

Non-Performing Loan and Management Guidelines for Remedies: An Empirical View of Bank Employees

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Abstract

Non Performing Loan (NPL) is the most important indicator to identify problems with asset quality in the loan portfolio. In Bangladesh, the empirical view about the ratio of NPL to total loans of all the scheduled banks have been in sliding trend, although the aggregate ratio is still soaring higher than the desired perimeter. The very high NPL ratio, as ascertained from Nationalized Commercial Banks (NCBs) and Development Financial Institutions (DFIs), especially for term lending, agricultural and micro lending, necessitates re-examining these activities and establishing a viable rationale for their continuation. From the views of Bank employees, it is clear that steps taken to prevent loan classification and provisioning requirements are not sufficient; and due to lack of persuasion, the rate of willful defaulters is high. Efficient usage of the CIB report, implementation of appropriate legal frameworks and improvement of corporate governance of banking operations have been denoted as management guidelines for enhancing banking sector reform while retaining NPLs within recommendation.

Key words: Non-performing loan, banking operation, loan defaulter, aggregate ratio, trend.

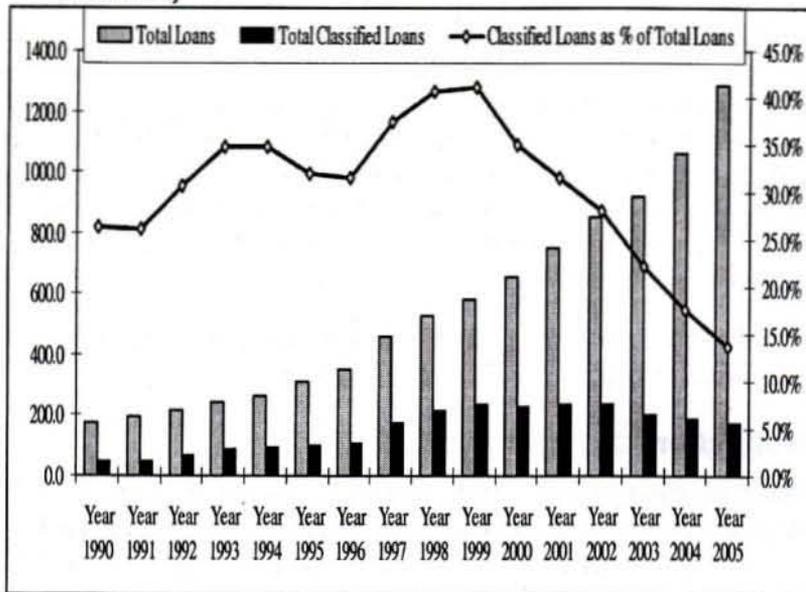
I. Introduction

The Non-Performing Loans (NPLs) are a major deteriorating factor for the performance of banks in developing countries like Bangladesh. The issue of NPLs has turned out to be one of the major problems for more than a decade in the banking sector in Bangladesh (Khan, Tanvir A. 2005). The National Commercial Banks (NCBs) and Development Financial Institutions (DFIs) continue to have very high NPLs mainly due to substantial loans provided by them on considerations other than commercial and under directed credit programs during the 70s and 80s (Choudhury, A. Toufic & Adhikary, K. Bishnu. 2002). Poor appraisal and inadequate follow-up and supervision of the loans disbursed by the NCBs

and DFIs in the past eventually resulted in massive booking of poor quality assets which still continue to remain significant in the portfolio of these banks.

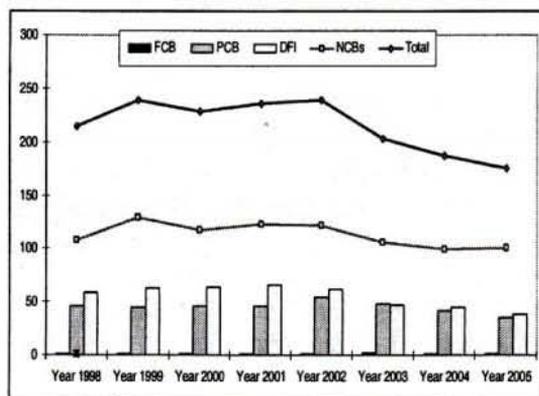
Furthermore, the banks were reluctant to write-off the historically bad loans because of poor quality of underlying collaterals and to avoid any possible legal complication due to lacunas in the judicial framework (Shajahan, K.M. 1998). Recovery of NPLs, however, witnessed some signs of improvement mainly because of the steps taken with regard to internal restructuring of these banks to strengthen their loan recovery mechanism and recovery drive and write-off measures initiated in recent years.

