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The Imperative for Banking Reforms in Bangladesh

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The Imperative for Banking Reforms in Bangladesh¹

A. Overview

Father of the Nation Bangabandhu Sheikh Mujibur Rahman dreamt of a Bangladesh that was prosperous, was free of poverty, where social justice prevailed, where there were equal opportunities for all, and where no rent-seeking behavior or corrupt practices prevailed. Considerable progress has been made since independence in many areas of relevance to this dream of Bangabandhu. Progress has been especially good over the past 10 years under the dynamic leadership of his daughter and the current Prime Minister Honorable Sheikh Hasina (Table 1). Yet, her government recognizes that there is still an unfinished agenda that needs to be addressed and resolved in order to fulfill Bangabandhu's dream. A part of this unfinished agenda is incorporated in the government's upcoming 2041 Perspective Plan (Government of Bangladesh 2019) that seeks to eliminate extreme poverty, limit moderate poverty to a low level, secure Upper Middle- Income Country (UMIC) status by FY2031 and attain High-Income Country (HIC) status by FY2041.

Table 1: Bangladesh Development Progress Since Independence

Indicators	1974	1980	2000	2018
GNI per capita (\$)	111	140	383	1909 ²
Poverty (UPL) (%)	77 ³	58.5 ⁴	52.3	21.8
Life expectancy (years)	46.2	54.8	63.6	72.3
Infant mortality (%)	138.8	111.5	58.0	22.0
Adult Literacy (%)	25.8	29.2	52.8	73.9
Population growth rate (%)	2.5	2.35	1.41	1.2

Source: Bangladesh Bureau of Statistics (BBS)

The laudable targets for the 2041 Perspective Plan (PP2041) are ambitious but achievable when measured against the true potential and capabilities of Bangladesh. The past track record of development progress summarized in Table 1 speaks to this. Bangladesh is richly endowed with a highly motivated and hard-working people, a fertile land that can produce three crops a year, plenty of water, open access to sea, broadly homogenous people who share a common language, history, culture and traditions, and a strong sense of national pride and a drive to move forward. In this development-friendly environment, it is not

¹ Sadiq Ahmed is Vice Chairman of the Policy Research Institute of Bangladesh (PRI). He would like to express his gratitude to Dr Farashuddin Ahmed and Dr. Fakhruddin Ahmed, both former Governors of the Bangladesh Bank, for their insightful comments on the first draft.

² Refers to FY2019

³ Refers to 1977. See Sen (2000)

⁴ Refers to 1983

surprising that the economic actors respond to incentives and opportunities, and equally well they rise to meet the challenges when they emerge. So, while the development agenda put forward in the PP2041 will challenge the country, with good policies and institutional reforms, Bangladesh should be able to secure or at least come close to these admittedly stretch development targets.

The reform agenda underlying PP2041 is massive, encompassing many areas including fiscal, monetary and exchange rate policies; tax reforms; public expenditure management; reforms for improving the investment climate for private domestic and foreign investors; banking and financial sector reforms; trade and industrial policy reforms; agricultural sector and water management reforms; energy, power and transport sector reforms; health and education sector reforms; social inclusion, female empowerment and social protection reforms; environment protection reforms; and public administration and governance reforms. In each of these areas, reforms entail the formulation of right policies and institutions and their sound implementation.

A review of past progress shows that while a wide range of policy reforms have been initiated and implemented, institutional reforms have lagged behind (Ahmed et. al.2016; 2017). This is a major gap that needs to be addressed much more forcefully than in the past. The rationale for this is easy to see. If Bangladesh aspires to reach UMIC by FY2031 and HIC by FY2041, it cannot do so by keeping its institutions unchanged to LMIC level as presently. On the economic front, there are a few over-arching institutions that need urgent strengthening. These include: the taxation system; the banking sector; land management; urban institutions; institutions for water management; the legal system; and public administration. Each of these institutions have far-reaching effects on economic and social outcomes and if they don't work well, they could constrain the ability to achieve that targets for FY2041.

The main objective of this paper is to focus on one of the key institutions of development –the banking sector. Financial sector performance is well recognized as a major determinant of the growth of the private sector in any modern economy. International evidence shows that over the longer-term economic development and the maturity of the financial sector are strongly correlated (Loyaza and Ranciere 2004; DFID 2004; Calderon and Liu 2003; Khan 2002; Khan and Senhadji 2000; Levine 1997) ⁵. In today's world of global markets and competition, the cost and efficiency of financial services can often make the difference between a competitive and non-competitive firm. In low- income developing economies the financial sector typically tends to be dominated by banking enterprises. The non-bank financial institutions normally tend to be at an evolutionary

⁵The literature on this subject is vast. DFID 2004, Khan and Senhadji 2000 and Levine 1997 provide useful summary of the literature and underlying issues. Since financial sector mismanagement including unduly rapid credit expansion can also cause short-term disturbances that reduce growth, the literature now makes a distinction between short-term and long-term effects of financial intermediation. See Loayza and Ranciere 2004 on this point.

stage. This is primarily because the regulatory and institutional capabilities required for managing a sound capital market typically do not exist in most low-income countries⁶. So, much of the financing for private enterprises is typically provided by the banking sector. This situation is also representative of Bangladesh, even though the country has moved ahead into LMIC status. In particular, the capital market as an institution is not well developed yet, although as development proceeds Bangladesh will need to pay attention to this important financial institution as well. The immediate priority, however, is to ensure the establishment of a strong, competitive and stable banking sector.

B. Evolution and Structure of the Banking Sector

Following independence, the banking sector was nationalized. The dominance of these nationalized banks continued well until the late 1990s, even though gradually private banks were allowed entry into the banking business. It is only since 2000 that the private banking has taken deeper roots. Currently, the banking sector comprises of 6 state-owned commercial banks (SCBs), 2 government-owned development finance institutions (DFIs), 40 private commercial banks (PCBs) and 9 foreign commercial banks (FCBs). The structure of the banking sector as of June 2018 is shown in Table 2.

Table 2: Structure of Banking in Bangladesh, June 2018

Bank Types	Number of Banks	Number of branches	Total assets (Taka billion)	Percent distribution	Deposits (Taka billion)	Percent distribution
SCBs	6	3721	3380	26	2701	27
DFIs	2	1407	318	2	273	3
PCBs	40	4758	8758	67	6508	66
FCBs	9	69	604	5	393	4
Total	57	9955	13059	100	9875	100

Source: Bangladesh Bank annual Report 2017-18

The structure of banking has changed substantially over the last 20 years or so following the initiation of a major banking sector deregulation policy. The policy opened up the banking sector to private competition. The response was substantial. The resultant structural transformation of the Bangladesh banking sector is shown in Table 3 and Figure 1. Thus, even as late as 2000, public banks (SCBs+ DFIs) accounted for some 65% of the deposits and 63% of the loans. By 2018, these shares had fallen to 21% each. The fact that the private sector banks now account for 79% of loans and deposits as compared with only around a third in 2000 has radically transformed the banking sector from a public-led activity to a private-led activity.

