BANKING SECTOR REFORMS IN BANGLADESH AND ITS IMPACT

by

Muhammad Mustafizur Rahman

A thesis submitted in partial fulfillment of the requirements for the degree of Professional Master in Banking and Finance

Examination Committee:	Dr. Juthathip Jongwanich (Chairperson)
	Dr. Sundar Venkatesh
	Dr. Sununta Siengthai

Nationality:	Bangladeshi
Previous Degree:	Masters of Business Administration The University of Dhaka Dhaka, Bangladesh
Scholarship Donor:	Bangladesh Bank

Asian Institute of Technology
School of Management
Thailand
May 2012

Acknowledgements

I would like to convey my profound gratitude to my supervisor, Dr. Juthathip Jongwanich, whose guidance helped me to develop an understanding of the subject. She has supported me throughout my research with patience and vast knowledge without which this research would not be possible.

I am very much indebted to Dr. Sundar Venkatesh for his valuable and relentless advices and remarks during the study. I am gratified to the research committee members for their valuable comments and suggestions.

I owe my deepest gratitude to my parents and family members. I would not be able to complete the study successfully without their continuous inspiration and encouragement.

While carrying out the study, I was blessed with a friendly group of fellow classmates and AIT Extension officials. It is a pleasure to thank all those for their cordial support to complete the research study.

Abstract

The aim of this study is to summarize the major reforms undertaken in the banking industry of Bangladesh and to evaluate their impact on the financial development and individual performances of the banks. Development of financial system is measured by financial deepening, competitiveness and profitability within the banking industry. Individual performances of the banks are measured by "Capital Adequacy, Asset Quality, Management Soundness, Earning performance and Liquidity" of the banks. The study reveals that the financial system in Bangladesh has been developed to some extent. However, we observe a mixed result for different types of banks in case of performance evaluation of the banks. While the local banks failed to achieve satisfactory improvement, the foreign banks were able to improve their performance considerably perhaps for having strong and efficient management, and additional compliance with the policy, guidelines, standards issued by their head office.

Keywords: Banking sector reform; Financial development; Bank performance; Competitiveness; CAMEL Framework

List of Abbreviations

BBO	:	Bangladesh Bank Order
BCA	:	Bank Companies Act
BCD	:	Banking Control Department
BIS	:	Bank for International Settlement
BKB	:	Bangladesh Krishi Bank
BRC	:	Banking Reform Committee
BRPD	:	Banking Regulations & Policy Department
CBPASS	:	Commercial Banking Problem Analysis and Strategy Study
CBRP	:	Commercial Bank Restructuring Project
CIB	:	Credit Information Bureau
CRAR	:	Capital to Risk weighted Assets Ratio
CRGS	:	Credit Risk Grading System
CRR	:	Cash Reserve Requirement
DFIs	:	State-owned Development Financial Institutions
EPZ	:	Export Processing Zone
EWS	:	Early Warning System
FCBs	:	Foreign Commercial Banks
FSRP	:	Financial Sector Reform Program
SCBs		State-owned Commercial Banks
IAS	:	International Accounting Standard
MOU	:	Memorandum of Understanding
NBFIs	:	Non Bank Financial Institutions
NCBs	:	Nationalized Commercial Banks
NPLs	:	Non-Performing Loans
OBU	:	Offshore Banking Unit
OECD	:	Organization for Economic Cooperation and Development
PCBs	:	Private Commercial Banks
PPS	:	Performance Planning System
RAKUB	:	Rajshahi Krishi Unnayan Bank
RWA	:	Risk Weighted Assets
SBs	:	Specialized Banks
SLR	:	Statutory Liquidity requirement
SMA	:	Special Mention Account
WB	:	World Bank

BANKING SECTOR REFORMS IN BANGLADESH AND ITS IMPACT

TABLE OF CONTENTS

List of Tables

Chapter 1
Introduction

1.1 Background

Financial sector of Bangladesh comprises with commercial banks, non-bank financial institutions, insurance companies etc. However, the banks play the key role in the financial system of Bangladesh. After liberation of Bangladesh in December 1971, all the financial institutions including the commercial banks carried out their operations in order to achieve the objectives of the government. This situation continued up to 1982. At that period, some regulations were formulated and some directions were made to the banks with a view to fulfill the economic objectives of the government rather than to fulfill the commercial interest of the banks. Expansion of bank branches was also directed to increase the network of the banking system. As a result, bank branches increased commendably which consequently reduced the population per branch.

Based on the socio-economic consideration, the government formulated the credit expansion policy and banks were directed to sanction credits to public sector enterprises and priority sectors. Banks were bound to provide funds to the priority sectors with low interest rates. Major portion of these loans became overdue and the profitability of the nationalized commercial banks (NCBs) was declined.

In 1983, the Bangladesh Government initiated "ownership reform" program and allowed private commercial banks (PCBs) to start their business in the industry and to enhance the efficiency of the individual banks. At the same time, government decided to denationalize two NCBs. This initiative was not fully successful due to two major obstacles, namely the undue influence in the credit sanctioning process, and the absence of requirement to report loan classification and provisioning.

In the backdrop of the prevailing poor performance and weak capacity of the banks, the government was sincerely concerned to identify the major problems in the financial system. Later on, a number of reform measures were initiated broadly under the Financial Sector Reform Program (FSRP) and subsequently under Banking Reform Committee (BRC) and Commercial Bank Restructuring Project (CBRP).

1.2 Problem Definition

The performance of banks is important to the individual consumers of bank deposit and loan services, stockholders, employees, government regulators, management and to the entire economy. Broadly speaking, bank performance is important to individual consumers of bank deposit and loan services as well as to the performance of the entire economy.

The foremost question now is whether the reform measures taken were successful or not. It is a matter of argument regarding how far these reforms have been effective towards both the development of Bangladesh's financial sector and the improvement in the banks' performance, and what measures still need to be undertaken to eliminate the present impediments in the sector.

The study aims to examine the progress in the financial development in the country, and to compare and analyze the progress under the CAMEL framework, which considers "Capital Adequacy, Asset Quality, Management Soundness, Earning performance and Liquidity".

1.3 Objectives of the Study

The broad objective of the study is to examine the reforms that took place in Bangladesh and to explore the financial implications of the reforms. Followings are the specific objectives of the study:

- To review the banking sector reform programs;
- To compare the financial performance of the banking system in Bangladesh before and after implementation of the banking sector reforms;
- To identify different problem areas of the banking sector of Bangladesh, which still needed careful restructuring for better performance; and
- To suggest some policy measures for strengthening the restructuring mechanism.

1.4 Scope and Limitations

This particular subject is extremely extensive in nature. To evaluate the effect of reform measures on the whole banking sector it is required to study the banking system as a whole. This report tried to concentrate only on the financial performance issues while evaluation of the reform measures also requires some other considerations. This particular study is extremely extensive in nature. Hard effort was given to make the study worthwhile and meaningful; even then, there exists some limitations.

Lack of appropriate measurement yardstick and complexity of interlinks of the reform measures among different parts of the economy and information availability constitutes one of the major limitations of this report. In addition, the financial information was collected from secondary sources and the accuracy could not be verified which may cause deviation from the reality if this information is inaccurate.

1.5 Research Methodology

In Bangladesh, the whole banking industry has been divided into four groups, namely "State-owned Commercial Banks (SCBs), state-owned Development Financial Institutions (DFIs), domestic Private Commercial Banks (PCBs), and Foreign Commercial Banks (FCBs)".

The report is based on a critical review of both primary and secondary data. Primary data are used in very limited cases and those are obtained through discussion with the relevant officials, who involve with reforms programs. The main sources of data used in this study are secondary data collected from various publications and annual reports of Bangladesh Bank, annual reports of different commercial banks and statements submitted to Bangladesh Bank. However, the secondary data are carefully scanned prior to using them in the report. In this regard, the secondary data collected from different sources are compared with those of departmental database to complement and enrich the secondary published data in order to arrive at a logical conclusion.

