Banking Sector Caught in Trap

Bangladesh Economic Update

July 2014

উন্নয়ন অন্বেষণ
UNNAYAN ONNESHAN

Bangladesh Economic Update
Volume 5, No.07, July 2014

Acknowledgement
Bangladesh Economic Update is a monthly publication of the Economic Policy Unit of Unnayan Onneshan, a multidisciplinary research organisation based in Dhaka, Bangladesh. The report is prepared by **Nabila Nasrin** under the guidance of **Rashed Al Mahmud Titumir**. The Update has been copy edited by **Abid Feroz Khan**.

উন্নয়ন অন্বেষণ
UNNAYAN ONNESHAN

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 issue of Bangladesh Economic Update analyses that the country's banking sector is caught in trap, characterised by high rate of interest, excess liquidity and declining growth in disbursement of credit to private sector.

The current issue of Bangladesh Economic Update analyses that the country's banking sector is caught in trap, characterised by high rate of interest, excess liquidity and declining growth in disbursement of credit to private sector, intermediating lower investment, coupled with poor risk management, fraudulence, driven by captured governance and lax oversight, resulting in lower profitability to the shareholders. Besides this backdrop, questions are being raised concerning the far-sighted deregulation of the financial sector.

Growth of credit in private sector registered at 11.46 percent in March 2014 over March2013 where it was12.72 percent in March 2013over March 2012 that indicates a 1.26 percent decrease witnessed at the same period in the previous year. Growth of credit in public sector has been observed a growth of 10.76 percent in March 2014 over March2013 compared to 8.71 percent in March 2013over March 2012, an increase of 2.05 percent.

The interest rate spread remains high in this year and the rate was 5.14 percent in April 2014, but in April 2013 the rate was below 5 percent. Both scenarios indicate that advances remain relatively too high and this is the obstacle of taking loan by the business community. The lending rate was 13.40 percent, 13.36 percent and 13.25 percent in February, March, and April of 2014 respectively.

Low level of demand for credits by the private sector is manifested in the increasing situation of liquidity of the banking sector.

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. 136201.24crore at the end of March 2014whereas this was Tk. 83000 crore in November, 2013 and 79440.56crore at the end of June2013. Furthermore, the loan-deposit ratio (LDR) has been on a declining trend for the past one year. In March 2014, LDR of the banking business stood at 63.9 percent that was 77.85 percent in December 2013.

Growth of credit in both industry and agriculture has declined. The disbursement of industrial term loan stood Tk. 9283.50 crore in the January - March 2014, which is the lowest among the last five quarters. This amount was TK 10061.24 crore in the same period of the previous year. As a result, the rate of growth of the disbursement of the industrial term loan stood negative at 8.94 percent in the January-March quarter of the FY 2013-14, compared to the positive rate of growth of 6.88 percent in the October-December quarter of the same fiscal year.

Growth of credit in both industry and agriculture has declined. The disbursement of industrial term loan stood Tk. 9283.50 crore in the January - March 2014, which is the lowest among the last five quarters.

The present inefficiency in banking sector can partially be attributed to captured governance and oversight. Lack of good management, poor surveillance over the bank, political instability and abuse of political power in this sector are worsening the situation.

The present inefficiency in banking sector can partially be attributed to captured governance and oversight.

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 bank).

Overall net non performing loan (NPL) increased to 3.4percent in March 2014 from 2 percent in December 2014. At the end of March 2014, net-NPLs were 4.7 and 24.2 percent in state owned commercial banks (SCBs) and development financial institutions (DFIs) respectively, whereas in December 2013, the percentages were 1.7 and 19.7 respectively.

The share of percentage of classified loan to total outstanding loan has been increasing in every six months. At the end of March 2014, the share of percentage of classified loan to total outstanding loan was 10.5 percent, whereas it was 8.9 percent at the end of December, 2013.

Finally, although liberalisation policy has been pursued for years, the result is still far from the expected ones .Interest

Various reform programmes have been taken but neither could curb the non performing loan and the incidence of bank fraudulence.

rate is still too high (above 13 percent) which is not favourable to business entities and economic growth of our country. Various reform programmes have been taken but neither could curb the non performing loan and the incidence of bank fraudulence.

2. CREDIT DISBURSEMENTS

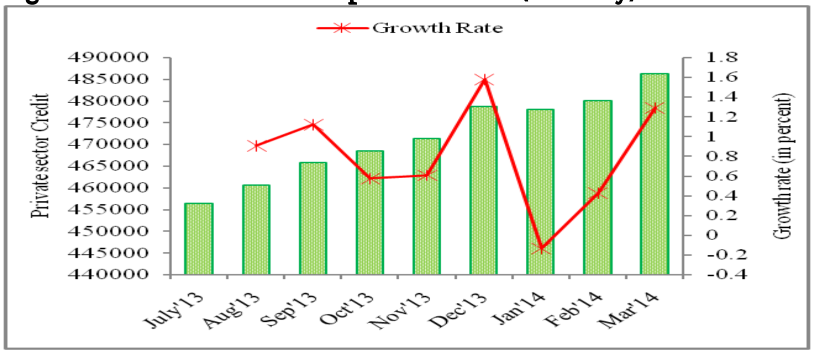
Three problems have mainly gained prominence in case of credit disbursement. First, the amount of non-performing loan is increasing, requiring higher allocation as provision. Second, lack of profitability is reducing the taxable income of the government from the banking sector. Third, state owned banks have continued to be dependent of recapitalisation from the government.