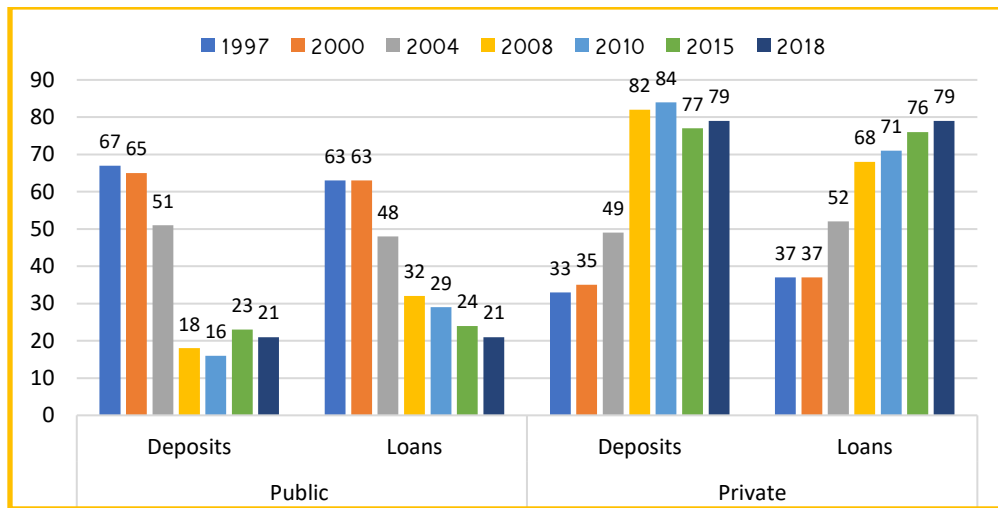
⁶ See IFC (2017) for a useful summary of the challenges in developing capital markets.

Table 3: Structural Change in Banking in Bangladesh

Year	Deposits (taka billion)		Deposits (percent share)		Loans (taka billion)		Loans (percent share)	
	Public	Private	Public	Private	Public	Private	Public	Private
1997	342	168	67	33	231	137	63	37
2000	400	213	65	35	282	166	63	37
2004	544	515	51	49	387	420	48	52
2008	414	1902	18	82	573	1243	32	68
2010	599	2768	16	84	737	1837	29	71
2015	1757	5967	23	77	1291	4070	24	76
2018	2238	8203	21	79	1802	6668	21	79

Source: Bangladesh Bank Annual Report 2017-18 and Scheduled Bank Statistics, Bangladesh Bank.

Figure 1: Share of Public and Private Deposits and Loans



Source: Table 1

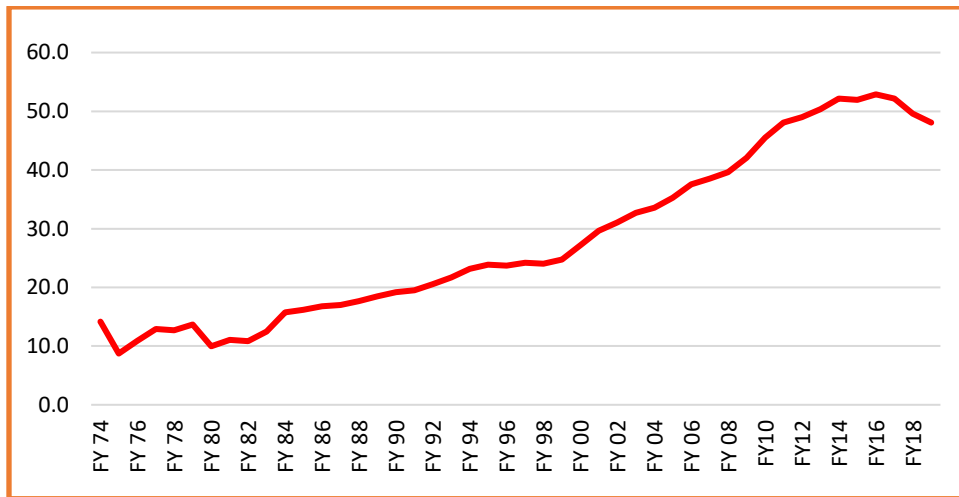
C. Economic Impact of the Banking Sector Transformation

The impact of the rapid transformation of the banking sector on economic activities can be gleaned from three related banking sector outcomes.

Financial deepening: First, there was a remarkable growth in deposits that led to a huge increase in broad money (M2) as a share of GDP (Figure 2). Market competition fueled a massive drive for deposit mobilization through a range of products. The growth in M2/GDP is one indicator of the deepening of the financial intermediation in Bangladesh.

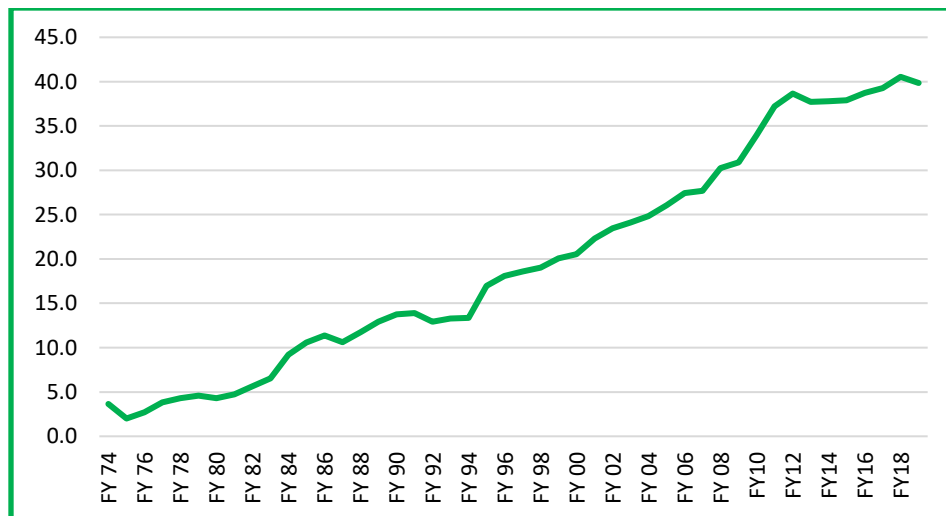
The other important indicator is the growth of private credit as a share of GDP. The deposit mobilization contributed to a huge expansion of private credit that spurred the growth of private investment, exports and GDP (Figure 3). In the absence of a well-functioning capital market, the banking sector financing was the main source of private business financing for investment, trade credit and working capital needs.

