LR GLOBAL INDUSTRY INSIGHTS 2018

Bangladesh Banking Sector

KEY TAKEAWAYS

- Mobile Financial Service, Agent Banking and Digital Payment have made tremendous progress in terms of achieving greater financial inclusion in the country.
- During 2012-2016, a shift in the aggregate income mix of the banking sector was observed as the share of net interest income in total operating income declined.
- Lower provisioning despite growing NPL inflated aggregate net income of the banking sector during 2012-16 even though aggregate profit before provision remained flat.
- Given the high level of NPL in the system, the capital buffer to withstand any sudden deterioration of asset quality is lacking in Bangladesh.
- Only 20% of the loans written-off by the banks have been recovered in the last 12 years, indicating the poor recovery ability of the banks.
- The recent amendment to the Bank Company Act is expected to lead towards further consolidation of power in the hands of too few.
- Overall, the magnitude of the problem in the banking sector is still at a manageable level. However, the regulators cannot afford further denial and must take preemptive actions to reform the system when there is still time.

Context

As a developing country, Bangladesh has made commendable progress in terms of achieving financial inclusion and establishing regulatory supervision in the banking sector. Despite the achievements made so far, the question remains whether the banking sector is prepared to support the higher pace of economic growth in coming years. The objective of this paper is to examine the health of the banking sector in Bangladesh and shed some light on the way ahead for the sector.

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Industry Balance Sheet	5 Years' CAGR of Balance Sheet
USD 145 billion	14.6%

Quick Facts

Number of Scheduled Banks
57

Outstanding Deposits
USD 113 billion

Bank Assets to GDP Ratio
67.2%

Outstanding Loans
USD 89 billion

Source: Bangladesh Bank (December 2016)

Banking sector in Bangladesh has played a tremendous role in mobilizing savings and providing funds to various sectors in the economy. Throughout the journey, the sector has experienced several challenges similar to those experienced by many developing countries in their early years of development. Consequently, the sector has undergone several reform programs during 1982-2002. Reforms taken at the early phase worked towards providing life support to an abandoned banking sector in a war-torn economy. During that time, opening the sector to private commercial banks facilitated competition and proliferation of banking service in the country. Later, substantial progress was made in terms of establishing risk-based supervision by the Central Bank. The Central Bank, with an aim to attain greater financial stability, adopted risk-based capital adequacy framework recommended under BASEL accord. As a developing country, Bangladesh has made commendable progress in terms of achieving financial inclusion and establishing regulatory supervision in the banking sector. However, given the ambitious development goals of the country, the banking sector in Bangladesh still has a long way to go.

Cross-country Comparison of Financial Depth

Country	Broad Money to GDP [1]	Bank Account Penetration in Adult Population [2]	Outstanding deposits with commercial banks (% of GDP) [3]	Outstanding loans from commercial banks (% of GDP) [4]
Bangladesh	65.9%	31.0%	52.4%	40.5%
India	75.6%	53.1%	63.2%	49.5%
Pakistan	56.2%	13.0%	31.8%	16.8%
Sri Lanka	56.4%	82.7%	42.4% [5]	38.9% [6]
Vietnam	151.1%	31.0%	136.6%	119.7%

Source: (1) World Bank 2016, (2) World Bank 2014, (3), (4) International Monetary Fund 2016, (5) , (6) International Monetary Fund 2015