2.1 Credit Disbursement between Private and Public Sector

Growth of credit in private sector registered at 11.46 percent in March 2014 over March 2013 and it was lower than the growth of 12.72 percent witnessed at the same time of the previous year. The target of credit in private sector in the current MPS (Monetary Policy Statement) has been set at 16.5 percent by June 2013. This target is 1 percentage points less than the target (15.5 percent) of previous Monetary Policy Statement.

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 and lack of physical infrastructure in the country. If the current trend continues, the gap may further widen in FY 2014-15.

Figure 1: Growth of credit in private sector (monthly)



Source: Authors calculation based on monthly economic trend, May 2014 Bangladesh Bank

In public sector, a rate of growth of 10.76 percent has been observed in March 2014 over March 2013 compared to 8.71 percent in March 2013 over March 2012. Domestic credits recorded a decrease of 11.32 percent at the end of March 2014 over March 2013 against the increase of 11.86 percent in corresponding period of the last year.

Table 1: Growth of credit in private and public sector

Indicators	March 2014 over March 2013(In percent)	March 2013 over March 2012(In percent)	July-March,2013-14(In percent)	July-March,2012-13(In percent)
Domestic Credit	11.32	11.86	7.34	7.06
Credit in Private Sector	11.46	12.72	7.57	6.98
Credit in Public Sector	10.46	8.71	6.49	7.37

Source:Bangladesh Bank, 2014

The rate of growth of the disbursement of the industrial term loan and agricultural credit stood negative in the last quarter of the FY 2013-14.

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 last quarter of the FY 2013-14.

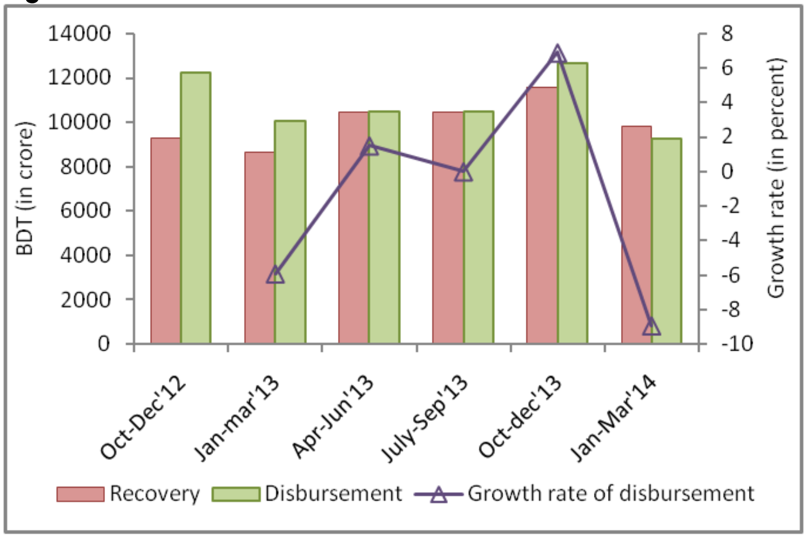
2.2.1 Industrial loan

The rate of growth in the industrial term loan has been experiencing an irregular movement with frequent negative rate of growth. Adequate capital is needed for 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 at Tk. 9283.5 crore in the January-March quarter of the FY 2013-14, which is the lowest among the last five quarters, whereas it was Tk. 10513.27 crore and Tk. 12684.66 crore in July-September and October-December quarters of the FY 2013-14. As a result, the rate of growth of the disbursement of the industrial term loan stood negative at 8.94 percent in the

January-March quarter of the FY 2013-14, compared to the positive rate of growth of 6.88 percent in the October-December quarter of the same fiscal year. The condition of the recovery of the industrial term loan has been improving by insignificant amount since the last quarter of the FY 2012-13.

Figure 2: Scenario of industrial loans



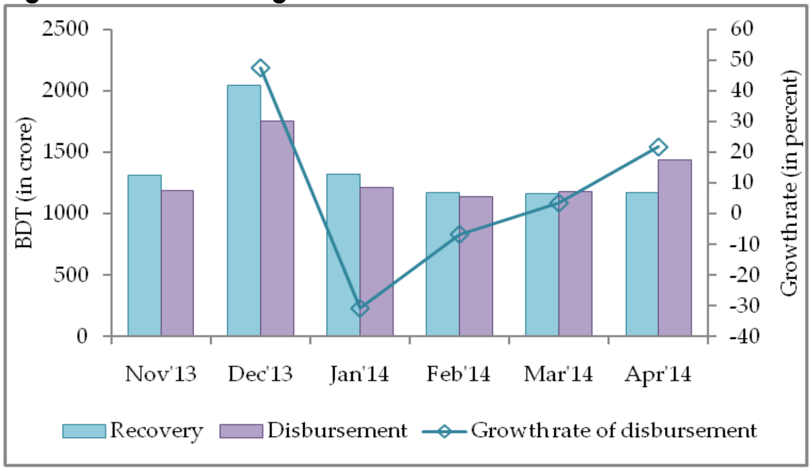
Source: Monthly Economic Update, UO

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 December, 2013.

