Banking Sector: Current Status

Bangladesh Economic Update

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For orders and request, please contact:
UNNAYAN ONNESHAN
16/2, Indira Road, Farmgate Dhaka-1215, Bangladesh
Tell: + (880-2) 8158274, 9110636
Fax: + (880-2) 8159135
E-mail: info@unnayan.org
Web: www.unnayan.org

1. INTRODUCTION

The current Bangladesh Economic Update focuses that the present situation of banking sector has been deteriorating in terms of growth of credit and disbursement and risk management.

The current Bangladesh Economic Update focuses that the present situation of banking sector has been deteriorating in terms of growth of credit and disbursement and risk management. Besides this backdrop, questions are being raised concerning the far-sighted deregulation of the financial sector.

Growth in investment exerts impact on the growth in GDP. The decline in the growth in credit illustrates the poor condition of investment which might drag down the current growth in GDP. For example, the government requires investment rate to rise at 32.0 percent of GDP for achievement of 7.2 percent rate of growth in GDP in FY 2013-14,

Some long term issues have been persisting in the banking sector. Growth of credit in private sector registered at 11.07 percent in September 2013 over September 2012, and it was lower than the growth of 19.88 percent witnessed at the same period in the previous year. Growth of credit in public sector has observed a negative rate of growth of 43.15 percent in July-September, 2013-14 over July-September, 2012-13, which also grew at a negative rate of 4.95 percent over July-September, 2011-12.

Excess of liquidity of the banking business reached over Tk. 83000 crore at the end of November 2013 whereas this was Tk. 80000 crore in July, 2013

Low level of demand for credits by the private sector is manifested in the increasing situation of liquidity of the banking sector. Excess of liquidity of the banking business reached over Tk. 83000 crore at the end of November 2013 whereas this was Tk. 80000 crore in July, 2013. Furthermore, the loan-deposit ratio (LDR) has been on a declining trend for the past one year. In September 2013, LDR of the banking business stood at 71.65 percent, meaning that a bank has lent Tk. 71.65 against a deposit of Tk. 100. This ratio was 77.85 percent in the same period of the previous year.

Growth of credit in both industry and agriculture has declined. The disbursement of industrial term loan stood Tk. 8880.79 crore in the first quarter of the current FY 2013-14, which is the lowest among the last five quarters. This amount was Tk.

9720.3 crore in the first quarter of the previous FY 2012-13. The rate of growth of the disbursement of the industrial term loan stood negative at 15.53 percent in the first quarter of the FY 2013-14, compared to the positive rate of growth of 4.49 percent in the last quarter of the FY 2012-13.

The rate of growth of agricultural credit disbursement and credit recovery has been experiencing lower trend as well as negative rate of growth after September, 2013

The rate of growth of agricultural credit disbursement and credit recovery has been experiencing lower trend as well as negative rate of growth after September, 2013. The rate of growth of the disbursement of the agricultural credit stood negative 5.4 percent in October 2013, whereas it was positive at 143.2 percent in September, 2013. Recovery of the agricultural credit disbursement has also been increasing at an insignificant amount.

Usually, basing on CAMELS ratio (CAMELS comprises: Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to market risk), Bangladesh Bank (BB) measures the performance of all individual banks. BB has taken credit risk related reforms due to the shortfall of capital by the four state-owned commercial banks (Sonali, Janata, Agrani and Rupali banks). In addition, to meet the requirement of the Extended Credit Facility (ECF) of IMF[1], finance ministry decided to revise the recapitalisation of bank proposals. After that revision, banking division will distribute Tk. 4100 crore in the first phase against their capital shortfall of Tk. 8863 crore.

Overall net NPLs increased to 4.38 percent in 2012 from 0.70 percent in 2011. In 2011, net-NPLs were 0.34 and 16.95 percent in state owned commercial banks (SCBs) and development financial institutions (DFIs) respectively, whereas in 2012, the percentages stood too high as 12.82 and 20.4 respectively.

State owned commercial banks (SCBs) have achieved nearly zero percent of return on assets (ROA) over the period of 2007 to 2012, which should have been more than 1 percent according to Basel- accord. In 2012, overall ROA in the banking sector

[1] http://www.thedailystar.net/beta2/news/sonali-agrani-to-get-tk-2000cr-to-fix-capital-deficit/

was 0.60 percent whereas it was 1.3 percent in 2011. If these trends continue, overall ROA in the banking sector might decrease to 0.55 percent in 2013. Similarly, overall ROE in banking sector was 14.3 percent in 2011, which reduced to 6.5 percentage point in 2012. Projection says that if the current trend of ROE in the banking sector persists, ROE might decrease to 6.80 in 2013. Reduction of ROE ratio in banking sector indicates that profits of share holder are declining gradually.

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The share of percentage of classified loan to total outstanding loan has been increasing in every six months. At the end of September 2013, the share of percentage of classified loan to total outstanding loan was 12.79 percent, whereas it was 11.91 percent at the end of June, 2013. If the trend remains as usual then share of percentage of classified loan to total outstanding might increase to 14.21 percent at the end of December 2013.

Finally, the interest rate spread has seen many ups and down in this year and in the month of October 2013, the rate was below 5 percent. But the fact is that, in April 2013, it was also seen below 5 percent and after that it increased as earlier trend. In both of the cases, it is seen that advances remain relatively too high and this is the obstacle of taking loan by the business community.

2 CREDIT DISBURSEMENTS

This section observes the disbursement, recovery, and trends of growth of credit to different sectors of the economy, such as private and public sector, agriculture, SME, and industry sector. Three problems have mainly gained prominence in case of credit disbursement. First, the amount of non-performing loan is increasing, requiring higher allocation as provision. Second, lack of profitability is reducing the taxable income of the government from the banking sector. Third, state owned banks have continued to be dependent of recapitalisation from the government.

2.1 Credit Disbursement between Private and Public Sector

The target of credit in private sector in the current MPS (Monetary Policy Statement) has been set at 15.5 percent by December 2013. This target is 3.0 percentage points less than the target (18.5 percent) of previous monetary policy statement.