The data used in this study are from both pre-reform stage and post-reform stage. In this study, the financial deepening is determined by the monetary aggregates and private credit in terms of the Gross Domestic Product. Financial indicators used are summarized in Table 1. Noted that these indicators are considered according to the CAMEL.

Table 1.1: Financial Indicators to Evaluate Bank Performance

Key Indicator	Indicators
Capital Adequacy	Capital to Risk Weighted Assets Ratio
Assets Quality	Non-performing Loan Ratio
Management soundness	Expenditure-Income Ratio
Earning performance	Return on Assets
	Return on Equity
	Net Interest Income
Liquidity	Liquid Assets/Deposit Ratio
	Excess Liquidity/Deposit Ratio

Trend analysis is done to indicate the performance. Various ratios were calculated and inter-bank comparisons are made using time series data. Thus the financial performance of banks during pre-reform and post-reform is compared and analyzed to reach a reasonable conclusion about the impact of reforms. Performance and efficiency of the foreign-owned and domestic banks are analyzed using the above mentioned indicators. Besides, while discussing different reform measures taken, some problems of banking reforms could be revealed.

1.6 Presentation of the report

Chapter 1 discusses background of the study, objectives, scope and limitations, and methodology.

Chapter 2 reviews relevant theoretical and empirical literature on banking reforms, its impact on financial development, and performance evaluation of banks.

Chapter 3 looks into the reform measures undertaken in order to remove the problems of the financial/banking sector of Bangladesh. After describing the chronological different reform phases, this chapter gives a short description of all reform areas.

Chapter 4 evaluates the impact of the reforms on the financial system of Bangladesh. The chapter also assesses about the financial performance of the four categories of banks.

Chapter 5 concludes from the financial picture depicted in the study and provides some policy inferences for further development of the banking system in Bangladesh.

Chapter 2
Literature Review

2.1 Theoretical Rationale of Financial Sector Reform

There are different views regarding the relationship concerning the economic growth and the financial development. A number of studies were conducted to find the relationship. Some authors believe that the economic growth mostly depends on finance (Shaw, 1973; McKinnon, 1973). In contrast, some others consider that the relationship between finance and economic growth is insignificant (Lucas, 1988). Benhabib and Spiegel (2000) argued that the economic growth is positively linked to financial development. Later on, it is observed that a country having a well-organized banking industry can achieve economic growth rapidly as a consequence of the financial development (Levine, 2005). Most studies concluded that the efficient financial activities channelize savings towards investment in the productive sector which ultimately facilitates economic growth.

Financial sector reform has been initiated in so many countries in order to achieve the financial development. Important issue is now whether there exists any connection between the development and reform; and whether financial reforms in developing countries stimulate growth. Though several academic literature and empirical studies show that financial reform develops financial system by improving banking industry's competitiveness, mobilization of savings, and allocation of efficiency whereby achieving economic growth (Besanko and Thakor, 1992; Claessens and Laeven, 2004), there are limited studies those indicate financial reforms are disruptive and increases the vulnerability of the financial system (Rajan, 1992; Allen and Gale, 2000).

There are some empirical evidences in support to the impact of the financial reforms. The consequence of financial reforms in some countries is reviewed by Sundararajan and Johnston (1999). The effects of the financial reform in Sri Lanka are evaluated by Cooray (2003). It can be concluded from their research that reform can establish the good governance in the financial sector and help to attain economic growth. They also find that the size of the market and the competition in the industry is also increased as the consequence of reforms.

2.2 Significance of Banking Sector

Banks are the foundation of the financial system of any country and an effectively functioning financial system requires an efficient banking system. According to Schumpeter (1934), the banking sector is the main source of fund for long term investment and the sector is the foundation of economic growth.

Considering the significance of the banking system, most of the financial reforms throughout the world focus on the reform of banking sector and try to make the sector robust, resilient and sound for efficient intermediation of financial resources.

2.3 Defining Banking Sector Reform

Banking sector reform is an inevitable process when the existing structure of bank cannot fulfill the desired level of economies of scale in operation. Disastrous banking system sometimes might cost the real sector severely. These sorts of banking sector problems have been epitomized by the analysts and donors as banking fragility, crisis, distress, failure, collapse, insolvency and so on, which call for "banking reforms" on the part of the concerned banking system. Sheng (1996) defines banking sector reform or restructuring of banks as "the package of macro-economic, micro-economic, institutional and regulatory measures taken to restore fragile banking systems to financial solvency and discipline".

Some authors consider that strengthening regulatory and supervisory framework is the essential part of reform process. This view is supported by Caprio and Klingebiel (1997). They argued that without having an efficient and effective set of prudential regulations from the governing authority, the financial markets and the institutions are vulnerable and face trouble to survive during the time of financial catastrophes. In addition, according to S. Golubović and N. Golubović (2005), the foundation of a successful reform is to enact and enforcement of appropriate laws and regulations.

2.4 Impact of Banking Sector Reforms: Empirical Evidences

Literatures analyze several aspects of banking sector reforms and show its consequences in different countries. Khan and Aftab (1994) reviewed the effect of denationalization and privatization aspects of financial reforms in Pakistan. They conclude that denationalization of banks improved performance of these banks in terms of growth of assets, recovery of loans and ratio of bad loans.

Impact of banking sector reforms to the fiscal and monetary stability of many transitional economies was assessed by Feldman and Wagnar (2002) and they observed that the success of reforms significantly contributes to the fiscal and monetary stability.

Relationship between reform and bank efficiency was also examined by Fu and Heffernan (2008). They studied the performance of Chinese banking sector, and reviewed the reforms and their influences on the ROE, ROA and NIM. They found a significant relationship between profitability and reform.

Brownbridge and Gockel (n.d.) examined necessity of banking sector reforms in Ghana in the 1980s and evaluated its impact. They concluded that while the reforms have brought about improvements in the banking system, banks are now more prudently managed and supervised.

2.5 Theoretical Structure of Performance Evaluation of Banks

An economy belonging to either developed or developing zones of the globe is significantly influenced by how well its banking industry performs. In fact, bank performance concerns almost all in and outside the hank. Consequently, there arises a crucial need for an evaluation of performance, and this analysis and measurement of performance requires a sound conceptual framework.

Similar to the previous literatures, different opinions are stated by different authors for evaluating banking system performance. Some authors argued to assess banks' performance using their income and expenses while some others opine to review the profitability ratios of banks.

For evaluation of overall banking sector performance, competition in the sector is assumed vital since it is related to the improvement in the competency level (Claessens and Laeven, 2004).

2.6 Financial Reforms in South Asia

Like most developing countries, South Asian countries also initiated financial sector reforms process in around 1980's. Most of these reforms relied on reforms broadly on policy, institutional and legal issues of the financial system. Reforms resulted in the regulatory framework strengthening of the central banks, establishing discipline and legal support within the financial sector, and improving capacity of the financial institutions (Adhikary et al., 2007).

2.6.1 India

During the Gulf crisis, India faced huge problems in the balance of payment in 1991. This crisis persuaded the initiation of structural measures in the financial system. Later on, India formed the following three committees to identify the underlying weaknesses in the system and to suggest the remedial measures:

- Financial System Committee in 1991;
- Balance of Payments Committee in 1992; and
- Banking Sector Reforms Committee in 1998.

The reform-measures in India have been originated based on recommendations put up in these three reports. Reddy (2005) evaluate the impact of reforms and conclude that there is a significant relationship between these reforms and the adequacy of banks' capital and the quality of banks' assets. He shows a positive relation between reform and financial sector stability. He finds that the non-performing assets ratio has been reduced to almost half after 1998. Profitability of banks was improved a lot.

2.6.2 Pakistan

The banking sector reform programs in Pakistan were instigated in 1988 which were completed in three different phases during 1988 –1996, 1997-2001, and 2002-2004.