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 December, 2013. The disbursement of agricultural credit stood at Tk. 1757.5 crore in December, 2013, whereas it became Tk. 1218.97 crore in January, 2014. In February, 2014, the disbursement of agricultural credit also decreased by Tk. 79.93 crore, whereas the amount slightly increased 1180.05 crore and 1438.05 crore in March and April of FY 2013-14 respectively. The rate of growth of the disbursement of the agricultural credit, therefore, stood at negative 6.56 percent, positive 3.60 percent and positive 21.86 percent in February, March and April of 2014 respectively. On the other hand, recovery of the agricultural credit disbursement has been increasing at an insignificant amount.

Figure 3: Scenario of agriculture loans



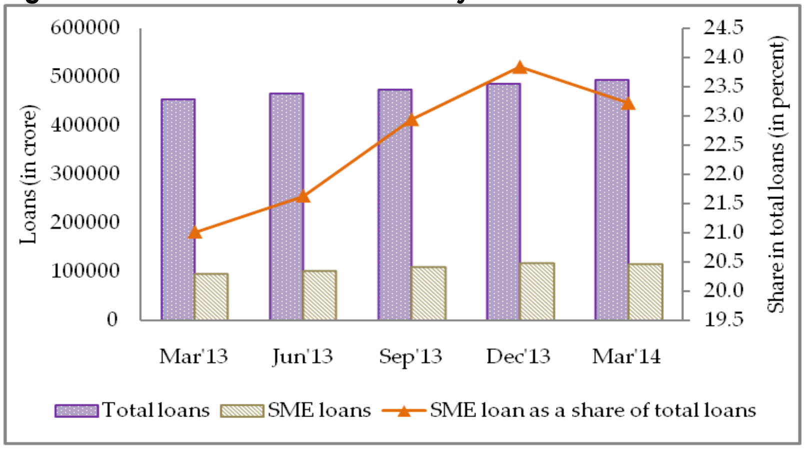
Source: Authors calculation based on Monthly Economic Trend, Bangladesh Bank.

The rate of growth of SME loan has decreased from 6.71 percent in December 2013 to negative 1.12 percent in March 2014.

2.2.3 Disbursement of SME loan

Although the total loan given by state owned commercial banks, foreign banks, and non-bank financial institutions, except the specialised banks, increased to Tk. 493306 crore at the end of March 2014 from Tk. 455884.6 crore at the end of December 2013, the SME loan as a percentage of total loans has decreased during the same period. The total SME loan decreased by Tk. 1301.4 crore between the period of December 2013 and March 2014 and has been calculated at Tk. 114583.5 crore in March 2014. As a result, the rate of growth of SME loan has decreased from 6.71 percent in December 2013 to negative 1.12 percent in March 2014.

Figure 4: Disbursement of SME loan by all banks



Source: Authors calculation based on Major Economic Indicators, May 2014, Bangladesh Bank

2.3. Liquidity Scenario of the Banking Business

At the end of March 2014, total liquid assets stood at Tk. 207493.91 crore compared to Tk. 182439 crore at the end of the September which was 174171.33 crore at the end of June 2013. Excess of liquidity of the banking business reached over Tk. 136201.21 crore at the end of March, 2014 Tk. whereas this was 83000 crore at the end of November 2013 and approximately Tk. 80000 crore in June, 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.

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. Another reason behind the slow growth of credit is the rigid attitude in giving loans due to a number of scams occurred as well as mismatch between credit and deposit growth.

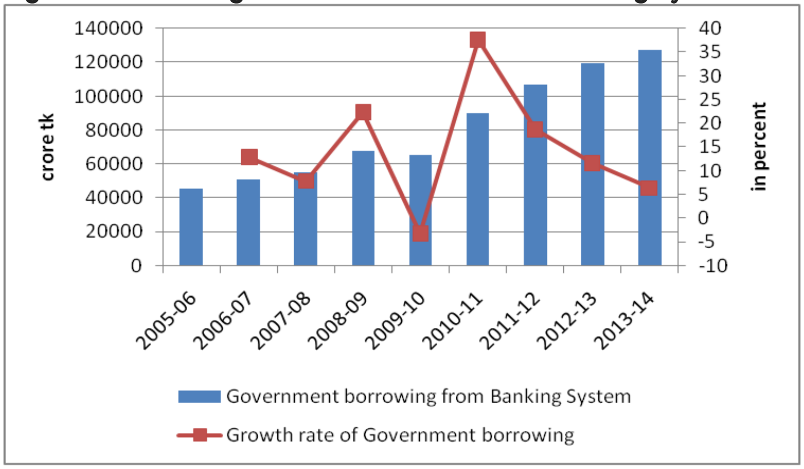
To decrease the excess of liquidity and to cut down the inflation, Bangladesh Bank increases the Cash Required Requirement (CRR) from 5.5percent to 6 percent. Now the question arises whether this policy will be effective or not as scheduled banks now have to deposit more to the Bangladesh Bank from which no earnings will come inspire them to increase the advance rate which will slow the growth of credit and investment.

2.4 Borrowing by the Government from Banking System

Borrowing by the government from the banking system has seen an increasing trend since July-September. As the borrowing increases every year, its expenditure is also going up due to higher interest payment.