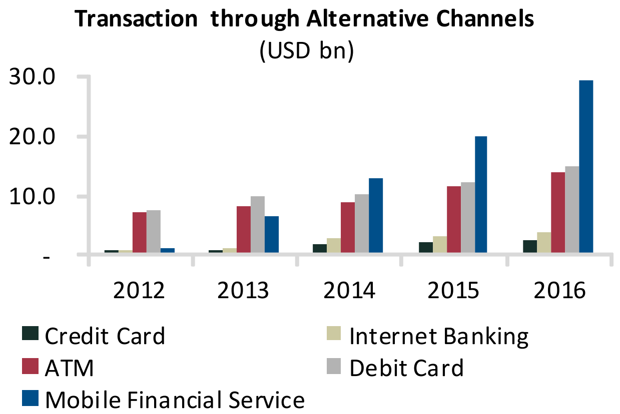
Key Milestones in Financial Inclusion

- The reach of banking service in Bangladesh has seen satisfactory progress through **expansion of bank branches**. Number of bank branches stood at **9,654** in December 2016 against 7,961 in December 2011.
- **Agent banking**, introduced in 2013, has seen tremendous growth in client acquisition. Through agent banking, fresh deposits worth **USD 115 million** and loan disbursement worth **USD 10 million** were made in rural and previously unbanked areas (Agent Banking Activities, March 2017).
- **Mobile Financial Service** (MFS) has posted staggering growth since its introduction in mid-2011. The services offered by MFS companies have facilitated faster transaction throughout the country.
- Shifting trends have been observed in the mode of transaction. Usage of **plastic money** has grown at unprecedented rate facilitated by a tech-savvy urban consumer base and proliferation of E-commerce.
- 100% of the private commercial banks in Bangladesh have adopted **Core Banking Solution (CBS)** to offer seamless service to the clients from any branch of a certain bank. Bangladesh Bank, in 2016, took one step further by introducing a uniform Core Banking Solution, which would offer greater risk-monitoring ability to the regulators and stakeholders.

Status of Alternative Transaction Channels

MFS Clients	53.7 million
Debit Card Clients	10.8 million
Internet Banking Clients	1.6 million
Credit Card Clients	0.9 million
Agent Banking Clients	0.9 million
No. of ATM	9,246
No. of Point of Sales	36,288

Source: Bangladesh Bank (June 2017)

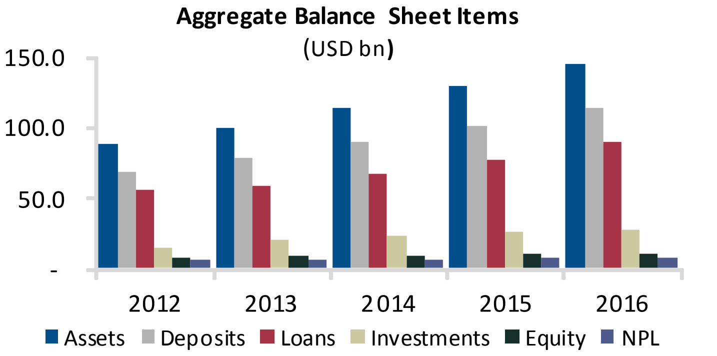


Source: Bangladesh Bank (June 2017)

Performance Highlights: 2012-2016

ASSETS AND LIABILITIES

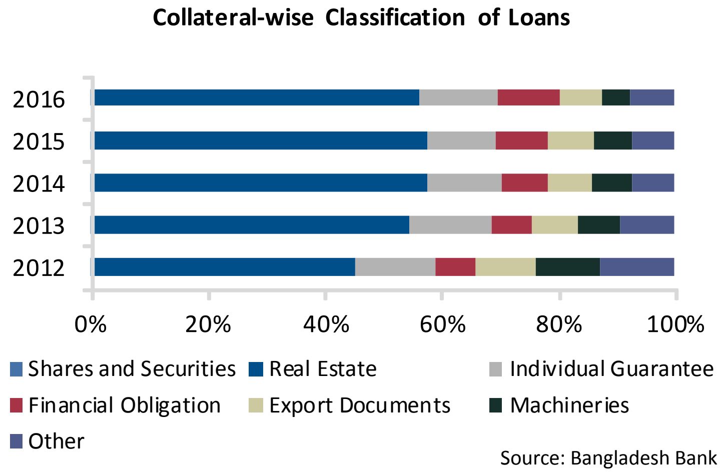
- **Aggregate credit** in the banking sector grew at a CAGR of 13% during 2012-2016, mostly in tandem with nominal GDP growth.
- **Consumer Finance, Working Capital and Construction sectors** saw the highest growth in credit flow in the last five years.
- A major portion of the credit (56%) was **secured against** real estate as of December 2016, albeit the share of credit secured against real estate has plateaued in recent years.
- **Investments** in Government bonds and other securities grew at a CAGR of 18%, higher than the credit growth during 2012-2016.
- **Deposits** grew at a CAGR of 14% during 2012-2016, slightly outpacing the credit growth.



