by the Bangladesh Bank. The government has also enacted the Money Loan Court Act 2003, and the Bank Company (Amendment) Act 2003 for quick settlement of filed cases relating to default loans. Directions were also given by Bangladesh Bank to all scheduled banks to maintain a "capital adequacy ratio" equal to 9% of risk weighted assets (RWA), with core capital equal to at least 4.5% of RWA. To protect depositors' interests, a provision has also been made to appoint two directors from the depositors by the central bank.

[8] **New Loan Laws and Regulations**

Screening	Monitoring	Transparency	Lenders recourse
i) LRA ii) CIB iii) Loans to Insiders and Connected Parties iv) Interest Rate Deregulation	i) NLLC ii) LLRS iii) PPS iv) Off-site Supervision	i) Loan Classification and Provisioning ii) Risk based Capital Adequacy	i) Money Loan Court Act, 1990 ii) Bankruptcy Act, 1997

Name of Measure	NPL Management Guidelines
Credit Risk Grading (CRG) Manual, 2005	• The credit risk grading system was made mandatory from the beginning of 2006 to analyze the borrowers' credit risk as well as to prevent fresh NPLs. In this codified system, if a borrower's risk falls within the range of 45-54 out of 100; he is not allowed to receive credit. Any borrower who has a score above the range of 45-54 is eligible to receive credits.
Credit Risk Grading (CRG) Manual, 2007	Bangladesh Bank vide its BRPD Circular No.18 dated December 11, 2005 advised all Banks to implement Credit Risk Grading for their borrowing clients as per Credit Risk Grading Manual. • If any credit facilities are extended to a Bank against 100% cash covered or near cash covered securities or covered by Government Guarantee or Guarantee by a top tier International Bank then the Credit Risk Grading should be Superior - 1(SUP-1) and in that case the CRG score sheet is not required. • Key Risk Parameters are to be evaluated and weighted very carefully, on the basis of most up-to date and reliable data and complete objectivity must be ensured to assign the correct grading.
Financial Stability Report, 2010	• Classified loans emanate from the deterioration in the quality of the loan portfolio which is expected to transpire due to the rapid credit expansion in recent years. However, the classified loans of the banking sector actually fell to 7.05 percent from 9.21 percent, a decrease by 2.16 percentage points as at end-2010 compared with end-2009. • The classified loans to total loans ratio has decreased to 7.05 percent in CY10 from 31.49 percent in CY01. Bad loans to total classified loans ratio decreased to 78.11 percent in CY10 from 88.53 percent in CY01, still it shows significant inferior asset quality of the banking sector.
Financial Stability Report, 2011	• Classified loans emanate from the deterioration in the quality of the loan portfolio which is expected to transpire due to the rapid credit expansion in recent years. However, the classified loans of the banking sector actually fell to 6.2 percent from 7.1 percent, a decrease by 0.9 percentage points as at end-2011 compared with end-2010. • The classified loans to total loans ratio has decreased to 6.2 percent in CY11 from 7.1 percent in CY10. Bad loans to total classified loans ratio decreased to 73.8 percent in CY11 from 86.1 percent in CY10, still it shows significant inferior asset quality of the banking sector.
Recent Reform Initiatives, 2012	• Banks desirous of financing the purchase of used vehicles shall prepare uniform guidelines for determining value of the

Name of Measure	NPL Management Guidelines
	used vehicles. However, the bank shall only finance the vehicles imported as described in the existing Import Policy Order. • Loan-margin ratio for fresh loans shall be maintained at 70:30 in case of house finance under consumer financing and 30:70 for all other consumer loans including motor car loans.
Other Measures	• Banks with net classified loans of up to five per cent are allowed to sanction a maximum of 56 percent of total loans and advances as “large loans". • Banks with net classified loans between five percent and ten percent are allowed to lend 52 percent of their portfolio as “large loans”. • Banks with net classified loans between 10 and 15 percent are allowed to lend up to 48 percent of their total loans as “large loans”. • Banks with net classified loans of 20 percent and more are allowed to lend a maximum of 44 percent of their total loans as “large loans”. • The Bangladesh Bank has also advised the banks pursue “syndicated loans” in case of large loan amounts. • An incentive package for bank officials of NCBs to speed up the recovery of default loans. NCB staff receives seven percent of the loan for helping the bank to recover any loan which remained unrealized for seven years or more and has already been labelled as a “bad debt”. In case of recovery of bad debts that remain unrealized for three to seven years, the staff would receive six percent of the amount, while they would receive five percent of the amount as incentive for realizing other bad loans. Besides, bank staff would get four percent in case of realization of “doubtful loans”. The incentives would be given on an yearly basis upon closure of a loan account. • “Habitual” defaulters are prohibited from getting any loan rescheduling facility. • Bangladesh Bank retains the right to check the transaction of a bank and to impose a penalty if it finds doubtful transactions and subsequently proves malpractice of the banks.