Figure 1: Ratio of total classified loans to total loans (in billion Tk.)



Source: BRPD, Bangladesh Bank, 2006.

Figure 2: Aggregate position of classified loans by clusters of Banks (in billion Tk.)



Source: Annual Report, Bangladesh

The overall scenario of NPLs for the year 1990 - 2005 has been given in figure-1 where the ratio of NPL to total loans of all the banks shows an encouraging trend since its decline from the peak (41.1 percent) in 1999, although the aggregate ratio is still as high as 13.6 percent in December 2005.

Out of 48 banks of Bangladesh, NCBs and DFIs, the outstanding NPL were 22.94% and 33.68% respectively in FY06; In Public Limited Banks (PCBs) classified loan of total loan outstanding decreased slightly and reached to 5.45% while Foreign Commercial Banks (FCBs) also witnessed slight decrease in the classified loan and reached to 0.81% as in FY06.

Banks in Bangladesh are doing social banking as per directives of the government and Bangladesh. While doing social banking particularly NCBs had to forego the idea of profit generation in many cases (Choudhury, T. Ahmad & Moral L.H., 1999). Monitoring and follow-up of loans are more personalized in PCBs compared to NCBs. External forces influencing or directing the sanction of loans contributed greatly towards enlargement of non-performing loans. After liberation, Government and Bangladesh Bank directed banks to provide loans to priority sectors and to state-owned enterprises. Loans given to priority sector like agriculture also contributed towards the growth of non-performing loans of banks in Bangladesh.

In addition to the above causes, the growth of NPLs in Bangladesh is due to high incidence of natural calamities like flood, drought and cyclone which damage standing crops as well as inadequate system of monitoring and diversion of funds. Other factors like erosion in ethical standards, willful defaulters and socio-political systems, etc. jeopardised the process of recovery drive undertaken by banks from time to time (Islam, Mainul.1999.)

Since the inception of provisioning by Bangladesh Bank regulatory body, the total NPL has declined significantly. The Bangladesh Bank has strengthened its capacity to supervise and regulate banks effectively by performing comprehensive audits and taking action against banks in violation of regulatory and prudential norms, especially in exercising the provisioning system (Moral, Liakat. 2000).

For successful implementation of regulatory and prudential norms, it is important to be aware of the perception of bank employees toward the NPLs issues and the probable remedies.

II. Objectives

- Bank employees perception toward NPLs and prevalent sector of NPLs
- Probable management guidelines for remedy for NPLs

III. Methodology

The primary population of this study had been identified as 48 schedule banks of Bangladesh. Those banks can be categorized as Nationalized Commercial Banks(4), Private Commercial Banks(24), Foreign Commercial Banks(9), Specialized Banks(5), and Islami Banks(6).

The secondary population of this study was the loan appraisal officers of loan approval department of credit division (both male and female) of those banks. Moreover, divisional head of credit division along with credit marketing department, audit and inspection and credit management committee had been included as the secondary population.

Primary sampling from the 48 banks had been done by following the purposeful stratified sampling method. The category of Bank, CRISL rating, and tenure of operation had been the strata for primary sampling.

Out of 4 Nationalized Commercial Banks, 2 banks (Sonali bank and Pubali Bank) were selected. Out of 24 Private Commercial Banks, 8 banks (The City Bank, NCC Bank, Southeast Bank, Dutch-Bangla Bank, Dhaka Bank, Bank Asia, Mercantile Bank, and One bank) were selected. Out of 9 Foreign Commercial Banks, 1 bank (HSBC) was selected, and out of 5 Specialized Banks 1 bank (BASIC Bank) was selected.

