A roadmap to restore banking sector stability

Wednesday, Jul 2, 2025

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I have been writing about the danger of non-performing loans (NPLs) and the related threat to the stability of the banking sector since 2012. Some 13 years later, the problem has escalated astronomically with little signs of reversal. The problem was somewhat muted between FY2012 and FY2020, but has gotten out of hand since then. The total value of NPL surged from a low of Tk 22,700 crore in FY2012 to a peak of Tk 4,20,300 crore in FY2025. In terms of share of the total loan portfolio, gross NPLs surged from six percent in FY2011 to 24 percent in FY2025.

The underlying factors for this rapid deterioration in the quality of the banking portfolio are well-known. Poor banking sector governance such as corruption in bank management, poor

lending and loan recovery practices, especially in public banks, large scale thefts often aided by political intervention, ineffective banking sector supervision, and dual banking oversight arrangement under which the public banks are managed by the government while private banks are supervised by the Bangladesh Bank (BB), are such factors.

With the induction of the interim government, it was expected that there would be a sea change in the management, regulation and supervision of the banking sector that would usher in visible positive outcomes.

Indeed, starting in mid-August of 2024, some swift actions were taken by the BB to restore the financial health of the 14 weakest-performing private banks. These included board and management changes, injection of new liquidity, and tighter supervision. To improve transparency, asset classification norms were modified to comply with Basel III norms. Banks were instructed to pursue vigorously the recovery of NPLs. A Bank Resolution Ordinance-2025, which allows BB to take swift actions against any financial institution to protect the stability of the sector, was adopted in May 2025. Several task forces were established to comprehensively address the ills. These include a task force to strengthen the independence of the Bangladesh Bank, another to develop specific resolution strategies for handling the problematic banks, and another to pursue asset recovery options at both home and abroad.

Many of the banking problems and solutions are long-term in nature. Yet, some visible signs of progress have emerged. Most prominently, the bleeding of the banks through outright theft has stopped. The liquidity situation of several problematic banks has improved, enabling them to service the deposits of their customers, thereby preventing a threat to the rundown on deposits. Lending decisions are now more professionally managed. The supervision oversight of BB has been strengthened. The progress with asset recovery, however, has been very limited.

What then explains the near doubling of NPLs between FY2024 and FY2025? BB argues that this reflects the application of internationally accepted asset classification norms. Previously, the true value of NPL was hidden through manipulation of the accounting norms, and now we have a correct picture of the problem at hand.

While there is no doubt that the true picture of NPL was hidden previously through accounting gimmicks, it is nevertheless important to do a holistic diagnosis of the NPL problem and changes over the past 10 months. The economy has been going downhill, with GDP growth sliding to four percent or less in FY2025. Businesses have been complaining regularly about cost escalation and weak profitability, especially in the manufacturing sector. It is hard to imagine that these factors had no impact on the banking portfolio, and the near doubling of NPL is all explained by a change in accounting norms.

A comprehensive resolution of the NPL problem will require two types of interventions: policies that address the flow of new NPLs, and policies that address the outstanding stock based on the adoption of Basel III loan classification norms for all banks, including public banks.

Regarding new NPL flows, first and foremost, the actions already taken by BB to stop the bleeding in the problem private banks must be extended to public banks as well. The system of dual banking supervision, where public banks are supervised by the Banking Division of the Ministry of Finance, must be stopped. All banks, public or private, must be regulated and supervised by the BB with full application of Basel-III norms.

Secondly, to the extent that the surge in NPL reflects the underlying economic downturn, swift policy actions are needed to reverse these trends. With the implementation of comprehensive reforms in fiscal policy, trade policy, investment climate, including establishing the rule of law, improvements in trade logistics and energy supply, acceleration of ITC adoption, and investment in critical skills are recommended. The government must understand that not all banking problems are necessarily due to theft and corruption. A significant part may be related to the downturn in the economy and has to be addressed accordingly.

Regarding the stock of NPL, the steps taken by BB are in the right direction, but they have to be substantially strengthened, and implementation must be stepped up. The necessary comprehensive approaches are: restoring the financial solvency of the distressed banks; ensuring the profitability of the rescued banks; closing the inherently unprofitable banks down; and strengthening built-in mechanisms for preventing future banking crises.

Restoring the financial solvency of distressed banks is relatively easy when the number of problem banks is limited, recovery prospects for outstanding loans are good, and there is adequate fiscal space. On all three counts, Bangladesh seems to be in a very difficult situation. BB will need to do a full workout of the amount of new financing required to restore the banks that are rescuable and can be put back in the market on a profitable basis. Once this amount is known, a financing strategy needs to be developed. This, arguably, will pose the biggest challenge to the banking reforms.

The financing can be a combination of additional financing from the treasury, additional funding from BB, new financing from current owners, and money raised from the capital market by new shareholders. Given the dire fiscal situation and the inflationary risk from BB financing, much of it will have to come from current and future owners. The government may also seek financial support from multilateral development financing institutions like the World Bank. Where public financing is involved, new capital must be injected only into potentially viable banks that can be restored with adequate operational reforms to earn profits from future operations. Furthermore, steps have to be taken to ensure that the treasury/BB has first claim on profits of the restructured banks to fully recover injected funds.

International experience shows that ensuring the profitability of rescued banks is easier said than done. This requires comprehensive banking reforms including sharp improvements in bank management, quality staffing and IT systems, strengthening financial accounting and auditing standards to international norms, strong internal mechanisms for loan supervision and recovery, strong internal controls and risk assessment, and sound outcome-based BB supervision.

Some banks are simply non-viable and suffer from inherent governance problems. These typically belong to the public sector. Even though the lending share of public banks has fallen to 25 percent of total loans, these banks present a huge fiscal risk.

Policy options include: privatisation of all except the Sonali Bank that will only pursue treasury functions; full corporatisation and stock market divestment with management control to private shareholders; and converting the four large public banks into narrow banks that allow deposit holding and investment in treasury bills but excludes lending, while closing down the two small banks—Basic Bank and the Bangladesh Development Bank.

Some private problem banks are also candidates for closure unless owners are willing to invest new capital to restore financial solvency and readiness to face the market with full compliance with Basel-III prudential norms.

Finally, there is an urgent need to strengthen the banking crisis prevention mechanisms. The most important policy reform is the need to sharply enhance the deposit insurance scheme. The US Federal Deposit Insurance Corporation is a good example of how a strong deposit insurance scheme can prevent a large-scale banking crisis. A second built-in mechanism is to increase the share of equity by increasing the tier-1 capital requirements beyond Basel-III minimum standards to provide an incentive to bank owners against undue risks. A third reform is the strict implementation of Basel-III supervision norms for all banks with no exceptions. A fourth crisis prevention action would be to establish a system of bank-risk ratings based on independent credit agencies. This information should be publicly available.

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