Figure 2: Trend in M2/GDP Ratio (Percent)



Source: Bangladesh Bank

Figure 3: Trend in Private Credit /GDP (Percent)



Source: Bangladesh Bank

Financial inclusion: A second important way that the banking sector transformation contributed to economic development was improved financial inclusion. Not only that the number of banks increased, bank branches multiplied rapidly serving an increasingly larger share of population (Table 4 and Figure 4). Private banks who are motivated primarily by

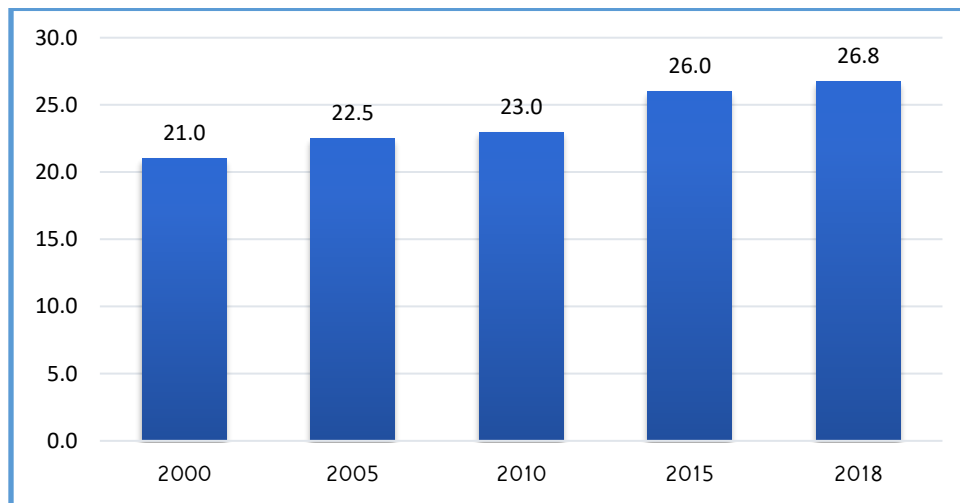
profits normally tend to serve the urban markets in the urban growth centers, typically the capital city Dhaka and the port city of Chittagong. Through policy, Bangladesh Bank (BB) was able to spread banking outside these two natural banking centers to other urban and rural areas (Table 4). To strengthen financial inclusion, the BB adopted other policies including establishment of the special small and medium enterprise (SME) window within BB, setting targets for bank lending to SMEs, introducing SME refinancing schemes, enhancing agricultural credit schemes, establishing the Micro Credit Regulatory Agency, and introducing the Mobile Financial Services.

Table 4: Spread of Bank Services in Bangladesh

Year	Number of Branches			Deposits (taka billion)			Loans (taka billion)		
	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban	Total
2000	3659	2460	6119	161	549	710	100	494	594
2005	3764	2638	6402	218	1198	1416	118	1000	1118
2010	4393	3265	7685	437	2942	3379	207	2367	2574
2015	5334	4063	9397	1575	6365	7940	571	5227	5798
2018	4890	5224	10114	2143	8224	10366	863	7607	8470

Source: Bangladesh Bank Annual Report 2017-18

Figure 4: Thousands of Population Per Bank Branch



Bangladesh Bank Annual Report 2017-18

Customer service: Before deregulation, much of the banking services were provided by the SCBs. Due to absence of competition, service quality was low both in terms of the range of banking products offered, both on the deposit and lending sides, and the basic client services. The transaction costs in terms of time spent on making deposits or withdrawing money were high. Lending was often discretionary based on contacts with government or elected officials. The deregulation policy changed all this substantially. As

the number of banks grew, customer service related to deposit mobilization improved dramatically in private banks. Competition for bank deposits led to the development of variety of bank products and banking service quality increased substantially. Banks invested heavily in customer facilities and customer service development. The ease and convenience of banking further improved as bank branches expanded that sharply lowered the time spent on commuting to the bank branch office and the wait time at the counter. The lending products and access to bank loans also improved, subject mainly to the usual credit-worthiness assessments. Progress, however, was mostly concentrated in private banks. Public banks have remained mostly dependent on government operations and lending to high-profile and politically well-connected enterprises and entities.

D. Banking Sector Policies

What factors have contributed to this positive structural change of the banking sector and related improved quantity and quality of banking services in Bangladesh? Historically, banking sector in Bangladesh has been plagued by the problem of non-performing loans (NPLs). Public banks with seriously infected portfolio dominated the banking sector. Even in the private banks, the portfolio infection was pretty high. A 1998 World Bank study of the banking sector noted that “The three institutional pillars of banking—a strong regulatory system, well-managed banks, and an effective court system—have crumbled to such a point that the banking institutions cannot be relied upon to ensure the safety of deposits and efficiently allocate credit, their two most important functions. In a more difficult economic environment, the banking system could become Bangladesh’s Achilles Heel” (World Bank 1998).

Due to weak management, constant political interference, corruption and directed lending, even as late as 2000, the four SCBs, holding 63% of the industry’s net assets, were technically insolvent, with the ratio of their gross NPLs to total loans estimated at 46%. The court system could not be relied upon to protect creditor rights, which further vitiated lender incentives and contributed to misallocation of credit. While the issue of NPLs in public banks is fundamentally a problem of political economy, there were many associated management problems in Bangladesh relating to the inadequacy of the legal framework for banking control, weak banking supervision, inefficient management and overstaffing in public banks, and poor service standards in many banks, particularly in public banks (World Bank 1998).

Faced with this rather alarming situation, reform efforts since 2000 have sought to improve the regulatory and legal environment for the banking sector aimed at facilitating more competition and improving the soundness of the banking sector.

Banking Sector Deregulation

The most fundamental reform that happened is the progressive deregulation of the banking sector that allowed a large number of private bank and non-bank financial institutions (NBFI) to grow. As a result, the total number of private commercial banks grew from 15 in 2000 to 40 in 2018. This was a fundamental policy change that signaled the government's intention to move away from an inefficient public-dominated banking to a more competitive and efficient private banking sector.