Secondary sampling had been conducted among the employees of those selected 12 banks by following the purposeful stratified sampling method. For determining the secondary sample size of the survey, following formula was used.

$$\sigma_x = \frac{S}{\sqrt{(n-1)}} \times \frac{\sqrt{(N-n)}}{\sqrt{(N-1)}}$$

Where N = Size of population, n = Size of sample, S = Standard deviation of sample,

σ_x = Standard error of the mean

Therefore,

$$\frac{0.1}{1.645} = \frac{0.65}{\sqrt{(n-1)}} \times \frac{\sqrt{(36708-n)}}{\sqrt{(36708-1)}}$$

Here,

N = 36708 (Number of employees in 12 Banks in 2006)

S = 0.65 (assumed, in perceptual survey, standard deviation is normally >.50)

Confidence level 90% (z = 1.64)

Precision level + 10%

$\sigma_x = 0.1 / z = 0.1 / 1.64$

So, the sample size, n = 114.93 \approx 115 (approximately).

120 questionnaire surveys had been targeted Finally, 91 questionnaire surveys were conducted which was quite close to the required sample size (about 80%).

IV. Views of Employees in Selected Banks about NPLs

Seven hypotheses have been developed and tested against the responses to know about the views of employees including top executives regarding the loan classification and provisioning requirement. The objective was to

know how much they are aware and what they are thinking regarding these issues.

1. H_a = Loan default rate in NCBs are high
2. H_a = Loan default rate in first generation bank is high.
3. H_a = Loan default rate in Manufacturing sector is high
4. H_a = Loan default rate in RMG sector is high
5. H_a = The steps to prevent bank defaulting is sufficient.
6. H_a = The rate of "willful defaulting" is high
7. H_a = Most banks follow strict loan recovery scheme

Hypothesis Testing 1

H_0 = Loan default rate in NCBs are not high.

H_a = Loan default rate in NCBs are high.

In other words,

$H_0: \chi^2 = 9.49^1$, $H_a: \chi^2 > 9.49$

	Strongly disagree	Moderately disagree	Somehow agree	Moderately agree	Strongly agree	Total (N)
Observed frequency (o_j)	5 (5.5%)	23 (25.3%)	33 (36.3%)	29 (31.8%)	1 (1.1%)	91
Expected frequency (e_j)	7 (7.7%)	21 (23.1%)	35 (38.4%)	21 (23.1%)	7 (7.7%)	91

$$\chi^2_{\text{Cal}} = \sum_{j=1}^{k=5} (o_j - e_j)^2 / e_j = 9.9$$

Since $\chi^2_{\text{Cal}} > \chi^2_{\text{critical value}}$, the null hypothesis is not accepted 4 d.f. at 5% level of significance. Therefore loan default rate in NCBs are high.

Hypothesis Testing 2

H_0 = Loan default rate in first generation bank is not high.

H_a = Loan default rate in first generation bank is high.

In other words,

$H_0: \chi^2 = 9.49$, $H_a: \chi^2 > 9.49$

¹ The critical value for $\chi^2_{0.95}$ for 4 [(5-1)=4] degree of freedom is 9.49

² According to normal distribution of frequencies

	Strongly disagree	Moderately disagree	Somehow agree	Moderately agree	Strongly agree	Total (N)
Observed frequency (o_j)	1 (1.1%)	36 (39.5%)	41 (45.1%)	11 (12.1%)	2 (2.2%)	91
Expected frequency (e_j)	7 (7.7%)	21 (23.1%)	35 (38.4%)	21 (23.1%)	7 (7.7%)	91

$$\chi^2_{\text{Cal}} = \sum_{j=1}^{k=5} (o_j - e_j)^2 / e_j = 25.2$$

Since $\chi^2_{\text{Cal}} > \chi^2_{\text{critical value}}$, the null hypothesis is not accepted. So at 5% significance level, it can be said that Loan default rate in first generation bank is high.

Hypothesis Testing 3

H_0 = Loan default rate in manufacturing sector is not high.

