Banking Sector Reforms in Bangladesh: Measures and Economic Outcomes

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Abstract

This paper discusses the reform measures of the banking system of Bangladesh along with economic outcomes of the reform measures. The paper finds that the government of Bangladesh undertook ownership reform program in 1982 to make the banking system more competitive and robust under the financial restraint framework. The banking system followed arms-length model since the 1990s by undertaking a broad based reform program in the name of FSRP. Afterwards, it undertook BRC/CBRP programs, liberalized interest rate policy, and adopted risk based capital adequacy norms, *inter alia*, to foster competiveness and efficiency in the banking system. However, the paper reveals that the banking sector still is not free from distortion, fragmentation and oligopolism even after the financial reform measures, as there exits high level of nominal lending rates, high nominal spreads, high non-performing loans in different clusters of banks and clout of the owners and directors. The paper concludes that creating an enable environment for a rational spread rate, introducing tailored products on both assets and liability front end proper management of NPLs along with accurate risk management device may improve financial stability in the banking system in the foreseeable future.

JEL Classification: E52, G21

Keywords: Reforms, Non-performing loans, profitability.

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1.1 Introduction

Unlike developed economies where “Anglo-Saxon” or “Arms-Length” mode of finance tends to play an important role in channelling funds to the entrepreneurs, the banking system of the developing and emerging economies such as Bangladesh plays a pivotal role in augmenting economic growth. Often cited reason in this respect is that the capital market of the developing economies lacks transparency and accountability in operations which reduce the trust and confidence of the general investors in undertaking financial transactions in this market. Additionally “information asymmetry” problem is seen fierce in developing economies and this information asymmetry problem reduces the depth of the capital market (Allen *et al.*, 2000). Developing economies also suffer from a shortage of supporting institutions such as venture capitalists, security houses, rating companies, and asset management bodies which are in fact preconditions for accepting the Anglo-Saxon system (King & Levine, 1993; Rajan and Zingles, 1998). Therefore, in developing economies, the banking system mainly mobilizes and allocates financial resources at a lower financial intermediation cost, and thereby enhances economic growth.

However, the reduction of financial intermediation costs requires continuous reforms in the banking system in tune with the technological advancements, prudential laws and regulations, accounting standards, supervisory capability of the banking regulators, and efficiency of the bank officials in applying latest tools and techniques to manage the operational, credit, and market risks of a transaction. Besides, for independence of the banking system in fixation of interest rates, allocation of credits without government intervention, and increasing of competition and efficiency in financial intermediation, reforms are indeed essential. In other words, effective reform measures ensure robustness of the banking system which helps increase the economic growth rate of a country by directing investments to those sectors that offer the highest risk-adjusted rates of return. However, unplanned financial liberalization is likely to aggravate financial malaise instead of improving the efficacy of the system as is observed in the latest Asian financial fiasco in 1997. This implies that the banking sector reform is a continuous process and multipronged in nature. It (reform) aims at developing the banking system competitive, prudent, resilient, and efficient in mobilizing and allocating financial resources at a least financial intermediation cost. It also covers integration strategies of the banking system with the global banking arena.

Looking at Bangladesh, the banking system captures the lion’s share of the financial market, although in recent years the number of non-banking financial institutions (leasing and merchant banks) is seen to increasingly catering the financing and technological needs of the entrepreneurs. In the banking system, the private commercial banks (PCBs) hold more than 61% of the total deposits and 59% of industry assets followed by the four nationalized commercial banks (SCBs) that hold 27.5% of the total deposits and 28.8% of industry assets (Annual Report, Bangladesh Bank 2010-11), and thus, they influence the efficacy of the banking system to a great extent. On the other hand, the equity financing from capital markets through issuing new shares is found to be lenient, and the debt financing through issuing corporate bonds is almost nonexistent. Bank financing was around 94% of total financing while equity financing accounted for the remaining 6% in 2007 (Banerjee et al.

2009). This represents that the financial system of Bangladesh is predominately bank centric and the country's economic growth primarily rests on the development of its credible and stable banking system.

Notably, in order to make the banking system competitive, effective, and international standard, the policy making institutions of Bangladesh adopted different measures and initiatives especially in the beginning of 1990s that include deregulation of interest rates, loan classification and provisioning requirement, adoption of indirect and market oriented monetary policy instruments, strengthening the operations of banking system by improving legal environment, making taka convertible and computerization of bank branches. However, the banking system of Bangladesh still holds large percentage of non-performing loans (NPLs) —9.2% as of December 2009 — which is in fact highest in comparison to the NPL ratios of neighbouring countries such as India (1.5%), Sri Lanka (5.6%), and Pakistan (7.7%). There is also absence of technological alliance among different banks and financial institutions to judge the credit risk of the borrower's effectively. Keeping this background in mind, this paper aims at addressing the following research questions:

1. *What reform measures have been undertaken in Bangladesh so far in order to increase the efficiency of the banking sector; and*

2. *How far, the widespread reform measures have increased the efficiency of the banking sector.*

In order to answer the above research questions the study proceeds as follows. Section II provides the theoretical framework of the study. Section III describes research methodologies. Section IV discusses reform measures so far under taken in the banking system of Bangladesh since its independence. Section V unfolds economic outcome of the reform measures. Section VI concluding remarks.

II. Theoretical Framework

In general, "information asymmetry", "transaction costs", "moral hazards", "incentives", "agency ship", "contracts" and "uncertainties" are the basic theories applied to discuss the cost of financial intermediation as well as needs for financial reforms in an economy. In practice, however, the policy-making institutions rely on two extreme theories: (1) the "financial restraint" or "financial repression" theory, and (2) the "financial liberalization" or "arms-length" model in order to ensure stability in the financial intermediation. In fact, information asymmetry can be considered as a prime determinant in calculating the costs of financial intermediation as this usually leads to increase adverse selection and moral hazards, which in turn, increases the cost of contract enforcements or say transaction costs. Besides, uncertainties increase "risk premium" which also triggers the transaction cost of financial intermediation. However, the banking system cannot directly charge the risk premium in the loan price as such a practice increases lending rates to an exceptionally high level resulting in the "lemon problem". This practice further contracts economic growth by way of shrinking the volume of financial transactions. Therefore, higher transaction cost becomes a disincentive to financial agents to discharge their agency duties perfectly unless adequate bank rents (spread) are ensured in the system of financial intermediation. Conversely, higher spread influences the cost of capital of the borrowers which creates disincentives for them in undertaking business activities. In other words, higher spread provides incentives to expand bank branches but it is likely to result in economic contraction and low growth by increasing cost of capital of the borrowers. This creates a "catch 22" situation for the policy making institutions in that unless the banking system is professionally and ethically sound leaving out financial intermediaries from the checks and measures of government control may lead to financial malaise on one hand and repression of interest rates incubates inefficiencies among the financial intermediaries on the other. This 'catch 22' situation becomes a vicious circle for the government of developing countries as these countries are usually suffer from capital shortage and institutional inefficiencies which may result in inefficient and improper allocation of credits.

On this vintage point, Stiglitz & Weiss (1981) argue that credits are intrinsically rationed in developing economies due to problems of asymmetric information. They note that lenders cannot perfectly select the right borrowers without costs *ex ante* and monitor the behaviour of borrowers *ex post*, and the price mechanism does not clear the excess demand for funds. For instance, even when a borrower deemed by a bank to be un creditworthy offers to pay higher interest rates, the bank may decline the loan application, because this offer is interpreted as a signal of higher default risk.

On the contrary, in the seminal work on financial development, McKinnon (1973) and Shaw (1973) raise questions on the applicability of the neoclassical approach to financial development in developing countries in that the financial system in developing countries is mostly characterized by low levels of formal intermediation with a weak institutional structure which impede financial deepening. Criticizing the Tobin's model (1965)[1] of economic growth, they argue that money and capital are compliments rather than substitutes — the more the real money balances, the greater the incentive to invest. Productive investment and capital accumulation occur as large amounts of real money stocks create greater amounts of loan able funds available to borrowers (McKinnon, 1973; Shaw, 1973, 1981). In this view, expanded financial intermediation between savers and investors increases the incentives to save and invest which improves the efficiency of investment (Fry, 1982). They argue that financial repression policies usually crowd out high-yielding investments, discourage future saving and shrink the supply of investment finance as this policy make depositors to move away from banks. In consequence, the quality and quantity of investment as well as financial deepening are reduced. There are also a significant number of empirical studies that report negative correlations between a low real interest rate, a high reserve requirement, and a low degree of financial intermediation on one hand, and investment and growth on the other (Easterly, 1993; Levine, 1993; King and Levine, 1993a, 1993b). As mixed results are observed through empirical analysis, it is better to accumulate country experience to argue whether the financial restraint or the financial liberalization policy is suitable for ensuring prudence and stability of the banking system. In this respect, the present study is expected to add knowledge by accumulating experience of reforms undertaken in the banking system of Bangladesh.