Chapter- Six

Identify the Causes and Remedies of non-performing loans

6.1 Causes of Loan Default Problem

A. Entrepreneurs Related:

A1: Young Age:

Young age is one of the reasons behind the failure of payment of regular loan. Because of young age people suffer from lack of business experience. On the other hand they normally don't have enough banking experience. As they are young and lack experience, it may be one of the reasons of default loan.

A2: Lack of Business Experience:

Sometimes people without prior business experience want to do something. It may so happen that after retirement from govt. or private service people want to establish a business which is not very relevant to his past experience. Besides his own equity they look for bank finance. Normally banks do not finance in the projects where the key personnel do not have enough background in that particular business. When banks finance in the projects where the key personnel lack relevant business experience, it becomes risky for the bank. Probability of failure in these sorts of projects tends to be higher.

A3: Lack of Business and Lack of Institutional Training Background:

Business experience is somehow related to business background. Here business background means family business background. Though family business has a role in entrepreneurial orientation, there is no direct relationship between business background and business performance or loan repayment. It is true that youths coming from business background are familiar with business and banking but there are other ways to get oriented with the same, not necessarily one has to come from business family.

A4: Unwillingness to Pay:

We all know this is one of the most common reasons behind default culture in Bangladesh. It can happen in some situations like when security backing loan is weak, customer feels that defaulting the loan will not harm him much. In that case he tends to default. In other cases like when cash flow from the business is not impressive, people are unwilling to repay the loans. Even sometimes without any reason customers default loan that is purely psychological and absolute unwillingness to repay loan.

A5: Lack of Supporting Facilities:

Sometimes business need support from other sources. When cash flow is lean and the project is in lull, it needs feeding. Without further feeding company may become sick and incur loss in consecutive time periods. In our country most of the companies do not have the supporting sources with which they can withstand the turmoil that comes in to their business from time to time.

B: Business Related:

B1: Non Attractive Industry:

Sometimes no attractive industry acts as primary cause of loan default. Companies operating in non attractive industries have higher probability of performing poor. Because of poor financial performance, company's cash flow gets affected. Because of cash flow the company becomes less liquid which contributes in defaulting bank loan. Not necessarily that all the companies of non attractive industry perform poor.

B2: Strong Competition:

Strong competition does not directly contribute in defaulting loan. Strong competition takes place when many companies enter into an industry where the industry cannot accommodate so many companies. In strong competition only efficient players survive. So the inefficient companies find it difficult to make profit and sale their product. Once they fail to make profit, the company is likely to default its loan installment in the bank.

B3: Poor Management Capability:

Before sanctioning a loan banks look in to the matter that how the management of the company is. If the bank feels that the management is capable enough to successfully run the business and utilize bank finance, then bank agree to finance otherwise not. Even sometimes banks sets conditions like some of the key personnel must not quit the organization before repayment of the loan. Managerial capability plays a vital role in repaying bank loan. The more professional the management is the less probability of defaulting loan.

B4: Poor Financial Performance:

Definitely Poor financial performance is the most important cause of loan default. Once a company is not solvent, it is un-likely to repay its loan. Poor financial performance is the key reason behind maximum loan default. Poor financial performance can be arisen from many other reasons described above.

B5: Poor Cash flow:

In most cases poor cash flow is the aftermath of poor financial performance. Because of poor cash flow companies mainly default loan. Because of irregular cash flow, business becomes unstable and illiquid. In that case business does not have enough cash to service loans payment and interest. Even if a company is profitable, the company may default because of cash flow. In some cases, a business may sell most of its finished goods in credit. So it may not have enough cash to support the loan and other debts. So it may cause default.