H_a = Loan default rate in manufacturing sector is high.

In other words,

$H_0: \chi^2 = 7.78$, $H_a: \chi^2 > 7.78$

	Strongly disagree	Moderately disagree	Somehow agree	Moderately agree	Strongly agree	Total (N)
Observed frequency (o_j)	7 (7.7%)	39 (42.9%)	29 (31.9%)	10 (10.9%)	6 (6.6%)	91
Expected frequency (e_j)	7 (7.7%)	21 (23.1%)	35 (38.4%)	21 (23.1%)	7 (7.7%)	91

$$\chi^2_{\text{Cal}} = \sum_{j=1}^{k=5} (o_j - e_j)^2 / e_j = 22.4$$

Since $\chi^2_{\text{Cal}} > \chi^2_{\text{critical value}}$, the null hypothesis is not accepted. So at 5% significance level, it can be said that loan default rate manufacturing sector is high.

Hypothesis Testing 4

H_0 = Loan default rate in RMG sector is not high.

H_a = Loan default rate in RMG sector is high.

In other words,

$H_0: \chi^2 = 9.49$, $H_a: \chi^2 > 9.49$

	Strongly disagree	Moderately disagree	Somehow agree	Moderately agree	Strongly agree	Total (N)
Observed frequency (o_j)	10 (10.9%)	26 (28.6%)	32 (35.2%)	16 (17.6%)	7 (7.7%)	91
Expected frequency (e_j)	7 (7.7%)	21 (23.1%)	35 (38.4%)	21 (23.1%)	7 (7.7%)	91

$$\chi^2_{\text{Cal}} = \sum_{j=1}^{k=5} (o_j - e_j)^2 / e_j = 3.9$$

Since $\chi^2_{\text{Cal}} < \chi^2_{\text{critical value}}$, the null hypothesis is not rejected. So at 5% significance level, it can be said that loan default rate in RMG sector is not high.

Hypothesis Testing 5

H_0 = The steps to prevent bank defaulting is not sufficient.

H_a = The steps to prevent bank defaulting is sufficient.

In other words,

$H_0: \chi^2 = 9.49$, $H_a: \chi^2 > 9.49$

	Strongly disagree	Moderately disagree	Somehow agree	Moderately agree	Strongly agree	Total (N)
Observed frequency (o_j)	10 (10.9%)	28 (30.8%)	34 (37.4%)	16 (17.6%)	3 (3.3%)	91
Expected frequency (e_j)	7 (7.7%)	21 (23.1%)	35 (38.4%)	21 (23.1%)	7 (7.7%)	91

$$\chi^2_{\text{Cal}} = \sum_{j=1}^{k=5} (o_j - e_j)^2 / e_j = 7.1$$

Since $\chi^2_{\text{Cal}} < \chi^2_{\text{critical value}}$, the null hypothesis is not rejected. So at 5% significance level, it can be said that the steps to prevent bank defaulting is not sufficient.

Hypothesis Testing 6

H_0 = The rate of “willful defaulting” is not high.

H_a = The rate of “willful defaulting” is high.

In other words,

$H_0: \chi^2 = 9.49, H_a: \chi^2 > 9.49$

	Strongly disagree	Moderately disagree	Somehow agree	Moderately agree	Strongly agree	Total (N)
Observed frequency (o_j)	6 (6.6%)	27 (29.7%)	31 (34%)	23 (25.3%)	4 (4.4%)	91
Expected frequency (e_j)	7 (7.7%)	21 (23.1%)	35 (38.4%)	21 (23.1%)	7 (7.7%)	91

$$\chi^2_{\text{Cal}} = \sum_{j=1}^{k=5} (o_j - e_j)^2 / e_j = 3.8$$

Since $\chi^2_{\text{Cal}} < \chi^2_{\text{critical value}}$, the null hypothesis is not rejected. So at 5% significance level, it can be said that the rate of “willful defaulting” is not high.

Hypothesis Testing 7

H_0 = Most banks do not follow strict loan recovery scheme.

H_a = Most banks follow strict loan recovery scheme.

