



The social cost of bank loan write offs

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Banking sector deregulation and progressive tightening of prudential regulations between 1998 and 2011 considerably strengthened the performance of the banking sector in Bangladesh, which contributed handsomely to positive development outcomes. The deregulation drive ushered in a vibrant and competitive private sector banking enterprise that changed the landscape of Bangladesh banking.

The dominance of corrupt and inefficient public banking gave way to private banking that mobilised a huge amount of financial resources to support the investment and working capital needs of a booming private sector. Competition for deposit and lending induced rapid improvements in banking services for the depositors and the borrowers. A progressive tightening of prudential norms improved the loan portfolio of the banking sector, thereby improving its financial health.

This progress, however, slowed down after 2011 and more recently has been facing substantial downside risks that if left unattended over an extended period could spell some serious trouble for the health of the banking sector. The simmering banking sector problems are directly reflected in the growing incidence of non-performing loans (NPLs). The value of NPLs surged from Tk226 billion in 2011 to Tk961 billion in 2020 (Figure 1). As a share of the total loan portfolio, NPLs increased from 6.1% in 2011 to 10.3% in 2018 and then came down

slightly to 9.2 % in 2020.



The slight downward trend in NPLs as a percentage of total loans after 2018 is not based on any meaningful reform and therefore does not reflect an improvement in the financial health of the banking sector. Most unfortunately, the government has chosen not to face the challenge of the worsening loan portfolio of the banking sector by introducing sustainable reforms but has opted for cosmetic actions to hide the magnitude of the real problem.

The actions to address the NPLs have mainly involved relaxation of the loan classification norms, restructuring of large loans, and extensive loan write offs. These policies have somewhat lowered the stock of NPLs but the fundamental problems that cause NPLs – the bad loan decisions and poor enforcement of loan recoveries – remain virtually untouched. So, while the stock of NPLs is being lowered cosmetically, the flow of new bad loans keeps growing. This flow problem has been further aggravated by the onset of Covid-19.

One particularly damaging element of the cosmetic approach to lowering the stock of NPLs is the issue of loan write offs. While this might appear to be the right thing to do to keep the banking sector's books clean since these loans would never be recovered, it is not obvious that the government has paid enough attention to the social cost of this policy. The volume of loan write offs since 2008 is shown in Table 1. The amount of annual loan write offs has grown progressively owing to rising NPLs. The loan write-offs continued to be dominated by public sector banks well until 2017. Since 2018, private banks account for a higher share of total loan write offs reflecting the growing portfolio problems of private banks.



The social cost of loan write offs is substantial, but these costs differ between public and private banks. For public banks, the social cost of loan write offs is huge as it amounts to either a diversion of taxpayer revenues or loss of revenues from public banks.

Fundamentally, the loan write offs of public banks is simply a reflection of the shifting of the burden of bad loans to the Treasury, which then finances the loan write offs from taxpayer resources or by foregoing income transfers from public banks.

These divert resources from high-priority spending like health, education, and social

protection to the borrowers of these funds from the public banks. This critical point is highlighted in Table 2, which tells a very sad story. Annual public bank write offs have substantially exceeded the total spending on health in all years from FY2010 to FY2020. In most years they have also exceeded the amount spent on social protection (excluding civil service pension).

The social cost of public bank loan write offs is obviously very high. These resources could have been well used to improve the health outcome of the Bangladeshi population and to reduce poverty through income transfers to the poor and vulnerable. Instead, the money went primarily to the pockets of the rich and powerful borrowers from public sector banks who took the money and never paid back interest or principal or both. This practice is highly unethical and socially harmful and must be stopped.



The social cost of private bank loan write off is less devastating but also harmful. High NPLs and associated loan write offs tend to increase the cost of financial intermediation that invariably puts pressure on interest rates as banks try to recoup income through higher lending rates and lower deposit rates. They also hurt the quality of banking services through cutbacks in administrative costs.

In a market economy, business losses can happen. For example, a worsening of the business environment, as has happened in today's Covid infected world, can hurt business income. Evidence shows that private enterprises globally have suffered income losses. Governments globally have intervened by protecting businesses from these losses through a range of fiscal and monetary stimulus packages. Yet, some banks have also likely lost income from Covid-induced NPLs. So, some amount of NPL and loan write offs is a part of the banking business globally. But good practice banking limits these losses, as reflected in the experience of private foreign banks operating in Bangladesh that have very low NPLs and a tiny amount of loan write offs.

It is no accident that private foreign banks have the best loan portfolio because lending decisions are primarily based on client quality considerations. On the other hand, public banks have the worst quality portfolio while a growing number of weak and poorly managed private banks have also been experiencing growing portfolio problems. A common element

for these banks is bad lending decisions owing to poor governance. The only sustainable way to scale back loan write offs is to stem the tide of bad loan decisions through sharp improvements in banking governance where lending decisions are guided by project quality and not political or business connections. The loan recovery process similarly should be guided by established business norms and not connections.

In the short run, Bangladesh Bank as the main banking oversight agency must adopt a swift program to stem the tide of the flow of bad loans through much stronger supervision and disciplinary actions against the management of poorly functioning banks. Frequent loan write offs and a softening of loan classification must be avoided.

The Finance Ministry must not get involved in cosmetic NPL solutions or provide political cover to loan defaulters. It should strengthen the hands of the Bangladesh Bank by giving them stronger autonomy including the application of full prudential norms for public banks.

Over the longer term, public banks must be either privatised, converted to narrow banks or given full autonomy to run as profitable ventures with a hard budget constraint that essentially prevents Treasury transfers. Weak private banks must be given a timeline to perform and fully meet all prudential norms, failing which they become candidates for mergers. Legal framework for loan recovery must be strengthened. A proper workout of the stock of NPLs must be adopted based on international good practice experience.

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