Table 1: Targets and Achievements

Particulars	Target	Actual
Credit to the Private Sector	The credit in private sector to grow by 15.5 percent in December 2013.	The rate of growth on credit to private sector declined to 8.89 percent in July-May 2012-13 from targeted 18.5 of previous MPS.
Net Domestic Assets	Target set at 16.8 percent by December 2013.	The net domestic assets increased by 8.69 percent till July-April, 2013* against the target of 18.4 percent in previous MPS

Source: Unnayan Onneshan, 2013. Abdicating Accountability: The Monetary Policy Statement of July - December 2013

Growth of credit in private sector registered at 11.07 percent in September 2013 over September 2012 and it was lower than the growth of 19.88 percent witnessed at the same time of the previous year.

In contrast, the rate of growth of actual disbursement of credit to the private sector in July to September, 2013 -14 over July to September, 2012-13 are 10.18 percent, representing a 5.32 percentage point gap. If the current trend continues, the gap may further widen in September to December, 2013-14.

Growth of credit in private sector registered at 11.07 percent in September 2013 over September 2012 and it was lower than the growth of 19.88 percent witnessed at the same time of the previous year. Growth of credit in this sector slowed in recent time mainly due to consecutive contractionary monetary policy taken by Bangladesh bank as well as recent political ambiguity in the country. In public sector it has observed a negative rate of growth of 43.15 percent in July-September, 2013-14 over July-September, 2012-13, which also grew at a negative rate of 4.95 percent over July-September, 2011-12. Domestic credits recorded an increase of 11.52 percent at the end of September, 2013 against the increase of 17.72 percent in corresponding period of the last year.

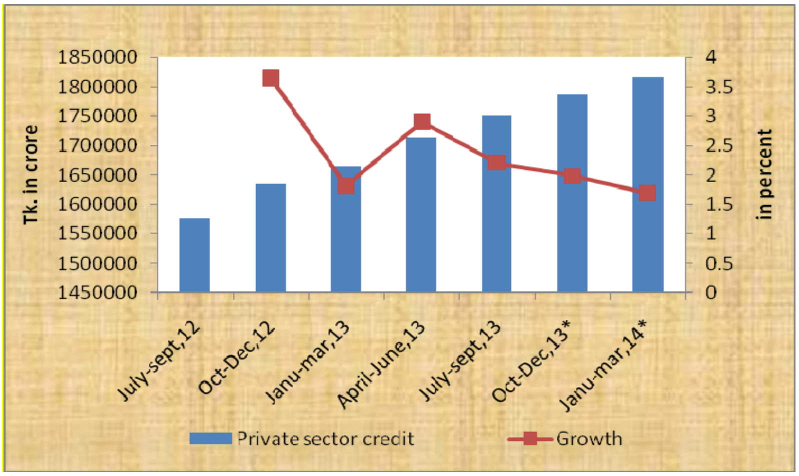
Table 2: Growth of credit in Private and Public Sector

Particulars	Sep. 2013 over Sep. 2012	Sep. 2012 over Sep. 2011	Jul-Sep 2013-14 over Jul-Sep 2012-13	Jul-Sep 2012-13 over Jul-Sep 2011-12
Domestic credit	11.52	17.72	9.9	15.77
Credit in private sector	11.07	19.88	10.18	16.68
Credit in public sector	-	-	-43.15	-4.95

Source: Author's calculation based on Statistics Department, Bangladesh Bank 2013

Growth of credit in private sector has been declining over the years after October-December, 2012 and projection says that in the first quarter of the 2013, and in the last quarter of the 2014 rate of growth of credit in private sector might decline from 2.21 percent in July-September, 2013 to 1.98 percent in October-December, 2013.

Figure 1: Growth of Credit in Private Sector (quarterly)



Source: Authors calculation based on monthly economic trend, November 2013 Bangladesh Bank.

At the end of September 2013, total liquid assets stood Tk. 182439.61 crore compared to Tk. 174171.33 crore at the end of June 2013. Excess of liquidity of the banking business reached over Tk. 83000 crore at the end of November 2013 whereas this was Tk. 80000 crore in July, 2013. Excess of liquidity of the banking sector has been increasing over the months mainly due to a noticeably low level of demand for credits by the private sector. Loan taking by the business community is seen because of decreasing trend for the forthcoming general election, consecutive contractionary monetary policy taken by Bangladesh Bank and long-persisting problems in supplying gas and power. At present, the economy has been suffering from regular strikes and blockades since beginning of the year. Another reason behind the slow growth of credit is the rigid attitude in giving loans due to a number of scams occurred this year as well as mismatch between credit and deposit growth. If this situation continues, then economy might contract further. Growth of credit in private sector went down to 11 percent in fiscal year 2012-13 compared to nearly 20 percent in the previous fiscal year.

Excess of liquidity of the banking sector has been increasing over the months mainly due to a noticeably low level of demand for credits by the private sector.

2.2 Credit Distribution in Agriculture and Industry

The disbursement of credit in both agriculture and industry sector in recent times is seen as decreasing trend which is alarming for the economy. The rate of growth of the disbursement of the industrial term loan and agricultural credit stood negative in the first quarter of the FY 2013-14.

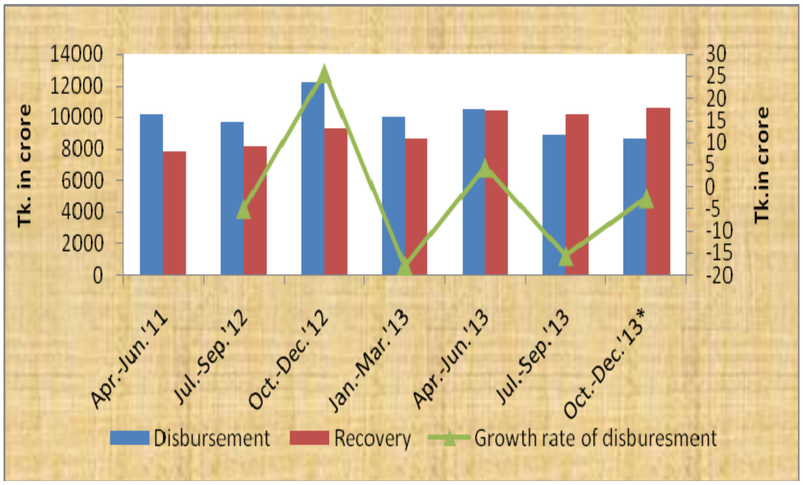
2.2.1 Industrial Loan

The rate of growth in the industrial term loan has been experiencing an irregular movement with negative rate of growth since April-June, 2011. Adequate capital is needed for fast industrialisation of a country. Loan is one of the most important factors of capital formation, mainly for developing country like Bangladesh.