In other words,

$H_0: \chi^2 = 9.49, H_a: \chi^2 > 9.49$

	Strongly disagree	Moderately disagree	Somehow agree	Moderately agree	Strongly agree	Total (N)
Observed frequency (O_j)	4 (4.4%)	26 (28.6%)	38 (41.8%)	20 (21.9%)	3 (3.3%)	91
Expected frequency (e_j)	7 (7.7%)	21 (23.1%)	35 (38.4%)	21 (23.1%)	7 (7.7%)	91

$$\chi^2_{\text{Cal}} = \sum_{j=1}^{k=5} (O_j - e_j)^2 / e_j = 5.1$$

Since $\chi^2_{\text{Cal}} < \chi^2_{\text{critical value}}$, the null hypothesis is not rejected. So at 5% significance level, it can be said that most banks do not follow strict loan recovery scheme.

V. Findings and recommendations

From the responses of employees of selected 12 banks, it was found that most of the employees were aware of the high loan default rate both in NCBs and first generation banks. From the statistical data of last 15 years, it was also revealed that NCBs and DFIs had been burdened by huge amount of classified loans comparing with PCBs and FCBs. Hence, employees' view has reflected the actual scenario.

Hence, it can be concluded that these employees are not aware of the issue, since they are habituated to their general banking activities only. To improve the awareness among the employees, it is required to impart training about loan classification, Financial sector reform, Basel II, write-offs etc.

It has also been clear that the employees have perceived that the recent steps taken to prevent loan classification are not sufficient. Since employees believe that proper remedies are not used for preventing classified loans, therefore, those remedies should be identified and utilized. Moreover, from the survey, some suggestions have been provided by the respondents to improve the NPL situations.

Finally, respondents think that most banks do not strictly follow the loan recovery system. It might be true for NCBs and DFIs; but most of the

PCBs and FCBs follow strict loan recovery procedure. Hence, employees' view did not reflect the actual situation.

The following measures can be undertaken to reduce the classified loans:

- For the credit worthiness of projects/borrowers, the CIB report could be checked on the credit standing, since Bangladesh Bank is in the process of modernizing CIB to provide online information. Current (under process) computerized voter-list information can be a good source of information for specialized banks to give micro credit/SME banking facility to subsistence borrowers.
- Banks should pursue advances on consortium basis in respect of large loans to reduce operational cost and increase income.
- Banks should continuously review loan accounts to meet credit requirements of existing borrowers and to take corrective actions to seize the growth of non-performing assets.
- Bankers should apply due human skill, diligence and prudence while delivering credit. To ensure this ability of employees, training should be provided. Moreover, awareness needs to be developed.
- Government should continue to amend existing laws and enact new laws to expedite the on-going process of loan recovery in order to reduce the year-by-year trend of increase in non-performing loans. Improvement of corporate governance of banks - strengthening institutional aspects of banking operations to achieve enhanced efficiency, transparency, and accountability.

VI. Conclusion

Banks in Bangladesh have shown significant improvements over the period through reduction in their existing recent prudential guidelines provided by Bangladesh Banks in the form of Capital Adequacy Ratio. Provisioning, CAMEL rating, write-off, etc. had salutary impact on the reduction of the overall level of NPLs in Bangladesh. As part of the bank-restructuring program adopted under IMF's recommendation, a National Steering Committee led by the Bangladesh Bank has been formed to proceed with the implementation of Basel II banking standards from 2009.

Bangladesh Bank is actively considering tougher legal steps against the bank loan defaulters by seeking cooperation of the finance ministry to

amend the Representation of the People Order (RPO) 1972. The RPO that bars bank loan defaulters from contesting any election is needed to be amended as its arm does not reach the loan defaulters of financial institutions. Realizing default loans by banks have become difficult as the defaulters take shelter to the High Court seeking stay orders. The volume of default loans has come down, but not up to the mark and it's because of the writ petitions.

The reduction of NPLs is an urgent need for the banking industry of Bangladesh. It is not easy to completely eradicate NPL, however, by exercising prescribed measures and steps, it will not be impossible to reduce NPL to a tolerable limit.

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