III. Methodology

The study uses secondary information. Publications of both printed and electronic sources of different banks, Bangladesh Bank, Ministry of Finance, different organs of the Govt.,

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[1] In Tobin's model money and capital are perfect substitutes for one another and if the rate of return on productive capital increases in comparison to money, then there will be a shift of resources from money to productive capital. Such a shift will create a beneficial impact on productivity, increase per capita income and accelerate economic growth.

International agencies like IMF, World Bank, Asian Development Bank have been used as sources of data.

In order to review the reform measures undertaken so far in the banking system of Bangladesh, the study segregates the reform measures into four phases. These are: (1) ownership reform (1982-89), financial sector reform project (1990-95), (3) BRC/CBRP (1996-2002), and (4) Current reforms programs (2003-onwards). Structural issues with respect to consultants, manpower, costs, timing and implementation of each reform measures have been thoroughly examined on the basis of reviewing documents relating to agreements, terms of references (TOR), etc. In this regard, procedures of neighboring countries, particularly South Asian Countries', have been used to find out the structural weaknesses of the reform measures.

The impact assessment of reforms in the banking sector has been measured primarily in terms of profitability, productivity and efficiency, and social justice parameters. In this regard, simple accounting techniques, descriptive statistics and relevant parametric tests have been used.

IV. Reform Measures — Background

The Banking system prior to the independence in 1971 was highly concentrated in the urban areas. It was also owned largely by Non-Bengalis to serve Non-Bengali enterprises, thereby enabling them to establish hegemony over the local economy. Therefore, immediately after the liberation, the then government nationalized and reorganized all banks and financial institutions, excepting a few foreign banks. In addition, the government established two specialized banks — Bangladesh Shilpa Bank (BSB) and Bangladesh Krishi Bank (BKB) — to cater to the industrial and agriculture financing needs of the country in a planned way. Notably, the primary goals of the banking policy at that time were (1) to exercise state control over the financial assets, (2) to save an abandoned banking system from the collapse, (3) to spread the coverage of the banking system to the rural areas for mobilizing financial resources, and (4) to provide easier access to bank financing to a wider constituency of borrowers drawn from a less privileged background. In other words, the government adopted a financial restraint framework based on rigid government control and central bank regulations. The regulation broadly covered fixation of interest rate on deposits and credits, direction of credit to public sector enterprises (PSEs), priority sectors and expansion of bank branches.

This system undoubtedly increased bank branches, volume of deposits, and deployment of credits but led to the deterioration in the efficiency of the banking system by increasing a number of unprofitable bank branches, which, in turn, reduced bank's profitability. For instance, at the time of nationalization (1972), there were only 1116 bank branches across Bangladesh of which 38% were located in the rural areas. At the end of 1980, the bank branches increased to 3748 of which 63% were located in rural areas (Economic Trends, various issues). Similarly, total deposits and credits increased to Tk. 2806.86 and 3049.95 crores respectively in 1980 from Tk. 523.61 and 2806.86 crores respectively in 1972 (Economic Trends, various issues). However, the total profitability (in per Tk. 100) of the banks fell down from 0.32% in 1973-74 to 0.32% in 1982-83 (Choudhuri et al., 1995). In addition, the level of customer services and overall quality of management also deteriorated due to the monopolization of the banking services by the government.

In the above backdrop, the government undertook several reform measures to improve competition and efficiency in the banking system, which are as follows:

(a) The Ownership Reform Program (1982-1989).

The ownership reform program was initiated in 1982 to encourage the private sector and to strengthen, fortify and reinforce overall banking efficiency. As a part of ownership reform program, the government denationalized two out of six nationalized commercial banks (SCBs) and allowed the operation of local private banks. The main reason for allowing local private banks was the desire on the part of the government to demonstrate its commitments to encourage the private sector and to create competition in the banking sector. However, it is argued that during the period of 1983 to 1985, the operational efficiency of the banking sector further declined due to improper allocation of credits which created huge nonperforming loans (NPLs) in the name of "sick industry syndrome". Thus, the government appointed a "National Commission on Money, Banking and Credit" in 1986 to diagnose the malaise and identify ways and means for banking recovery. The Commission undertook a detailed examination of various problems of the banking sector, such as the bank rate and refinancing policy of the Bangladesh Bank, overdue loans of SCBs and the development financial institutions (DFIs), supply of adequate loan to rural and agriculture sector, supervisory problems of the Bangladesh Bank and individual bank management, and frauds and forgeries in the banking sector. Based on the recommendations of the Commission, the government undertook a number of steps to improve the efficiency of the banking system that included fixation of recovery targets for the SCBs and DFIs, prohibiting defaulters from getting new loans, self classification of loans by banks based on their quality of loans, and increase of monitoring capabilities of the central bank. Nevertheless, the deterioration in banking efficiency could not be arrested although there was an increase of total number of bank branches, volume of deposits and credits. For instance, the number of branches for SCBs increased from 3270 in 1983 to 3560 in 1989, but in relative terms they shared 64.12% of the total branches in 1989 — a reduction of 6.92% in comparison to the year 1983 (Table 1). Similarly, the volume of deposits and credits for SCBs increased by more than 100% in 1989 as compared to the year 1983, but their relative share in total banking industry decreased by almost 22% and 25% respectively during the same period (Table-1). Likewise, the volume of deposits and credits for DFIs are found to have a declined trend when a relative measurement is applied. On the other hand, the share of bank branches, deposits, and credits for PCBs and FCBs are found to have an increasing trend during the period of 1983-89. Nevertheless, the operational efficiency of the banking system declined to 0.11% in 1989 from 0.32% in 1983, where SCBs shown to have a very poor performance (Table-1).

Table-1: Comparative Share of Different Categories of Banks in Total Banking Activities (1983-1989)

(Figures in the Bracket Indicate Share in %)

Year	Branch Expansion				Deposit Mobilization (Tk. in Crores)			
	SCBs	DFIs	PCBs	FCBS	SCBs	DFIs	PCBs	FCBS
1983	3270 (71.04)	780 (16.94)	536 (11.64)	17 (0.37)	5215.1 (83.13)	367.4 (5.86)	226.5 (3.61)	464.4 (7.40)
1989	3560 (64.12)	1146 (20.64)	824 (14.84)	22 (0.40)	11597 (64.10)	859 (4.75)	4266 (23.58)	1369 (7.57)
	Deployment of Credit (Tk. in Crores)				Operational Efficiency (profitability in per Tk.100)			
	SCBs	DFIs	PCBs	FCBS	SCBs	PCBs	All Banks	
1982-83	4069 (70.39)	1298 (22.45)	124 (2.15)	290 (5.01)	0.23	0.16	0.32	
1988-89	9898 (53.88)	3822 (20.81)	3563 (19.4)	1087 (5.91)	0.002	0.15	0.11	

Source: Compiled from various issues of Bangladesh Bank Economic Trends, Schedule Banks Statistics, and Annual Reports of different years.

This indicates that the ownership reform program (1983-89) helped increase in financial intermediation in the economy but the overall banking efficiency declined due to the presence of collusive behavior among banks followed by directed credits of the government. There were also improper accounting system for recording accrued interest income, lack of supervision on the part of Bangladesh Bank, inadequate support for debt recovery, and absence of prudential rules and regulations that can correct financial failures. All these phenomena ultimately reflected in declining profitability of the banking system. This situation demanded further reform for the banking sector.

(b) Financial Sector Reform Program (1990-1995).

The financial sector reform program (FSRP) was launched under Financial Sector Adjustment Credit (FSAC) of the World Bank in 1990 with the following objectives:

- Gradual deregulations of the interest rate structure with a view to improving the allocative efficiency;
- Providing market oriented incentives for priority sector lending;
- Making subsidies in the priority sectors more transparent;
- Adoption of appropriate monetary policy;
- Improvement in debt recovery environment; and
- Strengthening of the capital markets.

Accordingly, the FSRP brought about a number of developments in the banking system of Bangladesh. Table 2, shown below, summarizes this development into four broad groups such as: (i) screening, (ii) monitoring, (iii) transparency, and (iv) lender's recourse regulations. For instance, in case of screening, a ‘lending risk analysis manual’ was put into operation, directed lending and subsidy to the priority sectors were reduced, interest rates were liberalized, insiders’ loan was controlled and banks were asked to follow the credit information bureau (CIB) report formulated by Bangladesh Bank. In the case of monitoring, the performance-planning system, large loan reporting system and the supervisory role of the central bank was given emphasis while, to ensure stability and transparency in financial intermediations, minimum capital requirement (Tk. 100 crore), capital adequacy ratio (8% of the risk weighted assets), CAMEL rating and the International Accounting Standard for the preparation of bank accounts were introduced. Banks were also asked to classify their loans, make provision thereof as well as instructed to disregard accrued interest on classified loans as their income so as to protect them from vulnerability. Alongside these measures the Money Loan Court Act and Bankruptcy Act were enacted to improve the loan recovery performance.