B6: Low market share

Low market share may be a reason of loan default but not a single respondent mentioned it as one of the reasons of their loan default. Low market share means low sales, low sales mean low profit and low profit results default. But operating in a niche market, having a very low market share a firm can be profitable enough to repay its entire loan obligation as well as retain sizable earning.

C: Lending Related:

C1: Delayed Assessment of Loan Proposal:

Banks sometimes make delay in assessing loan proposals of the business firms. When the firm badly needs money, it does not get enough funds because of delayed assessment by the bank. This infuses shortage of cash in their business operations. They hardly manage their day to day business expenses let alone repayment of the loans.

C2: Delayed Disbursement of Fund:

Even after assessment of the proposal and taking positive decision, banks do not disburse funds until security documentation formalities are completed. As a result business do not get fund when actually it requires it. Some of the defaulters complained about subsequent disbursements.

C3: Lack of Proper Monitoring:

Monitoring is one of the most important parts in credit. Through monitoring lenders come to know that whether their fund is being used for the desired purpose or not. Sometimes disbursed money is used for purposes other than the specific areas. In that case risk of loan default gets higher. Banks sanction loan on the basis of feasibility of the project. Bank as a lender expect that the loan will be serviced by the cash flow generated from that particular business. But if credit is used in some other areas desired cash flow may not come from the business and chance of loan default gets high. Therefore banks monitor activities of the borrower whether the fund is being properly utilized or business is generating enough cash flow or not. Banks use specialized formats for loan monitoring. Bank periodically review the performance of the borrower and based on that bank decides whether to renew the facilities or not. The tools used for monitoring are portfolio review, profitability analysis etc.

C4: Lack of Taking Proper Action:

Action comes after loan monitoring. Monitoring is done for identifying deviations or exceptions. If there is any exception then corrective action needs to be taken. If corrective actions are taken on time chance of default loan reduces. When customer misses one installment, concerned officer of the bank must visit the customer and understand where the problem lies. If proper action is taken, probability of loan default is reduced.

D. Macroeconomic Factors:

D1: Low GDP Growth:

It is evident that companies which deal in consumer products are directly affected by the GDP growth of the entire economy. Regular customers and defaulters have opined that this macro indicator influences the cash generation of a company and hence the repayment of the loan.

D2: Increasing Crimes:

It is revealed that the effect of the increasing crimes in the business of the companies. They think that forced subscription sometimes make the profitability of the company lower.

D3: Hartals by the Political Parties:

Political instability of the country hampers the production and the distribution of the products in a smooth way and the the political turmoil is considered one of other causes of the loan default in our country.

D4: Frequent Policy Changed by the Government:

Government policy is considered as the minor cause of the loan default as per our survey since it has a little impact on the local sales and distribution of the products of the companies. Without these are other causes such as imperfect lending practice, lack of analysis of business risks, lack of proper valuation of security or mortgage property, undue influence by borrowers, external pressure, loan of Govt. organization, Govt. policy for disbursement of credit, lack of legal action.

6.2: Indicators and Remedies of Loan Default Problem:

Before analyzing the remedies of loan default problems we will discuss the indicators of default loan which would indicate financial trouble and serve as a “red flag” to the financial officer. There are many indicators of default loans but there is no set pattern of frequency of occurrences of events leading up to a point where a loan could be declared a problem loan.

A. Indicators of Default Loan:

- Delayed submission of financial statements
- Slowness in the ability to arrange plants visits and deterioration in the rapport
- Declining deposit balances and the occurrences of overdrafts and returned cheques
- An unusual rise in inventories and increase in trade payables
- An increase in receivables, this may indicate a lowering in the qualities of the firms products or services, a change in the terms of sale , or the sale to financially weak firms in an effort to increase sales and income
- Expansion through merger or acquisition : merger with another firm or sale of assets
- Irregular payment of the loan
- Change in management or the resignation of key personnel, labor problem
- New financial arrangement or indebtness

- Natural disasters such as flood, fire etc.