As a result of successful attainment of reforms, financial discipline and stability have been established in Pakistan. The country has also been able to achieve economic growth (Husain, 2005). Reforms have not only develop the macro-financial system, but also resulted in the improvement in the performance of the individual banks. Burki and Niazi (2006) investigated the outcome of financial reform in Pakistan. They find that efficiency was declined before 1996 because the banks were adjusting to liberalization, enhanced competition. However, they find improvement in efficiency after the completion of reform process.

2.6.3 Sri Lanka

During the late 1970s, Sri Lanka initiated its financial reform program with the introduction of open economic policies. Initial reforms during 1977 to 1988 focused mainly on the establishment of sound financial infrastructure. Afterward, the second phase of reform program started in 1989 aimed at stabilizing and further liberalizing the economy in order to support the non-public enterprises (Dunham and Kelegama, 1996). The third phase of reform initiated in 1994 to rationalize the economic reform process with public scrutiny.

Seelanatha and Wickremasinghe (2009) summarized the upshots arose out of the reform measures on the following aspects:

- Banking sector contributes more in the GDP,
- Institutional structure of deposit-taking institutions has been developed,
- Scope of banking industry has been increased,
- Banking density has significantly been improved, and
- Banking industry has become more competitive.

2.6.4 Nepal

Nepalese government carried out "Commercial Banking Problem Analysis and Strategy Study" in 1990 to find out the major problems prevailing in the banking industry. The study was completed with recommending some reform measures. However, there were no such organized and systematic reforms initiated by the government. Later on, the government had undertaken "Financial Sector Strategy Statement (FSSS)" in 2000 to identify the remedial measures and to overcome the problems.

The outcome of the reform measures undertaken in Nepal was not satisfactory. However, as the consequence of the reform programs, strong regulatory framework facilitated a sound financial structure and orderly financial markets, and institutional structure of banking industry has been improved.

Chapter 3
Banking Sector Reforms in Bangladesh

3.1 Instigation of Reforms

Having completed the literature review of banking sector reforms and bank performance evaluation, we will now look at the reform measures undertaken aiming to eliminate the problems of the financial/banking sector of Bangladesh. During the first decade of Bangladesh after independence, financial system has been suffering from deep crises; loan recovery was extremely disastrous, enterprises were experiencing mismanagement, financial market and institutions were inefficient to reach the commercial goal. In order to identify the major problems in the financial system and to suggest remedial measures, Government formed the "National Commission on Money, Banking and Credit (NCMBC)" in 1986.

After carrying out a thorough study, the NCMBC came out with some suggestions to the government. These recommendations were generally based on the capital adequacy requirement of banks, problems regarding to overdue loans, strengthening of infrastructure both for legal and institutional capacity etc.

Subsequently, a World Bank Mission conducted an comprehensive study of the financial sector and suggested reforms relating to

- fixation of interest rates on deposits and advances;
- classification of overdue loans;
- restructuring of capital of NCBs and PCBs; and
- market orientation of banking transactions. (Task Force Report, 1991)

Bangladesh Bank combined the observations and suggestions from both the NCMBC and WB, and undertook some initiatives aligned with the suggestions. Some of these initiatives are:

- decontrol of interest rates for both the deposit and lending;
- improvement of capital adequacy of NCBs and PCBs;
- exercising strict central bank supervisory roles;
- improving the operational structure of commercial banks;
- providing support by endorsing legal framework;
- computerization of banks.

All these reform measures undertaken by Bangladesh Bank aimed to achieve operational efficiency of the financial institutions and consequently to attain financial development in the long run.

3.2 Financial Sector Reform Program

In 1992, Financial Sector Reform Program (FSRP) was also instituted to assist in implementing the above measures. The broad objective of FSRP was to enhance competitiveness in the banking industry, whereas the Specific objective was to make NCBs commercially viable for subsequent privatization and help PCBs to increase their market share in total commercial banking.

The Financial Sector Reform Program (FSRP) was launched in 1990. The World Bank and USAID financed the program and the International Monetary Fund provided technical assistance. FSRP was instituted considering to make NCBs commercially viable for privatization and to help PCBs to increase their market share. FSRP focused to improve the operations of NCBs through introducing financial technologies, adopting international best-practices, setting up IT based banking operation etc.

During the tenure of the program, the FSRP consultants provided extensive training to a large number of bank officials on some tools and techniques. These tools covered how:

- To analyze the risk associated with lending,
- To introduce ledger card while sanctioning new loans,
- To report any loan of large monetary amount,
- To evaluate individual official's performance,
- To supervise and inspect the banks effectively, and
- To use the MIS effectively and efficiently.

3.3 BRC/CBRP Restructuring Measures

Just before the expiry of FSRP term, the government formed the "Banking Reform Committee (BRC)". Subsequently, in May 1997, government undertook another project, namely "Commercial Bank Restructuring Project (CBRP)". CBRP was also funded by the WB. This project was undertaken to identify urgent course of actions needed for continuing the pace and progress so far done. World Bank also submitted some recommendations in line with the activities of BRC.

The WB mentioned "effective legal system, good management, and effective central bank" as three pillars of banking and they proposed to rebuild these pillars first. The WB urged to go for privatization only after the successful completion of financial restructuring of the NCBs. The WB emphasized that the need for establishing strong financial infrastructure is much important than to privatize banks.

The WB identified less attractive pay structure of NCB officials, excessive influence of trade unions, absence of autonomy and accountability, poor internal governance and management, over-staffing and over-branching, and weak legal infrastructure. Going with these major obstacles, the banks cannot perform their most important function which is to ensure safety of their deposits. Based on these observations, the WB suggested some programs mainly focusing on to improve institutional capacity, restructure NCBs, ensuring transparency, formulating legal procedure related to realize the outstanding loans, compliance with international best practices etc.

Based on the recommendation of the WB, Bangladesh Bank undertook some initiatives. Subsequently, the WB again suggested a set of urgent and short to medium term measures. They drew attention mostly to the reform of Bangladesh Bank and urged for reestablishing credit discipline, restructuring of NCBs and PCBs, and overall governance quality of the banking system.

The BRC submitted detailed reports along with recommendations on various issues related to legal framework. The BRC realized that the financial discipline is a must in order to attain the financial stability. As the central bank of the country, Bangladesh Bank should have been empowered to play the key role in supervision and inspection. In order for doing that, the Bangladesh Bank should enjoy the full autonomy in all aspects. Moreover, the Board of Directors for the NCBs should also function without restraint. Lacking full autonomy, the Board may face interference from the government and may not perform effectively to achieve their own commercial objectives. Relevant Acts and laws should be reviewed and amended accordingly to ensure the legal enforcement.

Most of the CBRP's recommendations are similar to the BRC's recommendations. The recommendations of the BRC/CBRP are broadly focused on identification of existing problems and are able to put out recommendations for remedial measures.

3.4 Brief description of the Reforms

Having discussed the different reform measures undertaken in different phases in the banking sector of Bangladesh, now we give a brief description of all reform areas in particular. The basic objective of each of the reforms was the similar. However, each of the reform measures differ from one another in terms of individual or specific objectives. Some reform measures aimed to upgrade the policy guidelines, some to improve the institutional capacity, and some to enhance legal enforcement in the banking system. On the basis of the above argument, the reform measures can be classified into the following three groups:

- Policy Reforms
- Institutional Reforms
- Legal Reforms

3.4.1 Policy Reforms

A number of guidelines were promulgated by the Bangladesh Bank to enhance the policy framework. These are as follows:

  - Risk-Based Capital adequacy
  - Loan Classification and Provisioning
  - Credit Risk Grading
  - Interest Rate Deregulation (Loan Pricing)
  - Performance Planning System (PPS)

- **Risk-Based Capital Adequacy**

Capital is the cushion of a bank to cover credit risks, and therefore, capital adequacy is a generally used tool to assess the financial health of a bank. Capital adequacy is the most important indicator of a bank in the current banking system. Minimum capital adequacy guidelines based on Capital-to Liabilities approach was incorporated in the Banking Companies Act, 1991 and in the Banking Companies (amendment) Act, 1995.