Strengthening of Prudential Regulations

The government recognized that prudential regulations are key to developing an efficient and healthy banking system, especially in light of the prevailing weak governance in the banking sector. A number of steps were taken to improve prudential regulations. These focused on increasing the capital adequacy of banks, tightening guidelines for rescheduling various types of loans, improving accounting standards to align to international standards, moving towards tighter provision requirements for non-performing loans, imposing limits on individual loans and strengthening disclosure requirements. In a series of steps starting in 2003, the BB gradually tightened its supervision norms by adopting the Basel guidelines. According to BB, it has already implemented Basel accords I and II and Basel accord III is under implementation.

To ensure that these measures are properly implemented, efforts have been made to strengthen the regulatory capacity of the BB. Supervision capacity has been strengthened. The BB has issued new risk management guidelines for all banks, aiming to control the NPLs and the increasing risks in the banking sector. The new guidelines require each bank to prepare a Comprehensive Risk Management Guideline (CRMG) to be approved by the respective bank's Board and submitted to BB. Banks are required to appoint Chief Risk Officer as the head of the risk management department and reconstruct the risk management organogram. The BB also asked lenders to increase the use of electronic payment channels, such as the 'Real-Time Gross Settlement' and 'Bangladesh Electronic Fund Transfer Network,' to promote transparency and efficiency. The BB has asked banks to maintain an 'Internal Credit Risk Rating' to help them manage and control credit risks.

The BB has introduced a new policy for offshore banking operations. Banks, which are or intend to engage in offshore banking, must invest at least 75% of total outstanding offshore operations' funds inside the country and comply with the cash reserve requirement (CRR) and the statutory liquidity ratio (SLR). Any bank wishing to operate offshore banking must obtain approval from BB. Moreover, banks must follow Asset Liability Management (ALM) guidelines for their offshore banking operations. In addition, closure of a bank's offshore banking operations, as well as shifting and merging of any offshore banking unit, requires prior permission from BB. Loans under offshore banking operations are required to be reported to the Credit Information Bureau (CIB) of the BB.

E. Emerging Banking Sector Risks and Challenges

The deregulation of the banking sector led to the major transformation of the banking sector noted in Section C. However, the performance record in terms of improved health of the banking sector is mixed. There has been progress in improving capital adequacy on aggregate for the banking sector, but major concern remains about the capital adequacy of the SCBs. Regarding the incidence of NPLs, they did come down substantially for the banking sector as a whole from the high-level of the 1990s, but the menace of NPLs has re-emerged as a major concern over past several years, especially for the public banks. At the heart of the banking sector health concerns is the policy towards the SCBs. While banking sector deregulation has substantially reduced the operations of SCBs in Bangladesh, their poor performance continues to threaten the stability of the banking sector. Two additional issues that need to be watched and require policy actions are the observed sharp slowdown of growth in deposits and the re-introduction of interest controls.

Reform of SCBs

While the implementation of prudential regulations and greater competition in banking are welcome steps, progress in reforming the SCBs has been much more limited and hesitant. Between 2002-2008, some half-hearted attempts were made to reform SCBs with support from the World Bank. The reform sought to privatize three of the four SCBs through a two-step process. The first step involved efforts to strengthen SCB performance through better management based on corporatization; and then move to the second step to prepare them for transfer to private ownership. The reform effort proved short lived and was reversed once a new government took over in December 2008. At the heart of the SCB reform is the ownership issue and the associated political constraints. The government is yet to reconcile to the idea that public ownership of banks is not a sound banking concept (Ahmed, et. al 2003). Without change of ownership and relying on market forces, regulations are not likely to have the full desired impact especially in an environment of weak governance.

Capital Adequacy

A major reform implemented by the BB is to gradually adopt the main recommendations of the Basel prudential norms for bank supervision (Box 1). In addition to strengthening bank supervision and developing an early warning system for risk mitigation, the main focus of the Basel Accords is to lower banking sector risks by requiring the holding of high-quality capital in relation to risk-weighted assets that could be easily converted into cash to address any unforeseen drawdown of bank deposits.

Box 1: The Basel Accords for Strengthening Bank Supervision

The Basel Committee for Bank Supervision (BCBS) was established in 1974 in city of Basel, Switzerland as an international forum where members could discuss various bank supervision issues. The main objective of BCBS is to strengthen the stability of the banking system by minimizing systemic risks through Accords. These Accords seek to provide guidelines for improving banking supervision. The Basel Accords are not legally binding and member countries are expected to be responsible for their own banking system and its supervision. However, banks that are engaged in international transactions are expected to comply with these Accords to maintain international credit-worthiness. Countries where their banking system does not comply with the Basel accords can expect to be downgraded as high-risk countries with adverse implications for attracting international capital flows and engage in international transactions.

Basel has so far announced three Accords: Basel I, Basel II and Basel III. The first Basel Accord, known as Basel I, was issued in 1988. It focused mainly on credit risk by establishing a bank asset classification system and suggesting a minimum capital requirement based on the ratio of capital to risk weighted assets. Basel I fixed this ratio at 8% to be accomplished by 1992. The risk weights for calculating risk-weighted assets were defined under 5 categories with risks of 0%, 10%, 20%, 50% and 100%. Cash, central bank debt and government debt was considered as very safe assets and assigned a risk weight of 0% while all private sector debt is considered as extremely risky with a 100% risk weight.

Basel II was issued in 2004 with a view to further tightening supervision criteria for bank risks. It is based on three main pillars: minimal capital requirements, regulatory supervision, and market discipline. The minimum regulatory capital requirement was further tightened by defining the eligible regulatory capital of a bank into three tiers. The higher the tier, the less subordinated securities a bank is allowed to include in it. Each tier must be of a certain minimum percentage of the total regulatory capital. Basel II also tightened the definition of risk-weighted assets into a 2-step process. In the first step the eligible asset base is determined by using the Basel definition of risk weighted assets. In the second step. The asset base is recalculated by assigning higher risk weights to higher risk assets. This way, holding of bad assets is punished by not only reducing its eligibility for determining regulatory capital but also by reducing its value in measuring the risk weighted asset base.

The second pillar of Basel II provides the framework for national regulatory bodies to deal with various types of risks, including systemic risk, liquidity risk, and legal risks. The market discipline pillar provides various disclosure requirements for banks' risk exposures, risk assessment processes, and capital adequacy, which are helpful for users of financial statements.

Basel III was introduced in 2009 as a set of reforms designed to improve the regulation, supervision and risk management within the banking sector. Definition of eligible capital and eligible assets were further refined to foster greater resilience of individual bank in order to reduce the risk of system-wide shocks.

