Status of Non-performing Loans in Banking Sector in Bangladesh

By Christine I. Wallich

The financial sector and banking have been in the spotlight of late, and it is very opportune for us to discuss this topic. Bangladesh has made real strides in strengthening the banking sector, thanks to the dedicated efforts of the Bangladesh Bank Governor and of his predecessor. However, rising energy prices and pre-election politics are both increasing the number of loans at risk, and there is a very real risk that all the good work in the banking sector could be undone, all the hard-won gains lost, if pre-election politics are allowed their sway. In this environment, strong and committed leadership is needed to sustain existing efforts in the sector. I will take this opportunity to highlight some specific actions for Government’s full attention.

We all know that the nationalized commercial banks (NCBs) are under huge pressure—pressure which will only increase in the next months. One of the main sources is rising energy prices. Bangladesh imports petroleum at almost $70 a barrel, and sells petroleum products at less than their tax-inclusive cost. Not surprisingly, Bangladesh Petroleum Corporation (BPC) is making a loss—in fact, BPC loses some $10 million each month (December), $560 million in the last calendar year alone. To finance this loss, BPC has been borrowing from the NCBs. Sonali’s outstanding loans to BPC have spiralled to almost 60 billion Taka—one fourth of its total loan portfolio. This reluctance to raise energy prices is costing the NCBs dearly. By keeping these prices low, BPC losses will continue to accumulate.

As bankers and expert observers, I hope you agree with me: a loss-making company is a poor credit risk and unlikely to repay its loans. The situation with Agrani and Janata Banks is equally worrying. Both banks have just been directed to increase their exposure to this loss-making company further, even though both already have 18 percent of their portfolio at risk to BPC. For all three NCBs, loans to BPC now approach Tk.100 billion, some 0.3 percent of FY05 GDP.

These are not just abstract figures. BPC’s borrowing from NCBs has dried up liquidity in the banking system, raising interest rates and making credit unavailable to sound borrowers. The money required to fill this staggering energy-related hole has to come from somewhere, and Government has, ultimately, only two ways to finance these losses.

(i) First, Government can borrow. However, further borrowing, especially taking high-cost commercial loans to finance petroleum imports—a $250 million credit costing 14.78 percent was reported last week—is itself a source of worry. Additional borrowing, in turn, raises questions about the balance of payments, debt sustainability, and future creditworthiness. Or,

(ii) Government can cut already low public development spending to accommodate the energy subsidy, which will have adverse implications for growth, inflation, and poverty reduction.
Understandably, it is politically sensitive in this period to raise oil prices in line with global markets—but this is the only way to reduce BPC losses and the pressure on the NCBs. Given this sensitivity, perhaps an increase in energy prices—diesel prices, specifically—to their equivalent levels in India, at the very least to stop the smuggling of this expensive imported fuel, is politically possible.

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Some time ago, I spoke about “ring-fencing” key areas of economic development from the political arena—an agreement between the two main parties that a few key development priorities will not become “political footballs” or fodder for party politics. This issue—adjusting energy prices—seems to me to be one of those key issues. I very much hope that both parties can agree, in the best interests of Bangladesh, on a common goal of enhancing Bangladesh’s energy security by making the necessary price adjustments, reducing BPC losses, and, in the process, strengthening the financial sector, and BPC’s lenders—the banks. It is important that pre-election politics not further exacerbate the risks to the banking sector.

Pre-election politics may also be influencing the regulatory side of the financial sector: As reported by the media, the Government and Bangladesh Bank appear to be under pressure from certain quarters. This has become evident with the recent relaxation of the guidelines issued by Bangladesh Bank on defaulters accessing fresh loans.

Before the last elections (1996), I am told that several hundred bank licences were issued, due to electioneering pressures. Certainly, Government and Bangladesh Bank should withstand any demands to issue new bank licences in the run-up to the 2007 elections: These would be hard to justify, as Bangladesh already has 30 private banks, not all of which are in a good shape financially. If anything, consolidation of the sector, not more new banks, is needed.

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This is clearly not an easy environment to operate in. However, specific steps can and should be taken to prevent the situation from further deteriorating and undermining the banking sector.

The first action would relate to defaulters. It’s useful to distinguish between genuine and “willful” defaulters—since these require two very different approaches. To deal with genuine defaulters, greater capacity needs to be built in the banks for handling loan workouts, and expertise further developed in Bangladesh. Debt recovery tribunals, now being tested in Bangladesh, have also been an effective tool.