Table 2: New Loan Laws and Regulations

Screening	Monitoring	Transparency	Lenders recourse
i) LRA ii) CIB iii) Loans to Insiders and Connected Parties iv) Interest Rate Deregulation	i) NLLC ii) LLRS iii) PPS iv) Off-site Supervision v) Repo and Reverse Repo Operations	i) Loan classification and Provisioning ii) Risk based Capital Adequacy iii) CAMELS rating iv) Adoption of IAS 30	i) Money Loan Court Act, 1990 ii) Bank Companies Act 1991 iii) Financial Institution Act 1993

Source: Choudhury and Moral 1997.

However, a review of the outcomes of the FSAC indicates that from the viewpoint of implementation, the reform measures were implemented satisfactorily, but from the viewpoint of desired outcome, the results were not very encouraging. For instance, the share of SCBs and PCBs in total deposits remained constant nearly within 62% and 27% respectively during the FSRP period (1991-95), but the share of deposits for DFIs increased to 6.34% in 1995 from 4.88% in 1991 (Table 3). On the other hand, the share of FCBs in total deposits declined from 6.91% in 1991 to 4.54% in 1995 with a volatile trend. Similarly, the SCBs' share of advances during the stated period was volatile. Somehow, SCBs' share increased from 52.66% in 1991 to 53.13% in 1995. PCBs' share in advance increased from 22% in 1991 to 27.59% in 1995 but the share of FCBs and DFIs declined from 6.01% to 5.14% and 19.33% to 14.14% respectively during the stated period. However, the amount of net profit of the SCBs increased from Tk. (-) 38.78 in 1991 crore to Tk.112.37 crore in 1995. Similar trend is observed in the case of PCBs and FCBs, but the DFIs shown to have a declined trend in their net profit that reduced Tk. (-) 250.88 crore in 1995 from Tk.9.81crore in 1991 (Table-3).

Table-3: Distribution of Deposits, Advances and Net Profit by Category of Banks

Year	SCBs			PCBs			FCBs			DFIs		
	Share of deposits (%)	Share of Advances (%)	Net Profit (Tk. in crore)	Share of deposits (%)	Share of Advances (%)	Net Profit (Tk. in crore)	Share of deposits (%)	Share of Advances (%)	Net Profit (Tk. in crore)	Share of deposits (%)	Share of Advances (%)	Net Profit (Tk. in crore)
1991	61.18	52.66	-38.78	26.99	22.00	-11.45	6.95	6.01	25.32	4.88	19.33	9.81
1992	62.78	49.56	-143.39	25.63	24.75	-7.62	6.48	6.13	38.36	5.11	19.59	-193.4
1993	62.16	52.16	-31.90	28.33	26.25	-9.46	4.17	4.71	54.36	5.44	16.88	-97.14
1994	62.52	50.60	18.82	27.22	27.35	16.40	3.95	5.01	68.32	6.31	17.04	-307.10
1995	61.19	53.13	112.37	27.93	27.59	76.49	4.54	5.14	90.76	6.34	14.14	-250.88
1996	61.33	52.88	28.11	27.83	26.73	137.87	5.30	5.40	98.72	5.54	14.99	-292.07
1997	60.26	53.03	16.77	28.19	26.94	199.73	6.40	5.77	135.02	5.15	14.26	-209.12

1998	60.21	51.09	-5.98	27.22	25.58	160.97	7.36	5.21	149.43	5.02	17.92	-261.02
1999	59.91	50.08	-16.66	27.54	25.92	178.44	6.99	5.21	149.70	5.56	18.07	-296.70
2000	55.81	48.53	24.58	30.30	29.16	309.97	7.93	5.22	220.46	5.96	17.09	-532.37
2001	50.92	46.50	38.24	36.49	34.87	514.48	6.85	6.86	259.81	5.64	11.77	-79.81
2002	50.32	45.56	19.88	36.84	36.16	458.79	7.02	6.81	224.08	5.82	11.47	-114.64
2003	46.00	41.7	68.21	41.1	40.8	475.59	7.4	7.3	276.44	5.5	10.2	-24.32
2004	42.8	39.6	-1904.72	44.3	43.5	736.49	7.2	7.2	392.01	5.7	9.7	-87.89
2005	40.0	37.4	-1209.41	47.0	45.6	954.71	7.2	7.3	470.18	5.8	9.7	-240.68
2006	35.2	32.7	-4415.92	51.3	47.7	931.54	8.1	11.8	624.12	5.4	7.8	-123.00
2007	32.6	33.1	-809.10	53.5	51.4	1995.75	8.5	8.2	723.33	5.4	7.3	-143.62
2008	29.6	31.1	897.68	56.6	54.2	2818.66	8.4	8.0	1138.42	5.4	6.7	-167.17
2009	28.6	28.6	2533.58	59.0	57.4	3947.72	7.0	7.4	708.78	5.3	6.6	40.16
2010	28.1	28.5	1176.26	60.9	58.8	6032.03	6.1	6.6	645.62	4.9	6.1	105.76

Source: Bangladesh Bank, Economic Trends, various issues, Bangladesh Bank, Annual Report, various issues.
Note: (1) Net profit figures are after Tax.
(P) = Provisional.

Another important area that the FSRP brought under attention is the failure to curb NPLs of the banking system of Bangladesh. For instance, in 1990, 26.09% of the total loans were classified as NPLs, which increased to 32.04% in 1995. As per different cluster of banks, NPLs for SCBs increased to 31% in 1995 from 27.95% in 1990, and NPLs for PCBs increased to 39.43% from 23.73% during the same period (Banking Regulation & Policy Department, Bangladesh Bank, 1995). NPLs for FCBs, however, reduced to 5.40% in 1995 from 20.65% in 1990. In addition, the percentage of rural deposit and advances remained more or less stable i.e. 21.9% to 22.1% and 19.8% to 19.8% respectively during the FSRP period (Schedule Bank Statistics, various issues, Bangladesh Bank).

This implies that the FSAC failed to address the issue of efficient resource allocation in terms of access to credit by productive sectors. Interest rate deregulation could not instill competition in the sector rather the banking sector remained somewhat fragmented and oligopolistic. Besides, management efficiency in the SCBs could not be perceptibly improved despite implementation of new operational and management/loan quality assessment tools such as the capital adequacy and the loan classification and provisioning system. This implies that the FSAC placed more emphasis on economic deregulations rather than on broadening of the prudential regulation and supervision for the sector. It is argued that it would have been more appropriate, in the context of Bangladesh, to introduce measures to deal with the "debt default syndrome" and the management of the SCBs, prior to more general interest rate liberalization in order to improve the financial health of the banking sector of Bangladesh. The impact evaluation of FSRP-TA Project (1995) itself recognized that though many of the operational building blocks needed to permit SCBs to function soundly had been provided successfully by FSRP, yet effective incorporation of new operating procedures required leadership and vision on the part of senior management, which was not ubiquitous in the SCBs. Almost same conclusion was drawn by Cookson and Alamgir (1993), when they said, "the expected improvement of the management of SCBs has not been forthcoming after the financial sector reform measures are taken in Bangladesh." All these scenarios, in fact, demanded a third stage reform program for the banking system of Bangladesh.

(c) Banking Reform Committee (BRC)/Commercial Bank Restructuring Project (CBRP) (1996-2002).

In order to fix the problem unveiled by FSRP, the government formed a Banking Reform Committee (BRC) in October 1996. The broad objectives of BRC were to place recommendations in regard to:

(i) Improving debt recovery environment of banks;
(ii) Increasing income, reducing expenditure and upgrading service standard of banks;
(iii) Improving the personnel quality of the banks;
(iv) Strengthening supervisory capacity of Bangladesh Bank; and
(v) Any other related important issues, considered by the committee.

In May 1997, the government also undertook a Commercial Bank Restructuring Project (CBRP) funded by the World Bank. The CBRP mainly focused on improving the supervisory and regulatory framework of the commercial bank, enforcement of the power of Bangladesh Bank in loan monitoring, and restructuring the legal framework related to finance and banking.

The report of the Bank Reform Committee (BRC) gave highest priority on restructuring of the supervisory and regulatory set up for ensuring strong system of enforceable oversight of banks. At the same time, the CBRP also asked for strengthening of legal framework and effective restructuring of the SCBs. For reducing the political interference, BRC proposed not to interfere with the affairs of the Bangladesh Bank Board and to set a clear-cut guideline for deficit financing of the government. The BRC also suggested that the Directors of the NCB boards cannot be Member of Parliament or an office bearer of a political party or a loan defaulter. The BRC also opined that the 'regulatory forbearance' on the part of the Bangladesh Bank has been responsible for the continuing problems with the “problems banks”. The government also removed the floor rates of deposits in 1997. Finally, in August 1999, the government eliminated interest band on agriculture and small and medium enterprises (SMEs) loans.