Borrowing by the government from the banking system has seen an increasing trend since July-September. As the borrowing increases every year, its expenditure is also going up due to higher interest payment. In the June of 2012, however, government borrowed Tk. 91728.90 crore from the banking system, which is Tk. 110124.70 crore in June2013 and 114044 crore in March 2014. Borrowing increases by16.42 percent in March2014 over March2013 which was 8.47 percent in March 2013 over March 2012.

Figure 5: Borrowing of the Government from Banking System



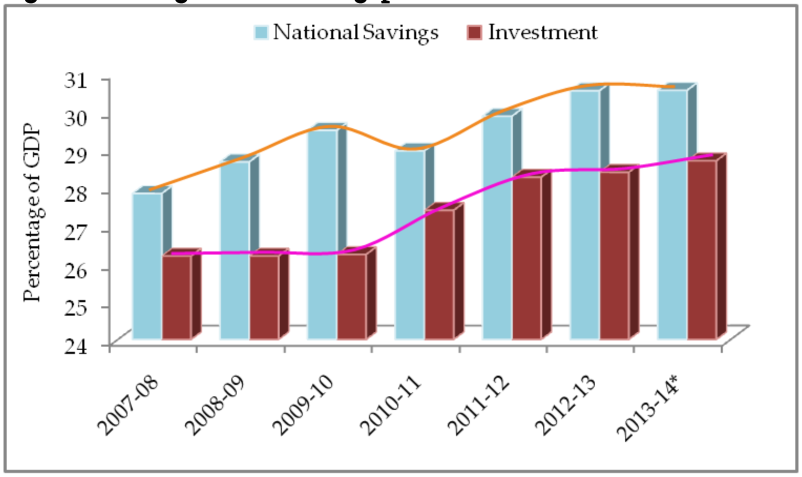
Source: Authors calculation based on Bangladesh Economic Survey, Ministry of Finance, 2013.

A gap of 1.6 percent of GDP has been observed between total savings and investment in the FY 2011-12, whereas the gap reached 2.14 percent in FY 2012-13 and slightly decreased to 1.85 percent (provisional) in FY 2013-14.

2.5 Credit, Investment and GDP

The failure of the government to achieve the target of growth in credit 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 percent of GDP for achievement of 7.2 percent GDP rate of growth in FY 2013-14, but actually it was 28.69 percent and growth rate in the GDP was 6.12 percent. This tendency of the ICOR is also necessitating greater investment, and thus further growth of credit in the private sector. Moreover, the gap between savings and investment has increased over time, which is also a problem for the expansion of the economy. An increase in savings and investment ratio increases the rate of growth of the economy. On the other hand, the government fails to create the investment demand due to lack of infrastructure development. The savings-investment gap has been increased sharply and considering the same business scenario will continue further if the existing policies prevail in future. A gap of 1.6 percent of GDP has been observed between total savings and investment in the FY 2011-12, whereas the gap reached 2.14 percent in FY 2012-13 and slightly decreased to 1.85 percent (provisional) in FY 2013-14.

Figure 6: Savings –investment gap



Source: Unnayan Onneshan, long on targets, short on reality, June 2014

3. RISK MANAGEMENT

Risk management comprises of capital adequacy, asset quality, expenditure- income ratio and Return on Asset (ROA), Return on Equity (ROE) and NPL which indicates the lack of presence of prudential surveillance on the financial sector and profitability of bank.

3.1 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).

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 recapitalization of bank proposals. After that revision, banking division will distribute Tk. 41 billion in the budget FY 2014 against their capital shortfall of Tk. 88.6 billion in December 2013.

Table 2: Capital to Risk Weighted Assets Ratio (CRAR) by Types of Banks (in percent)

Types of Banks	2009	2010	2011	2012	2013(June)
SCBs	9.02	8.92	11.68	8.13	1.2
DFIs	.36	-7.25	-4.49	-7.78	-9.0
PCBs	12.12	10.08	11.49	11.38	11.4
FCBs	28.13	15.63	20.97	20.56	20.3
Total	11.67	9.31	11.35	10.46	9.1

Source: Bangladesh Bank, 2013

The four SCBs failed to meet the capital adequacy requirement. On the other hand, FCBs acquired 20.30 percent capital to its risk weighted assets in the year of June 2013 which is the highest among all. The capital adequacy of PCBs increased from 11.38 percent in the year 2012 to 11.4 percent in 2013 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 third quarter of 2014, gross non-performing loan of the banking sector reached from 8.9 percent in December 2014 to nearly 10.5 percent.

3.2 Asset quality

At the end of the third quarter of 2014, gross non-performing loan of the banking sector reached from 8.9 percent in December 2014 to nearly 10.5 percent. Gross non-performing loans to total loans are higher in state owned commercial banks (SCBs) and development financial institutions (DFIs). In March 2014, gross-NPLs stood too high as 22 percent and 30.6 percent in state owned commercial banks (SCBs) and development financial institutions (DFIs) respectively whereas in December 2013, the percentages were 19.8 and 26.8 respectively. Overall net NPLs was 2 percent in December2013 which increased to 3.4 percent in March 2014. 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 3: Gross NPLs to total loans ratios by types of banks (in percent)

Year	SCBs	DFIs	PCBs	FCBs	Total
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
End of june,2013	26.4	26.2	6.6	4.7	11.9
September 2013	28.8	29.4	7.3	6	
December 2013	19.8	26.8	4.5	5.5	8.9
March 2014	22.0	30.9	5.8	5.3	10.5