Following the recommendation of the Bank for International Settlement (BIS), Bangladesh Bank also started Risk Weighted Capital Adequacy system in January 1996. Banks were instructed to submit their capital ratios together with summary information about components on a risk assessed basis by June, 1996. The risk based capital system primarily deals with credit risk and explores the possible ways to handle other risks also. It is, in fact, a significant prudential regulatory instrument in assessing bank's capital position and disciplining their market behavior.

- **Loan Classification and Provisioning**

In order to ensure early recognition of Non-Performing Loans, Bangladesh Bank has formulated the Loan Classification and Provisioning policy. All the commercial banks have to set up of required provisions for their loans. According to the policy, a certain portion of the loans and advances sanctioned by all the banks have to be kept under the newly set up provisions. "Offshore Banking Unit (OBU)" of the banks has also to follow this new policy. This attempt made the OBU transactions more transparent.

- **Credit Risk Grading**

In order to manage the risk effectively, Bangladesh Bank has introduced the Credit Risk Grading System (CRGS). As per the policy, the banks have to grade their loans into 8(eight) categories. These grades are Superior, Good, Acceptable, Marginal/Watch list, Special Mention Account, Substandard, Doubtful and Loss.

- **Interest Rate Deregulation**

According to the recommendation of NCMBC, Bangladesh Bank has taken the policy for deregulation of interest rate both on deposit and lending. The policy empowered the banks to set different interest rates depending on the risks involved with individual borrowers. The maximum allowable limit that a bank can differentiate is 3 percent. Based on the assessment of the credit risk, the banks are allowed to change interest rate freely for various customers and for various sectors.

- **Performance Planning System (PPS)**

Performance Planning System (PPS) comprises of setting a concrete goal on the part of a banker based on his priorities and followed by a well-defined action plan to achieve that goal. Through this goal statement and action plan, the concerned banker can keep himself up to date in terms of his performance. PPS also facilitates the immediate senior authority to monitor the progress of his subordinates including those concerning loans. PPS has been introduced in all NCBs for recovery and other functions.

All the branches of NCBs (excepting their overseas branches) have been covered by PPS by 1995. It was expected that the employee appraisal system would be developed in the light of the PPS. The controlling authority can easily judge the initiative and efforts made by the employees. Objective appraisal system is consistent with the psychological principle that people work better when they have definite goals.

3.4.2 Institutional Reforms

To improve the institutional capacity of the financial sector, following reform measures were initiated:

- Off-site Supervision (CAMEL Rating)
- Credit Information Bureau (CIB)
- Large Loan Reporting System (LLRS)

- **Off-site Supervision (CAMEL Rating)**

Bangladesh Bank has introduced a number of reporting forms and returns to be submitted by the commercial banks regularly. On the basis of those returns, Bangladesh Bank prepares a composite rating on yearly basis for each bank. This rating is known as CAMEL rating.. Based on the CAMEL rating, Bangladesh Bank gives Early Warning Signal (EWS) to a particular bank which is facing problems. CAMEL comprises of the following five performance measures and these components are explained below:

Capital Adequacy	:	Banks have to maintain the capital equal to 8% of its "Risk weighted Assets" out of which minimum 4% of their core capital.
Assets Quality	:	Amount & nature of non-performing assets, provision, etc.
Management efficiency	:	Knowledge, experience, administrative, organizational, leadership ability and integrity.
Earning performance	:	Sound control of expenses, efficient fund management, budgeting discipline etc.
Liquidity	:	Asset/liquidity management procedure/policies, reliability of funding source, etc.

- **Credit Information Bureau (CIB)**

Before considering any loan proposal, a bank has to know the status of the loan applicant in regard to his/her liabilities outstanding with any other banks/branches. Bangladesh Bank has established CIB in August 1992. CIB report is considered as one of the basic information for consideration of a loan. The aim of the report is to avoid duplication of credit facilities, avoid credit facilities to defaulters and justify the status of the borrowers. It was made mandatory for all banks to collect data from CIB before sanctioning any loan proposal above Taka 5.00 million. Apart from this, to maintain record of the borrowers' performance, NCBs have to submit report to Bangladesh Bank regularly on their progress in collection of the larger overdue loans and on larger loans sanctioned since January 1, 1990.

- **Large Loan Reporting System (LLRS)**

Large Loan Reporting System was introduced by the Bangladesh Bank to keep a control and supervision on a regular basis in the process of sanctioning loans having bigger amount. By July 1995, 78 percent of new large loans of NCBs have been reported by LLRS. Now, almost all large loans are reported by LLRS. In the mean time, Bangladesh bank has formed a separate section in the Department of Banking Operation and. Development (DBOD). The commercial banks have to seek permission from the section prior to sanction any large loan. This section closely monitors and reviews the issues of larger loans of the banks. The responsibility of the section is to advise the concerned bank to take immediate appropriate actions if any loan is assumed undue risky.

3.4.3 Legal Reforms

Weak legal framework was one of the major drawbacks of the financial system in Bangladesh. Enforcement of legal action was even worse. In order to strengthen legal infrastructure of the financial system, following Acts were enacted:

- The Banking Companies Act, 1991
- Artha Rin Adalat Act, 1990
- Bankruptcy Act, 1997

- **The Banking Companies Act, 1991**

The Banking Companies Act, 1991 was enacted in February 1991 in order to make the role of Bangladesh Bank authoritarian in dealing with licensing, monitoring, regulating and supervising the banking sectors. The Act was subsequently amended twice in 1993 and 1995 which empowers Bangladesh Bank further.

The Act deals mainly with the operations and permitted activities of the banking companies. Bangladesh Bank exercises the Act in order to reestablish the discipline in the sanctioning and rescheduling of loans and advances. Direct or indirect relationship between the borrower and bank authority which is known as the "Connected lending" was identified as the most critical problem in the banking sector. In order to prevent this sort of lending, some restrictions were imposed on loans and advances as mentioned in the Section 27' of the Act. Rescheduling of defaulted loans is now critically monitored by Bangladesh Bank. It is not allowed to reschedule the outstanding loans more than twice.

- **Artha Rin Adalat Act, 1990**

In order to recover the defaulted loans, Artha Rin Adalat Act, 1990 was enacted in 1990 in order to recover the defaulted loans. Prior to setting up of Artha Rin Adalat, there was no special law for recovery of loans. Banks had to file cases in sub-judge commercial courts to sue any defaulter. However, the disposal of cases was procrastinated due to long legal procedures and over burdened judges.

Recognizing the problem, the government enacted the Act. A series of amendments were made to the Act in 1990, 1992, 1994 and 1997 to incorporate the effective rules accommodated with the changed situation. Even after so many amendments, the Act still suffers from some drawbacks.

- **Bankruptcy Act, 1997**

The Bankruptcy Act, 1997 has been enacted in March 1997. According to the Bankruptcy Act, all the District Judges are deemed as bankruptcy courts and they are empowered to authorize Additional District Judge to deal with and dispose of bankruptcy issues. Apart from these, two exclusive Bankruptcy Courts in Dhaka and Chittagong were set up. All these courts were institutes in addition to the financial loan courts.

The Act has been enacted with a view to judge a debtor as bankrupt, make smooth realization of a bankrupt's assets, discharge the debtor after distribution of his assets, and take effective measures against defaulting borrowers.

Chapter 4
Impacts of Reforms on Banking Sector in Bangladesh

This chapter presents the consequences of banking sector reforms especially on the financial sector development and the performance of different types of commercial banks operating in Bangladesh. While evaluating the performances of banks, this chapter makes a comparison between the performance indicators of local banks with that of foreign banks.