The performance of the different types of banks by the capital adequacy requirement indicator is shown in Table 5. Several results stand out.

First, when the performance of public banks against this criterion is considered, it is rather dismal. Capital adequacy improved over the 2000-2011 periods but has been deteriorating since then. It has now reached a stage where they can be considered as virtually bankrupt and under prudential norms should not be allowed to lend any more. This has happened

despite frequent episodes of equity injections by the Treasury amounting to an estimated Taka 175 billion over FY2010-FY2019.

Second, the private commercial banks have been maintaining the required capital adequacy ratio on the aggregate. However, there is considerable dispersion in performance. There are a number of PCBs who are unable to meet the capital adequacy ratio and their performance is under observation by the BB.

Third, not surprisingly, private foreign banks have played it most safe in maintaining very generous capital adequacy ratio. These are the safest banks in the industry and as a result are able to attract a considerable deposit base with lower than average deposit rates.

Table 5: Progress with Capital Adequacy (percent)

Bank type	1997	2000	2005	2010	2011	2015	2017	2018
SCBs	6.6	4.4	5.2	8.9	11.7	6.4	5.0	2.0
DFIs	6.0	3.2	6.0	-7.3	-4.5	-32	-35.5	-31.9
PCBs	8.3	10.9	9.2	10.1	11.5	12.4	12.5	12.2
FCBs	16.7	18.4	17.1	15.6	20.6	25.6	24.9	23.0
Total	7.5	6.7	7.3	9.3	11.4	10.8	10.5	10.0

Source: Bangladesh Bank Annual Reports 2003 and 2017-18

Asset Quality: The Menace of Non-Performing Loans

The trend in NPL is shown in Table 6. The asset quality challenge facing the banking sector in Bangladesh can be grouped under three phases: A historical pre-reform phase lasting up to 1999. A reform phase running from 2000-2011. A drifting phase since 2012 and ongoing that is characterized by mixed performance with some reforms but many challenges.

Table 6: Trend in Non-Performing Loan as Percent of Total Loans 1997-2011

Bank type	1997	1998	1999	2000	2002	2008	2011
SCBs	37	40	46	39	34	25	11
DFIs	66	67	65	63	56	26	25
PCBs	31	33	27	22	16	4	3
FCBs ⁷	4	4	4	3	3	2	3
Total	37	41	41	35	28	11	6

Source: Bangladesh Bank Annual Report 2003, 2005, 2015

⁷ The observed deterioration of NPLs in foreign banks reflects the effects of two poorly performing banks: the Islamic Commercial Bank owned by the Malaysians and the National Bank of Pakistan. Their share of the deposit base is negligible and do not pose a major stability threat.

Pre-reform phase (Up to 1999): In the historical pre-reform phase, the portfolio quality issue was a major problem. Generally, the public banks have always been saddled with a large infected portfolio and this infection got sharply severe between 1997 and 1999, raising the share of NPL to 46% for the SCBs and 65% for the DFIs. The reasons are well known and international experience shows that Bangladesh was not alone in this regard, although the severity of the problem was more intense. Much of the problem is a manifestation of corruption linked with the politics of public ownership, but this also reflects poor banking decisions due to weak management, poor staffing quality and lack of accountability. The private commercial banks also had a fairly large share of bad loans, reflecting inadequate regulation and weak supervision by the BB. The only good-performing banks were the foreign commercial banks.

Reform phase (2000-2011): In the reform phase starting in 2000, the portfolio quality registered significant improvements. Initially much of the portfolio performance improvement happened in private commercial banks; thus, NPLs fell sharply from 27% in 1999 to 16% in 2002. This performance gathered momentum subsequently as prudential norms and supervision effort of BB gained strength. NPLs fell dramatically to 6% in 2011. The portfolio quality also improved in public banks, initially very slowly but gained speed during 2010-2011 periods. By 2011, the NPL ratio of SCBs had fallen to only 11%, down from 46% in 1999. Even the DFIs registered improvement with the share of NPL falling from its peak of 67% in 1998 to 25% in 2011. This improvement in the banking portfolio was a very welcome development and shows that good reforms lead to good results.

Banking policy drift phase (2012-ongoing): The improvements secured over the banking sector reform phase has come under pressure in the third and the currently ongoing phase of banking policy drift. The portfolio quality improvement has been reversed and the menace of NPLs is creeping up again (Table 7). While the main problem is with the public banks who, as noted above, are getting bankrupt owing to the growing menace of NPLs and are unable to maintain the required prudential regulatory capital base, the infection is also spreading to private commercial banks. As noted, the performance of private commercial banks is uneven and the aggregate NPL hides the portfolio difficulties faced by several weakly-performing private commercial banks. In general, the increase in NPL incidence in private banking, despite improved supervision efforts by the BB reflected in the progress with implementation of Basel Accords, and the continued slide in the performance of SCBs is a reflection of the growing political interference in the working of the banking system that must be stopped and reversed.

Table 7: Trend in Non-Performing Loan as Percent of Total Loans 1997-2019

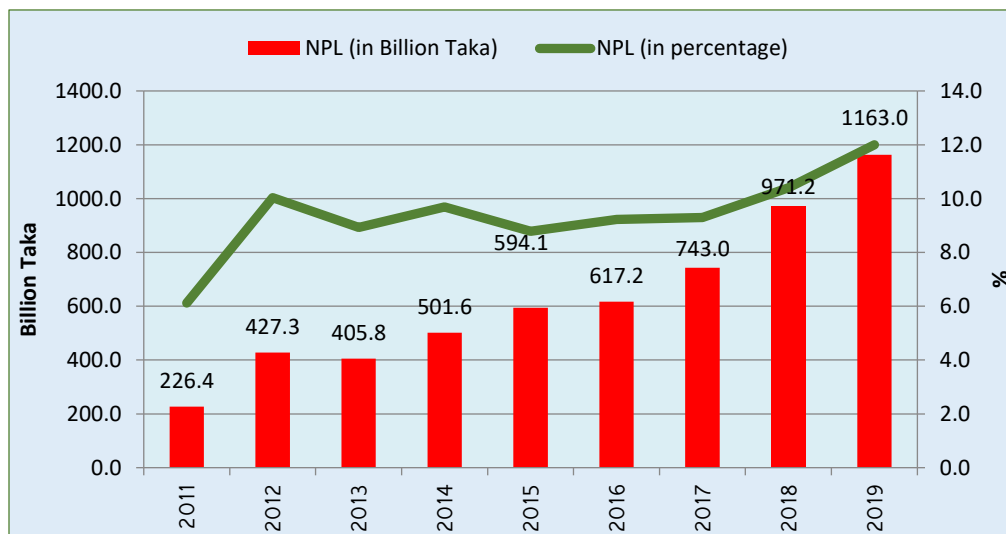
Bank type	2011	2012	2013	2014	2015	2016	2017	2018	2019
SCBs	11	24	20	22	22	25	27	28	32
DFIs	25	27	27	33	23	26	23	22	18
PCBs	3	5	5	5	5	5	5	6	7
FCBs	3	4	6	7	8	10	7	7	6
Total	6	10	9	10	9	9	9	10	12

Source: Bangladesh Bank Annual Report 2017-18 and Bangladesh Bank Website.