The disbursement of industrial term loan stood Tk. 8880.79 crore in the first quarter of the current FY 2013-14, which is the lowest among the last five quarters, whereas it was Tk. 9720.3 crore in the first quarter of the previous FY 2012-13.

The disbursement of industrial term loan stood Tk. 8880.79 crore in the first quarter of the current FY 2013-14, which is the lowest among the last five quarters, whereas it was Tk. 9720.3 crore in the first quarter of the previous FY 2012-13. In the first quarter of the current FY 2013-14, disbursement of the industrial term loan decreased by Tk. 1632.48 crore compared to the last quarter of the previous FY 2012-13. The rate of growth of the disbursement of the industrial term loan stood negative at 15.53 percent in the first quarter of the FY 2013-14, compared to the positive rate of growth of 4.49 percent in the last quarter of the FY 2012-13. If the trend remains as usual, the disbursement might decline to Tk. 8657.887 crore as well as the rate of growth might become negative and will reach at 2.51 percent in the second quarter of the current FY 2013-14. Recovery of the industrial term loan has been increasing but at an insignificant amount. The condition of the recovery of the industrial term loan has been improved by insignificant amount since the last quarter of the previous FY 2012-13.

Figure 2: Scenario of Industrial loans



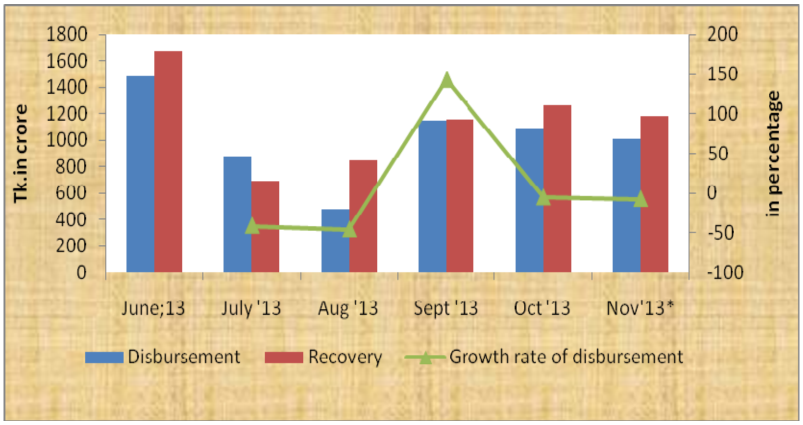
Source: Authors calculation based on Major Economic Indicators, November 2013, Bangladesh Bank

The rate of growth of agricultural credit disbursement and recovery of credit has been experiencing lower trend as well as negative rate of growth after September, 2013.

2.2.2 Agricultural Credit Disbursement and Recovery

The rate of growth of agricultural credit disbursement and recovery of credit has been experiencing lower trend as well as negative rate of growth after September, 2013. The disbursement of agricultural credit stood at Tk. 1086.56 crore in October, 2013, whereas it was Tk. 1149.04 crore in September, 2013. In August, 2013, the disbursement of agricultural credit also decreased by Tk. 399.08 crore. The rate of growth of the disbursement of the agricultural credit stood negative 5.4 percent in October 2013, where as it was positive 143.2 percent in the September 2013. Recovery of the agricultural credit disbursement has also been increasing at an insignificant amount. If the trend remains as usual, the disbursement, recovery and rate of growth of the agricultural credit disbursement might decline to Tk. 1007.36 crore, Tk. 1180.32 crore and 7.3 percent respectively in November, 2013.

Figure 3: Scenario of Agriculture Loans



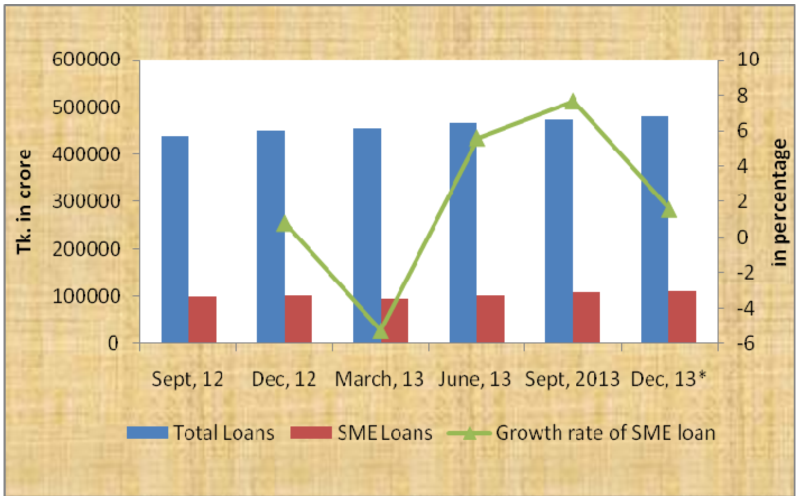
Source: Authors calculation based on Major Economic Indicators, November 2013, Bangladesh Bank

2.2.3 Disbursement of SME Loan

The total SME loan decreased by Tk. 9451.91 crore at the end of September 2013 from Tk. 24398.34 crore at the end of September 2012.