B. Remedies of Default Loans:

Keeping in mind the above indicators we can proceed on to find out some remedies. According to Prof. Muzaffer Ahmad(1997) the way out of the current crisis of bank loan default lies in evolution and entrenchment of responsive and participate governance from grass roots upwards which can be instrumental in decartelizing the decision making process. In this visualized governance process the governments will take on itself the task of removing imperfections due to invisibilities, externalities, imperfect access to information, knowledge and resources (Ahmad 1997). Bhattacharya (1998) highlights the crucial need of building up a strong financial infrastructure an adequate legal framework for enforcing lenders' recourse on borrowers, effective supervisory and regulatory role of the central bank through formulation of broad-based prudential guidelines, commercial autonomy of bank management, and institution of a readable and transparent accounting base. He mentions the following reform Issues such as autonomy of Bangladesh Bank should be strengthened and the post of governor should be made constitutional, role of banking division of the Ministry of Finance should be reduced, the Scheduled banks should be put fully under the regulatory oversight of the Bangladesh Bank (corporate governance of the banks), members of political parties and defaulters should be barred from the boards of directors of banks, state owned enterprises should be pursued for defaulter loans, loan amnesty and loan forgiveness undermines financial discipline, PCBs should not be bailed out through re-capitalization, which may encourage moral hazard, International Standard based audit of the loan portfolio, assets, liabilities and capital adequacy should be introduced for a full and proper disclosure of the financial situation of the banks, elimination of remaining restrains on interest fixation by the banks should be expedited, alternatives for industrial finance should be explored (NBFLs), wider use of on-leading mechanisms through the Grameen Bank and the NGOs (MFIs) should be a way-out for small for and micro-credit. diversification of product base of banks : Venture capital, factoring, asset securitization, leasing, and consumer product financing, issuance linked deposit schemes, mutual funds, card business, certificates of deposit, etc. integrated computerized and upgradation of professional skills of officials should be taken up on a priority basis, delinking of pay scales of bankers from the national pay scale should be expedited and Strategic Business Plans to reduce excess manpower should be undertaken, privatization of banks on ideological grounds should be stopped. It must be based on empirical grounds.

The agenda outlined above contain the key elements of a comprehensive action plan, which, if pursued in right earnest, can effectively arrest the deterioration of the trend of mounting bank loan default, we believe. The proposed amendments of existing laws and the enactment of new laws will help in achieving the following objectives:

- The amendments will increase Bangladesh Bank's autonomy and power to regulate and supervise (both on-site and off-site) the financial system.

- The amendments should be designed to severely restrict insider lending plaguing the private commercial banks.
- The amendments should aim at providing exemplary punishments to people issuing had cheques and banks involved in corruption and malpractice's.
- They should be designed to improve the governance of NCBs.
- They should improve the deposit insurance schemes.
- The new laws will provide effective mechanism to pursue the willful defaulters. The proposed tribunal should be entrusted to deal with cases of the top 500 defaulters only to speed up the disposal of the recovery cases significantly.

6.3: Recommendations of World Bank:

6.3.1 The officer of the Ombudsman for the Financial Sector:

The proposed office of ombudsman for the financial sector will be responsible only to the Board of Director of Bangladesh Bank. The ombudsman will be helped by a network of ethics in each bank. Who will be responsible only to the respective Boars of Directors? The office of ombudsman will deal with complaints of malpractices and corruption in the banking sector independently, and will recommend appropriate punishments for the investigated cases.

6.3.2 De-politicization of Governance of Banks:

- A management selection committee should be formed to recommend appointments of members of the boards of different banks.
- International auditing and accounting standards should be uniformly followed in all the banks to bring transparency and comparability of accounts of different banks.
- Financial control systems should be standardized.
- Trade unions should be delinked from direct political affiliations, and the number of trade unions should be limited to three for each bank.
- The post of Governor of Bangladesh Bank should be made constitutional
- The banking division of the Ministry of Finance should be entrusted the role of supervising the NCBs and the specialized banks remaining under government ownership.
- The autonomy of Bangladesh Bank should get the priority it deserves.

6.3.3 Enforcement of Laws:

The legal system allows defaulters to delay lenders recourse process indefinitely, making the enforcement process a virtual mockery. Therefore, the issue of establishing a specialized debt collection agency for pursuing the top 500 defaulters needs special attention.

