Nonperforming Loans in the Banking Sector of Bangladesh: Realities and Challenges

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Abstract

This paper discusses the magnitude of Nonperforming Loans ("NPLs") in the banking sector of Bangladesh since the adoption of prudential norms in the loan classification and provisioning system in 1990. The paper reveals that the presence of an alarming amount of NPLs both in the Nationalized Commercial Banks (NCBs) and in the Development Financial Institutions (DFIs), along with maintenance of inadequate loan loss provisions, diminishes the overall credit quality of Bangladesh. Poor enforcement of laws relating to settlement of NPLs, followed by insufficient debt recovery measures on the part of the banks, has also aggravated the financial malaise, although a decrease in NPLs is noticed since the year 2000. The paper suggests that the prevention of the 'flow problem of bad loans' accompanied by other resolution measures might help to sort out the nonperforming loan mess in Bangladesh.

Keywords: Loan classification system, nonperforming loans, commercial banks, enforcement status of loans, loan recovery measures, Bangladesh.

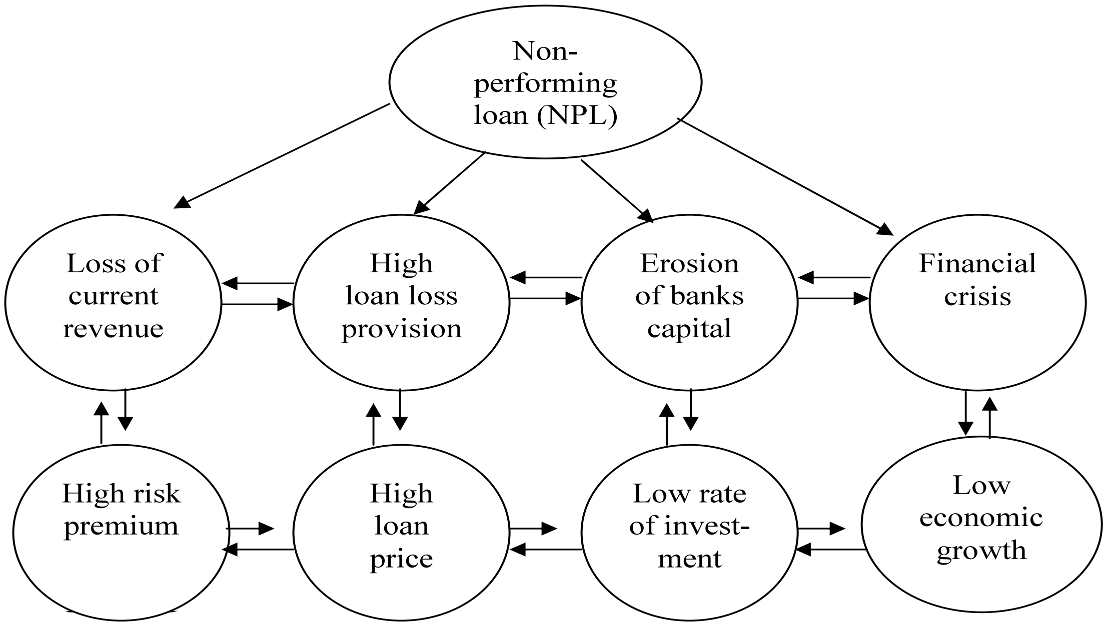
Introduction

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. Choudhury et al. (2002: 21-54) state that 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 macro economic management (Woo, 2000: 2). 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: 204-248).

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: 25-26) 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: 197-214) 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. 1 Economic and financial implications of NPLs



The above 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.

It can be said unequivocally that NPLs are the result of economic slowdown. For instance, Cargill et al. (2004: 125-147), Barseghyan (2003: 12), Fukui (2003), Shiozaki (2002: 27), Hoshino (2002: 3-19), Takeuchi (2001: 37-38) have identified Japan's high level of NPLs as an outcome of prolonged economic stagnation and deflation in the economy since the bursting of the "bubble" in the early 1990s. In addition, Hanazaki et. al. (2002: 305-325) and Yanagisawa (2001: 2-9) highlight cross-shareholdings, stock market volatility, virtual blanket guarantee of bank debts and the system of "relationship banking"[2] as factors responsible for the prolonged fragility of the Japanese banking

[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.