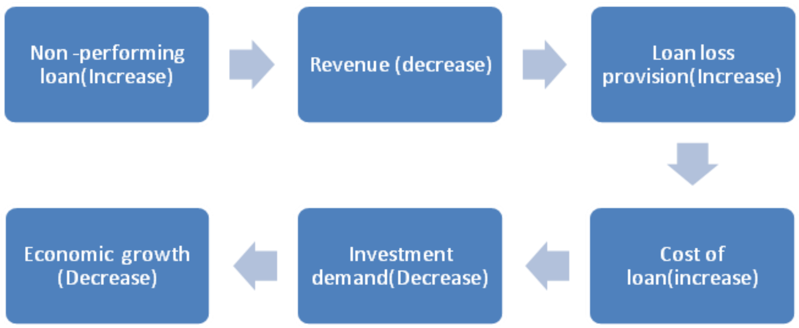
Source: Bangladesh Bank, 2014

3.2.1 Economic implications of NPLs

Higher non-performing loan reduces current revenue, resulting high loss of 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:

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

Figure 7: 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.

3.3 Expenditures- incomes ratio (EIR)

Expenditures- incomes ratio (EIR) is the indicator of sound management of banking sector. 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 4: Expenditure-Income Ratio (EIR) by Type of Banks

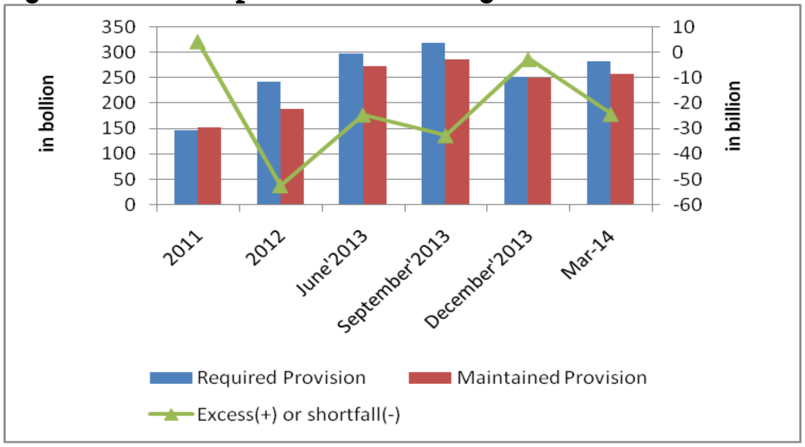
Types of Banks	2008	2009	2010	2011	2012
SCBs	89.6	75.6	80.7	62.7	73.2
DFIs	103.7	112.1	87.8	88.6	91.2
PCBs	88.4	72.6	67.6	71.7	76.0
FCBs	75.4	59	64.7	47.3	49.6
Total	87.9	72.6	70.8	68.6	74.0

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 which was Tk. 5262 crore whereas in March 2014, required provision was Tk.28300 crore against the provision maintained Tk. 25870 crore results in shortfall which was Tk. 2430 crore. A business as usual projection says that in 2014, the shortfall of required provision and the provision maintained might increase which is an alarming situation for the bank's profitability.

Figure 8: Loan loss provisions of banking sector

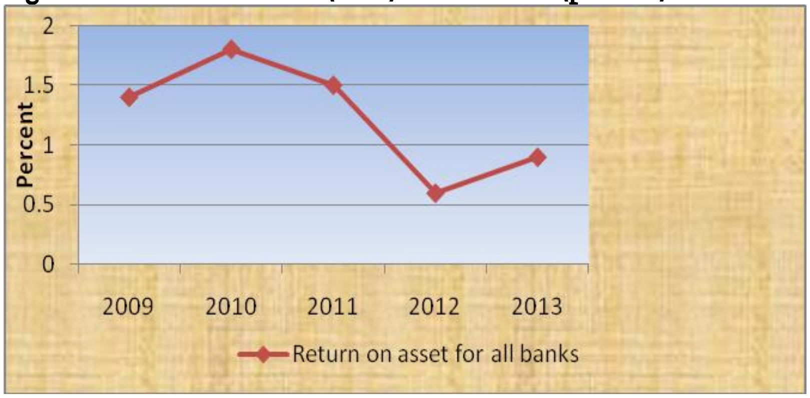


Source: Authors calculation based on Major Economic Indicators, May 2014, Bangladesh Bank

3.4 Earnings

ROA indicates the productivity of the assets i.e. how much income is earned from per unit of assets. According to Basel-II accord, ROA should be more than 1 percent. On the other hand, ROE is another important measure of earning and profitability determination which indicates net income after tax to total equity. In 2013, overall ROA in the banking sector was 0.90 percent where as it was 0.60 percent in 2012. If these trends continue, overall ROA in the banking sector might be 0.82 percent in 2014. 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 9: Return on Assets (ROA) for all banks (percent)