Though one should not expect that within the BRC/CBRP period (1996-2002), all predetermined objectives would be achieved, yet the movement of key financial variables during 1996-2002 should be looked into to see the direction of movement of the banking variables. For instance, the share of SCBs in total deposits declined from 61.33% in 1996 to 50.32% in 2002. But the share of PCBs increased from 27.83% to 36.84% during the above period (1996-2002). On the other hand, the share of FCBs increased from 5.30% in 1996 to 6.81% in 2002. Similarly, the share of DFIs' also increased from 5.54% to 5.82% during the period 1996-2002 (Table 3).

In regard to advances, SCBs' share in advances declined from 52.88% to 45.56%, PCBs' share sharply increased from 26.73% to 36.16%, the share of FCBs also increased from 5.40% to 6.81%; but the share of DFIs sharply declined from 14.99% to 11.47% during the FSRP period 1996-2002. The amount of net profit of the SCBs during the same period declined from Tk. 28.11 crore to Tk.19.88 crore, whereas PCBs' net profit increased from Tk.137.87 crore to Tk.458.79 crore. FCBs also remarkably earned Tk.224.08 crore in 2002 from Tk.98.72 crore in 1996. Importantly, the net loss of DFIs declined from Tk.292.07 crore to Tk. 114.64 crore during the period of 1996-2002 (Table-3).

This indicates that the BRC/CBRP initiatives improved the financial health of the banking system to a great extent, however, it failed to curb the NPLs of the banking industry. For instance, the NPL ratio of the banking system reached to the highest level (41.11%) in 1999, although it reduced to 28.01% in 2002. There was also unsatisfactory performance with respect to the settlement of cases in Money Loan Court and under the PDR Act. In addition, poor recovery, withdrawal of refinance and interest rate band aggravated the negative flow in the rural banking after the BRC/CBRP program instead of improving it. In fact, the scheduled banks' advances to the agricultural sector reduced to 11.27% in 2002 from 21.07% in 1990 (Schedule Bank Statistics, various issues, Bangladesh Bank).

As previously mentioned, the government liberalized interest rate fully in 1999 to make the banking system market driven and competitive. In such a market-driven system, one of the important indicators of competitiveness in the financial markets is the interest rate spread (the difference between lending and deposits rate of interest). The higher the level of competitiveness, the lower the interest rate spread. However, in the wake of the deregulation of interest rates it has been observed that the spread has increased over the years in Bangladesh — the spread in the banking sector increased from 5.88 in 1990-91 to 7.30 in 1995-96 (Table 4). In 2002-03, the spread was declined to 6.49%, but in terms of competitiveness, this remained very high for the banking system. In other words, the high nominal spread indicates that previous reforms are yet to bring about the expected degree of competitiveness in the banking system, rather, market distortions have increased. Arguably, the presence of higher NPLs is one of the factors responsible for those market distortions, but government-led distortions (for example, high interest rates on government savings certificates) and misconceived price strategies of the bank management are also responsible for these unusually high spreads. Fortunately, the real interest spread is found negative in most of the years during the period of 1990-91 to 2002-03, indicating that the financial liberalization policies provided incentives for banks to expand their bank branches as well as financial intermediations.

Table-4: Interest Rates, Spread and Inflation Rates (All Banks)

Year	Deposit Rate	Lending Rate	Spread	Inflation	Real Spread
1990-1991	9.11	14.99	5.88	8.9	-3.02
1991-1992	8.11	15.12	7.01	5.1	1.91
1992-1993	6.51	14.39	7.88	4.3	3.58
1993-1994	5.34	12.78	7.44	3.28	4.16
1994-1995	4.86	12.22	7.36	8.87	-1.51
1995-1996	6.11	13.41	7.30	6.65	0.65
1996-1997	6.67	13.69	7.02	3.96	3.06
1997-1998	7.07	14.02	6.95	8.66	-1.71
1998-1999	7.28	14.16	6.88	7.06	-0.18
1999-2000	7.21	13.86	6.65	2.79	3.86
2000-2001	7.03	13.75	6.72	1.94	4.78
2001-2002	6.74	13.16	6.42	2.79	3.63
2002-2003	6.29	12.78	6.49	4.38	2.11
2003-2004	5.65	11.01	5.36	5.83	-0.47
2004-2005	5.62	10.93	5.31	6.48	-1.17
2005-2006	6.68	12.06	5.38	7.16	-1.78
2006-2007	6.85	12.78	5.93	7.20	-1.27

2007-2008	6.95	12.29	5.34	9.94	-4.6
2008-2009	7.01	11.87	4.86	6.66	-1.8
2009-2010	6.01	11.31	5.30	7.31	-2.01
2010-2011	7.27	12.42	5.15	8.88	-3.73

Note: Rate of interest on scheduled banks (weighted average);
Source: Bangladesh Bank, Economic Trends Various issues.

(d) Current Reform Programs (2003 onwards)

After the expiry of BRC/CBRP program, the government of Bangladesh continued undertaking different measures and initiatives to make the banking system robust and competitive. A summary of these measures is presented below in Box 1.

Box 1: Selected Current Reforms in the Banking Sector

- Formation of Audit Committee by individual banks to assist the Board in fulfilling its oversight responsibilities.
- Provision for appointing two independent directors representing the depositors' interest.
- Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes.
- Several provisions of the three important Acts relating to Banking, viz. the Bangladesh Bank Order, 1972, the Bank Company Act, 1991 and the Banks Nationalization Order, 1972 have been amended during the period 2003 with a view to further strengthening the activities of the banking sector, bringing dynamism and extending greater autonomy to the central bank.
- Enactment of the Artha Rin Adalat Ain 2003 to provide mainly for speedy procedures for obtaining decrees and execution. Provision was also made for Alternative Dispute Resolution to ensure early settlement of disputes through settlement conference and negotiations.
- Development of a basic risk management model for selected areas of banking operation.
- Promulgation of "Money Laundering Prevention Act, 2012 repealing Money Laundering Prevention Act, 2009 and Anti Terrorism (Amendment) Act, 2012".
- High priority is accorded to ensure Corporate Governance in Banks.
- Introduction to uniform account opening and KYC profile form for all banks. Besides, the National Payment System Council (NPSC) was reorganized to support the development of sound and efficient payment, clearing and settlement systems, and to serve as a forum for cooperation in domestic and international payment matters.
- Mapping of External Credit Assessment Institutions (ECAIs) rating with the Bangladesh Bank Rating Grade.
- Introduction to New Capital Accord (Basel II) and Risk Based Capital Adequacy (RBCA) for Banks, and preparation to introduce Basel III".
- Prudential Guidelines for Consumer Financing and Small enterprise Financing have been issued.
- Marking to Market Based Revaluation of Treasury Bills & Bonds Held by the Banks.
- Introduction of CAMELS supervisory rating system, move towards risk-based supervision, consolidated supervision of financial conglomerates, strengthening of off-site surveillance through control returns.
- Corporatization of nationalised commercial banks (NCBs)
- Stress Testing became mandatory for the Schedule Banks.
- Introduction to Corporate Social Responsibility
- Safeguard Policy for the banks on capital market activities.
- Financial inclusion.
- Green Banking- a new dimension.
- On-line CIB services.

Source: Banking Regulation & Policy Department, Department of Off-Site Supervision, Bangladesh Bank.

V. Economic Outcomes

As pointed out in the previous section, the banking system of Bangladesh undertook different reform measures to improve overall efficiency and stability of the banking system. However, to what extent this has been successful? In this section an attempt has been made to address this issue by investigating several performance indicators such as (1) profitability (proxied as profit after tax divided by average assets [ROA]), and profit after tax divided by average stockholders' equity (ROE); (2) earnings efficiency (measured as interest rate spread (IRS) and net interest margin (NIM); (3) cost efficiency (proxied as expenditure over income ratio); and (4) share of non-performing loans. In addition to these indicators, capital adequacy, liquidity, and technological readiness of different clusters of banks have been taken into account.