6.4 Other Remedies:

- Banking profitability in the long run depends on a bank’s ability to collect and analyze information and to put optimal conditions to its loan supply. To develop this ability, financial institutions must be in a condition of sound market competition and appropriate prudential regulation.

- Considering credit as a scarce resources and source of economic and political power, all the societies around the world are careful about its distribution and use. In order to best utilize credit an attempt should be made in order to avoid concentration of loans into few hands.
- Strengthening the security market will have a positive impact on the overall development of the banking sector by increasing the competitiveness in the financial sector. In a developed capital market the range of portfolio selection is wider and people can compare the security of their investment among the banks and the security market. As a result banks remain under some pressure to improve their financial soundness.
- Bangladesh has a bright prospect in the sectors of small and medium scale enterprises. Poorer sections of the society have innate entrepreneurial ability of undertaking some small profitable projects. Successful operation of some NGOs (Grameen Bank and BRAC are few of them) provides evidences that the poor people can be bankable even without collateral.
- Bangladesh may look for and utilize a number of merger and acquisition cases especially among the larger banks if any for the better information sharing, management, and diversification of activities.

In the Bangladesh banking sector, the main conflict is that the loss due to inefficiency of collection of bad loans for whatever reasons, where the shareholders are definitely not responsible, are adjusted by making provisions out of profit and then utilizing this provision to write off bad loans, the collection of which is uncertain. It may not be justified because the amount and payment sys tem is not linked to performance, especially in case of less than average performance. To minimize this conflict, loan classification should be stopped, that is, regular repayment should be ensured. This will reduce the provision for the loan loss amount, which in turn will result in more tax payment and more after tax profit of the organization, which is the precondition for maximization of shareholders' wealth. Provision in other business is an estimation based on the past experience of the uncollectible amounts. If banks can stop classification, then 1 percent of unclassified loans will suffice or in the future this percentage may also reduced: "Prevention is better than cure. This should be the watchword for monitoring and supervising loan accounts of bank. Making classification and pursuing borrowers to regularize the accounts rarely meet success. The cost of such exercise is also heavy. So, the bank should evolve appropriate systems to detect deficiencies in the management of credit operations well before it calls for classification. In this regard an effective on-site and off-site supervision system should be in place both in the schedule banks and central banks (Alam and Jahan)."

The hypothetical example shown in the table may help better understanding of the analysis and findings assuming all other information in both systems remain the same except where changes have been shown:

Table 12: Z Bank Ltd. Income statement for the year ended December31, 20XX

Particulars	Existing system (Amount)	Proposed system (Amount)
Interest income (including receivables)	5000	5000
Less: interest paid on deposit and borrowings	1000	1000
Net interest income	4500	4500
Non-interest income	1500	1500
Total operating income	6000	6000
Total operating expense	1800	1800
Profit before provision and taxes	4200	4200
Less: loan loss provision	1200 (a)	700 (b)
Profit before tax	3000	3500
Tax @45 %	1350	1575
Net income	1650	1925
Proposed dividend 10%on paid up capital Tk 5000	500	500
Transfer to statutory reserve 20% on before tax profit	600	700
Retained earnings	1050	1225

Notes: (a) On principle receivable
(b) On interest receivable

Chapter- Seven

Summary of Findings, Challenges and Concluding Remarks

7.1 Summary of Findings and Challenges:

The foregoing discussion regarding NPLs in Bangladesh reveals that the banking sector of Bangladesh is yet to get out of its NPL mess, although substantial improvement has been noticed recently. In terms of adoption of the international loan classification and provisioning system, Bangladesh follows the international standard (table 2) to a great extent, but lags far behind with regard to the management of NPLs. At present (2011), the banking system of Bangladesh exhibits a very high proportion of NPLs (6.59%) when compared to India and Sri Lanka is lower. The most dissatisfactory performance is seen in the management of "bad loans" which consistently account for more than 80% of total NPLs (table 5). This situation clearly demonstrates the inefficacy of the banking system to tackle the "flow problem of bad loans". Therefore, the first challenge facing the banking sector of Bangladesh is how to constitute sufficient measures to address the flow problem of bad loans effectively.