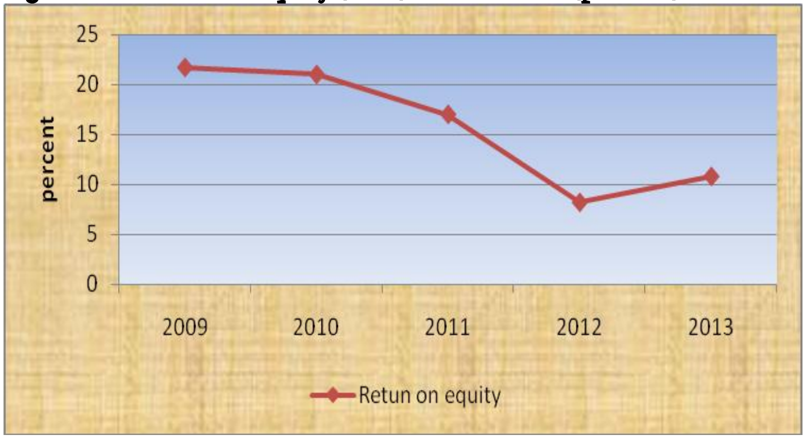


Source: Bangladesh Bank, 2013.

Higher value of ROE is an indication of high productivity of equity. Overall ROE in banking sector was 17.0 percent in 2011 which reduced to 8.2 percentage points in 2012, then again increased to 10.8 percent in 2013.Projection says that if the current trend of ROE in the banking sector persists, then ROE might 9.44 percent 2014. Reduction of ROE ratio in banking sector indicates that share holder profits are declining gradually.

The position of state owned commercial banks (SCBs) in 2013 was better than in the previous year 2012 and ROE of state owned commercial banks was -11.9 percent in 2012 improved to 8.7 in 2013. The negative value means huge loss in the business of SCBs. Private commercial banks (PCBs) possessed a good progress of 10.7 percent in 2013. On the other hand, foreign commercial banks (FCBs) hold a consistent level of ROE which was 17.6 percent in 2013. DFIs were also in a worse situation in 2013, probably due to huge provision of shortfall and net loss in that year.

Figure 10: Return on Equity (ROE) for all Banks (percent)



Source: Bangladesh Bank, 2014.

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.

3.5 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 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.

3.6 Loan classification and provisioning

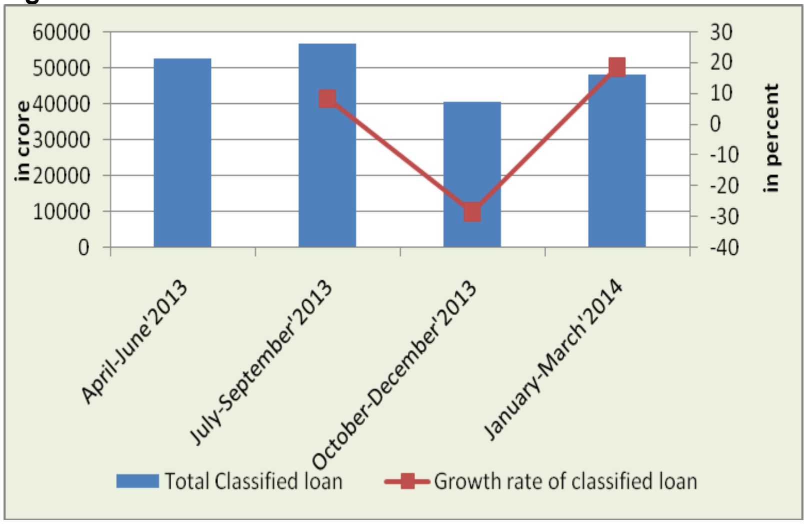
The extent of default loans increased in the third quarter due to tightening the loan classification guideline, sluggish business activities during the political uncertainty and interruption in energy supplies.

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 stood 8.9 percent at the end of December, 2013 and increased to 10.5 at the end of March2014. 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 June 2014.

The classified loans increased to 48170 crore in the January-March quarter from Tk.40590 crore of the October-December quarter of this year2014 that is, according to Bangladesh Bank data,that is, the total classified loan increased by 15.73 percentTk.51000 crore in March 2013, which was Tk.29000 crore in June 2012.

Figure 11: Total Classified Loan



Source: Major Economic Indicators, Jan-Mar 2014, Bangladesh Bank

Embezzlement of Hall-mark, Bismillah Group and BASIC bank etc. 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 5: Loan scrap in banking sector

Name of Company	Amount(Taka)	Name of Branch & Bank
Hall Mark	2554 crore	Ruposhi Bangla branch of Sonali Bank
Bismillah Group	1100 crore	Four private banks(Prime Bank, Jamuna Bank, Shahjalal Islami Bank
BASIC Bank Limited	1500 crore	By Dilkusha, Gulshan and Shantinagar Branch
Imran Group	101crore	Sholoshahar , Chittagong branch of Bangladesh Krishi Bank
Director of Shahjalal Islami Bank limited	140 crore	Shahjalal Islami bank
Ideal Cooperative society	1000 crore	Directly from 70000 clients
Destiny Group	3800 crore	Directly from clients
Paragon Group	146.60 crore	Sonali bank
T&Brothers	609.9 crore	Sonali bank

Source: The daily star, April, September and July 2013,The New age,2012 The daily prothom-alo,July,2014

Comparatively poor administration, lack of transparency, weak regulations and monitoring cell, interest rate spread and rent seeking behaviour of the politician are also noticeable causes for increasing NPLs.