Non-Performing Loans and Fiscal Risks

The rapid transformation of the banking sector from public-dominated banking to private-led banking has reduced the overall riskiness of the banking sector by sharply lowering the share of the loan portfolio of the public banks. This is a positive development that has helped lower the overall NPL ratio for the banking sector as a whole. Yet, in absolute taka terms, the total value of NPLs is a huge source of concern. This is shown in Figure 5. The total value of NPL for the banking sector as a whole has grown from Taka 226 billion in 2011 to taka 1242 billion in 2019, which is a 450% increase in 8 years. As a share of GDP, gross NPL surged from 2.4% of GDP in 2011 to 4.9% in 2019.

Figure 5: Gross Non-Performing Loans of the Banking Sector



Source: Bangladesh Bank

The large amount of NPL raises two important policy questions: first, who will bear this loss in the event that little or nothing of the outstanding NPL amount is recovered? And second, what are the implications for the sustainability of the banking sector? Some of the NPL value is accumulated interest income. While this will not directly affect the liability of the banks in the short term, it will reduce the profitability of the banking sector and

thereby adversely affect ability to keep provisions for bad loans while also lowering the capacity to mobilize and service the deposit base.

But a significant part of the NPLs is the principal amount owed. As far as private commercial banks are concerned, they are partly protected by the build-up of provisioning and the remaining exposed position will have to come from future earnings. As noted, this provisioning can only be sustained if the stock of NPLs does not grow. So, a growing NPL over a prolonged period will drive the concerned private banks towards bankruptcy and could severely jeopardize ability to service the deposits.

Regarding the SCBs, large NPLs pose a major fiscal challenge to the government for three reasons. First, the SCBs have much larger share of the NPL value even though their lending base has shrunk because of the large incidence of the NPL ratio. Thus, their share of NPL for 2019 is estimated at Taka 596 billion. After allowing for interest suspense and provisioning, net NPL amounts to an estimated Taka 231 billion that becomes contingent fiscal liability. The Finance Ministry is already facing a severe fiscal crunch owing to a very low and falling tax/GDP ratio (presently less than 9% of GDP) (Ahmed 2019). In this environment, the large contingent fiscal liability of the SCB operations could challenge fiscal sustainability and or ability to protect the interest of the depositors.

F. Loan Recovery and Banking Courts

This is another area where progress is slow. Generally, getting decisions from the court system on outstanding loans is a long-drawn process, discouraging financial institutions from seeking this remedy. To obviate this problem, the Artha Rin Adalat Ain 2003 (Money Loan Court Act, 2003) was enacted in March 2003 with a view to streamlining the process of realization of overdue loans and advances by banks and financial institutions. Provisions have been made in this Act for realization of the banks dues by selling properties held as security, without prior orders of the court. This is an encouraging step; its effectiveness remains to be proven due to the tremendous implementation challenges including logistical arrangements.

Interest Rate Management

The role of interest rate management for development has been studied extensively. The most cited work is that of McKinnon (1973) and Shaw (1973), who define financial liberalization to mean the establishment of higher interest rates that equate the demand and supply of savings. The authors argue that higher interest rates will lead to increased savings, higher financial intermediation and improvements in the efficiency of use of financial resources. Increases in savings along with more efficient use will add to economic growth.

Balassa (1989) summarizes available empirical evidence that suggests that higher real interest rates increase the extent of financial intermediation while increased financial intermediation raises the rate of economic growth in developing countries. Furthermore, he also found evidence that moderately high real interest rates have a positive effect on investment efficiency and on economic growth. The paper notes, however, that excessively high interest rates will have unfavorable economic effects. Such a situation can be avoided if the liberalization of the banking system takes place under appropriate conditions, including monetary stability and the appropriate supervision of the banks. This would further the goal of establishing equilibrium interest rates.

The World Bank's seminal study on the factors that contributed to the performance of the High-Performing East Asian Economies (HPAEs) concluded that a major determinant was the sound management of the financial sector (World Bank 1993). Financial sector policies in HPAEs were geared to increasing financial savings and channeling them into activities with high social returns. On the policy front two major policies were to keep real interest rates positive to help mobilize financial savings and establish a stable and secure banking system based on protection and prudential regulations.

While there is controversy about implementation of financial liberalization for developing countries, especially in its broadest neo-classical definition of lifting all restrictions on domestic and foreign financial flows and letting domestic and international interest rates equilibrate (adjusting for exchange rate movements), there is much more consensus that the domestic interest policy should avoid severe financial repression that keeps domestic interest rates negative in real terms for depositors and very low for borrowers such that these lending rates are substantially below the marginal productivity of capital leading to excessive demand for credit. Such financial repression could stifle the growth of financial savings, reduce the scope for financial intermediation and lead to capital rationing to avoid excess demand for credit. Credit rationing in turn would seriously misallocate capital to inefficient uses. Severe financial repression could also contribute to instability of the financial system (Xu and Gui 2019).

So, regarding interest rate management, the most important policy message for Bangladesh is to keep real deposit rates moderately positive (2-3%) while keeping the real lending rates in line with the marginal productivity of capital (the 6-7% range would seem reasonable).

As against these theoretical arguments and empirical findings, what has been the experience in Bangladesh? Table 8 shows the trend in nominal and real 5-year average deposit and lending rates. The yearly rates are weighted average rates for different banks. The Bangladesh has persistently followed a controlled interest rate policy that was periodically adjusted. There is no clear policy pattern that emerges from Table 8. However, overall, it would appear that Bangladesh has generally shied away from financial

liberalization and followed a policy of mild financial repression with the objective of keeping the cost of borrowing to a low level (Mickinon 1973 and Shaw 1973).