(1) Profitability

Table-5 presents ROA and ROE ratios of different clusters of banks over the period 1998-2009. As it is observed from table 5, ROA and ROE ratios differ largely by types of banks even after the reform measures. The ROA of the SCBs were found to be nil during the period 1998-2000, which were even worst (negative) in case of the DFIs. In 2010 these have been 1.1 percent and less than 1.0 percent respectively. SCB's return on equity ratio was 0.3 percent in 1998, but it suddenly rose to 22.52 percent and 26.4 percent in 2008 and 2009 respectively (Table-5). In the case of DFIs, the ROE position remained worst (-171.7 percent) in 2009 due to huge operating losses. On the other hand, the PCB's ROA ratio is found to have a positive but inconsistent trend, whereas the FCB's showed a consistently better trend over the last 14 years. The superior performance of foreign banks might be due to their technological advantage and product differentiation capabilities which might have been eroded to an extent by the local private banks in recent years. Notably, the difference of ROE between PCBs and FCBs reduced substantially since the year 2005. The ROE of PCBs and FCBs were strong (21.0 percent and 22.4 percent respectively) in 2009. This implies that there is a growing competition between FCBs and PCBs after the reform measures.

Table-5: Profitability Ratios by Type of Banks

(In percent)

Type of Banks	Return on Assets (ROA)													
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 June
SCBs	0.0	0.0	0.0	0.06	0.10	0.08	-0.14	-0.10	0.00	0.00	0.70	1.0	1.1	0.6
DFIs	-2.8	-1.6	-3.7	0.67	0.33	-0.04	-0.13	-0.13	-10.15	-0.27	-0.60	0.4	0.2	-0.3
PCBs	1.2	0.8	0.8	1.12	0.75	0.69	1.24	1.06	1.07	1.28	1.37	1.6	2.1	1.6
FCBs	4.7	3.5	2.7	2.80	2.36	2.55	3.15	3.09	3.34	3.10	2.94	3.2	2.9	3.6
All Banks	**0.3**	**0.2**	**0.0**	**0.69**	**0.52**	**0.49**	**0.69**	**0.60**	**0.79**	**0.89**	**1.1**	**1.4**	**1.8**	**1.3**

Contd. table-5

Type of Banks	Return on Equity (ROE)													
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 June
SCBs	0.3	-1.1	1.7	2.39	4.21	3.00	-5.75	-6.90	0.00	0.00	22.52	26.4	18.4	10.0
DFIs	-36.3	-29.4	-68	12.28	5.76	-0.61	-2.14	-2.14	-2.00	-3.40	-6.94	-171.7	-3.2	-5.2
PCBs	26.8	15.3	17	20.94	13.56	11.37	19.53	18.10	15.19	16.65	16.37	21.0	20.9	15.6
FCBs	40.7	41.8	27.3	32.39	21.47	20.39	22.47	18.40	21.53	20.44	17.75	22.4	17.0	20.2
All Banks	**6.6**	**5.2**	**0.3**	**15.90**	**11.56**	**9.75**	**12.97**	**12.40**	**14.13**	**13.78**	**15.60**	**21.7**	**21.0**	**15.5**

Source: Bangladesh Bank Quarterly, Annual Reports of different years.

*ROA and ROE for state owned commercial banks have become nil due to provision shortfall/ cumulative loss.

(2) Earnings Efficiency

Table-6 presents deposit rates, lending rates, and spreads of the clusters of banks over the period 1990-2010. As it is revealed from Table-6, the banking system remained fragmented and distorted even after the reform program. For instance, in almost all cases the lending rates, the nominal spreads and the real spreads of SCBs are found to be lower while comparing the same with the PCBs and FCBs (Table 6). In fact, the average real spread of SCBs was much lower, -0.29 only in 2010, in comparison to the PCBs (1.10%) and FCBs (2.25%)[2]. However, with respect to the nominal deposit rates among the cluster of banks, SCBs are found to be higher in comparison to that of PCBs and FCBs during the period 1995-2001 whereas, in other periods (1990-94 and 2002 –2010), a reverse situation (lower deposit rates) can be seen, except in some cases (Table- 6)[3]. Importantly, the nominal deposit and lending rates for every cluster of banks are found in a declining trend, except in some cases, indicating increased competition within the banking system during this period (Table-6). But with respect to the real spreads, a varied level of performance is found among SCBs, PCBs and FCBs. While real spreads of FCBs are found positive in most of the cases, the real spread of SCBs and FCBs are found to be varied with negative and positive outcomes. Importantly, the real spread of SCBs and PCBs became negative from the year 2004 onwards as compared to PCBs during the same period that ultimately reflects that the banking system remained uncompetitive, distorted and inefficient even in the liberalized regime.

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[2] The reason is that the government continued directed lending at an administered rate in certain sectors (especially state owned enterprises in energy and civil aviation) through nationalized commercial banks as well as government owned specialized banks (SBs). Also, the government continues borrowing from the public by selling National Savings Directorate Certificate (NSDC) at a non-market rate (presently 11.5%) which also affects banks to set their lending rates and spreads as well.

[3] This indicates the reflection of an important political change in Bangladesh that took place in the year 1990 by way of taking power of a democratic government which encouraged politicians to set-up private commercial banks. There is also effect of stock market crash in Bangladesh (1996-1997) that derailed the trust and confidence of the investors to invest in shares and to deposit in banks. In consequence, the government took initiative to restore the confidence of the depositors by offering higher rates by the nationalized commercial banks.

Table-6: Interest Rate, Inflation and Spread of Major Cluster of Banks

Nationalized Commercial Banks

Year	Deposit Rate	Lending Rate	Inflation	Nominal Spread	Real Spread
1990	9.29	14.06	9.3	4.77	-4.53
1991	9.12	14.03	8.31	4.91	-3.4
1992	6.98	14.36	4.56	7.38	2.82
1993	6.08	13.14	2.73	7.06	4.33
1994	5.14	11.63	3.3	6.49	3.19
1995	5.43	11.85	8.9	6.42	-2.48
1996	6.89	13.16	6.7	6.27	-0.43
1997	7.3	13.81	3.96	6.51	2.55
1998	7.43	13.98	8.66	6.55	-2.11
1999	7.69	13.69	7.06	6	-1.06
2000	7.36	13.36	2.79	6	3.21
2001	6.9	12.93	1.94	6.03	4.09
2002	6.27	12.42	2.79	6.15	3.36
2003	5.82	11.59	4.38	5.77	1.39
2004	4.88	9.75	5.83	4.87	-0.96
2005	4.59	10	6.49	5.41	-1.08
2006	5.21	10.84	7.16	5.63	-1.53
2007	4.96	11	7.2	6.04	-1.16
2008	4.96	8.92	9.94	3.96	-5.98
2009	5.04	8.51	6.66	3.47	-3.19
2010	5.01	9.18	7.31	4.17	-3.14
Average	**6.30**	**12.01**	**6.00**	**5.71**	**-0.29**

contd. table-6

Private Commercial Banks

Year	Deposit Rate	Lending Rate	Inflation	Nominal Spread	Real Spread
1990	9.13	16.44	9.3	7.31	-1.99
1991	9.12	16.5	8.31	7.38	-0.93
1992	8.33	16.73	4.56	8.4	3.84
1993	6.49	14.97	2.73	8.48	5.75
1994	5.33	14.09	3.3	8.76	5.46
1995	4.88	14.05	8.9	9.17	0.27
1996	5.6	14.41	6.7	8.81	2.11
1997	6.21	14.66	3.96	8.45	4.49
1998	6.3	14.88	8.66	8.58	-0.08
1999	6.49	14.91	7.06	8.42	1.36

2000	6.75	14.71	2.79	7.96	5.17
2001	6.84	14.39	1.94	7.55	5.61
2002	7.07	14.12	2.79	7.05	4.26
2003	6.99	13.54	4.38	6.55	2.17
2004	6.46	12.00	5.83	5.54	-0.29
2005	7.4	12.47	6.49	5.07	-1.42
2006	8.62	14.06	7.16	5.44	-1.72
2007	8.44	13.43	7.2	4.99	-2.21
2008	8.91	13.61	9.94	4.7	-5.24
2009	7.14	12.43	6.66	5.29	-1.37
2010	6.8	12.02	7.31	5.22	-2.09
Average	**7.11**	**14.21**	**6.00**	**7.10**	**1.10**

contd. table-6

Foreign Commercial Banks

Year	Deposit Rate	Lending Rate	Inflation	Nominal Spread	Real Spread
1990	6.58	15.54	9.3	8.96	-0.34
1991	5.55	14.5	8.31	8.95	0.64
1992	4.7	14.12	4.56	9.42	4.86
1993	3.46	12.86	2.73	9.4	6.67
1994	2.69	11.86	3.3	9.17	5.87
1995	3.52	11.13	8.9	7.61	-1.29
1996	4.71	12.15	6.7	7.44	0.74
1997	5.53	12.8	3.96	7.27	3.31
1998	6.27	13.49	8.66	7.22	-1.44
1999	5.58	13.15	7.06	7.57	0.51
2000	5.04	12.68	2.79	7.64	4.85
2001	4.04	12.27	1.94	8.23	6.29
2002	4.57	11.97	2.79	7.4	4.61
2003	4.78	12.1	4.38	7.32	2.94
2004	4	11.45	5.83	7.45	1.62
2005	3.96	11.83	6.49	7.87	1.38
2006	4.77	12.89	7.16	8.12	0.96
2007	4.81	13.57	7.2	8.76	1.56
2008	5.25	14.58	9.94	9.33	-0.61
2009	3.81	13.07	6.66	9.26	2.6
2010	3.01	11.84	7.31	8.83	1.52
Average	**4.60**	**12.85**	**6.00**	**8.25**	**2.25**