It is observed that among the different clusters of banks in Bangladesh, SCBs and DFIs continue to have an alarming amount of NPLs is 14.1% and 21.8% respectively in 2011 since the adoption of prudential norms in 1990. Although it is not clear which sectors contain major NPLs, available data indicates that the highest ratio of NPLs are in the category of loans of both SCBs and DFIs are14.1% and 21.8% respectively, followed by term loans having a maturity of more than 20 years in the case of DFIs (Table 6). The NPL ratio of term loans given by SCBs is also observed to be very high. Another important observation is the gradual reduction of capital in SCBs due to maintenance of poor loan loss provisions against default loans (table 7). These aspects clearly call for ending the operation of SCBs and DFIs. However, it needs to be mentioned here that the stock markets of Bangladesh are not efficient enough to channel funds for industrial growth, and thus SCBs as well as DFIs play a vital role in meeting the overall industrial credit needs of the country. Hence, the second challenge before the banking system is to decide whether to stop operations of the SCBs and DFIs, to privatize them, or to reorient them through financial engineering in full phase.

The study reveals the dissatisfactory performance of the courts (Money loan Court, Bankruptcy Court and PDR Court) in terms of rate of settlement of NPL disputes as well as rate of recovery of loans over the years in review (tables 9&10). The main problem related to very low recovery lies in the very slow execution of the decrees. The Financial Sector Reform Project (FSRP) argues that the huge loan delinquency of the Bangladesh banking system reflects, among other things, the weakness of the legal infrastructure, which cannot ensure lenders' recourse on borrowers. The inefficacy on the part of the legal system also sometimes encourages borrowers to refrain from paying legitimate dues to the banks. The Center for Policy Dialogue (CPD) Task Force Report (2001) also indicates that the main hindrance at this moment in Bangladesh is the existing legal framework and its lengthy procedures. However, if the delay in the settlement process arises due to the shortage of judges, then separate posts like "Bank Magistrates" can be created to settle NPL issues. It is to be kept in mind, however, that without having the proper cooperation and sincerity of the concerned individuals, the law itself can by no means expedite the process. Thus, the third challenge before the banking sector is how to ensure cooperation, sincerity and accountability of the involved parties like plaintiff, defendants, lawyers and judges, in order to make the settlement process vibrant and speedy.

Concerning recovery strategies by artha-rin adatal, it is observed that Bangladesh has concentrated mainly on legal measures to address the NPL issue (table 8). Unfortunately, these legal measures have been found to be very time consuming, resource draining and ineffective, and have ultimately resulted in poor recovery performance (table 9 & 10). Interestingly, despite being aware of this fact, the banking system of Bangladesh has barely begun to adopt non-legal measures such as out of court settlements, compromise settlement schemes, formation of loan workout departments etc. as operate in India for the effective recovery of NPLs. Therefore, the fourth challenge confronting the banking sector is how to constitute a concrete NPL management strategy equipped with both preventive and resolution measures.

In a bank-centered financial system, it is very crucial to determine whether the defaulter is a willful one or a genuine one. In the case of the former, if timely and adequate measures are not taken and problems are left unresolved, the willful defaulters can have a psychological impact on good borrowers, acting as a catalyst to financial degradation. In fact, in developing countries like Bangladesh, a large number of willful defaulters operate in the financial market, trying to degrade the credit environment either by window-dressing their financial health or by influencing the bank management through vested groups, or both. In many reports (BRC, SAPRI, CPD), serious concerns have been shown about the presence of willful defaulters in Bangladesh and it has been suggested that loan facilities should not be offered to this group. Nevertheless, in reality, the banking system has not yet come up with any effective strategies to identify the habitual defaulters and to take action against them. In this regard, a prominent challenge before the banking sector could be seen as how to develop specific tools and techniques to distinguish the willful defaulters from the genuine ones.

Almost a decade ago, the banking system of Bangladesh adopted a lending risk analysis (LRA) device – a prescribed manual given by FSRP for analyzing loans of Tk. 10 million and above – with the objective of gauging the intensity of risk associated with large loans and to choose loan proposals with low risk exposures. LRA has now been superseded by the "credit risk grading system" for better identification and management of borrower's risk. However, the application of this sophisticated technique (CRG) as a credit screening and monitoring tool largely depends on sufficient business data and know-how of the concerned credit officials. Surprisingly, these are seen to be very poor in the credit environment of this country. Thus, the appropriate authorities should pay proper heed to redressing these problems to ensure meaningful application of the CRG device in the credit environment of Bangladesh.