In the early years after independence (1976-1985), nominal deposit and lending rates were kept low despite high inflation, causing real deposit rates to be substantially negative while keeping real lending rates low. Interest rate management improved over the 1986-2005 period supported by better macroeconomic management that sharply lowered the average inflation rate. The real deposit rates were positive but the average real lending interest rates were on the high side owing to the large spread between average lending and deposit rates caused by the growing incidence of NPLs. Real deposit and lending interest rates have fallen sharply during 2006-2019 through a combination of inflation control and interest rate control policies.

Table 8: Average Nominal and Real Interest Rates

Period Average	Nominal deposit rate	Real deposit rate	Nominal lending rate	Real lending rate
1976-1980	6.7	-1.63	11.1	5.19
1981-1985	7.6	-4.29	13.7	1.82
1986-1990	8.8	1.48	14.7	7.44
1991-1995	6.8	1.24	13.9	8.35
1996-2000	6.9	1.04	13.8	8.00
2001-2005	6.3	2.39	12.3	8.55
2006-2010	6.7	-0.95	12.1	4.41
2011-2015	7.7	0.12	12.9	5.33
2016-2019	5.3	-0.30	9.9	4.25

Source: Bangladesh Bank

What have been the effects of these interest rate management on financial intermediation and investment rates? The results are summarized in Table 9. Negative real deposit rates, low GDP real growth, low real per capita incomes and lack of banking competition all militated against financial intermediation keeping the M2/GDP ratio at a very low level well up to the mid-1980s. The private investment rate also remained depressed despite low real lending rates owing to weak investment climate and slow growing economy. Interest rate management became more supportive of deposit mobilization over 1986-2005 when real deposit rates became positive. Along with high real GDP growth rates, rising per capita real incomes and banking competition the M2/GDP ratio surged, reaching an average of 32.4% during 2001-2005. Real deposit rates fell in the negative zone during 2006-2019. But the adverse substitution effects were offset by the income effects of high GDP growth and the rising real per capita incomes. Therefore, the M2/GDP ratio continued to grow over 2006-2015. However, a prolonged period of negative real deposit rates has started to take a toll and the M2/GDP ratio has been stagnant during FY2016-19.

So, on the whole it would appear reasonable to conclude that positive real deposit rates are an important determinant of deposit growth in Bangladesh and are necessary to support further financial deepening as concluded by the McKinnon-Shaw hypothesis.

Table 9: Real Interest Rates, Financial Intermediation and Private Investment

Period Average	Real deposit rate	Real lending rate	Real GDP growth rate	M2/GDP	Average private investment rate
1976-1980	-1.63	5.19	4.2	12.0	6.1
1981-1985	-4.29	1.82	3.8	13.2	7.7
1986-1990	1.48	7.44	3.6	17.8	7.2
1991-1995	1.24	8.35	4.4	21.8	11.3
1996-2000	1.04	8.00	5.2	24.8	15.1
2001-2005	2.39	8.55	5.4	32.4	15.9
2006-2010	-0.95	4.41	6.0	40.7	19.6
2011-2015	-0.29	4.92	6.9	50.3	22.1
2016-2019	-0.30	4.25	7.6	50.7	23.0

Source: Bangladesh Bank

The behavior of private investment rate is interesting. It remained depressed despite low real lending rates during 1976-1985. But it jumped from an average of 7.2% of GDP during 1981-86 to 15.9% in 2001-2005 even though real lending rates reached historical high levels of 8 percent plus. Real lending rate fell dramatically between 2006-2015 and private investment rate surged to 22.1%. Real lending rates fell further during FY2016-19 but private investment rate barely increased. The main conclusion that appears plausible is that the real lending rates are not well correlated with private investment and there are other variables including real GDP growth on the demand side and investment climate on the supply side that influence investment behavior. Indeed, the fact that the private investment rate has remained stagnant at around 22-23% of GDP over the past 10 years (FY2010-FY2019) despite falling real lending rates and rising GDP growth rate leads to the inevitable conclusion that the investment climate facing Bangladesh needs an overhaul to boost private investment (Ahmed 2020). Forcing real interest rates to fall further to push private investment is not going to work.

It would appear from the above experience that continued financial repression even in its present mild form that drives down real lending rates to the negative zone as a means to promote private investment and GDP growth is not a sound policy. This approach tends to hurt deposit mobilization and financial intermediation, which can adversely affect long-term growth by lowering financial savings. There is already evidence that mild financial repression is hurting the growth of deposits and M2/GDP. Thus, the M2/GDP ratio is on a declining trend since FY2016, falling from the peak of 52.9% to 48.5% in FY2019. This trend should be reversed as soon as possible. Regarding the relationship between

investment rate and real interest rate, the evidence suggests that real interest rate is only one variable that influences investment. Other determinants include the rate of growth of GDP and the cost of doing business. Evidence shows that the cost of doing business in Bangladesh is very high (Ahmed 2020). This must be addressed forcefully while keeping real interest rates in line with the marginal productivity of capital. Single-minded pursuit of driving real interest rates to very low levels without regards to the marginal productivity of capital and the investment climate will not boost private investment rate or GDP growth rate on a sustained basis.

G. The Way Forward

The banking sector deregulation in Bangladesh since 2000 has served the country well by establishing a competitive private-sector led banking sector that has substantially boosted financial intermediation, enhanced access to banking services and improved service quality. This progress needs to be consolidated with further improvements in the quality and efficiency of banking services. The reforms will have to be real that goes to the root causes of the emerging banking sector weaknesses describe in Section E and seek to address them comprehensively and in a sustained manner. Frequent loan restructuring and efforts to delay the implementation of the Basel Accords or to change accounting practices to hide the NPLs and regulatory capital deficiencies will be futile and further hurt the health of the banking sector. This can compromise the government's ability to achieve the PP2041 targets, which are key elements of Prime Minister Sheikh Hasina's strategy to realize the dream of Bangabandhu.

The bank reforms of 2000-2011 have successfully limited the role of the poor-performing public banks. But, with a large infected portfolio and continuous need for financial support from the Finance Ministry to stay in business, these banks cannot function as presently. They already present a huge contingent fiscal liability to the government in an environment of low tax revenues. Political interventions in private banks are also a source of concern that is creating financial difficulties in a number of private banks. This must be forcefully addressed to avoid creating major headaches for the health of the banking sector. Furthermore, the government needs to adopt a sound management of the interest rate policy to ensure that deposit rates are positive in real terms to avoid the risk of a financial disintermediation at a time when the M2/GDP ratio and private credit to GDP ratio needs to grow further to facilitate private investment and growth as envisaged under PP2041.