4.1 Impact of Reforms to Financial Development

One of the major objectives of banking sector reforms is to develop the financial system. It also aims to increase the competition among the banks in addition to the improvement in the profitability. Now, we will examine the overall financial development in the following areas:

- Financial Deepening
- Competitiveness within the banking industry
- Profitability of the banking industry

4.1.1 Financial Deepening

Financial deepening means the overall growth of the system. Depth of financial system is conventionally determined by the monetary aggregates in terms of a country's Gross Domestic Product. Growth of Monetary aggregates and GDP have been on an upward trend for the last decade. Broad money growth in FY 2010-11 was 21.3 percent which is slightly lower than the growth occurred in FY 2009-10 (22.4 percent). Net domestic asset has been increasing since FY 1993-94 due to considerable increase of the total domestic credit (including private credit). Income velocity of money is declining since FY 1993-94 which reveals the deepening in the financial system. Table 4.1 shows some selective indicators of Bangladesh financial sector.

We now evaluate the impact of reforms to financial development in terms of

- o Size and depth of the banking sector
- o Mobilization of savings
- o Stimulation for long term savings
- o Improvement in the cash flows towards the banking system

- **Size of banking sector**

The overall size and depth of the banking sector is conventionally measured by the following two ratios:

- o M_2/GDP Ratio,
- o Private Credit/GDP Ratio.

Table 4.2 exposes the M_2/GDP and Private Credit/GDP ratios since FY 1993-94. At that period, the M_2/GDP ratio was 26.9% which has been increased every year and stands now at 55.9%. Private credit to GDP ratio has also been increased since FY 1993-94. The private credit to GDP ratio in FY 2010-11 was 43.3% which was almost 3-fold of that in FY 1993-94. The rising trends of these two ratios reveal that the size of Bangladesh's banking sector is increasing.

Table 4.1: Selective Indicators of Bangladesh Financial Sector

(BDT in billions)

Financial Year	M_1	M_2	M_3	Total Domestic Credit	Private Credit	GDP at current price
1993-94	111.67	364.03		303.99	209.72	1354.12
1994-95	131.79	422.12		403.28	300.23	1525.18
1995-96	144.59	456.90		468.68	348.69	1663.24
1996-97	151.67	506.27		530.86	389.47	1807.01
1997-98	158.88	558.69		599.70	442.05	2001.77
1998-99	172.49	630.27	763.18	686.98	511.24	2196.97
1999-00	198.81	747.62	912.06	778.19	565.20	2370.86
2000-01	223.47	871.74	1078.08	910.46	656.58	2535.46
2001-02	241.61	986.16	1241.38	1023.96	745.54	2732.01
2002-03	267.43	1139.94	1435.47	1106.49	840.27	3005.80
2003-04	304.48	1297.21	1631.57	1267.85	958.69	3329.73
2004-05	354.04	1514.46	1879.21	1488.37	1120.15	3707.07
2005-06	426.52	1806.74	2212.84	1790.87	1323.17	4157.28
2006-07	501.68	2115.04	2562.46	2056.72	1521.77	4724.77
2007-08	593.14	2487.94	2965.05	2486.77	1901.35	5458.22
2008-09	664.26	2964.99	3490.55	2885.52	2179.27	6147.95
2009-10	879.88	3630.31	4293.37	3402.13	2707.60	6943.24
2010-11	1031.01	4405.20	5104.56	4335.25	3407.12	7874.95

Source: Statistics Department, Bangladesh Bank

- **Mobilizing savings**

Reform measures are able to channelize savings from the individuals to the banking system. M_1/M_2 ratio is the traditional tool to measure the ability of a country's financial sector to be succeeded in mobilizing savings. Table 4.2 shows that the ratio has been decreasing during the period from FY 1993-94 to FY 2010-11 with a very little fluctuation which means that the term deposits have been increasing throughout the period as a percentage of broad money M_2.

Table 4.2: Key Ratios of Financial Indicators

Financial Year	M_1/M_2	M_2/M_3	M_2/GDP	M_3/GDP	Income Velocity of Money
1993-94	30.7%		26.9%		15.5%
1994-95	31.2%		27.7%		19.7%
1995-96	31.6%		27.5%		21.0%
1996-97	30.0%		28.0%		21.6%
1997-98	28.4%		27.9%		22.1%
1998-99	27.4%	82.6%	28.7%	34.7%	23.3%
1999-00	26.6%	82.0%	31.5%	38.5%	23.8%
2000-01	25.6%	80.9%	34.4%	42.5%	25.9%
2001-02	24.5%	79.4%	36.1%	45.4%	27.3%
2002-03	23.5%	79.4%	37.9%	47.8%	28.0%
2003-04	23.5%	79.5%	39.0%	49.0%	28.8%
2004-05	23.4%	80.6%	40.9%	50.7%	30.2%
2005-06	23.6%	81.6%	43.5%	53.2%	31.8%
2006-07	23.7%	82.5%	44.8%	54.2%	32.2%
2007-08	23.8%	83.9%	45.6%	54.3%	34.8%
2008-09	22.4%	84.9%	48.2%	56.8%	35.4%
2009-10	24.2%	84.6%	52.3%	61.8%	39.0%
2010-11	23.4%	86.3%	55.9%	64.8%	43.3%

- **Stimulating long term savings**

M_3/GDP ratio suggests the banks' ability to stimulate long term savings. Table 4.2 shows a rising trend in the ratio which means the rising of long term savings. Bangladesh Bank started to compute M_3 from FY1998-99 and at that FY, the ratio was 35% which increased to 65% in FY 2010-11. M_2/GDP ratio also shows the similar trend. This ratio started to increase from 27% in 1993-94 to 39% in 2003-04 and now is 56% FY 2010-11.

- **Improvement in the cash flows towards the banking system**

M_2/M_3 ratio is generally used as a proxy to determine the direction of cash flows to/from the banking sector. In Bangladesh, M_2 includes assets in banking sector only; whereas M_3 includes assets in banking sector as well as in National Savings Directorate (NSD) and Non-Bank Depository Corporations (NBDC). An increasing M2/M3 ratio indicates that the assets in banking sector increases in comparison to assets in NSD and NBDC which ultimately reveals that cash flows are increasing towards the banking system. Bangladesh Bank started to compute M_3 since the period 1998-99. Initially, the ratio declined for the 3 years up to FY

2001-02 and after that period, it started to increase till date. This increasing ratio validates that the cash flows are increasing towards the banking system.

4.1.2 Competitiveness of the Banking Industry

We know from the literature review that the competition in the banking sector is assumed vital since it impels the participants to innovate attractive financial products and services. A country can be able to achieve higher economic growth if the banking system of that country is more competitive. We analyze the competition in the banking industry for the previous six years by the following two ways:

- the concentration ratio within the total assets
- Herfindahl-Hirschman Index (HHI)

- **Concentration Ratio**

We analyzed the concentration ratio within the total deposits for top bank, top 5 banks and top 10 banks for the last 6 years. Moderate competition is found when we consider top 5 banks' concentration ratio, in contrast to oligopoly competition while we consider top 10 banks. However, Table 4.3 shows that all the concentration ratios are on decreasing trend. It reveals that the banks having higher market share are losing their shares which are grabbed by the other banks. This exposes an increasing competition among the banks in the industry.

Table 4.3: Concentration Ratio within the Total Deposit

	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Top Bank	15.9%	14.9%	13.9%	13.1%	12.6%	11.7%
Top 5 Banks	42.9%	41.3%	39.2%	37.8%	36.7%	36.5%
Top 10 Banks	57.6%	56.2%	53.7%	52.9%	50.9%	50.6%

- **Herfindahl-Hirschman Index (HHI)**

The Herfindahl-Hirschman Index (HHI) is a generally used indicator which determines the concentration prevailing in any market. We analyze the HHI for market share of all the individual banks for the last 6 years. Market share of banks is determined by both the liabilities (deposits from customers) and assets (loans and advances to the customers).

Table 4.4: Herfindahl-Hirschman Index (HHI)

	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Deposits	0.056	0.053	0.049	0.047	0.045	0.043
Loans and Advances	0.053	0.043	0.041	0.039	0.038	0.038

Table 4.4 exposes that the banking industry is being more competitive from 2005 to 2011 both for the deposits and loans and advances. For both the cases, HHI has been decreased which indicates an increased competitive environment within the banking industry.