3.7 Reasons behind the increase of NPLs: Captured Governance and Oversight

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, weak regulations and monitoring cell, interest rate spread and rent seeking behaviour of the politician are also noticeable causes for increasing NPLs. NPLs reduce profitability, as banks cannot take interest income from their classified loans. It also reduces loanable funds by preventing recycling.

The appointment of Directors of the Board of the SCBs based on the political loyalty and affiliation has traditionally been practiced for a long time.

The appointment of Directors of the Board of the SCBs based on the political loyalty and affiliation has traditionally been practiced for a long time. Members of the Board of the SCBs and DFIs are hardly independent, qualified, efficient and socially acceptable persons with integrity. Their political background is more considerable than their qualification and efficiency. Nepotism is not only a problem for public banks but also for the private banks. Although political influence is less the top level officials like chairman or directors are choosen from the family tree. For example, if the present chairman is Mr. X then next will be his son or daughter or brother even if there is more efficient person in that bank.

Although Bangladesh Bank (bb) is the highest monetary authority of the financial system it holds limited control over the economy. A bill was passed in the national parliament in 2003 to bring reforms in the banking sector. Most important of the relevant initiatives was the Bangladesh Bank Amendment bill 2003 through which Bangladesh Bank received the autonomy to operate on its own and also to formulate the monetary policy which increases the power of BB over financial system. The bill gave BB the authority over the scheduled private commercial banks but SCBs and DFIs are under the authority of the Ministry of Finance. As most of the scrap loans are from SCBs and DFIs, BB only can alert the ministry of finance but cannot make any action. Moreover BB is not free from the political allegations.

A functioning financial intelligence is needed to collect information and identify specific cases and trend of committing fraud, money laundering and other financial crime.

Feeble legal framework is another reason for increasing non-performing loans. Anti corruption Commission (ACC) Act-2004, The Bank Companies Act-1991and The Companies Act-1994 is the suitable laws to prevent the bank fraudulence but their implementation is very rare. A functioning financial intelligence is needed to collect information and identify specific cases and trend of committing fraud, money laundering and other financial crime. The investigation agencies are not well trained with adequate knowledge and procedure to investigate financial crimes.

Lack of human resource policy, especially in SCBs and DFI motivates the inefficiency of the bank. Department of human resources development is not so strong to take decision on recruitment partly due to lack of capacity and external influence.

4. REFORM -programme formulations in banking sector

This round of reform, however, achieved little success due to the unprecedented influence of vested private commercial banks (PCBs) and NCBs' interest groups, which resulted in a loan default culture.

Financial liberalisation (FL) refers to the regulation of domestic financial markets and the liberalisation of the capital account. The financial sector reform was initiated in 1982 with the denationalisation of commercial banks, followed by the establishment of the National Commission on Money, Banking and Credit in 1984. A number of steps were taken for the recovery targets for the nationalised commercial banks and development financial institutions and prohibiting defaulters from getting new loans. This round of reform, however, achieved little success due to the unprecedented influence of vested private commercial banks (PCBs) and NCBs' interest groups, which resulted in a loan default culture.

The Financial Sector Adjustment Credit (FSAC) and Financial Sector Reform Programme (FSRP) were formed in 1990, upon contracts with the World Bank with the objective to remove distortions by the government and lessen the financial repression. FSAC failed to address the issue of efficient resource allocation in terms of access to credit by productive sectors

The national parliament passed a bill in 2003 to bring more reforms in the banking sector. The focus of this project was on three broad areas such as (i) improving debt recovery situation of banks (ii) increasing income and cutting the expenditure and (iii) strengthening the supervisory capacity of Bangladesh Bank. But BRC/CBRP initiatives improved the financial health of the banking system to a great extent; however, it failed to curb the NPLs of the banking industry. For instance, the NPL ratio of the banking system reached to the highest level (41.11%) in 1999, although it reduced to 28.01% in 2002. In fact, the scheduled banks' advances to the agricultural sector reduced to 11.27% in 2002 from 21.07% in

1990 (Schedule Bank Statistics, various issues, Bangladesh Bank).

After the expiry of BRC/ of CBRP programmme, the government of Bangladesh continued undertaking different measures and initiatives to make the banking system robust and competitive like- a) Formation of Audit Committee by individual banks to assist the Board in fulfilling its oversight responsibilities. b) Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes.

4.1 Liberalisation of Interest Rate and Financial Inclusion

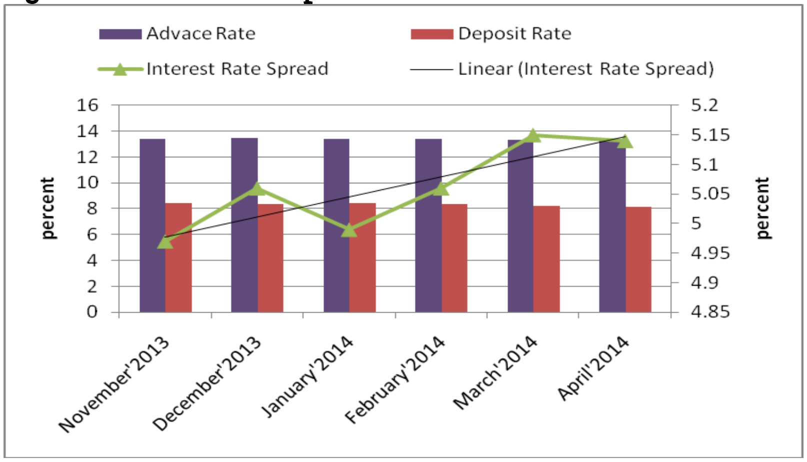
The Bangladesh Bank (BB) introduced a flexible market oriented interest rate policy in January 1990, abolishing the earlier system of centrally administered interest rate structure and providing for sector specific concessional refinance facilities. Banks are now free to fix their rates of interest on 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.