Source: Bangladesh Bank

CAPITAL

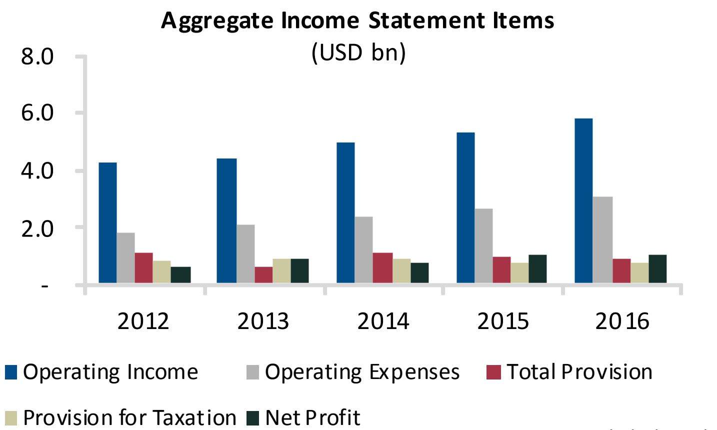
- **Shareholders' Equity,** on an aggregate level, grew at a CAGR of 10% during 2012-2016.
- The share of **Risk-weighted Assets (RWA)** to total assets recorded a steady decline, denoting a possible shift to low-risk assets.
- To comply with BASEL-III capital regulation, banks' issuance of **subordinate bonds** saw a spike taking advantage of the low interest rate. As of December 2016, cumulative value of subordinate bonds at listed banks stood at USD 1 billion.
- On an aggregate level, banks have maintained **capital** position above regulatory requirement in the period under study.



Source: Bangladesh Bank

EARNINGS AND EXPENDITURE

- Spread squeezed in the banking sector, leading to a meager 4% CAGR in **Net Interest Income** during 2012-2016. A shift in income mix was observed as the share of net interest income in total operating income showed a declining pattern.
- **Operating Income** grew at a CAGR of 8% during 2012-2016, driven by investment income and commission based earnings.
- **Cost-to-Income** ratio on an aggregate level exhibited an upward trend. The ratio stood at 53% of Operating Income in 2016 against 42% in 2012.
- Even though Profit Before provision remained flat, **Net Income** grew at a CAGR of 17% during 2012-2016. Two factors contributed to the bottom line expansion:
  - Inadequate provisioning for loan losses as evident from the declining provision to Gross NPL ratio (discussed in the next page)
  - A gradual decline in effective tax rate due to a shift in income mix

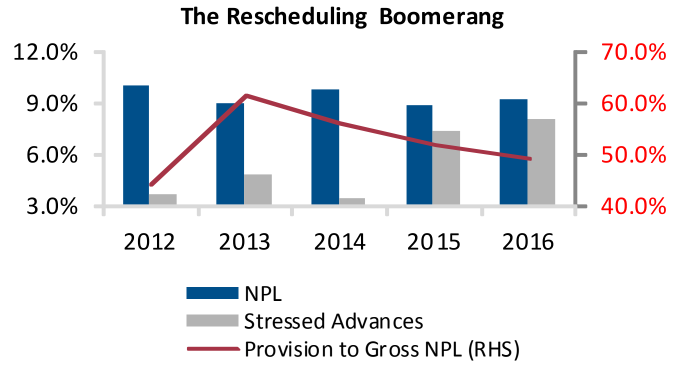


Source: Bangladesh Bank

Key Attention Areas in the Banking Sector

ASSET QUALITY

Non-performing loans in the banking system have outpaced the credit growth in the last five years. As of 2016, **stressed advances (NPL + Restructured Loans + Rescheduled loans)** in the sector stood at 17% of total outstanding loans. In absolute terms, the size of NPL stood at USD 7.8 billion and that of restructured and rescheduled loans at USD 6.7 billion. At the same time, provision coverage exhibited a declining trend, indicating enhanced vulnerability of the sector. Although the NPL scenario in the SCBs gained more attention from different corners, the asset quality in the PCBs has also deteriorated to a serious level. In the last five years, NPL at PCBs grew at a faster pace than that of the SCBs. Poor risk assessment of credit, subdued demand in the economy, rescheduling facilities to known defaulters, and mostly the culture of borrowers' unwillingness to repay loans were the major reasons behind the deterioration of the asset quality in Bangladeshi banks.