Although the total loan given by state owned commercial banks, foreign banks, and non-bank financial institution, except the specialized banks sector, increased to Tk. 473242.7 crore at the end of September, 2013 from Tk. 466162.3 crore at the end of June 2013, SME loan as a percentage of total loans has been increasing at an insignificant amount. Even though the total SME loan decreased by Tk. 9451.91 crore at the end of September 2013 from Tk. 24398.34 crore at the end of September 2012, the rate of growth of SME loan was negative at 5.25 percent in March, 2013. Especially, state owned banks observed a negative growth of 38.47 percent at the end of September 2013 compared to September 2012. According to the historical track record, total loans and SME loans might increase to Tk. 480342.4 crore and Tk. 110319 crore in December 2013, from Tk. 473242.7crore and Tk. 108599.5 crore in November2013, respectively.

Figure 4: Disbursement of SME Loan by All Banks



Source: Authors calculation based on Major Economic Indicators, November 2013, Bangladesh Bank

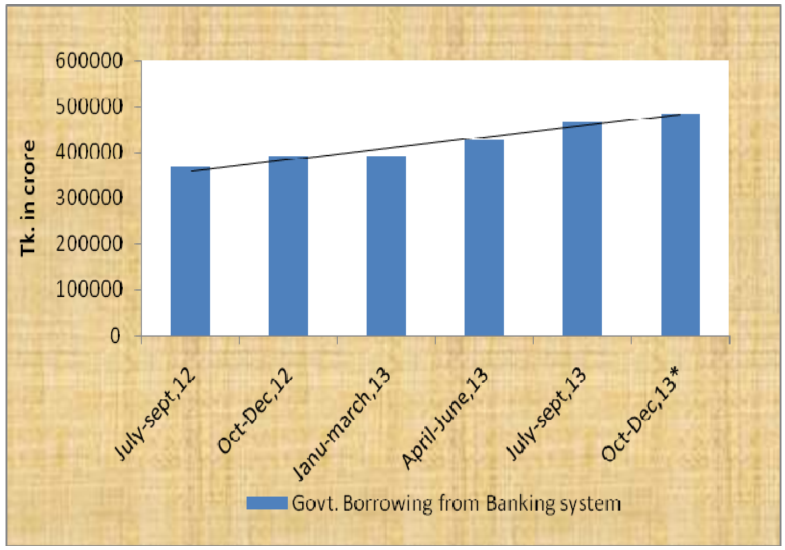
Lower disbursement of credit as well as lower recovery in agricultural, industrial, and SME sector not only impact in the present time and increase the default loan but also might impact on the medium term in the economy results in contracts the economy.

Borrowing of government from the banking system has been on the increase since July-September. As the borrowing increases every year, its expenditure is also going up due to higher interest payment.

2.2.4 Borrowing of the Government from Banking System

Borrowing of government from the banking system has been on the increase since July-September. As the borrowing increases every year, its expenditure is also going up due to higher interest payment. However, in the first quarter of 2013, government borrowed Tk. 465409.7 crore from the banking system, which is Tk. 38225.3 crore lower than the last quarter of the previous year when this amount was Tk. 427184.4 crore. In September 2013, borrowing from the banking system decreased to Tk. 152731.0 crore from Tk. 153868.9 crore in August, 2013. This borrowing results in recapitalisation by government in the SCBs.

Figure 5: Borrowing of the Government from Banking System



Source: Authors calculation based on Monthly Economic trends Novemver,Bangladesh bank 2013.

2.2.5 Credit, Investment and GDP

If the existing policies remain unchanged, the savings-investment gap might increase sharply and might continue to increase in the upcoming fiscal years.

The failing of the government to achieve growth of credit target is contributing to lower investment. At the same time, the incremental capital output ratio (ICOR) that measures investment required to increase GDP has deteriorated in the past few years. For example, the government would require investment rate to rise at 32.0 percent of GDP for achievement of 7.2 percent GDP rate of growth in FY 2013-14, if the ICOR remains same of the outgoing year. This tendency of the ICOR is also necessitating greater investment, and thus further growth of credit in the private sector. Moreover, if the existing policies remain unchanged, the savings-investment gap might increase sharply and might continue to increase in the upcoming fiscal years. This gap might increase5.47 percent and 5.81 percent of the nominal GDP in FY 2013-14 and FY 2014-15. Low credit delivery is likely to have an adverse effect on this gap as well.

3. RISK MANAGEMENT

Risk management comprises of capital adequacy, asset quality, non-performing loan, expenditure- income ratio and return on Asset (ROA), return on Equity (ROE) and non-performing loan

(NPL) which indicates the lack of presence of prudential surveillance on the financial sector and profitability of bank. Here, ROA is the ratio of net earnings of a year to average whole assets of a business in a financial year while ROE means the measurement of the rate of return on the ownership interest of the common stock owners and the term NPL refers to the loan that is in default.

Shortfall of capital by the four state-owned commercial banks (Sonali, Janata, Agrani and Rupali banks) imposed a condition that government would have to restore capital position under the extended credit facility loans driven by International Monetary Fund (IMF).

3.1.1 Capital Adequacy

Capital adequacy is determined by Capital to Risk Weighted Assets (CRAR) which is most important. Currently, a banking company is to maintain 10 percent of Risk Weighted Assets (RWA) or Tk. 200 crore whichever is higher as its minimum required capital.

Shortfall of capital by the four state-owned commercial banks (Sonali, Janata, Agrani and Rupali banks) imposed a condition that government would have to restore capital position under the extended credit facility loans driven by International Monetary Fund (IMF). To meet the requirement of the IMF, finance ministry decided to revise the recapitalisation of bank proposals. After that revision, banking division will distribute Tk. 4100 crore in the first phase against their capital shortfall of Tk. 8863 crore.

Table 3: Capital to Risk Weighted Assets Ratio (CRAR) by Types of Banks (in percent)

Types of Banks	2007	2008	2009	2010	2011	2012
SCBs	-7.12	6.93	9.02	8.92	11.68	8.13
DFIs	10.36	-5.29	0.36	-7.25	-4.49	-7.78
PCBs	10.63	11.43	12.12	10.08	11.49	11.38
FCBs	22.73	23.81	28.13	15.63	20.97	20.56
Total	7.37	10.05	11.67	9.31	11.35	10.46

Source: Bangladesh Bank, 2013.