[2] "Relationship banking" - a system wherein banks maintain intimate relationships with their client firms. This system gives bank managers substantial room for manipulating accounting figures on NPLs and capital bases if not strongly verified by law enforcing agencies.

sector. According to the definition of the Financial Reconstruction Law (FRL), the total amount of NPLs of all banks in Japan as of the end of March 2003 was 35.3 trillion yen, although there are claims that the actual amount of NPLs might exceed 100 trillion yen. On the other hand, the causes of the financial and exchange rate crisis that erupted in East Asia (Thailand, Taiwan, Malaysia and Indonesia) in 1997 are viewed as high short-term external debts, excessive loans for real estate, large current account deposits, high international interest rates and weaknesses in the balance sheet of financial institutions. In addition, Kwack (2000: 195-206) finds that the 3-month LIBOR interest rate and nonperforming loan rates of banks were the major determinants of the Asian financial crisis. Huang and Yang (1998: 11) report that unlike the other countries of East Asia, China did not face financial fragility because of the size of its foreign exchange reserve, its current account surplus, the dominance of foreign direct investment in capital flows and the control of the capital account. As of June 2003, China recorded only 5.68% of its total loans as nonperforming while, in contrast, Thailand, Indonesia, Philippines and Malaysia record NPLs at 15.29%, 8%, 15% and 8.7% respectively. Unfortunately, the present (December, 2005) rate of NPLs in China has increased to 8.6%.

In the Indian subcontinent (India, Pakistan, Sri Lanka, Bangladesh and Nepal), however, the causes of nonperforming loans are usually attributed to the lack of effective monitoring and supervision on the part of banks (as required by the BASEL principles of bank monitoring and supervisions), lack of effective lenders' recourse, weaknesses of legal infrastructure, and lack of effective debt recovery strategies. Among the countries in the Indian sub-continent, the rate of NPLs as a percentage of total loans disbursed in 2005 is seen to be minimal in India (5.2%), followed by Sri Lanka (9.6%). Bangladesh, however, still records a staggering rate of 13.56%.

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: 35-37). Moral et al. (2000: 13-27) 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 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".[3]

Islam et al. (1999: 22-31) 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: 57) 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"[4], 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.

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

[4] 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.

In the 1990s, however, a broad based financial measure was undertaken in the name of FSRP[5], 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.

The paper is organized as follows: Section 2 deals with the current loan classification and provisioning system in use in Bangladesh with a view to understanding the country's system of classification of NPLs as compared to the international standard. Section 3 traverses the different varieties of NPLs (substandard, doubtful and bad). Section 4 discusses the enforcement status of laws relating to default loans in Bangladesh. It needs to be mentioned that in a bank-centered financial system, the central bank plays an important role in the governance of banks. Therefore, an attempt is made in section 5 to understand the measures undertaken by the central bank in relation to the management of NPLs in Bangladesh. Section 6 provides a summary of the findings and the major challenges to addressing the NPL problem, while concluding remarks are given in section 7 of this paper.

Loan classification system in use 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)[6], substandard, doubtful and bad/losses to comply with international norms of loan 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 1.

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

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

Table 1 Current loan classification and provisioning system 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 installment payable in 12 months ▶ If the default amount of installment is equal to the installment payable in 18 months	Unclassified SMA Sub-standard Doubtful Bad/Loss	1% (except SE&CF) 2% (for SE&CF) 5% 20% 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. 34, 16, 9 and 14. Financial Sector Review, May 2006, Bangladesh Bank. 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:

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

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 2 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.

Base for provisioning and accounting treatment of NPLs

The bank managers of Bangladesh deduct the amount of interest suspended and the value of "eligible securities"[7] 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[8] 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.

Realities of NPLs in Bangladesh

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, 2003) comprises four types of scheduled banks – 4 nationalized commercial banks (NCBs), 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.