Source: Scheduled Banks Statistics, 1990-2010, Bangladesh Bank

Table-7 portrays the aggregate net interest income (NII) of the banking sector. It reveals that the NII of the banking system positively and consistently increased from Taka 6.3 billion in 1997 to Taka 121.9 billion in 2010. However, the NII of the SCBs became negative in 2000-2004. Since 2005, SCBs have been able to increase their net interest income (NII) by reducing their cost of fund. In 2010, the NII of SCBs was Taka 19.8 billion. On the other hand, the DFIs showed a positive trend since 2000 and their NII was Taka 6.2 billion in 2010. Likewise, the NII of the PCBs has shown positive trend since 1997. They also exhibited incredibly high trends over the period from 2000 to 2010. As a whole, the trend of NII indicates that the PCBs and the FCBs are charging interests at a very high rate on their lending as compared to the interest they are paying to the depositors. This also implies that the banking system of Bangladesh remained fragmented and oligopolistic.

Table-7: Net interest income by type of banks

(billion Taka)

Bank types	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 June
SCBs	2.7	2.2	3.1	-1.2	-1.8	-1.5	-0.3	-1.1	7.7	9.0	7.4	7.9	12.1	19.8	10.0
DFIs	-0.1	0.5	-0.1	1.0	2.7	1.4	1.3	1.8	1.0	1.7	1.4	1.9	1.9	6.2	4.0
PCBs	1.7	2.3	3.0	6.1	9.2	10.2	12.0	13.7	21.0	25.4	36.1	48.5	56.7	82.8	42.2
FCBs	2.0	2.2	1.8	2.5	3.3	3.4	3.6	4.2	5.6	8.2	69.9	12.6	10.7	13.0	8.4
Total	**6.3**	**7.1**	**7.8**	**8.4**	**13.4**	**13.5**	**16.6**	**18.3**	**35.3**	**44.3**	**54.8**	**70.9**	**81.5**	**121.9**	**64.6**

Source: Bangladesh Bank Quarterly, & Annual Reports of different years.

(3) Cost Efficiency

Table-8 presents expenditure to income ratio as an indicator of the operating efficiency of the banking system. It reveals from Table-8 that expenditure-income (EI) ratio of the DFIs was very high with 180.4 percent in 1998. This was mainly because the DFIs made loan loss provisions by debiting 'loss' in their books. The position however improved after 2000 and the ratio came down to 89.1 percent and 95.9 percent in 2001 and 2002 respectively. However, it again rose to 101.1 percent in 2003. Later on, the DFI's EI ratios were increased to 112.1 percent in 2009 due to huge operating losses and improved to 87.8 percent in 2010. Similarly, the EI ratio of the SCBs exceeded 102.3 percent in 2004, which was improved to 75.6 percent in 2009. This high EI ratio of SCBs mainly attributed to their higher administrative and overhead expenses, and suspension of income against NPLs. Likewise, the EI ratios of PCBs were found to be substantially high due to deduction of loan loss provision, other assets and corporate tax from current income. However, the FCB's EI ratio is found to be the lowest in the banking system, indicating that FCBs are better operationally managed than SCBs, DFIs, and PCBs.

Table-8: Expenditure-Income Ratio by Type of Banks

(percent)

Bank types	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 June
SCBs	99.4	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	65.9
DFIs	142.3	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	101.7
PCBs	85.9	86.3	90.4	90.8	88.1	91.9	93.1	87.1	89.3	90.2	88.8	88.4	72.6	67.6	69.1
FCBs	59.7	60.1	67.4	77.7	75.7	78.3	80.3	76.3	70.8	71.1	72.9	75.8	59.0	64.7	45.4
Total	95.3	95.4	96.6	99.9	91.2	93.3	93.9	90.9	92.1	91.4	90.4	87.9	72.6	70.9	69.1

Source: Bangladesh Bank Annual Report of different years

(4) Non-performing Loans

The ratios of non-performing loans (NPLs) to total loans as per different clusters of banks are provided in Table-9 to understand the asset quality of the banking system of Bangladesh. Table-9 reveals that FCBs have the lowest and DFIs have the highest ratio of gross NPLs to total loans. SCBs had gross NPLs to total loans ratio of 14.1 percent whereas in case of PCBs, FCBs and DFIs, the ratios were 3.5, 3.1 and 21.8 percent respectively in 2011.

Table-9: Trend of Classified Loans (Gross) by Clusters of Banks.

(in percentage)

Bank types	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
SCBs	27.59	26.30	31.86	32.23	32.12	31.00	32.55	36.6	40.4	45.6	38.6	37.0	33.7
DFIs	-	-	-	-	-	-	-	65.7	66.7	65.0	62.6	61.8	56.1
PCBs	23.73	34.20	31.10	44.42	44.53	39.43	34.77	31.4	32.7	27.1	22.0	17.0	16.4
FCBs	20.65	11.87	12.64	10.46	8.89	5.40	4.72	3.6	4.1	3.8	3.4	3.3	2.5
Total	**26.09**	**25.00**	**30.67**	**34.86**	**34.85**	**32.04**	**31.49**	**37.5**	**40.7**	**41.1**	**34.9**	**31.5**	**28.0**

Contd. Table 9

Bank types	2003	2004	2005	2006	2007	2008	2009	2010	2011
SCBs	29.0	25.3	21.4	22.9	29.9	25.4	21.4	15.7	14.1
DFIs	47.4	42.9	34.9	33.7	28.5	25.5	25.9	24.2	21.8
PCBs	12.4	8.5	5.6	5.5	5.0	4.4	3.9	3.2	3.5
FCBs	2.7	1.5	1.3	0.8	1.4	1.9	2.3	3.0	3.1
Total	**22.1**	**17.6**	**13.6**	**13.2**	**13.2**	**10.8**	**9.2**	**7.3**	**7.1**

Source: Compiled from various issues of Bangladesh Bank Annual Report of different years

Note: Data of DFIs are not available for the period 1990-1996.

Notably, the ratio of NPLs to total loans of all the banks demonstrated an encouraging trend since its peak (41.1 percent) in 1999, although the aggregate ratio is still as high as 7.1 percent (in 2011). The reason is being high NPLs of the SCBs and the DFIs. The SCBs and DFIs continue to have high level of NPLs mainly due to substantial loans provided by them on considerations other than commercial and under directed credit programs during the 1970s and 1980s. Poor appraisal and inadequate follow-up and supervision of the loans disbursed by the SCBs and DFIs in the past eventually resulted in massive booking of poor quality assets which still remained significant in the portfolio of these banks. Furthermore, these banks were reluctant to write-off the historically accumulated bad loans because of poor quality of underlying collaterals. 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. It is worthwhile to note that although continual reduction of NPLs indicates overall improvement in the prudence of the banking operation, the high nominal lending rates followed by high absolute level of NPLs signify that there remains room for creating bank rents to monitor the borrowers effectively.

As regards to provision adequacy against NPLs, Table-10 presents a comparative picture of different clusters of banks since 1997. Table-10 shows that actual provision fell short of required provision for all categories of banks, except the FCBs, during the period of 2001-2008. This implies that the banking system lacks efficiency in fund management especially in disbursing and recovering loans. However, after the year 2008, actual provisioning scenario for SCBs has been reversed. The actual provision remained higher than required provision for SCBs in 2009 mainly because of intensified recovery drive and rescheduling of overdue loans under the new management of the SCBs. This was supported by the Election Commission's requirement of non-defaulter status of potential candidates in national and local elections. For

FCBs, the amount of actual provision remained higher than required provision throughout the whole period. It is noteworthy to mention that while the shortfall in the provisions for all PCBs is improving, the shortfall for DFIs remained high during the whole period (2001-2011) indicating financial uneasiness in the overall banking system of Bangladesh.