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 liberalsation of rate of interest.

The interest rate spread has seen many ups and downs in this year and in the month of January 2014, the rate was below 5 percent. But in April 2014, it was seen 5.14 percent. 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.

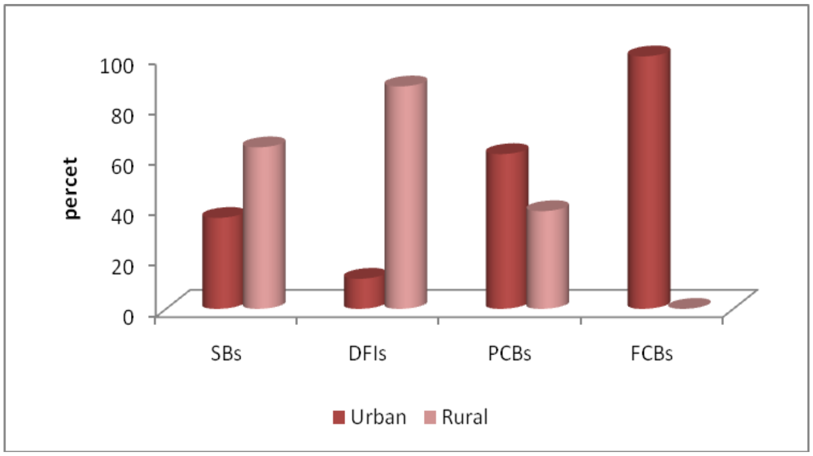
Figure 12: Interest Rate Spread



Source: Major Economic Indicators, November 2013, Bangladesh Bank

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.

Figure 13: Regional stance by category of banks



Source: Bangladesh Economoic Review, BBS, 2014

For example, between February 2008 and December 2012 the percentage of br:anches of bank in rural areas decreased from 57.94 to 57.13 percent, whereas the share of branches of bank in urban areas increased from 42.06 to 42.87percent. Disparity also exists between the level of commitment of state owned commercial banks and that of private and foreign commercial banks. As of December 2013, for example, 63.98percent branches of state owned commercial banks were located in rural areas, as opposed to only 38.7 percent branches of private commercial banks. The foreign banks have yet to establish any branch in rural areas as of December 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 although banks have enough funds to lend.

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.

Although liberalisation policy has been pursued for years, the result is still far from the expected ones .Interest rate is still too high (above 13 percent) which is not favourable to business entities.

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 13 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 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 2012 and 2013, the situation continues worsening and projection reveals that in 2014 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.

Reference

Bangladesh Bank. 2014, Major Economic Indicators. May, 2014. Dhaka, Bangladesh: Bangladesh Bank.

Bangladesh Bank. 2014, Monthly Economic Trend, November 2014. Dhaka, Bangladesh: Bangladesh Bank.

Bangladesh Bank. 2013, Selected indicators, up to 27 November 2013. Dhaka, Bangladesh: Bangladesh Bank.

Ministry of Finance (MoF). 2014, Bangladesh Economic Review, 2014. Dhaka, Bangladesh: Finance Division, Ministry of Finance, Government of Bangladesh.

Bangladesh Bank. 2014, Annual report from 2011-2012. Dhaka, Bangladesh: Bangladesh Bank.
Unnayan Onneshan. 2014, The Monetary Policy Statement of January-June 2014, Bangladesh Economic Update, Volume 5, No. 1, January 2014, Available at:http://www.unnayan.org/reports/meu/january_2013/MEU%20on%20MPS.pdf

Dhaka tribune.2013, 3 new IMF conditions for state banks, Dhaka tribune [on line] 10 December, Available at: http://www.dhakatribune.com/business/2013/dec/10/3-new-imf-conditions-statebanks [Access 11 December, 2013]

Dhaka tribune.2013, Default loans rise in Q3 due to tight rules, Dhaka tribune [on line] 8 November, Available at: http://www.dhakatribune.com/banks/2013/nov/08/default-loans-riseq3- due-tight-rules [Access 10 November, 2013]

Bangladesh Bank. 2014, Financial Stability Report 2012. Dhaka, Bangladesh: Bangladesh Bank.

The daily star.2013, Banks' excess liquidity rises further, The daily star [on line] 15 December, Available at: http://www.thedailystar.net/beta2/news/banks-excess-liquidity-rises-further/ [Access 15 December, 2013]

The Daily Star. 2013, Hall-Mark's Tk 2,964cr Swindling- A year on Sonali mulls litigation, The Daily Star [on line] 03 September, Available at: http://www.thedailystar.net/beta2/news/a-yearon

The Daily Star.2014,Will increase of cash requirement ratio deliver, the Daily Star(on line) 22 July,2014 Available at :http://www.thedailystar.net/newsarchive/will-increase-of-cash-requirement-ratio-deliver-33013.(Access 22 July,2014)

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