Status of total loans, total NPLs and NPLs as a percentage of total loans for all banks (1990-2005)

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, 22.1% in 2003 and 13.55% in 2005 (Table 3). 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. 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 (Table 3). In 2005, doubtful loans increased by 0.36% as opposed to 6.6% in 2004. 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 (at present, 84.37%). Unfortunately, this trend has not shown any

[7] Eligible securities include certificate of deposits, gold and gold ornaments, government bonds / savings certificates, easily marketable goods and land & buildings.
[8] IAS stands for International Accounting Standard. IAS 30 deals with the preparation of the bank's financial statement. Bangladesh adopted this standard in 2000.

improvement over the period 1990 to 2005. It is also to be mentioned that with regard to the comparison of NPLs with neighbor countries, Bangladesh exhibits a higher level on NPLs than either India or Sri Lanka (Table 4). While NPLs to total loans in India declined from 11.4% in 2001 to 5.2% in 2005, NPLs still account for 13.6% 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.

Table 3 Status of classified loans: sub-standard, doubtful and bad/loss loans of all banks (1990-2005)

(Taka in billion)

Year	Total loans	Total classified loans	Classified loans as % of total loans	Sub-standard loan as % of TCL	Doubtful loans as % of TCL	Bad/loss loans as % of TCL
1990	177.12	46.21	26.09	N.A	N.A	N.A
1991	185.60	46.54	25.00	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	17.60	63.19
1995	310.29	99.42	32.04	13.08	12.36	74.56
1996	351.00	110.54	31.49	13.42	12.27	74.31
1997	462.27	173.32	37.49	7.88	11.70	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	86.60
2002	851.73	238.57	28.01	8.56	5.09	86.35
2003	914.90	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

Source: Banking Regulation & Policy Department, Bangladesh Bank, 2005; various annual reports of Bangladesh Bank.

Note 1: a. DFIs have been included in the classification system from 1997.
b. In 1997, DFIs comprise BKB, BSB and RAKUB.
c. In 1998, BSRS was included in the above list.
d. In 1999, BASIC was included in the above list.
e. Data corresponding to calendar years 1990 – 1996 include all banks except DFIs

Table 4 Nonperforming loan as a percentage of total loans for selected Asian countries

Year	Bangladesh	India	Sri Lanka
	December 2005	March 2005	June 2005
2001	31.5	11.4	15.3
2002	28.1	10.4	15.3
2003	22.1	8.8	13.7
2004	17.6	7.2	9.1
2005	13.6	5.2	9.6

Source: Global financial stability report, IMF and Bangladesh Bank. Financial Sector Review, May 2006, Bangladesh Bank

Trend in classified loans as a percentage of total loans for different clusters of banks (1990-2005)

It was stated earlier that the banking sector of Bangladesh comprises of four types of scheduled banks: NCBs, PCBs, FCBs and DFIs. Therefore, in order to gain a deeper understanding of the magnitude of NPLs in the banking system of Bangladesh, the ratio of NPLs to total loans in all these scheduled banks must be examined. It is observed that with respect to the ratio of NPLs to total loans in the year 2005, DFIs are in the worst position (34.87%), followed by NCBs (21.35%) (Table 5). While the NPL ratio of NCBs showed an increasing trend from 27.59% in 1990 to 45.62% in 1999 and then a declining trend to 21.35% in 2005, DFIs were not able to change their position markedly as NPLs continued to account for 42.8% in 2004 (Table 5). However, the percentage of NPLs to total loans both in PCBs and FCBs showed a substantial declining trend since 1998. In 1998, the NPL ratio of PCBs and FCBs was 32.72% and 4.14% respectively; the same declined to 5.62% and 1.26% respectively in 2005 (Table 5). In the final analysis, it can be concluded that the performance of DFIs and NCBs are basically maligning the overall banking performance of Bangladesh, although improvements have been observed for the last half-decade.