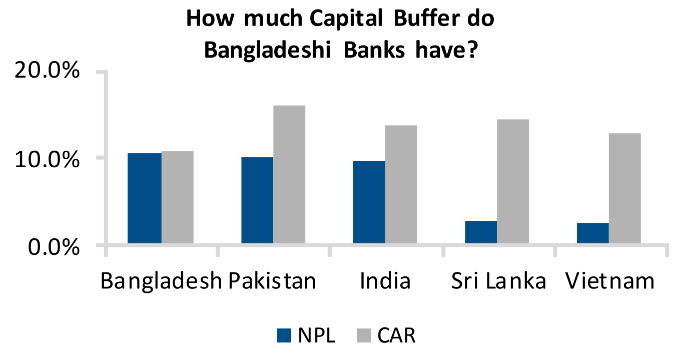


The NPL Malaise
Stressed Advances: **USD 14.5 Billion**
Stressed Advances to GDP: **6.4%**
Stressed Advances to Shareholders' Equity: **136%**

Source: Bangladesh Bank

CAPITAL ADEQUACY

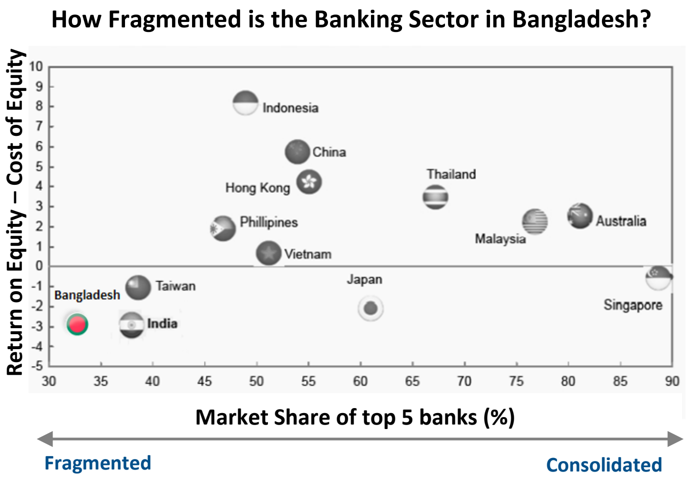
The banking sector in Bangladesh has the highest share of NPL and the lowest Capital Adequacy Ratio compared to its peer economies. Considering the high level of NPL in the system, the buffer to withstand any sudden deterioration of asset quality is lacking in Bangladesh. Despite the generous recapitalization of SCBs for the past nine years with taxpayers' money, there has been no material improvement in these banks' capital position, asset quality and profitability. While the PCBs have maintained sufficient capital above the regulatory requirement, the major risk to their capital position is the solvency of the top borrowers at these banks. According to a stress test done by the Central Bank, default of top 3 borrowers in each of the banks would make 50% of the banks non-compliant in maintaining the minimum regulatory capital.



Source: Bangladesh Bank and other Central Banks, Data as of March 2017

FRAGMENTATION AND LACK OF INNOVATION

Compared to the banking sector of its peer economies, the banking sector in Bangladesh is highly fragmented. Burdened with unrealistic 'business targets', banks involve in unhealthy competition and often provide cheaper credit to an already struggling customer. Besides, the pace of innovation remains strikingly low in the banking sector. Although 17 banks were granted the license to operate Mobile Financial Service (MFS) in the country, the number of full-fledged MFS providers remains far below that. Further problems have been created by the new banks, some of which are already under special observation just within four years of commencement. Specialized banks created to foster agricultural lending and mobilizing investments from non-resident Bangladeshis put up a disappointing performance in achieving their respective targets.