Table: 2 shows that DFIs and SCBs are unable to meet the required capital over the period except SCBs in 2011 and DFIs in 2007. Most of the time SCBs possessed negative capital adequacy due to provision of shortfall, over burden expenditure and write off.

The 4 SCBs also fails to meet the capital adequacy requirement. On the other hand, FCBs acquired 20.56 percent capital to its risk weighted assets in the year of 2012 which is the highest among all. However, FCBs achieved very strong capital adequacy percentages over the period. PCBs dropped from 11.49 percent in the year of 2011 to 11.38 percent in 2012 which is not satisfactory. This indicates that state owned commercial banks are in vulnerable situation compared to private and foreign commercial banks.

At the end of the second quarter of 2013, non-performing loans of the banking sector reached from 8 percent in March to nearly 12 percent.

3.1.2 Asset Quality

At the end of the second quarter of 2013, non-performing loans of the banking sector reached from 8 percent in March to nearly 12 percent. Net Non-Performing Loans to total loans are higher in state owned commercial banks (SCBs) and development financial institutions (DFIs). In 2011, net-NPLs were 0.34 and 16.95 percent in state owned commercial banks (SCBs) and development financial institutions (DFIs) respectively whereas in 2012, the percentages stood too high as 12.82 and 20.4 respectively. Overall net NPLs was 0.70 percent in 2011 which increased to 4.38 percent in 2012. Increasing of NPLs means the increasing of risk on investment. The new MPS might increase the NPLs and subsequently might be acute for the new banks.

Table 4: Gross NPLs to Total Loans Ratios by Types of Banks (in percent)

Year	SCBs	DFIs	PCBs	FCBs	Total
2007	29.87	28.58	5.01	1.43	13.23
2008	25.44	25.45	4.44	1.9	10.79
2009	21.38	25.91	3.92	2.27	9.21
2010	15.66	24.15	3.15	2.99	7.27
2011	11.27	24.55	2.95	2.96	6.12
2012	23.87	26.77	4.58	3.53	10.03

Source: Bangladesh Bank, 2013.

High percentage of non-performing loans in the banks generally causes 'credit crunch' i.e. shrinkage in credit flow from the supply side of the bank.

3.1.3 Reasons behind the Increase of NPLs

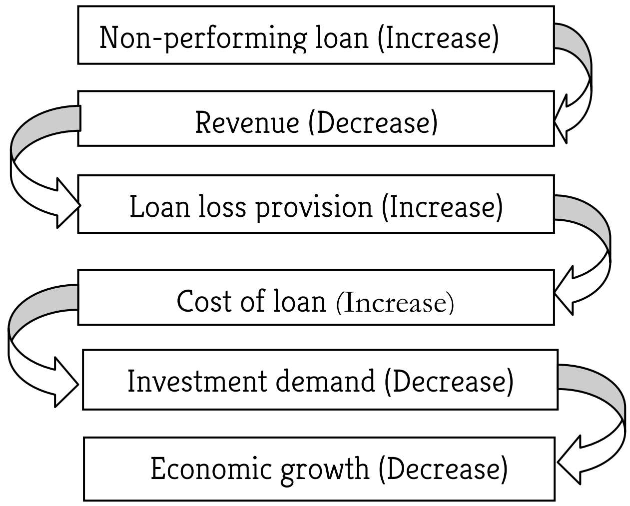
High percentage of non-performing loans in the banks generally causes 'credit crunch' i.e. shrinkage in credit flow from the supply side of the bank. At the same time, comparatively poor administration, lack of transparency, week regulations, weak monitoring cell, interest rate spread and rent seeking behaviour of the politician are also noticeable causes for increasing NPLs. NPLs reduce banks' profitability, as banks cannot take interest income from their classified loans. It also reduces loanable funds by preventing recycling.

3.1.4 Economic Implications of NPLs

Higher non-performing loan reduces current revenue, resulting high loss of loss provision and high cost of loan which causes low investment and decrease of economic growth.

Mechanism of the contraction of the economy for non-performing loan:

Figure 6: Consequences of Non-performing Loan in the Economy



Source: Authors perception

Only increased cost of loan is not liable for low investment demand, consecutive contractionary monetary policy taken by Bangladesh Bank and present political turmoil are also liable. It is obvious that NPLs reduce banks' profitability, as banks cannot appropriate interest income from their classified loans. NPLs reduce loanable 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.

Expenditures- incomes ratio (EIR) is the indicator of sound management of banking sector. This are explained below by different types of banks. The reason behind high EI ratio of DFI and SCBs are mainly because of loan loss provision, high administrative, overhead expenses, interest suspense for classified loan and the lack of presence of prudential surveillance of the banking sector. Internal control system and high-quality management contributes to lower the EIR in PCBs; on the other hand, FCBs business is mostly based on important cities and their operating cost is low for which they have low EIR.

Table 5: Expenditure-Income Ratio (EIR) by Type of Banks

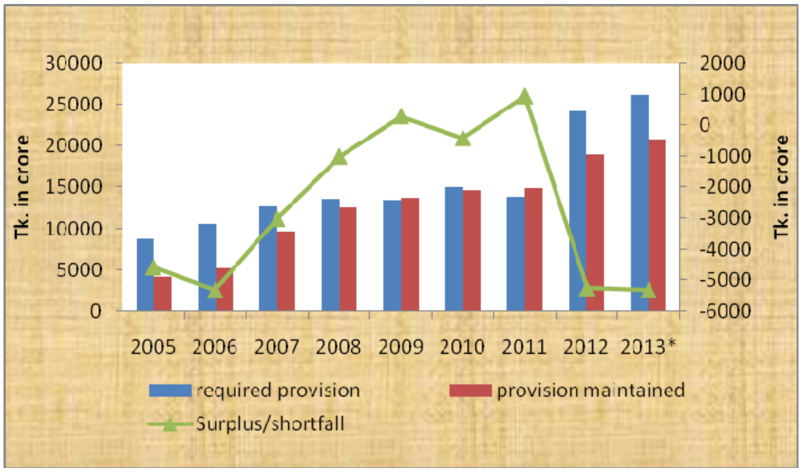
Types of Banks	2007	2008	2009	2010	2011
SCBs	100	89.6	75.6	80.7	62.7
DFIs	107.7	103.7	112.1	87.8	88.6
PCBs	88.8	88.4	72.6	67.6	71.7
FCBs	72.9	75.8	59	64.7	47.3
Total	90.4	87.9	72.6	70.8	68.6

Source: Bangladesh Bank, 2013

The gap between required provision and the provision maintained has been experiencing a negative trend over the years since 2005, except in 2009 and 2011.