4.1.3 Profitability of the Banking Industry

Profitability is one of the indicators to measure the improvement in the banking industry. We analyze two profitability ratios, namely "Return on Assets (ROA)" and "Return on Equity (ROE)", and the "Net Interest Income (NII)" for the banking sector since 2000. All these variables have increased considerably during the period.

Table 4.5: Profitability of the Aggregate Banking Industry

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
ROA	0.47	0.74	0.5	0.5	0.7	0.6	0.8	0.9	1.2	1.37	1.8
ROE	10.91	16.94	11.6	9.8	13	12.4	14.1	13.8	15.6	21.72	15.5
NII	8.4	13.4	13.5	16.6	18.3	35.3	44.3	54.8	70.9	81.46	121.9

Source: Statistics Department, Bangladesh Bank

4.2 Performance Evaluation of Banks

We now evaluate the performance of banks on the basis of CAMEL framework. This evaluation is done for the four categories of banks, namely "state-owned commercial banks (SCBs), government-owned development financial institutions (DFIs), domestic private commercial banks (PCBs), and foreign commercial banks (FCBs)".

4.2.1 Capital Adequacy

Before 2004, all the commercial banks in Bangladesh had to maintain a minimum Capital which is not less than 8 percent of their Risk weighted Assets (RWA). Out of this, they had to maintain a minimum of 4.5 percent in core capital. Later on, the ratio was increased and the banks had to maintain the higher amount of these two: 9% of their RWA or BDT 200.00 crore.

At the end of December in 2010, the PCBs and FCBs were able to maintain the required Capital Adequacy Ratio and the ratio was 10.1 percent for PCBs and 15.6 percent for FCBs. The SCBs marginally failed to maintain the required level of adequacy as the ratio was 8.9 percent and the adequacy ratio for the DFIs was negative. Overall CAR of the industry in 2010 was 9.3 percent which was lower than that of the previous 3 years. Before 2010, the FCBs were maintaining a capital adequacy ratio more than 20 percent for the last 8 years.

PCBs and FCBs could maintain the required level of capital to risk weighted assets throughout the period under consideration. It is evident that the ratio maintained by the FCBs is much higher than the required level. SCBs could maintain the required level of adequacy for 2009 and 2010, and DFIs could maintain the level only in 2004. National aggregate position of capital to risk weighted assets fulfills the required level in the recent years only due to the higher capital maintained by the FCBs.

Table 4.6 shows the "Capital to Risk weighted Assets Ratio" maintained by the four different types of banks.

4.2.2 Asset Quality

The Non-Performing Loans (NPLs) Ratio is the most important indicator to identify the problem inherent in asset quality. At the end of 2010, NPLs of the SCBs, DFIs, PCBs and FCBs are 15.7, 3.2, 3.0 and 24.2 percent respectively of their total assets.

The overall aggregate NPLs ratio is still very high, the scenario is improving to a large extent after 1999 when the ratio reached its peak (41.1 percent). FCBs could maintain a significant low ratio of NPLs to total assets. SCBs and DFIs experienced much higher NPLs to total assets ratio before 2002. Later on, they started to strengthen the mechanism of loan recovery and it is clear from the Table 4.7 that the situation has been improved a lot.

4.2.3 Management Efficiency

It is difficult to quantify the efficiency of bank management; however, expenditure to income ratio, and income and expenditure to manpower ratio may be used to determine the management efficiency.

Table 4.8 shows that at the end of 2010, expenditure-income (EI) ratio of the banking industry was 70.9 percent. DFIs possessed the EI ratio of 87.8 percent and it was higher than the other three groups of banks. The EI ratio of SCBs, PCBs and FCBs are 80.7, 67.6 and 64.7 percent respectively.

It transpires from the Table 4.8 that the EI ratio is significantly higher in case of the DFIs. In 1997, the ratio was 150 percent. Surprisingly the ratio was increased more to 180.4 percent in the next year. The EI ratio for the DFIs is still very high in comparison with the other types of banks. The DFIs had to made loan loss provisions; as a result, their financial statement exhibits a high EI ratio. Due to operating loss incurred by 2 DFIs, income of the DFIs again declined and the EI ratio again increased to 107.7 percent in 2007 and 112.1 percent in 2009. Most of the years, the SCBs could maintain the EI ratio below 100 percent. It is seen from the Table 4.8 that the EI ratio for the SCBs never went below that ratio maintained by PCBs and FCBs.

Table 4.6: Capital to Risk Weighted Assets Ratio by Types of Banks

(Percent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
SCBs	6.64	5.25	5.30	4.45	4.27	4.14	4.38	4.13	-0.45	1.16	7.97	6.91	9.05	8.91
DFIs	6.01	5.94	5.81	3.25	3.91	6.97	7.71	9.11	-7.55	-6.70	-5.57	-5.38	0.41	-7.35
PCBs	8.32	9.21	11.01	10.96	9.91	9.76	10.51	10.37	9.12	9.89	10.61	11.42	12.15	10.16
FCBs	16.72	17.16	15.81	18.47	16.82	21.58	22.92	24.29	26.02	22.70	22.72	24.09	28.11	15.65
Total	**7.52**	**7.35**	**7.41**	**6.78**	**6.79**	**7.41**	**8.40**	**8.75**	**5.69**	**6.71**	**9.60**	**10.11**	**11.66**	**9.33**

Source: Statistics Department, Bangladesh Bank

Table 4.7: Non-Performing Loans to Total Loans Ratio by Types of Banks

(Percent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
SCBs	36.61	40.49	45.60	38.68	37.02	33.77	29.04	25.32	21.44	22.97	29.91	25.46	21.43	15.72
DFIs	65.72	66.71	65.09	62.64	61.87	56.22	47.46	42.91	34.94	33.72	28.65	25.51	25.97	24.21
PCBs	31.48	32.75	27.18	22.07	17.04	16.76	12.40	8.52	5.69	5.53	5.09	4.44	3.98	3.22
FCBs	3.56	4.12	3.83	3.48	3.31	2.69	2.73	1.59	1.33	0.85	1.42	1.95	2.36	3.04
Total	**37.52**	**40.73**	**41.19**	**34.92**	**31.54**	**28.12**	**22.17**	**17.64**	**13.68**	**13.24**	**13.28**	**10.82**	**9.23**	**7.19**

Source: Statistics Department, Bangladesh Bank

Table 4.8: Expenditure-Income Ratio by Types of Banks

(Percent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
SCBs	99.30	99.8	100.5	99.4	99.0	98.5	98.8	102.3	101.9	100.0	100.0	89.6	75.6	80.7
DFIs	150.0	180.4	145.2	175.3	89.1	95.9	101.1	104.0	103.9	103.5	107.7	103.7	112.1	87.8
PCBs	83.45	85.3	90.4	90.8	88.1	91.9	93.1	87.1	89.3	90.2	88.8	88.4	72.6	67.6
FCBs	59.40	60.10	67.40	77.73	75.78	78.32	80.31	76.34	70.82	71.19	72.91	75.83	59.01	64.7
Total	**95.31**	**95.43**	**96.62**	**99.93**	**91.21**	**93.36**	**93.93**	**90.96**	**92.11**	**91.44**	**90.42**	**87.96**	**72.61**	**70.94**

Source: Statistics Department, Bangladesh Bank

4.2.4 Earning Performances

The generally used indicator to determine the earning is "Return on Assets (ROA)". The other two ratios namely the "Return on Equity (ROE)" and the "Net Interest Margin (NIM)" are also used to measure the profitability.

Tables 4.9 and 4.10 expose ROA and ROE attained by different types of banks. It transpires from those tables that these ratios vary considerably for different categories of banks. The FCBs' ROA was 4.82 percent in 1997. In the last year, it was 2.9 percent. Though the ratio declined after 1997, the FCBs could attain a strong ROA throughout the period under consideration. ROA of PCBs has also on increasing trend for the last 7 years. The ROA of the SCBs and the DFIs are very poor. These two types of banks even failed to earn a positive ROA in some years.