Source: McKinsey, Bangladesh Bank

Challenges in Regulatory Affairs

CENTRAL BANK

Bangladesh Bank has been very successful in terms of monetary policy management, curbing inflation and building a healthy forex reserve in the past few years. But the regulator's success was limited in terms of curbing non-performing loans in the system. At the institutional level, deficiency in analytical capacities such as assessing macroeconomic risks and forecasting major indicators undermines the regulator's ability to take proactive policy measures. In many cases, despite having an apt guideline, the implementation of the regulation remains a challenge.

CORPORATE GOVERNANCE

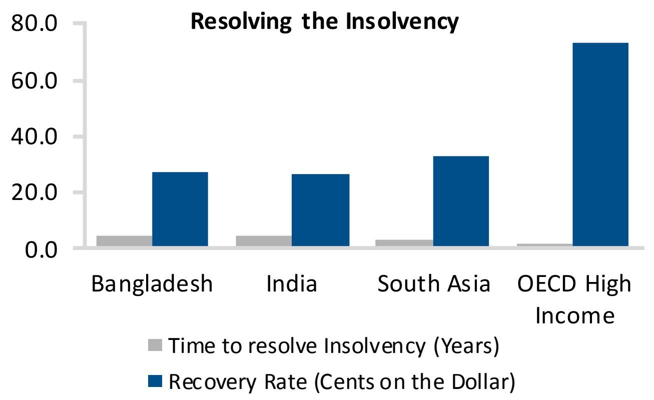
In Bangladesh, most of the banks are controlled by families or related businesses. A recent amendment to the Bank Company Act has further exacerbated the situation. According to the amendment, PCB boards can have four members from the same family and the tenure of the directors has been extended from six years to nine years. Although the policy move was aimed towards increasing the accountability of the directors, considering the current status of the industry, such a policy can backfire.

TRANSPARENCY

Discrepancies can be observed among the banks in terms of disclosing the names of top borrowers, information on rescheduled and restructured loans, sector-based loan exposure and capital market exposure. The lack of such information often paints a distorted picture of the health of a bank and gives rise to information asymmetry among different groups of stakeholders especially the common shareholders.

LEGAL SYSTEM

According to Bangladesh Bank, **only 20%** of the loans written-off by the banks have been recovered in the **last 12 years**, showing the poor recovery ability of the banking sector of the country. The stalemate in the recovery of assets is a result of the archaic legal environment of the country. The absence of a strong legal system encourages the practice of willful defaults. Besides, the duration and costs associated with liquidation and recovery of insolvent businesses slow down the recovery of impaired assets. India, faced with similar challenges, has recently overhauled its bankruptcy code to reduce the time to resolve cases to 180 days from 4.3 years and create a pool of insolvency professionals to ensure a smooth transition and liquidation of insolvent firms.



Source: World Bank

How Vulnerable is the Banking Sector?

Considering the low level of financial penetration, the irregularities in the banking sector of Bangladesh, compared to the size of its economy, is still at a manageable level. But, as evident from the Asian Financial Crisis, in the first stage of a systematic banking crisis, there is a degree of denial among the banks and the Government (IMF, 1999). Besides, consistent macroeconomic growth often masks the fragilities hidden in the pile of undisclosed information. In most of the cases of banking crisis, major macroeconomic shocks or incidents of massive fraudulent activities started the falling dominoes. As such, the journey from 'denial' to 'shock' phase might occur at a unprecedented speed. In Bangladesh, the macroeconomic scenario is still resilient. However, challenges might emerge from rising inflation, subdued exports and remittance, rise in real interest rate due to increased Government borrowing, devaluation of BDT and finally massive capital outflow due to political uncertainty. Thus, the regulators cannot afford further denial and must take preemptive actions when there is still time.