The gap between required provision and the provision maintained has been experiencing a negative trend over the years since 2005, except in 2009 and 2011. In 2012, required provision was Tk.24239 crore against the provision maintained Tk. 18977 crore results in shortfall was Tk. 5262 crore whereas in 2011, there was surplus in case of loan loss provisioning. A business as usual projection says that in 2013, the shortfall of required provision and the provision maintained might increase which is an alarming situation for the bank's profitability.

Figure 7: Loan Loss Provisions of Banking Sector

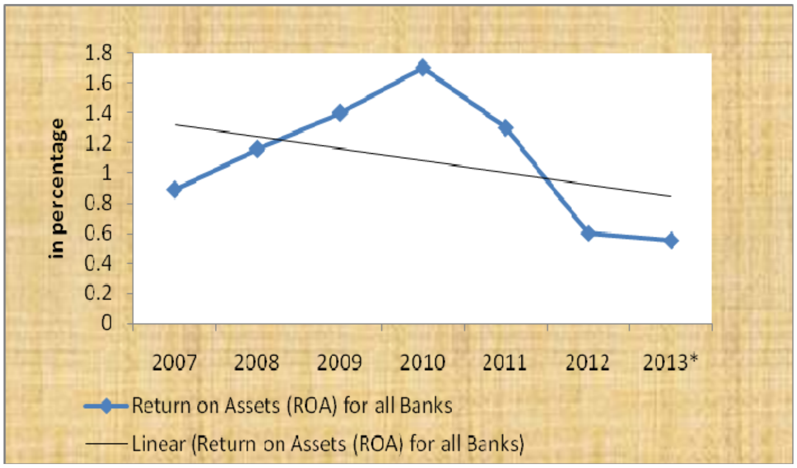


Source: Source: Authors calculation based on Major Economic Indicators, November 2013, Bangladesh Bank

3.1.5 Earnings

Return on Assets (ROA) indicates the productivity of the assets i.e. how much income is earned from per unit of assets. According to Basel- accord, ROA should be more than 1 percent. On the other hand, return on Equity (ROE) is another important measure of earning and profitability determination which indicates net income after tax to total equity. State owned commercial banks (SCBs) have achieved nearly zero percent of ROA over the period of 2007 to 2012. The scenario is much worst in case of Development Financial Institutions (DFIs) while most of the time ROA was less than 1 percent in 2010 to 2012. In 2012, overall ROA in the banking sector was 0.60 percent where as it was 1.3 percent in 2011. It these trends continue then overall ROA in the banking sector might decrease to 0.55 percent in 2013. Insignificant profit during this period has occurred due to the worst ratio of ROA scenario in SCBs and DFIs. The position of foreign commercial banks (FCBs) was strong enough over the whole period. The DFIs' situation is not found better due to the operating loss incurred by Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB).

Figure 8: Return on Assets (ROA) for all Banks (percent)



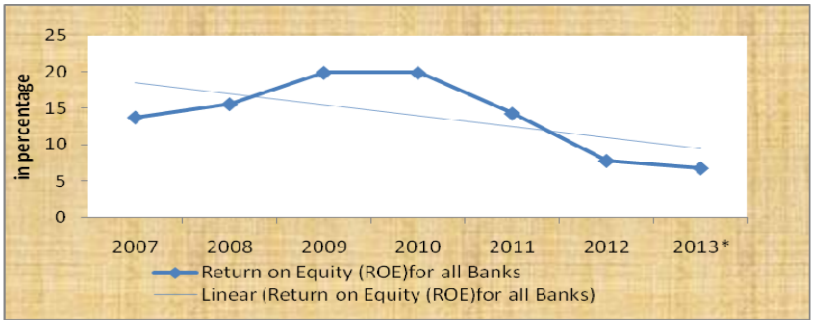
Source: Bangladesh Bank, 2013.

Overall ROE in banking sector was 14.3 percent in 2011 which reduced by 6.5 percentage points in 2012. Projection says that if the current trend of ROE in the banking sector persists, then ROE might decrease to 6.80 in 2013

Higher value of ROE is an indication of high productivity of equity. Overall ROE in banking sector was 14.3 percent in 2011 which reduced by 6.5 percentage points in 2012. Projection says that if the current trend of ROE in the banking sector persists, then ROE might decrease to 6.80 in 2013. Reduction of ROE ratio in banking sector indicates that share holder profits are declining gradually.

In 2010, the position of state owned commercial banks (SCBs) was the worst among the other types of banks and ROE of state owned commercial banks was -11.87 percent. The negative value means huge loss in the business of SCBs. Private commercial banks (PCBs) possessed a good progress of 10.17 percent in 2012. On the other hand, foreign commercial banks (FCBs) hold a consistent level of ROE which was 17.29 percent in 2012. DFIs were also in a worse situation in 2010, probably due to huge provision shortfall and net loss in that year.

Figure 9: Return on Equity (ROE) for all Banks (percent)



Source: Bangladesh Bank, 2013.

3.1.6 Implications of Risk Management and Stress on Fiscal System

Presently, return on equity and return on assets of banking sector are low, which indicate the low profit of the bank and this might be lesser collection of taxes

Presently, return on equity and return on assets of banking sector are low, which indicate the low profit of the bank and this might be lesser collection of taxes since bank is the number one source of tax under large tax unit of NBR and NBR collects the major portion of revenue from banking sector. In addition, the revenue target might fail to achieve the revenue target since lesser investment is witnessed from lower growth of credit.