After the financial crisis of 1997, the East Asian countries (China, Malaysia, Singapore, and Indonesia) realized that asset management companies can play a vital role in addressing the bad loan problem and can ensure robust financial discipline. Recently, India has set up an asset management company as a trust to reorganize their bad loans. India has also instituted "factoring devices" and "asset securitisation techniques" to remove NPLs from the balance sheet of a bank. In Bangladesh, however, no initiative has been taken so far towards the formation of an asset management company which could undertake activities relating to asset reconstruction and develop markets for distressed assets. Factoring devices and securitisation techniques are hardly ever employed for the removal of NPLs in Bangladesh. Therefore, the next challenge before the banking sector is how to set up an asset management company or institute factoring services and asset securitisation techniques that would address NPLs effectively without generating moral hazards.

This study reveals that the highest loan defaults are in the category of micro and agricultural credits, followed by term loans / large loans having maturity of 20 years and more than 20 years (table 5). To resolve this issue, the loan syndication technique might be considered as an effective financial tool. However, proper application of this technique requires cooperation, sincerity and transparency among banks, practices which are seen to be absent in the country at present. Moreover, bankers have been observed to engage in unhealthy competition in the market. Therefore, another issue is how to exercise syndicated financing technique minimizing unhealthy competition among banks in Bangladesh.

Finally, maintenance of an ethical standard in the banking profession from all concerns can be viewed as an important means for making the credit environment credible and vibrant. Ethics contributes great deals to fair practices of lending when law itself becomes impotent due to invisible contingencies. Hence, the importance of ethics in financial institutions should not be overlooked.

7.2 Concluding Remarks:

More than 20 years have passed since the adoption of prudential norms in the banking system of Bangladesh in 1990. Unfortunately, the banking system is still burdened with an alarming amount of NPLs and lags far behind the neighboring countries of India and Sri Lanka. Although Bangladesh has to a large degree adopted international standards of loan classification and provisioning, the management of NPLs is found ineffective, as the system has failed to arrest fresh NPLs significantly. It needs to be mentioned that management of NPLs must be multi-pronged, with different strategies pursued at the different stages through which a credit facility passes. Measures should be in place for both prevention and resolution. With regard to preventive measures, emphasis needs to be placed on credit screening, loan surveillance and loan review functionaries both at individual bank levels and in the central bank of the country. Resolution measures must be accompanied by legal measures, i.e. improving the efficiency of the legal and the judicial system and developing other out of the court settlement measures like compromise settlement schemes, incentive packaging, formation of asset management companies, factoring, and asset securitisation and so on. Unfortunately, Bangladesh is found to be very weak from the above point of view, and strictly speaking, it has mainly concentrated on a few legal measures that have also been found to be ineffective. Therefore, this study has highlighted some challenges, shown below, for improving the debt recovery environment and solving the NPL problems of the country as well.

- To institute sufficient measures to address the flow problem of bad loans effectively.
- To decide whether to stop operations of the SCBs and DFIs, to privatize them, or to reorient them through financial engineering.
- To ensure cooperation, sincerity and accountability of involved parties such as plaintiffs, defendants, lawyers and judges to make the settlement process vibrant and speedy.
- To institute immediately a concrete NPL management strategy equipped with both preventive and resolution measures.
- To develop specific tools and techniques to distinguish the willful defaulters from the genuine ones.
- To pay proper attention to addressing problems relating to meaningful application of the CRG device in the credit environment of Bangladesh.
- To establish an asset management company or to institute factoring services as well as asset securitisation technique so as to address NPLs effectively without generating moral hazards.
- To exercise syndicated financing technique for large loans and to minimize unhealthy competition among banks in Bangladesh.
- To strengthen the supervisory and monitoring functions of Bangladesh Bank so as to discipline banks that engage in malpractice.
- Finally, to place emphasis on ethical standards in the banking profession from all corners to make the credit environment trustworthy and vibrant.

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