Selected Indicators of Financial Vulnerability**

Selected Indicators of Financial Vulnerability**
Inflation >5%
Fiscal Deficit> 2% of GDP
Emphasis on collateral when making loans
Stock of nonperforming loans >10% of total loans
Credit to the private sector, real growth >20%
Public Debt> 50% of GDP
Current Account Deficit> 5% of GDP
Capital Inflows> 5% of GDP
Ratio of short-term debt to international reserves> 1
Credit to the private sector > 100% of GDP
Estimated share of bank lending to the real estate sector >20%

Below Cut-off **Above Cut-off**

****Source: IMF (Financial Sector Crisis and Restructuring Lessons from Asia , June 1999), the cut-off points have been based on relevant literature that predicts banking crisis**

The Way Ahead

Given the current situation, the banks can either clean up their balance sheets or continue to be in denial. While cleaning up might result in a short period of low profitability, such action will develop an agile banking sector ready to serve the growing economy. However, not doing so might lead the economy towards a full-scale banking crisis, which would put the economy back to square one. Therefore, the way ahead requires a shift in the mindset of the regulators and the board members of the banks. Achieving long-term sustainable growth, be it at the expense of some short-term pain, should be the essence of future policies in the banking sector.

DEVELOPING PRUDENTIAL REGULATIONS

- To ensure a sound regulatory environment, policies must be in place to keep Bangladesh Bank free of political pressure.
- Bangladesh Bank must build its capacity in forecasting and assessing risks associated with various sectors to develop proactive policies.
- The Central Bank should establish a strict monitoring cell to prevent the misuse of low provisioning requirement for priority sectors such as SME.
- The Credit Rating Agencies in Bangladesh should involve in independent due diligence to evaluate the health of the banks and companies.
- The progress made by the new banks in terms of achieving their original objectives needs to be carefully evaluated. These banks should be strictly monitored so that they remain within their mandated business categories.

BOLSTERING CORPORATE GOVERNANCE

- While the representation of family members in the board of a family-owned bank cannot be eliminated, checks and balances need to be in place to ensure the welfare of shareholders and depositors.
- The Central Bank should disclose the deviation between loan provisioning figure arrived by the Central Bank and external auditors to reduce information asymmetry about the health of the banking sector.
- Boards should shift away from rewarding management based on short-term performance, a practice that motivates excessive risk-taking to showcase unsustainable profit boost.

IMPROVING ASSET QUALITY

- Rescheduling and restructuring facility to habitual defaulters should be stopped completely. Exemplary measures must be taken to dissuade such behavior.
- Banks should reform the archaic collateral policy and give more weight to the liquidity of the underlying collateral while sanctioning a loan.
- Adoption of a dynamic loan-loss provisioning policy should be adopted to increase loss provisioning for exposure to risky sectors on a 'proactive' basis.
- To facilitate speedy asset recovery process, specialized Asset Restructuring Companies might be established. Besides, banks should develop more effective non-legal measures such as regular visits to recover assets.

STRENGTHENING CAPITAL BASE

- The issuance of subordinate bonds needs to be monitored carefully. Interest rate on subordinate bonds should reflect the risks associated with the issuer bank.
- Recapitalization of state-owned banks with the taxpayers' money should be terminated. The Government should take bold steps to restructure the management and the business model of these banks.

PROMOTING INNOVATION

- Banks need to focus on the shifting trends in the economy and develop innovative deposit and loan products for corporate and retail customers.
- Investments must be made in technology to digitize service delivery channels and risk-monitoring system of the banks.

Despite many challenges in the banking sector of the Bangladesh, the ray of hope lies in the country's strong macroeconomic fundamentals. As the demand side of the economy improves, the health of many of the non-performing companies is expected to recover. However, it is the willful defaulters who pose the major threat to the stability of the banking sector of the country. And it is only the regulators that can rein in such activities with strict disciplinary action. Old banks must look beyond traditional means of doing business and tap into the untapped credit market in the country. Embracing change will require letting go of the soured parts of the business and refocusing on emerging segments of the country. Only with prudent regulations and efficient boards, the banking sector of Bangladesh can transform itself to cater to the growing need for capital in the country.