3.1.7Loan Classification and Provisioning

Gross and/or net non-performing assets or loans (NPA/NPL) are considered as the most important indicators identifying problems with asset quality. Government dictated the credit disbursement in the early years and political influence also played its part in the decision making for sanctioning loans from the banking sector. Besides, State Owned Enterprises also borrowed from the banking sector and these loans were never fully repaid. The privatization process along with the financial sector reforms with globalisation necessitated further impetus in the process of reform. The reforms should continue for a smooth functioning of the financial market.

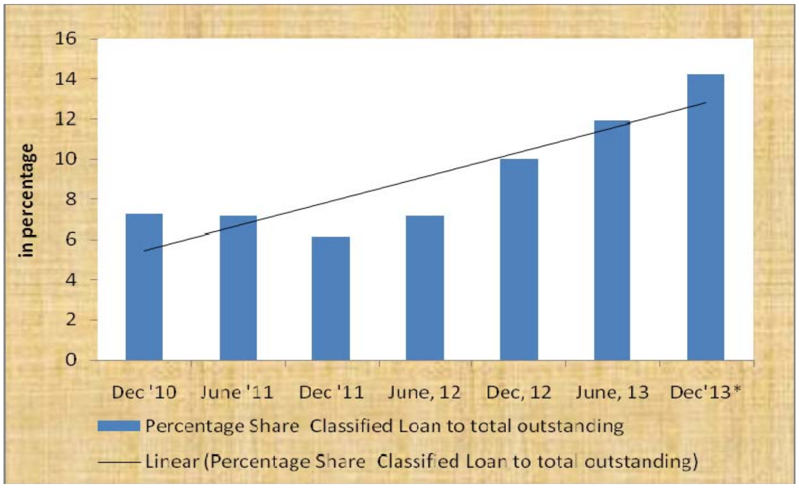
Loans that are not paid on time and are nominated as troubled assets by banks are classified loans. Classified loans are usually issued according to terms and regulations of the bank. The extent of default loans increased in the third quarter due to tightening the loan classification guideline, sluggish business activities during the political uncertainty and interruption in energy supplies.

The percentage share of classified loan to total outstanding loan has been increasing in every six year. At the end of September 2013, the percentage share of classified loan to total outstanding loan was 12.79 percent, whereas it was 11.91 percent at the end of June, 2013. If the trend remains as usual, the percentage share of classified loan to total outstanding might increase to 14.21 percent at the end of December 2013.

The classified loans increased by Tk.4400 crore or 8 percent to Tk.56700 crore in the July-September quarter from Tk.52300 crore of the April-June quarter of this year, according to Bangladesh Bank data. The total classified loan was Tk.51000 crore in March this year, which was Tk.29000 crore in June, 2012.

The classified loans increased due to tightening the guideline. Besides, sluggish business during the political uncertainty and lack of gas and electricity pushed the classified loans up. According to the Financial Stability Report (FSR)-2012 brought out by Bangladesh Bank, it seems that the classified loans in the state-owned banks are high due to the nature of their operations (lack of efficiency in fund management, extending obligatory financing towards social and economical priority sectors and politically motivated lending).

Figure 10: Share of Classified Loan to Total Outstanding



Source: Major Economic Indicators, November 2013, Bangladesh Bank

Embezzlement of Hall-mark, Bismillah Group and BASIC bank has become talk of the country in recent times. This loan scrap is alarming for our banking as well as the financial sector. A brief description of loan scrap is given below:

Table 6: Loan Scrap in Banking Sector

Name of Company	Amount(Taka)	Name of Branch
Hall -mark group	Tk. 2,554 crore	Ruposhi Bangla branch of Sonali Bank
Bismillah Group	Tk. 1100 crore	Four private banks(Prime Bank, Jamuna Bank, Shahjalal Islami Bank and Premier Bank
BASIC Bank Limited	Tk. 1500 crore	By Dilkusha, Gulshan and Shantinagar Branch

Source: The daily star, April, September and July 2013

4. FINANCIAL REFORM

Financial liberalisation (FL) refers to the regulation of domestic financial markets and the liberalisation of the capital account. It is generally believed to improve financial sector development, which in turn, will enhance economic growth. The liberalisation process began with the privatisation of state owned enterprises in 1976 in the backdrop of a significant deterioration of the economic condition. Formally, the financial sector reform programme was launched in 1984 with the appointment of the national commission on money, banking and credit (NCMBC).

4.1 Liberalisation of Interest Rate and Financial Inclusion

The Bangladesh Bank (BB) introduced a flexible market-oriented interest rate policy in January 1990, abolishing the earlier system of centrally administered interest rate structure and providing for sector specific concessional refinance facilities. Banks are now free to fix their rates of interest on their deposits of different types after withdrawal of restriction about the floor rate of interest in 1997. Banks are also free to fix their rates of interest on lending except for export sector, which has been fixed at 7 percent per annum with effect from January 10, 2004. A high spread could also mean that the deposit rates are unusually low which discourage savings and reduce resources available to finance bank credit.

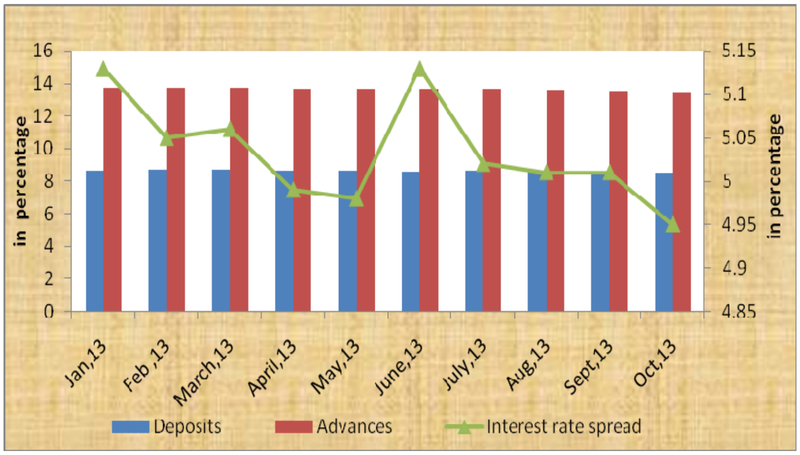
Although liberalisation held in Bangladesh earlier but interest rate spread(IRS) did not decrease as well as lending rate is still now so high and business persons are not capable of taking loan with high rate of interest. This means that Bangladesh did not get the opportunity of the liberalization of rate of interest.