Bangladesh Krishi Bank incurred huge loss in 2009 which leads the DFIs' return on equity to negative 171.7 percent in that year. ROE of the DFIs were negative in most of the years. PCBs and FCBs are able to achieve considerable ROE in the last 14 years whereas the SCBs are improving to attain high ROE after 2007.

Table 4.11 shows that the overall net interest income (NII) has been consistently on the positive trend. NII of PCBs and FCBs are on upward trend which means that they are enjoying high spread between interest rates of lending and deposit collecting. SCBs are able to increase their NII after 2004 by reducing their cost of fund and during 2010 it was Taka 19.8 billion. NII of DFIs is also on positive trend for the last couple of years.

4.2.5 Liquidity

Table 4.12 and 4.13 reveal that all the four categories of banks are maintaining excess liquidity. SCBs and FCBs have comparatively higher excess liquidity ratio over the other two groups throughout the period from 1997. Excess liquidity maintained by the banks reveals that the banks have un-utilized fund which can be invested in profitable sectors.

Table 4.9: Return on Assets (ROA) by Types of Banks

(Percent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
SCBs	0.04	0.01	-0.03	0.04	0.33	0.13	0.18	-0.15	-0.12	0.04	0.06	0.76	0.96	1.14
DFIs	-2.12	-2.92	-1.65	-3.77	0.71	0.33	0.06	-0.27	-0.12	-0.27	-0.39	-0.63	0.37	0.23
PCBs	1.12	1.24	0.81	0.83	1.13	0.85	0.72	1.27	1.12	1.18	1.33	1.49	1.55	2.11
FCBs	4.82	4.66	3.52	2.68	2.84	2.42	2.68	3.24	3.19	2.20	3.13	2.92	3.18	2.93
Total	**0.63**	**0.68**	**0.46**	**0.47**	**0.74**	**0.53**	**0.56**	**0.72**	**0.68**	**0.85**	**0.92**	**1.27**	**1.37**	**1.81**

Source: Statistics Department, Bangladesh Bank

Table 4.10: Return on Equity (ROE) by Types of Banks

(Percent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
SCBs	1.27	0.34	-1.08	1.52	12.32	4.25	3.07	-5.34	-6.95	0.01	0.03	22.55	26.15	18.43
DFIs	-29.13	-36.34	-29.48	-68.03	12.30	5.86	-0.67	-2.13	-2.06	-2.09	-3.42	-6.95	-171.68	-3.23
PCBs	24.4	26.81	15.32	17.1	21.0	13.6	11.4	19.5	18.1	15.2	16.7	16.4	20.95	20.9
FCBs	38.21	40.71	41.84	26.9	32.4	21.5	20.4	22.5	18.4	21.5	20.4	17.8	22.38	17.0
Total	**12.95**	**13.32**	**10.33**	**10.9**	**16.9**	**11.6**	**9.8**	**13.0**	**12.4**	**14.1**	**13.8**	**15.6**	**21.72**	**15.5**

Source: Statistics Department, Bangladesh Bank

Table 4.11: Net Interest Income by Type of Banks

(Taka in Billions)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
SCBs	2.72	2.23	3.16	-1.22	-1.8	-1.5	-0.3	-1.1	7.7	9.0	7.4	7.9	12.11	19.8
DFIs	-0.12	0.53	-0.14	1.01	2.74	1.4	1.3	1.8	1.0	1.7	1.4	1.9	1.92	6.2
PCBs	1.77	2.32	3.22	6.13	9.2	10.2	12	13.7	21.0	25.4	36.1	48.5	56.71	82.8
FCBs	2.01	2.25	1.83	2.56	3.3	3.4	3.6	4.2	5.6	8.2	9.9	12.6	10.71	13.0
Total		**6.33**	**7.15**	**8.41**	**13.4**	**13.5**	**16.6**	**18.3**	**35.3**	**44.3**	**54.8**	**70.9**	**81.46**	**121.9**

Source: Statistics Department, Bangladesh Bank

Table 4.12: Liquid Assets/Deposit by Types of Banks

(Percent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
SCBs	22.77	24.42	25.23	26.56	25.79	27.35	24.49	22.82	20.06	20.17	24.99	32.93	25.13	27.22
DFIs	16.92	16.63	15.75	16.21	15.32	13.76	12.02	11.22	11.28	11.99	14.28	13.73	9.68	21.33
PCBs	24.26	24.89	25.97	24.83	24.25	26.37	24.42	23.13	21.01	21.44	22.22	20.77	18.28	21.54
FCBs	31.24	39.85	51.31	34.77	34.11	41.68	37.83	37.84	41.56	34.45	29.26	31.36	31.85	32.18
Total	**23.38**	**25.29**	**27.05**	**26.19**	**25.37**	**27.26**	**24.75**	**23.45**	**21.73**	**21.52**	**23.24**	**24.83**	**20.66**	**23.09**

Source: Statistics Department, Bangladesh Bank

Table 4.13: Excess Liquidity/Deposit by Types of Banks

(Percent)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
SCBs	2.65	4.39	5.24	6.47	5.71	7.3	8.4	6.8	2	2.1	6.9	14.9	17.6	8.2
DFIs	9.74	9.15	8.71	9.86	8.87	6.9	5.8	4.7	6.2	3.8	5.6	4.9	7.1	2.3
PCBs	5.97	6.65	7.95	6.8	6.23	8.5	9.8	8.8	5.1	5.6	6.4	4.7	5.3	4.6
FCBs	11.2	19.9	31.4	14.8	14.3	21.8	21.9	21.9	23.6	16.4	11.2	13.3	21.8	13.2
Total	**4.46**	**6.4**	**8.31**	**7.47**	**6.72**	**8.7**	**9.9**	**8.7**	**5.3**	**5.1**	**6.9**	**8.4**	**9.0**	**6.0**

Source: Statistics Department, Bangladesh Bank

Chapter 5
Conclusions and Policy Inferences

5.1 Conclusion

The problems inherent in the banking sector of Bangladesh have been developing over many years. Bangladesh Bank and the Government have promoted a number of the reform measures with a view to bring the situation under control. The very first objective of the reforms was to identify systematic problems and threats for overall banking system and to identify the specific problems in individual banks. The reforms were in fact wholly successful in fulfilling the first objective.

Following restructuring initiatives, financial system in Bangladesh has been developed considerably and it is continuously improving. Particularly, financial sector has been deepened further, while monetary aggregates are growing. Efficient financial products are also being introduced as mobilization of savings tends to be improved. In addition, long term investments are stimulated, competitiveness within the industry has been enhancing, and the profitability scenario of the banking industry has been improved.

Prior to the banking sector reforms, the banks did not consider the fate of the outstanding loans. A large number of non-performing loans were considered as performing assets, because there was no appropriate criterion for loan classification and provisioning. As a result, banks were able to achieve a high accounting profit. The loan classification and provisioning and loan losses were not even required to report in their financial reports.

In order to comprehend the status of the defaulted loans, new loan classification and monitoring policies were formulated. As a result, defaulted loans could be identified easily, and hence bank could monitor the loans continuously for recovery. In addition, Bangladesh Bank issued new reporting guidelines on the basis of International Accounting Standard (IAS-30). Banks are now compelled to prepare the financial statements complying with IAS-30. Therefore, classified loans, provision shortfall and loan losses are now more transparent to the stakeholders and the bank management is more accountable.

Actual capital as percentage of required capital, maintenance of liquidity, operational efficiency and profitability improved to some extent. As the banks had to gradually adopt the internationally accepted loan classification policies and accounting procedures, loan classification and provisioning shortfall was higher initially in the post-reform stage which affected the profitability as well as the financial strength of the banks.