Table 5 Trend of nonperforming loans as a percentage of total loans for different clusters of banks (1990-2002)

Year	NCBs	PCBs	FCBs	DFIs
1990	27.59	23.73	20.65	NA
1991	26.30	34.20	11.87	NA
1992	31.86	31.10	12.64	NA
1993	32.23	44.42	10.46	NA
1994	32.12	44.53	8.89	NA
1995	31.00	39.43	5.40	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	66.70
1999	45.62	27.09	3.80	65.02
2000	38.56	22.01	3.38	62.56
2001	37.02	16.98	3.32	61.80
2002	33.73	16.38	2.61	56.19
2003	29.0	12.4	2.7	47.4
2004	25.3	8.5	1.3	42.8
2005	21.35	5.62	1.26	34.87

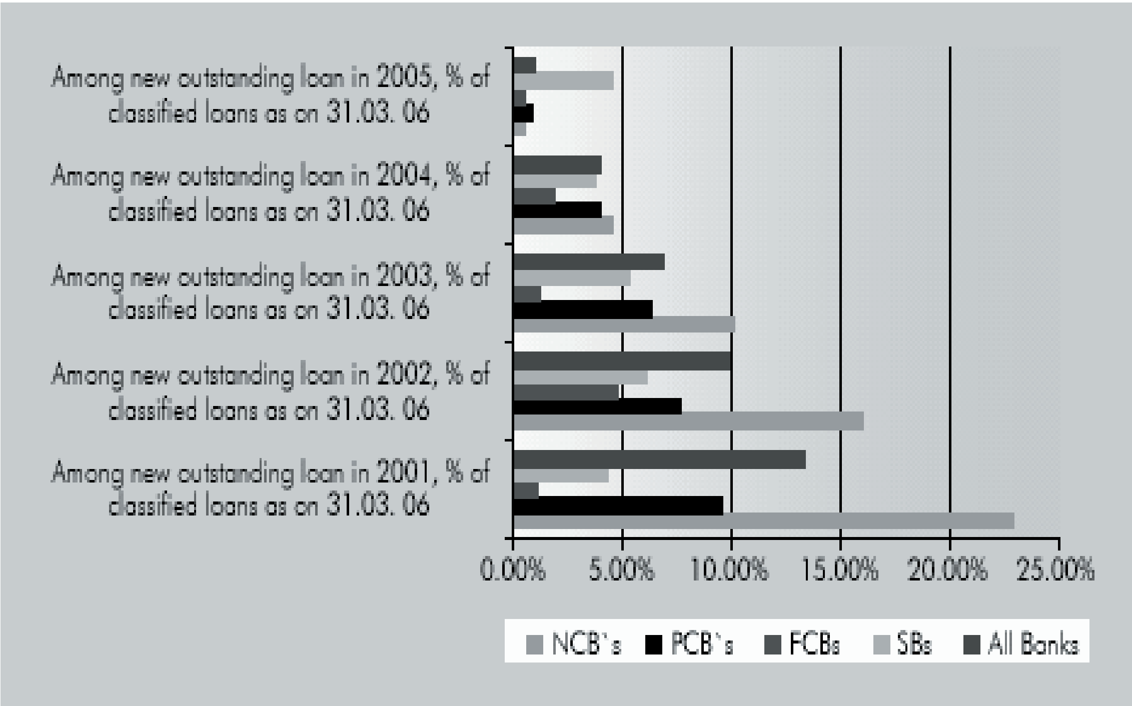
Source: Banking Regulation & Policy Department, Bangladesh Bank, 1995-2005.

NPL ratio of banks by type of loans as well as flow of NPLs

An analysis of the aggregate NPLs in clusters of banks and types of loans in 2005 indicates that the highest ratio of NPLs is in the category of micro and agricultural loans of NCBs (47.09%). This is followed by term loans over a maturity of 5 years (42.68%) for DFIs. DFIs also record a staggering rate of 40.45% NPLs in case of term loans having a maturity of 5 years, followed by NCBs which have 33.83% NPLs for such loans. However, in the case of continuous loans and demand loans, NCBs have the largest ratios of NPLs (19.95% and 10.21% respectively) among the bank clusters in December 2005 (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 NCBs and DFIs, are aggravating the NPL situation of Bangladesh.