It is more likely that the IRS in Bangladesh is indicative of interactions of the factors: (i) high costs of intermediation as a consequence of large non performing loan (NPL) (ii) practice of setting higher than competitive deposit interest rates resulting in high lending rates and hence IRS.

Interest on advances remains relatively too high and this is the obstacle of taking loan by the business community.

The interest rate spread has seen many ups and downs in this year and in the month of October 2013, the rate was below 5 percent. But the fact is that, in April 2013, it was also seen below 5 percent and after that it increased as earlier trend. In both the case, it is seen that advances remain relatively too high and this is the obstacle of taking loan by the business community.

Figure 11: Interest Rate Spread



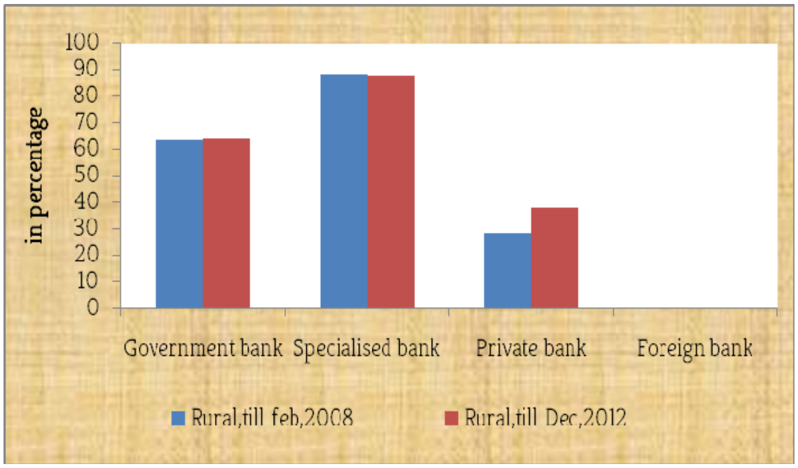
Source: Major Economic Indicators, November 2013, Bangladesh Bank

It is possible to reduce the IRS to some extent by increasing operating efficiency in the banking sector through reducing overhead costs and the proportion of NPL could contribute in reducing IRS and strengthening of capital market could be an alternative mode of mediating private savings, and in this way it is possible to make the sector more competitive in the medium-to-long run.

between February 2008 and December 2012 the percentage of branches of bank in rural areas decreased from 57.94 to 57.20 percent, whereas the share of branches of bank in urban areas increased from 42.06 to 42.80 percent.

Moreover, even after following the financial liberalisation thesis for more than decades, wide disparity exists between rural and urban communities in terms of financial inclusion .The avowed strategy of government in promoting financial inclusion has witnessed little realisation as private and foreign banks have made hardly any progress in setting branches in remote and rural areas of the country though they control almost 75 per cent of the banking sector. For example, between February 2008 and December 2012 the percentage of branches of bank in rural areas decreased from 57.94 to 57.20 percent, whereas the share of branches of bank in urban areas increased from 42.06 to 42.80 percent. Disparity also exists between the level of commitment of state owned commercial banks and that of private and foreign commercial banks. As of December 2012, for example, 63.97percent branches of state owned commercial banks were located in rural areas, as opposed to only 38.08 percent branches of private commercial banks. The foreign banks have yet to establish any branch in rural areas as of December 2012.

Figure 12: Expansion of Bank Branches in Rural Areas



Source: Bangladesh Economic Review 2008 and 2013

5. CONCLUSIONS

Reduction in growth of credit is affecting the trends of investment of the country. Especially, as the savings-investment gap might increase in the upcoming fiscal years, the channeling of private investment becomes critical.

Problem of banking sector is widespread and is not related to banking system only. The regulatory entity should be independent but accountable. Prudential regulation should be limited to deposit-taking institutions and should be clearly separated from non-prudential regulation.

The problem of lower profitability of bank is that it might reduce the tax and thus make a trace on fiscal system where bank is the number one source of tax under large tax unit of NBR. Moreover, the revenue target may face hurdle from another side where lower growth of credit may affect investment and growth, and thus tax collection.

Although liberalisation policy has been pursued for years, the result is still far from the expected ones .Interest rate is still too high (above 15 percent) which is not favourable to business entities. In addition, the target of financial inclusion has not been facilitated by this avowed policy.

Therefore, channeling sufficient loan to productive sectors and investors should be a major aim of the reform activities. Additionally, non-performing loans need to be e focused exclusively in an efficient and creative way. A medium- to long-term financial sector strategy should be developed that lays out further reforms based on previous reform experiences.

An effective legal framework provides the central bank with necessary power for improvement in supervision and regulatory capacity, and streamlining of enforcement of prudential guidelines.

The sector has been facing several problems in terms of low profitability (return on Asset (ROA), return on Equity (ROE) and non-performing loan (NPL)) after 2010. In 2011 and 2012, the situation continues worsening and projection reveals that in 2013 it might further deteriorate. Furthermore, several loan scams occurred in this sector but no proper action is taken yet. So steps should be taken to make the banking sector stable; otherwise country might miss the target of revenue collection because a large amount of tax comes from this source.

An effective legal framework provides the central bank with necessary power for improvement in supervision and regulatory capacity, and streamlining of enforcement of prudential guidelines.

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UNNAYAN ONNESHAN
16/2 Indira Road, Farmgate
Dhaka-1215, Bangladesh
Tel.: +880 (2) 8158274, +880 (2) 9110636
Fax: +880 (2) 8159135
Email: info@unnayan.org
Web: www.unnayan.org