Table-10: Comparative Position of Provision Adequacy by Different Clusters of Banks

(billion Taka)

Year	Items	SCBs	DFIs	PCBs	FCBs
2001	Required provision	59.54	18.37	23.08	1.25
	Provision maintained	20.71	17.99	19.61	1.56
	Provision maintenance ratio (%)	34.78	97.93	84.97	124.80
2002	Required provision	61.51	17.09	27.85	1.23
	Provision maintained	18.94	17.30	22.81	1.57
	Provision maintenance ratio (%)	30.79	101.22	81.90	127.64
2003	Required provision	53.3	14.7	23.1	1.4
	Provision maintained	3.5	14.6	17.5	1.7
	Provision maintenance ratio (%)	6.6	99.2	75.4	125.2
2004	Required provision	50.7	13.5	22.3	1.3
	Provision maintained	3.4	12.4	18.5	1.6
	Provision maintenance ratio (%)	6.7	91.9	83.0	123.1
2005	Required provision	52.8	13.4	20.5	1.6
	Provision maintained	13.2	9.3	17.8	2.2
	Provision maintenance ratio (%)	25.0	89.4	85.8	137.5
2006	Required provision	61.6	14.8	27.5	2.2
	Provision maintained	18.2	9.1	22.6	3.1
	Provision maintenance ratio (%)	229.5	61.5	82.2	140.9
2007	Required provision	71.4	17.3	34.9	3.5
	Provision maintained	56.5	8.7	28.2	3.8
	Provision maintenance ratio (%)	79.1	50.3	80.5	108.6
2008	Required provision	73.1	17.0	41.3	4.6
	Provision maintained	75.6	8.6	37.0	5.0
	Provision maintenance ratio (%)	103.4	50.6	89.6	108.7
2009	Required provision	66.0	17.5	46.5	4.6
	Provision maintained	79.5	8.9	43.6	5.9
	Provision maintenance ratio (%)	120.5	50.9	93.8	128.3
2010	Required provision	70.64	19.07	53.31	6.19
	Provision maintained	69.87	13.29	51.78	7.39
	Provision maintenance ratio (%)	98.9	69.7	97.1	119.4
30June 2011	Required provision	69.8	20.6	60.0	7.5
	Provision maintained	69.8	14.3	60.0	8.2
	Provision maintenance ratio (%)	100.0	69.4	100.0	109.3

Source: Bangladesh Bank Annual Report of different years

(5) Liquidity

The Statutory Liquidity Requirement (SLR) is one of the quantitative and powerful tools of monetary control of the central banks. Changes in SLR can have a marked effect on money and credit situation of a country. If the central bank raises average reserve requirement of the commercial banks, this would create a reserve deficiency or decrease in available reserve of depository institutions. If the banks are unable to secure new reserves, they would be forced to contract both earnings and deposits which would result in a decline in the availability of credit and increase the market interest rates. The reverse would happen if the central bank lowers its reserve requirements.

Table-11 shows that the FCBs are having the highest liquidity ratios followed by the SCBs. This situation of constant surplus of liquidity warrants creation of effective demand for credit at lower costs. Last, all banks have maintained a sufficient liquidity position in terms of cash and balance with banks and the BB and investment in government securities, suggesting that they are relatively resilient to systemic banking crises.

Table-11: Liquidity Ratio by Type of Banks

(In percent)

	Liquid assets														
Bank types	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 June
SCBs	22.7	24.4	25.2	26.5	25.7	27.3	24.4	22.8	20.0	20.1	24.9	32.69	25.1	27.2	27.0
DFIs	16.9	16.6	15.7	16.2	15.3	13.7	12.0	11.2	11.2	11.9	14.2	13.7	9.6	21.3	22.1
PCBs	24.2	24.8	25.9	24.8	24.2	26.3	24.4	23.1	21.0	21.4	22.2	20.7	18.2	21.5	24.5
FCBs	31.2	39.8	51.3	34.7	34.1	41.5	37.5	37.8	41.5	34.4	29.2	31.3	31.8	32.1	31.1
Total	**23.3**	**25.2**	**27.0**	**26.1**	**25.3**	**27.2**	**24.7**	**23.4**	**21.7**	**21.5**	**23.2**	**24.8**	**20.6**	**23.0**	**25.9**

Contd. Table.11

	Excess Liquidity														
Bank types	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 June
SCBs	2.7	4.4	5.2	6.5	5.7	7.3	8.4	5.8	2.0	2.1	5.9	14.9	17.5	8.2	8.1
DFIs	9.7	9.2	8.7	9.9	8.9	6.9	5.8	4.7	6.2	3.8	5.5	4.9	7.1	2.3	3.1
PCBs	6.0	6.7	8.0	6.8	6.2	8.5	9.8	8.8	5.1	5.8	5.4	4.7	5.3	4.6	8.0
FCBs	11.2	19.9	31.4	14.8	14.3	21.8	21.9	21.9	23.5	16.4	11.2	13.3	21.8	13.2	12.2
Total	**4.5**	**6.4**	**8.3**	**7.5**	**6.7**	**8.7**	**9.9**	**8.7**	**5.3**	**5.1**	**8.9**	**8.4**	**9.0**	**6.0**	**7.9**

Source: Bangladesh Bank Annual Reports of different years.

(6) Capital Adequacy

Capital position of a bank reflects its ability to absorb risk deriving from its internal and external economic environment and creates confidence among depositors by the ability to protect their money from losses. It is also considered as one of the major financial soundness indicators of a bank. BB has commenced the implementation of Basel II from January 2009 and has provided banks with a Guideline on 'Risk Based Capital Adequacy for Banks" (Revised regulatory capital framework in line with Basel II vide BRPD circular no. 9/2008) to make the banks' capital more risk sensitive and shock absorbent. Beneath the Basel-II regime, SRP–SREP dialogue stands for an exclusive meeting between the team of Supervisory Review Process (SRP) of a scheduled bank and the team of Supervisory Review Evaluation Process (SREP) of BB on capital adequacy. The objective of the dialogue is to determine the adequate level of capital needed for a bank beyond minimum capital by reviewing the Internal Capital Adequacy Assessment Process (ICAAP). On this background, Table 12 provides risk weighted capital asset ratios by type of banks over the period 1992-2011. Table-12 shows that in 2010 the SCBs, DFIs, PCBs and FCBs maintained CAR of 8.9, -7.3, 10.1 and 15.6 percent respectively, implying that SCBs and DFIs are yet to comply the required 10% CAR.

Table-12: Risk Weighted Capital Asset Ratios by Type of Banks

(In percent)

Type of Banks	1992	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
SCBs	4.29	4.91	6.6	5.2	5.3	4.4	4.2	4.1	4.3	4.1	-0.4	1.1	7.9	6.9	9.0	8.9	9.5
DFIs	-	-	6.0	6.9	5.8	3.2	3.9	6.9	7.7	9.1	-7.5	-6.7	-5.5	-5.3	0.4	-7.3	-7.0
PCBs	5.00	4.97	8.3	9.2	11.0	10.9	9.9	9.7	10.5	10.3	9.1	9.8	10.6	11.4	12.1	10.1	10.4
FCBs	10.12	13.17	16.7	17.1	15.8	18.4	16.8	21.4	22.9	24.2	26.0	22.7	22.7	24.0	28.1	15.6	17.1
All Banks	**5.81**	**6.30**	**7.5**	**7.3**	**7.4**	**6.7**	**6.7**	**7.5**	**8.4**	**8.7**	**5.6**	**6.7**	**9.6**	**10.01**	**11.6**	**9.3**	**9.7**

Source: Bangladesh Bank, Annual Report of different years

(7) Modern and Innovative Products and Services

The existing modern and innovative banking products and services in Bangladesh are: (i) modern and innovative products- Debit Card and Credit Card, modern and innovative (ii) services- Automated Teller Machine (ATM), Point of Sales (POS), and e-services- Internet, Tele-banking, On-line-banking, Society for Worldwide Inter-Bank Financial Telecommunication (SWIFT), and Reuter. In this regard, Table-13 shows that out of different innovative technology driven products and services, significant response among the banks is observed in adopting ATM, on line, and SWIFT during the period 1998-2009. More specifically, the number of banks offering credit cards increased from 2 to 15, debit cards from nil to 24, ATM service from 1 to 30, POS services from 1 to 11, internet service from nil to 7, tele-banking service from nil to 4, any branch banking through individual bank on line network from 2 to 35, SWIFT service from 4 to 43, and Reuter service from 7 to 25. Although all these are positive developments, more attention is needed to enhance ICT capabilities of the banking system especially for the SCBs for successful implementation of e-banking all over the country.