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 March 2006 was much higher for all banks than in 2005. In the case of NCBs, the proportion of classified loans in relation to total loans disbursed in the year 2001 was 24% on 31 March 2006. However, as of the same date, the proportion was less than 1% for loans disbursed in 2005. The flow of NPLs for FCBs and DFIs has also shown a declining trend over the period 2001 to 2005, with some exceptions.

Fig. 2 The Flow of Classified Loans



Source: Financial Sector Review, May 2006, Bangladesh Bank.

Table 6 NPL percentage ratio by type of loans and bank clusters (December 2005)

Bank types	Continuous loans	Demand loans	Term loans		Micro and agriculture loans
			Up to 5 years	Over 5 years	
NCBs	19.95	10.21	33.83	24.54	47.09
PCBs	6.43	3.83	5.91	5.37	2.03
FCBs	2.31	0.78	0.9	0.49	0
DFIs	18.44	5.26	40.45	42.68	39.20
Total	11.06	6.26	13.20	19.56	41.80

Source: Annual report 2004-05, Bangladesh Bank; Financial Sector Review, May 2006, Bangladesh Bank.

Growth rate of advances and classified loans for all clusters of banks

It is evident that in 2005, the growth rate of advances is the highest in NCBs (19%), followed by FCBs (13.06%). Prior to 2005, however, PCBs played a leading role for a number of years (Table 7). NCBs also show an increasing trend in advances since 1999, whilst DFIs show a declining rate of growth, except for the years 2001 and 2005. 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 NCBs 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 7). Presently in 2005, 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 7 Growth rates of advances and classified loans for all clusters of banks (1997-2005)

Year	NCBs		PCBs		FCBs		DFIs		All Banks	
	GRA	GRCL	GRA	GRCL	GRA	GRCL	GRA	GRCL	GRA	GRCL
1992	10.34	33.64	24.82	60.43	33.66	42.28	-	-	15.50	41.25
1993	15.61	16.94	11.13	58.71	10.23	-8.79	-	-	13.96	29.54
1994	3.79	3.46	13.86	14.11	20.06	1.04	-	-	7.62	7.52
1995	16.58	12.51	17.21	3.79	39.91	-14.25	-	-	18.03	8.58
1996	13.47	19.14	12.65	-0.65	12.12	-2.01	-	-	13.12	11.19
1997	11.74	25.54	13.70	2.74	17.96	-10.43	-	-	31.70	56.78
1998	9.38	20.78	12.53	17.20	16.30	34.42	33.28	35.27	14.07	23.69
1999	6.09	19.87	17.73	-2.55	11.13	2.13	9.87	7.11	10.15	11.39
2000	7.69	-8.99	25.69	2.11	13.52	.84	4.48	.53	12.67	-4.31
2001	8.54	4.20	28.11	-1.17	10.31	8.70	5.98	4.68	14.53	3.28
2002	9.32	-0.39	24.48	20.08	24.86	-2.14	1.67	-7.56	13.64	1.10
2003	0.84	-13.21	15.5	-23.21	16.91	21.42	4.94	-11.49	7.42	-14.83
2004	8.01	-5.77	47.1	-11.41	16.47	-34.70	-4.54	-13.60	18.01	-6.48
2005	19.37	.62	12.28	-25.76	13.06	-5.45	12.65	-8.42	19.70	-7.83

Source: Banking Regulation & Policy Department, Bangladesh Bank (BB), 1995- 2005; Annual reports of BB.

Note: Data corresponding to calendar years 1990 – 1996 include all banks except DFIs.

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 (2005), the provisioning shortfall of NCBs is found to be 24.97% followed by PCBs at 13.22%. For both NCBs 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 8). This provisioning shortfall position depicts erosion of banks' capital, one of the inherent weaknesses of the banking system in Bangladesh.