The results from this research show that the adoption of risk-based capital adequacy certainly improved performance of capital adequacy of banks in the post-reform era. Management performance in monetary terms was also increased throughout the period under consideration.

In terms of profitability the banking sector had mixed experience during the period under consideration. Profitability of state-owned commercial banks (SCBs) had declined because of higher provision maintenance from their income and accounting of interest income on classified loans as interest suspense, which was earlier shown as income in the pre-reform stage. On the other hand, the profitability of PCBs and FCBs showed an increasing trend in the post-reform stage because of deregulation of interest rates in loan pricing and liberty to select potential clients and projects for investment and involve in diversified businesses.

Liquidity performance of the banks indicates that there is no such improvement over the period. All types of banks have much liquid assets excess of their requirements.

The performances of the foreign banks are significantly better in comparison to the local banks in every aspect. FCBs could be able to maintain a "Capital to Risk Weighted Assets Ratio (CRAR)" which is higher than that maintained by the rest three groups of banks. Non-performing assets of FCBs are negligible comparing with their assets. Though FCBs maintained a substantial amount of liquidity, their profitability in terms of ROA and ROE, and NIM are higher than the local banks. If we consider the management efficiency in monetary terms, the FCBs were capable to control their expenditure- income ratio lower than the other three groups of local banks.

FCBs are performing much better than the local banks due to a number of reasons. Apart from complying with the policies and guidelines issued by Bangladesh Bank, the FCBs have also to comply with the policies and guidelines issued by their head office. They are exploiting the international best practices in their operation. In addition, they are audited on a regular basis by their head offices. Hence, they have more controlling systems and become more transparent which lead them to build an excellent management and administration. They can get support from their head office in analyzing risks including credit risks and operational risks. They can easily track the recovery of loans as they have limited branches and customers, and advanced Management Information System and Accounting Information System. The FCBs have efficient human resources as well who are being trained up from the beginning of their job on the state of the art banking technology.

In short it can be concluded that because of reform measures banks are now goal oriented, more equipped with information and analysis, and more independent to decide strategy for growth. In terms of making things accountable and transparent, the impact of reform is excellent. At the same time, if recovery is ensured, then overall financial position would also improve.

5.2 Policy Inferences

The restructuring measures taken so far are definitely not sufficient considering the gravity of the situation. Based on the above discussion the following steps may need to be taken as reform or restructuring measures to speed up the progress:

- The aim of any restructuring process is to attain solvency first. Though capital position of the banking system has improved slightly in the recent years, yet most of the SCBs and DFIs, and a number of PCBs are significantly undercapitalized. If injection of new capital is not possible then the banks should be allowed/motivated to raise new capital from the security market.

- Non-performing loans should be focused exclusively in an efficient and productive way. Separate management within the same organization should be deployed to look after NPLs.

- The problem of excess liquid asset of the banks should be handled with due attention. In order to utilize the excess liquidity, efficient fund management should be exercised by the banks.

- Compliance with International Accounting Standard should be ensured in preparation of financial reports. Auditing of the particulars of financial statements should be done as per international standard for a transparent and proper disclosure of the financial strength of the banks.

- Banks under Early Warning System have to prepare course of actions with individual deadlines to overcome specific problems. Bangladesh Bank has to deal with these banks properly and monitor their progress closely.

- A number of measures were taken to strengthen the legal framework. However, in order to attain the benefit of improved legal framework, enforcement of legislations should be ensured. Legal procedures should be uncomplicated and disposal of case should be speedier.

- Government interference, political involvement, pressure from the trade unions has to be reduced for the smooth functioning of the banks.

- For developing the asset utilization ratio, portfolio of asset structure should be rearranged by removing the non-earning assets or transforming the non-earning assets into earning one.

- Local commercial banks can also employ qualified and efficient employees with higher salary package and can train them according to their needs for achieving the better output.

- Technological up-gradation of the banking system is needed equipped with state-of-the-art infrastructure and logistics.

- One of the major causes of the non-fulfillment of the entire objectives of the reform measures is lack of proper and extensive training. Arrangement of large scale training program from both central bank and commercial bank is must to get the concrete result from the reform programs.

- Lastly, the problem of Bangladesh financial system is widespread and not related to banking system only. Therefore the scope of the reform measures should also be applied to the non-bank financial institutions, for sustainable banking reform.

List of References

Adhikary, D. K., Pant, R., & Dhungana, B. R. (2007). *Study on Financial Sector Reform in Nepal*. Pakistan: South Asian Network of Economic Institutes. Retrieved from http://www.saneinetwork.net/pdf/SANEI_VIII/5.pdf.

Allen, F. & Gale, D. (2000). *Comparing Financial Systems*. Boston, MA: MIT press.

Benhabib, J. & Spiegel, M. M. (2000). The Role of Financial Development in Growth and Investment. *Journal of Economic Growth*, 5, 341-360.

Besanko, D. & Thakor, A. (1992). Banking Deregulation: Allocational consequences of relaxing entry barriers. *Journal of Banking and Finance*, 16, 909-932.

Brownbridge, M., & Gockel, A. F. (1996). *The Impact of Financial Sector Policies on Banking in Ghana*. Sussex: Institute of Development Studies.

Burki, A. A., & Niazi, G. S. K. (n. d.). *Impact of Financial Reforms on Efficiency of State-owned, Private and Foreign Banks in Pakistan*. CMER Working Paper No. 06-49, Lahore: Lahore University of Management Sciences. Retrieved from http://www.eastasiaforum.org/testing/eaber/sites/default/files/documents/LUMS_Burki_2006.pdf

Caprio, G. & Klingebiel, D. (1999). *Episodes of systematic and borderline financial distress*. USA: The World Bank.

Claessens, S. & Laeven, L. (2004). What drives bank competition? Some international evidence. *Journal of Money, Credit and Banking*, 36, 563-584.

Cooray, A. (2003). An Evaluation of the Financial Reform Process in Sri Lanka. *Sri Lanka Economic Journal*, 4 (1), 1-23.

Dunham, D. & Kelegama, S. (1996). *Economic Liberalisation and Structural Reforms: The experience of Sri Lanka 1977-93*. New Delhi, India: New Age International Publishers.

Feldman, R., & Wagner, N. (2002). Proceedings of EIB Conference on Economics and Finance '2002. Luxemburg.

Golubović, S., & Golubović, N. (2005). Financial Sector Reform in the Balkan Countries in transition. *Facta Universitatis Economics and Organization*. 2(3), 229 - 236.

Heffernan S.A., & Fu, X. (2009). The Effects of Reform on China's Bank Structure and Performance. *Journal of Banking and Finance*. 33(1), 39 - 52.

Husain, I. (2005). Governor's speech in a Conference on Economy Management. Pakistan. 12 May 2005.

Khan, S. R. & Aftab, S. (1994). Assessing the Impact of Financial reforms on Pakistan's Economy. *Pakistan Journal of Applied Economics*, 10(1&2), 99-116.

Levine, R. (2005). Finance and Growth: Theory and Evidence. In P. Aghion & S. Durlauf (Ed.), *Handbook of Economic Growth* (pp. 865-934). Netherlands: Elsevier B. V.

Lucas, R.E. (1988). On the mechanics of economic development. *Journal of Monetary Economics*, 22(1), 3-42.

McKinnon, R. I. (1973). *Money and Capital in Economic Development*. Washington D.C.: The Brookings Institution.

Rajan, R. (1992). Insider and Outsiders, the Choice between Informed and Arm's-Length Debt. *Journal of Finance,* 47, 1367-1400.

Reddy, Y. V. (2005). Governor's speech. Bankers' Institutions, Karachi, May 2005.

Seelanatha, L. & Wickremasinghe, G. B. (2009). Financial reforms and their consequences on the Sri Lankan banking sector. *Banks and Bank Systems*, 4(4).

Shaw, E.S. (1973). *Financial Deepening in Economic Development*. New York: Oxford University Press.

Sheng, A. (1996). *Bank Restructuring: Lesson from the 1980s*. Washington: The World Bank.