Ensure the Autonomy of the Bangladesh Bank

At the very top of the reform list is the need for autonomy of the BB. In the absence of adequate autonomy, political interventions have compromised the ability of BB to fully implement its supervision role, especially in the case of the public banks. The government should carefully review the issue of the independence of the BB and the amount of

autonomy it wants to convey to the regulator. There is clear evidence from international experience that an independent Central Bank is necessary to move to UMIC and HIC status. This is an essential institutional reform for achieving the targets of the Perspective Plan 2041 (PP2041). A fully autonomous regulator that can hire quality staff it needs, procure the technology it requires to strengthen its effectiveness, and implement prudential norms without the fear of political influence is essential to prevent inefficiencies and corruption in the banking sector. An autonomous Central Bank is also necessary to conduct sound monetary policy management and to exercise utmost prudence in such matters as the licensing of new banks.

Improve Supervision of the Banking Sector

The positive experience with better supervision of banks leading to adoption of Basel I and II is a reflection of the importance of continuously improving high-quality supervision. The deterioration in the portfolio quality of PCBs suggest that the supervision effectiveness of the BB may have been selectively compromised owing to political interventions in support of the politically-connected owners of poor-performing PCBs. The government must not interfere or compromise the BBs implementation of the full supervision norms of PCBs. The government should also rethink the strategy for the supervision of public banks. The weakly performing public banks with a huge amount of infected portfolio is a serious threat to the soundness of the banking sector. In addition to efforts to improve their performance, these banks must be brought under the full regulatory supervision of the BB and must be required to comply with all prudential norms, including certification of the bank boards and senior management as per the approved fit and proper criteria. The government must understand that it cannot both be a producer of banking services (as owner) and also a regulator of these services. This is a serious conflict of interest that must be corrected.

Reforming the Public Banks

Over the longer term, the government should reassess whether it really needs be in the business of providing banking services. There is plenty of international evidence that publicly-owned banks do not perform well in an environment of weak governance. The quality of portfolio inevitably gets tainted owing to political interventions that are inconsistent with sound banking decisions. The first best option is to privatize the state-owned banks. The government should plan to retain the Sonali bank to conduct Treasury operations. The other three SCBs should be privatized. This is not simply a matter of listing them on the stock market and selling some shares to raise capital, but a full-fledged operation leading to privatization of ownership and management as private commercial banks. Even Sonali bank that is retained as an SCB, must be reformed to be financially viable and required to be fully compliant with all prudential norms under the supervision of the BB.

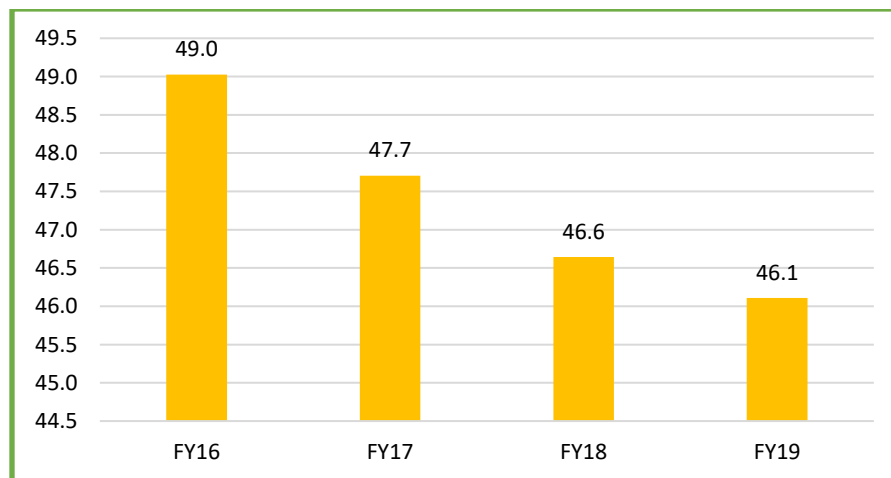
In a political environment where privatization is not imminent, there is a second-best approach that might work. This option is to take away the lending role of public banks. If such banks are allowed to only hold government paper, their deposit growth would be indirectly limited and sounder banks would intermediate more flows. Such lending restrictions are akin to a “dual banking system” with “narrow banks” that are likely to remain state-owned (and only allowed to gather deposits to invest in government paper) and conventional private sector banks. No new laws are required because the government as owners of the public banks could take this decision.

The idea of narrow bank is not a new one and merits serious attention (Ahmed, et. al. 2003). At the least the government might ask the Bangladesh Bank to review this option carefully and provide a technical proposal. The government must understand that it faces a very tight fiscal situation and it cannot absorb a fiscal shock from a potential liquidity crisis in public banks emerging from an overload of infected portfolio.

Proper Management of the Interest Rate Policy

Bangladesh should seriously rethink its approach to interest rate policy. As noted in Section E, interest rate management has been unstable with periods of relaxation and then followed by tight control. As a result, the real deposit rate has often been negative. This is presently the case where the real deposit rate has been negative for past several years and the rate of growth of bank deposits has been falling significantly (Figure 6). A slow-growing deposit base in the face of rising NPLs could create serious liquidity and profitability problems for banks that could lead to financial disintermediation and hurt growth. It could also hurt the stability of the banking sector that must be avoided.

Figure 6: Recent Trend in Deposit to GDP Ratio (Percent)



Source: Bangladesh Bank

In the short term, BB must ensure that the real deposit rates are positive and real lending rates are aligned to the marginal productivity of capital. As noted earlier, a rough rule of thumb could be to target real average deposit rates at 2-3 percent and real average lending rates in the range of 6-7 percent. Interest rates offered on specific products should be market determined based on supply and demand for such loans and associated risks. Fixing a single interest rate ceiling for all products without regards to supply, demand and risk profile would create serious inefficiencies in credit allocation and also lead to credit rationing. This type of financial repression must be avoided.

Over the longer term, since Bangladesh is aspiring to move to UMIC and HIC in the next 20 years or so, it is appropriate that instead of pursuing a control-oriented and administratively determined interest rate policy, Bangladesh should adopt a proper market-driven interest rate policy. As in other UMIC, Bangladesh can influence interest rate level through a proper use of monetary policy instruments. Presently, the link between monetary policy instruments (reserve requirements, BB discount rate and open market operations involving sale and purchase of Treasury bills) is weakened by the absence of a well-developed bond market. The government can spur the development of the bond market by opening up the market for Treasury bills (T-bills) for private trading. This will then set a benchmark for other interest rates. The BB can then influence interest rates more forcefully through the supply of T-bills as a key monetary policy instrument. This would modernize interest rate management and offer savers a major secured financial asset. It would also facilitate deposit mobilization as banks compete with each other through attractive financial products as substitutes for T-bills.

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