

Swinging Banking : Not Very Promising

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Not too bad if you may claim so

The Bangladesh banking sector relative to the size of its economy is comparatively larger than many economies of similar level of development and per capita income. The total size of the sector at 26.54% of GDP dominates the financial system, which is proportionately large for a country with a per capita income of only about US\$370. The non-bank financial sector, including capital market institutions is only 3.22% of GDP, which is much smaller than the banking sector. The market capitalization of the Dhaka Stock Exchange was US\$1,025 million or 2.19% of GDP as at mid-June 2002. In contrast, the size of the total financial sector in India, including banks and non-banks as well as the capital market is 150% (March 2002) of its GDP, with commercial banks accounting for 58.3% of GDP.ⁱ

Access to banking services for the population has improved during the last three decades. While population per branch was 57,700 in 1972, it was 19,800 in 1991. In 2001 it again rose to 21,300, due to winding up of a number of branches and growth in population. Compared to India's 15,000 persons per branch in 2000, Bangladesh is not far behind in this regard. This indicates that access to the banking system in the country is not a significant problem.

However the story tells a different tale

The finance sector remains predominantly bank-based, accounting for 96% of the sector's resources. While there are sound banks, based on IAS, the banking sub-sector as a whole is technically insolvent. Consolidated data reported tend to have significantly understated provisions. Adjusting partly for the understatements, the financials of the banking sub-sector are characterized by about 32% NPL ratio, US\$720 million shortfall in provisions, US\$1,106 million shortfall in provisions and capital combined, and losses of US\$685 million after adjusting for the shortfall in provisions in mid 2001. The adjustments would possibly be larger if provisioning as followed by major international auditors were applied. State-owned Commercial Banks (SCBs) also have disproportionately large and unexplained "Other Assets" that include, in particular, jute and other subsidized credits, suspense accounts and various receivables. To what extent these questionable assets have been provisioned remains unclear.

Wonder why so ?

The large capital deficiency, operating inefficiencies and recurring losses of the banking system is the product of a combination of different factors including: a) weak corporate governance (bank-wide structures, policies, systems and procedures, especially credit risk management); b) deficient executive and staff banking skills; c) absence of professionalism, accountability and

incentives; d) policy lending (particularly to jute and other loss-making State-owned Enterprises or SoEs); e) political patronage and directed lending in the SCBs; f) insider lending in private local banks; g) pervasive systemic default culture; h) non-cost recovery for governmental services extended; i) loss-making branches; j) unproductive assets; k) politically-influenced recruitment, extraordinary staff redundancy, bank-wide security of tenure, and disruptive union activity; and l) poor IT/MIS that hinders efficient and cost-effective operations.

Who is who

At mid-2001, the US\$13 billion stock of financial market instruments was predominantly tilted toward banking products (72.2%), basically in the form of term deposits, and secondarily toward non-bank debt instruments (27.8%), with private sector obligations accounting for 0.4% of all non-bank debt instruments and GOB-related instruments making up for the balance of 99.6%. Of the GOB-related instruments, Savings Schemes, redeemable instruments with disproportionately high yields, accounted for 59.3%, the balance made up of T-Bills (26.7%) and Treasury Bonds (13.9%). Private sector instruments are basically debenture-type issues mainly of one business group listed in the stock exchanges. With the exception of T-Bills and private sector debentures, the fixed income securities are non-transferable and, where they are transferable, there is no secondary market activity. There are no government securities dealers or market makers and the 'buy-hold' culture is quite pronounced. The commercial banks have not issued any securities to raise funds, other than for government-administered programs.

Pot belly or belly up already ?

The ratio of bank deposits to GDP in Bangladesh has increased from 19.53% in 1990 to 32.35% at end 2001. As the private sector banks are still in a rudimentary stage, they are way behind the SCBs in terms of deposit mobilization and asset accumulation. But classified loans of SCBs are large, constituting 3.94% of GDP in 1990 and 8.66% in 2001. In 1990, the SCBs had 27.59% of their total outstanding loans classified, compared to 23.73% in private commercial banks and 20.65% in foreign commercial banks. The NPL ratio reached 44.62% in the SCBs and 25.76% in private banks, but in foreign commercial banks, it came down to 3.74% in 2001.

The banks achieved some success in reducing the percentage of non-performing assets by 3.31% of cumulative total loans, although in absolute figures it aggravated by 3.32% between 2000 and 2001. NPLs came down from 34.92% (of total loans and advances) in 2000 to 31.61% in 2001. About 86.60% or Tk204.35 billion in the total classified loans of Tk235.99 billion in 2001 have been

identified as bad or irrecoverable. Classified loans during the 1997-1999 were 33.49%, 40.65%, and 41.11% respectively. Most of the banks were running with a deficit on loan provisioning as well as risk-weighted capital adequacy requirement.