Table 8 Trend of provisioning surplus/ shortfall as a percentage of total required provision for all clusters of banks (1990-2005)

Year	NCBs	PCBs	FCBs	DFIs	All Banks
1990	-83.12	-66.79	-4.59	NA	-76.65
1991	-7.24	-64.21	9.51	NA	-20.59
1992	-31.72	-35.21	3.13	NA	-31.97
1993	-25.09	-66.65	4.40	NA	-39.51
1994	-33.05	-54.26	3.20	NA	-39.82
1995	-51.19	-53.20	20.40	NA	-50.69
1996	-51.18	-45.61	22.46	NA	-49.41
1997	-54.75	-43.89	33.61	-12.49	-42.91
1998	-61.54	-45.58	32.41	-17.92	47.62
1999	-64.11	-39.23	21.45	-10.74	-48.03
2000	-62.65	-27.27	22.58	4.20	-41.74
2001	-65.23	-23.04	24.17	-2.13	-43.28
2002	-69.21	-18.10	27.64	1.22	-44.22
2003	-93.4	-24.6	25.2	-0.8	-59.7
2004	-93.3	-17	23.1	-8.1	-59.1
2005	-24.97	-13.22	43.64	30.74	-51.80

Source: Banking Regulation & Policy Department, Bangladesh Bank, 1995-2005

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.

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 2004 (Table 9). It is also encouraging that the percentage of settled suits has increased considerably from 11.59% in 1991 to 37.71% in 2001, then to 43.30% in 2004. Unfortunately, the recovery rate is seen to be very slow and is confined to 6%-8% only during the last several 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 9 Statement of Suits Filed and Settled in Artha Rin Adalat from 1991 to 2004 (All Banks)

(Tk. in Crore)

Year	No. of suits filed	Amount claimed	No. of settled suits	Amount recovered	% 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	127.20	18.09	4.54
1994	38995	3444.49	7854	181.82	20.14	5.28
1995	42789	4071.12	9726	237.50	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	492.60	30.51	7.10
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	89747	19018.34	38856	1563.88	43.30	8.22

Source: Banking Regulation and Policy Department (BRPD), Bangladesh Bank, 2001-2005.

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 court shows that the recovery rate is only 1.12% against Tk. 254662 crore in 2005 (Table 10). The recovery rate of cases settled through the PDR court is also seen to be unsatisfactory (46.02%), although it shows better performance than other courts. Therefore, the main hindrance 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.

Table 10 Status of Suits Filed and Settled in the Bankruptcy Court, PDR Act and other Courts as of 30 June 2005

(Tk. in Crore)

Name of the Courts	No. of suits filed	Amount claimed	No. of settled suits	Amount recovered	% of settled suits	Recovery rate
Bankruptcy Court	464	254662	155	2874	33.40	1.12
P.D.R. Act	647424	96957	468225	44626	72.32	46.02

Source: BRPD, Bangladesh Bank, 2005.

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.
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[9] 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.
Banking Reform Committee, 1996	• 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.

[9] 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
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.
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.
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.

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 (2005), the banking system of Bangladesh exhibits a very high proportion of NPLs (13.55%) when compared to India (5.2%) and Sri Lanka (9.6%). The most dissatisfactory performance is seen in the management of "bad loans" which consistently account for more than 80% of total NPLs (Table 3). 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, NCBs and DFIs continue to have an alarming amount of NPLs (21.35% and 34.87% respectively in 2005) 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 micro and agricultural loans of both NCBs and DFIs (47.09% and 39.20% respectively), followed by term loans having a maturity of more than 5 years in the case of DFIs (Table 6). The NPL ratio of term loans given by NCBs is also observed to be very high (Table 6). Another important observation is the gradual reduction of capital in NCBs due to maintenance of poor loan loss provisions against default loans (Table 8). These aspects clearly call for ending the operation of NCBs 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 NCBs 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 NCBs and DFIs, to privatize them, or to reorient them through financial engineering.

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, it is observed that Bangladesh has concentrated mainly on legal measures to address the NPL issue (Table 11). 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 5 years and more than 5 years (Table 6). 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 a great deal 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.

Concluding remarks

More than 15 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, 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 NCBs 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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