“Willful” defaulters—those that can pay, but do not—present a completely different set of challenges. Several simple and effective mitigating measures have been successfully used in other countries. These include: various degrees of blacklisting, withdrawal of passports, and barring defaulters from contesting for, or holding, public office, barring them from membership in chambers of commerce and trade bodies, from participating in trade delegations, etc. Debarment from fresh lending is the norm.
Tackling willful defaulters also requires internally focused control measures in the banks themselves. For every willful defaulter, collaboration with bank officers in this process cannot be ruled out. It usually takes two hands to clap. Greater scrutiny of loan proposals, stringent monitoring and supervision of the loan portfolio, immediate action on any defaulter, to signal a “zero tolerance approach,” and a vigilant internal control team are all part of the control environment that needs reinforcing, especially in a pre-election period.

Pakistan provides a good example of a thoroughgoing and very successful financial sector reform, whose benefits included a sharp fall in lending rates, a huge fiscal windfall from privatization, and much sounder banks, able to lend and intermediate credit more efficiently. Access to financial services by the poor and middle classes grew significantly. One of the key success factors was the strong political commitment to going after defaulters who were threatening the banks’ soundness. Admittedly, the political environment in Bangladesh is different, but the underlying point remains the same. Real reform requires a good plan, and real political commitment, especially to tackling wilful defaulters.

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The Government of Bangladesh should be credited with making significant progress in the financial sector over recent years. Key reforms have included: (i) greater competition, which improved access to finance and consumer lending; (ii) improved prudential regulation, increasing the soundness and stability of banks; (iii) interest rate deregulation; and (iv) key initial steps towards privatization of three NCBs: Rupali Bank, followed by Agrani and Janata Bank.

Let me say a few words about privatization. Privatization is not a goal in itself, but a means to put a weak bank in the hands of owners who can manage it better, i.e., profitably and for the productive benefit of society. A “bad privatization” which ends up replacing ineffectual and corrupt public officials with ineffective and corrupt private owners/managers—as has happened in some countries (Russia, Philippines)—is to be avoided at all costs.

A "good privatization" ensures that the new owners—often strategic investors—meet the "fit and proper test" for bank ownership; that they bring a strong, experienced management team; that a substantial equity contribution is made. Ensuring fit and proper owners for the NCBs is probably the single most important aspect of this privatization process in Bangladesh. Finally, continued strengthening of Bangladesh Bank’s regulatory capacity and oversight is a necessary complement to privatization.

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Lastly, I would like to say a few words about the lower end of the financial spectrum—micro-finance. Bangladesh is widely considered to be the “natural home” of micro-finance. But to maintain its leadership in the world, the sector must stay cutting edge. Further development of micro-finance will help build a more inclusive financial sector, offering greater access and services better suited to needs.
The Government’s role here is providing an appropriate regulatory environment, setting standards that promote public confidence and protect the interests of the poor, while not stifling the growth and innovation that have characterized the industry to date. Government should not own or operate micro-finance banks or programs, but should focus on basic regulation.

The debate on interest rate ceilings is probably not yet over. We have been concerned to learn that some micro-finance institutions are no longer able to provide loans to the ultra-poor, due to interest rate ceilings which reduce the ability to cross-subsidize this important activity from earnings made on ordinary loans. We have also been told by some NGOs that their repayment rate (NPLs) is lower in those parts of the country where their micro-finance is delivered on a stand-alone basis, and not jointly with their health and education services. Since it is the spread on lending that finances these services, interest rate ceilings may act to undermine loan repayments.

We urge Bangladesh Bank, PKSF, and others to study both issues carefully, and to develop an appropriate policy response—which might include greater flexibility in interest rates. In addition, specific subsidies to support micro-finance for the ultra-poor could be introduced.

The proposed micro-finance law can go a long way towards achieving this, since it will provide a stronger legal basis for NGOs. The law should give the option to those micro-finance institutions that wish to establish micro-finance banks under proper regulatory and prudential regulations. Moreover, so long as the Government continues to operate its own micro-finance programs, such programs should be subject to the same provisions of the law.

In closing, let me say that civil society involvement and support can play an important role in ensuring the effective implementation of banking reforms.