Spreads trimmed but bottom-line up

The interest spreads available to scheduled commercial banks in Bangladesh are actually not so high as being perceived, compared to both developed and developing countries. Interest spread came down recently mainly because they have to offer considerably higher rates on deposits to compete with various high yield savings instruments of the Government-run schemes as well as to compensate for the huge burden of NPLs. Despite a decline by 0.11% in the average lending rate recently, the average yield on loans and advances increased significantly, mainly due to time factor in incidence of the rates. Average deposit interest rate decreased by 0.18%. Actual yield on loans and advances for the sector came down much below the lending rate due to a huge component of non-performing advances.

The performance of the banks during year 2001 was relatively better than the previous year. During 2001, the commercial banks registered a 14.12% growth in loans and advances, and reported increasing operating profits. Most of the listed commercial banks declared higher dividends for the year 2001 than for 2000 and some announced stock dividends. However, the banks are acutely undercapitalized, which enabled declaration of high percentage of dividends, though in the long run such trend could prove unproductive if not fatal.

Cost of inefficiency ... who is paying ?

The operational cost (i.e. general and administrative cost) in the banking system is a staggering 3.13% of net assets against an international norm of 1%. In neighboring India it is 2.5%, also on the higher side. The substantial excess cost therefore stands at 2.13% of net banking assets, which translates to 0.56% of the current GDP. On the other hand, the recapitalization needed to meet the statutory capital adequacy requirement is 3.20% of GDP. The annual cost of servicing the recapitalization at 10 percent interest per annum therefore stands at 0.32% of current GDP. The total of the two cost indicators indicates that the annual cost of inefficiency of the banking sector in Bangladesh is 0.88% of current GDP. Again, there are reasons to believe that the recapitalization needs are grossly understated, especially in provisioning against loans and advances to the SoEs and sector corporations. Based on other studies, the recapitalization requirement can be estimated at around US\$2.89 billion and the annual cost of financing placed at 0.62% of GDP. Using these figures, the total annual cost of the banking sector inefficiency would stand at 1.18% of GDP. The recapitalization requirement of the development financial institutions (DFIs) and specialized banks are also large, and the cost of financing would be roughly around an additional US\$1.165 billion or 0.24% of GDP. Thus, the

aggregate cost of refinancing for banks and DFIs and specialized banks through issuance of bonds with 10% coupon would be as high as 1.42% of GDP. In comparison, such refinancing cost in India is roughly at 0.75% of GDP.

The road map ahead

The Bangladesh economy registered noteworthy developments and growth in some major areas including the social sector and achieved relative fiscal stability in the decade of the 1990s. However, the vulnerability of the apparent stability has been exposed in the aftermath of the September terror and changing environmental uncertainties. The authorities now have limited room for maneuver in responding to external shocks.

Substantive unresolved or unattended issues remain which could pose a threat to macroeconomic stability. There is a strong need to introduce a legislative program that would enable the regulatory authorities to take timely measures to ensure soundness and efficiency of the banking system, strengthen credit discipline among borrowers as well as speed up the recovery process. The resolution of issues relating to the banking sector could strengthen macroeconomic stability, while enhancing growth and depth, governance, efficiency, private sector presence, and an enabling environment. Conceptually, and potentially by any measure, the Banking Reform and Development (BRD) should be the centerpiece for any program for the finance sector, with other supporting projects having varying degrees of impact. A holistic strategic framework for the finance sector could include potential response initiatives that address targeted performance metrics and strategic results relating to growth and development, governance, sustainability, efficiency, reach, governmental presence and the enabling environment.

Some time-bound quantitative indicators and targets could be considered for the banking sector. Few such targets and indicators could be: 1) Review of all financial sector and specifically banking related laws, rules and regulations within 1 year; 2) Enactment of foreclosure law within 1 year; 3) Provision shortfall and re-capitalization requirement of SCBs met through market priced bonds within the next 2 years; 4) Transformation and divestment of the BASIC Bank within the next 2 years; 5) Adoption of all IAS and ISA standards by the Institute of Chartered Accountants of Bangladesh within 2 years; 6) Establishment of an AMC to take over bad debts of commercial banks within 3 years; 7) Only one commercial bank under state ownership at the end of 5 year; 8) No fully state-owned commercial bank after 10 years etc.

ⁱ India: *Improving the Financial Sector's Efficiency and Performance*; December 2001; Continental Group Holdings for the Asian Development Bank (ADB)

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