Table-13: Adoption Frequency of Technology in Banking, 1998-2009

(No. of banks adopting modern and innovative technology driven products and services)

Year	Type	No.	Cr. Card	Dr. Card	ATM	POS	Internet	Tele banking	Online	SWIFT	Reuter
1998	SCBs	4	0	0	0	0	0	0	0	0	3
	DFIs	5	0	0	0	0	0	0	0	0	0
	PCBs	30	1	0	0	0	0	0	0	1	2
	FCBs	10	1	0	1	1	0	0	2	3	2
	Total	**49**	**2**	**0**	**1**	**1**	**0**	**0**	**2**	**4**	**7**
1999	SCBs	4	0	1	0	1	0	0	0	0	3
	DFIs	5	0	0	0	0	0	0	0	1	0
	PCBs	30	2	0	0	1	0	1	0	7	5
	FCBs	10	1	0	2	1	0	0	2	3	2
	Total	**49**	**3**	**1**	**2**	**3**	**0**	**1**	**2**	**11**	**10**
2000	SCBs	4	0	1	0	1	0	0	0	1	3
	DFIs	5	0	0	0	0	0	0	0	1	0
	PCBs	30	2	0	0	1	0	1	1	11	6
	FCBs	10	1	0	2	1	0	0	3	4	2
	Total	**49**	**3**	**1**	**2**	**3**	**0**	**1**	**4**	**17**	**11**
2001	SCBs	4	0	1	0	1	1	0	0	2	3
	DFIs	5	0	0	0	0	0	0	0	1	0
	PCBs	30	3	3	5	2	0	1	3	16	9
	FCBs	10	1	0	2	1	0	1	3	4	3
	Total	**49**	**4**	**4**	**7**	**4**	**1**	**2**	**6**	**23**	**15**
2002	SCBs	4	0	3	2	2	1	0	0	3	3
	DFIs	5	0	0	0	0	0	0	0	1	1
	PCBs	30	3	7	8	2	1	1	4	21	10
	FCBs	10	1	0	2	1	1	1	3	5	3
	Total	**49**	**4**	**10**	**12**	**5**	**3**	**2**	**7**	**30**	**17**
	SCBs	4	0	3	2	2	1	0	0	3	3
	DFIs	5	0	0	0	0	0	0	0	2	1

Year	Type	No.	Cr. Card	Dr. Card	ATM	POS	Internet	Tele banking	Online	SWIFT	Reuter
2003	PCBs	30	3	8	9	2	1	2	12	25	14
	FCBs	10	1	0	3	1	1	1	4	6	4
	Total	**49**	**4**	**11**	**14**	**5**	**3**	**3**	**16**	**36**	**22**
2004	SCBs	4	0	3	2	2	1	0	0	4	3
	DFIs	5	0	0	0	0	0	0	0	2	1
	PCBs	30	7	11	12	4	3	2	15	28	16
	FCBs	10	1	1	4	1	3	2	4	6	4
	Total	**49**	**8**	**15**	**18**	**7**	**7**	**4**	**19**	**40**	**24**
2005	SCBs	4	0	3	2	2	1	0	0	4	3
	DFIs	5	0	0	1	0	0	0	0	2	1
	PCBs	30	11	13	15	7	3	2	18	29	16
	FCBs	9	1	2	4	1	3	2	4	6	5
	Total	**48**	**12**	**18**	**22**	**10**	**7**	**4**	**22**	**41**	**25**
2006	SCBs	4	0	3	3	2	1	0	0	4	3
	DFIs	5	0	0	1	0	0	0	0	2	1
	PCBs	30	14	17	17	7	3	2	22	29	16
	FCBs	9	1	2	5	1	3	2	7	8	5
	Total	**48**	**15**	**22**	**26**	**10**	**7**	**4**	**29**	**43**	**25**
2007	SCBs	4	0	3	3	2	1	0	0	4	3
	DFIs	5	0	0	1	0	0	0	0	2	1
	PCBs	30	14	18	19	7	3	2	24	29	16
	FCBs	9	1	2	5	1	3	2	7	8	5
	Total	**48**	**15**	**23**	**28**	**10**	**7**	**4**	**31**	**43**	**27**
2008	SCBs	4	0	3	3	2	1	0	0	4	3
	DFIs	5	0	0	1	0	0	0	0	2	1
	PCBs	30	14	18	20	8	3	2	26	29	16
	FCBs	9	1	2	5	1	3	2	7	8	5
	Total	**48**	**15**	**23**	**29**	**11**	**7**	**4**	**33**	**43**	**29**
2009	SCBs	4	0	3	3	2	1	0	0	4	3
	DFIs	5	0	0	1	0	0	0	0	2	1
	PCBs	30	14	19	21	8	3	2	28	29	16
	FCBs	9	1	2	5	1	3	2	7	8	5
	Total	**48**	**15**	**24**	**30**	**11**	**7**	**4**	**35**	**43**	**32**

Source: BIBM Survey, 2010

VI. Concluding Remarks

In fact, the banking system followed true financial liberalization policy since the beginning of 1990s especially with the introduction of FSRP. Since then, several legislations related to the financial sector were enacted and amended to support the reform process. The newly enacted laws responded to the need for promoting a sound and orderly financial markets by providing appropriate legal framework for the licensing, organizing, operating, and supervising of a broad range of financial services companies. All the depository institutions were brought under the regulatory jurisdiction of Bangladesh Bank and all of them are monitored and supervised by the central bank by issuing prudential regulations.

The reform measures have had major impact on the over all efficiency and stability of the banking system of Bangladesh. A good number of banks and other financial institutions with various types of financial instruments emerged up. The institutional network and volume of operations of the financial sector have expanded and diversified. A number of scheduled banks have gone up from 11 in 1980 to 47 in 2011. The banks' involvement in non-traditional activities and the increase in profits from these activities have contributed to improvements in banking sector performance in terms of profitability, cost efficiency, and earnings efficiency. Banks were allowed to engage in diverse activities including securities and foreign exchange transactions, brokerage and dealing activities, and other fee-based business. The expansion of the scope of banks business has certainly helped offset a decline in net interest income from advances. This has an important policy implication for the sequencing of financial liberalization. Likewise number of non-bank financial institutions have also been increased. Additionally, the development of new financial instruments and services, introduction of regulatory framework and institutionalization of savings facilitated for economic growth and development. The present capital adequacy of banks is comparable to those at international level. There has been a marked improvement in the asset quality with the percentage of gross non performing assets (NPAs) to gross advances for the banking system reduced from 41.1 percent in 1999 to 7.1 percent in 2011. The reform measures have also resulted in an improvement in the profitability of banks. The Return on Assets (ROA) of the banks rose from 0.0 percent in the year 2000 to 1.3 percent in 2011. Further SCBs have steadily improved their cost efficiency (measured by expenditure income ratio) after 2008 even though FCBs and PCBs generally performed better than SCBs and DFIs in terms of profitability and cost efficiency in their initial stage. This suggests that the banking sector reforms since 1990 have exerted increased pressure and, thus had a positive moderate impact on the performance of SCBs and tiny impact on DFIs.

However, it should be stressed that this does not imply that the reforms have had wholly satisfactory results, for the following reasons.

First, the banking system is still found to be geographically fragmented, distorted and noncompetitive even in the post-reform period. The public sector banks (SCBs and DFIs) have remained more or less dominant in the banking sector. Still SCBs and DFIs hold 32.9% of deposits and 34.6% of advances of the banking sector of Bangladesh.

Second, profitability of SCBs has remained small where in case of DFIs it is less than 1.0 percent even worst (negative) during the whole period. This is because public sector banks have continued to suffer from poor management skills, over branching, and overstaffing. Although their NPLs ratios have gradually declined, the ratios have remained high. Some public sector banks (mainly DFIs) have been suffering from the shortage of capital, demanding further recapitalization.

Third, given that SCBs and DFIs enjoy scale of advantages because of their nationwide branch networks (especially compared with PCBs and FCBs, which tend to compete in the retail market). The current approach, therefore, for improving their performance without rationalizing them may not have further and substantial benefits for banking sector. As 30 years have passed since the reforms were initiated and SCBs and DFIs have been exposed to the new regulatory environment and pressures, it may be time for the government to take a further step for promoting the quality of managements and assets of banks and for closing unviable branches.

Fourth, problem of banking system is "systemic" not related to the banking system only. Reforms only in the SCBs, keeping away the DFIs and non-bank financial institutions (NBFIs), may not generate desired results. Therefore, the scope of reforms should also be extended to other organs of the financial system to make the financial system more resilient and stable. In addition, initiatives are required to be taken to address the problems of sick banks and to improve the performance of SCBs and DFIs by way of adopting effective risk management techniques and undertaking efficient monitoring of their credit portfolios. So the Government should give the highest priority to take reform measures for reforming DFIs and NBFIs and liberalizing the whole commercial banking sector, through careful consideration of the various aspects indicated above in the next reform agenda.

Finally, in the current scenario, banks are required for constantly pushing the frontiers of risk management compulsions arising out of increasing competition, as well as agency problems between management, owners and other stakeholders. In addition, banks are also required to look at newer avenues to augment revenues, while trimming costs. Consolidation, competition and risk management are no doubt critical to the future of banking but one should believe that governance and financial inclusion would also emerge as the key issues for a country like Bangladesh at this stage of socio economic development.

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