



Classified Loans and Recovery Performance:

A Comparative Study between SOCBs and PCBs in Bangladesh

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Abstract

Banking system plays a vital role for the economic development of Bangladesh. It is clear that a poor banking system cannot support economic development in a country. Average Percentage of Classified Loans are higher in Bangladesh compared to other countries. Government has taken different initiatives to reduce this rate. Now trend of percentage of classified loans is decreasing. But it is still of two digits. The objective of this study is to compare the amount of classified loans and non-performing loans of four state-owned commercial banks and four first generation private commercial banks in Bangladesh. Data of four state-owned commercial banks and four selected first generation private commercial banks for the period 2000 to 2010 were analyzed. In addition, a regression model is used to estimate the impact of spread and loan & advances on the classified loans of these banks.

Key words: Classified loan, Non Performing Loan, State-Owned Commercial Banks (SOCBs), Private Commercial Banks (PCBs).

I. INTRODUCTION

Non-performing loans ("NPLs") refer to those financial assets from which banks no longer receive interest and/or installment payments as scheduled. They are known as non-performing because the loan ceases to "perform" or generate income for the bank. Choudhury et al. (2002) state that the nonperforming loan is not a "uniclass" but rather a "multiclass" concept, which means that NPLs can be classified into different varieties usually based on the "length of overdue" of the said loans. NPLs are viewed as a typical byproduct of financial crisis: they are not a main product of the lending function but rather an accidental occurrence of the lending process, one that has enormous potential to deepen the severity and duration of financial crisis and to complicate macro economic management (Woo, 2000). This is because NPLs can bring down investors' confidence in the banking system, piling up unproductive economic resources even though depreciations are taken care of, and impeding the resource allocation process.

Banking system plays a vital role for the economic development of Bangladesh. The performance evaluation of a commercial bank is usually related to how well the bank can use its assets, shareholders' equities and liabilities, revenues and expenses. The performance evaluation of banks is important for all parties including depositors, investors, bank managers and regulators.

It is clear that a poor banking system cannot help for the economic development in a country. Before liberation poor banking system was continuing in Bangladesh (the then East Pakistan). After independence, the Govt. of the peoples' Republic of Bangladesh nationalized all the local banks as well as Pakistani banks. The rapid increase in overdue loans in different years, irregular payment, irregularities in management, inefficiencies of the official, staffs, pressure of trade union, deterioration of the level of customer services, or salary, job security, week communication systems etc. has made profit performance poor. As a result non-performing loans are being increased and amount of classified loans are also being increased. Many researches have highlighted operational efficiency of the NCBs in Bangladesh, performance evaluation of NCBs in Bangladesh, profitability of the commercial banks in Bangladesh etc. But adequate no. of researches have not been performed about classified loans though it is a vital issue at present. That is why, this study has been designed.

Basis for Loan Classification

In general the loans are repaid in installment according to bank's direction. Some loans are repaid all at a time. Nonperforming loans ("NPLs") refer to those financial assets from which banks no longer receive interest and/or installment payments as scheduled. They are known as non-performing because the loan ceases to "perform" or generate income for the bank Choudhury et al. (2002) state that the nonperforming loan is not a "uniclass" but rather a "multiclass" concept, which means that NPLs can be classified into different varieties usually based on the "length of overdue" of the said loans. If any loan is not repaid then notices are sent to the customer with the consent of HO. HO has a separate credit recovery wing. It advises the branch to take all necessary actions against the loan. Sometimes legal actions may require recovering the loan. All types of loans a Bank fall into following four categories:

- a. Unclassified: Repayment is regular.
- b. Substandard: Repayment is irregular but has reasonable prospect of improvement.
- c. Doubtful Debt: Unlikely to be repaid but special collection efforts may result in partial recovery.
- d. Bad/Loss: Very little chance of recovery.

(A) Objective Criteria

Continuous Loan or Demand Loan not repaid/renewed within the fixed expiry date for repayment is taken as past due/overdue from the following day of the expired date.

Determination of Past Due/Over Due:

- (i) Any Continuous Loan if not repaid/renewed within the fixed expiry date for repayment or after the demand by the bank will be treated as past due/overdue from the following day of the expiry date.
- (ii) Any Demand Loan if not repaid within the fixed expiry date for repayment or after the demand by the bank will be treated as past due/overdue from the following day of the expiry date.
- (iii) In case of any installment(s) or part of installment(s) of a Fixed Term Loan, irrespective of amounting, is not repaid within the due date, the amount of unpaid installment(s) will be termed as 'past due or overdue installment'.
- (iv) The Short-term Agricultural and Micro-Credit if not repaid within the fixed expiry date for repayment will be considered past due/overdue

after six months of the expiry date.

(B) Qualitative Judgment

Uncertainty or doubt in respect of recovery of any Continuous Loan, Demand Loan or Fixed Term Loan needs classification on the basis of qualitative judgment or objective criteria. If any situational changes occur after the loan was extended or if the capital of the borrower is affected due to adverse conditions or if the value of the securities decreases or if the recovery of the loan becomes uncertain due to any other unfavorable situation, the loans are classified on the basis of qualitative judgment.

2. LITERATURE REVIEW

Adhikary (2006) found, immediate consequence of large amount of NPLs in the banking system is bank failure as well as economic slowdown. The causes of nonperforming loans are usually attributed to the lack of effective monitoring and supervision on the part of banks, lack of effective lenders' recourse, weakness of legal infrastructure, and lack of effective debt recovery strategies. Hou (2001) said, There is no global standard to define non-performing loans at the practical level. Variations exist in terms of the classification system, the scope, and contents. Such problem potentially adds to disorder and uncertainty in the NPL issues. Non-performing loans have non-linear negative effect on banks' lending behavior. Adhikary (2008) found Poor enforcement of laws relating to settlement of NPLs, followed by insufficient debt recovery measures on the part of the banks, has also aggravated the financial malaise, although a decrease in NPLs is noticed since the year 2000. Islam (2012), in a study on BHBFC found that 97.6 per cent of the variability in the volume of classified loans can be explained by total advances, provisions, legal charges and spread. The variable legal charge was found to be statistically insignificant. Dash (2010) found, all the selected independent variables (Real GDP per Capita, Inflation, and Total Loans as independent variables) have significant impact on the depended variable (Non Performing Loan Ratio), however, values of coefficients are not much high. Banks should control and amend their credit advancement policy with respect to mentioned variables to have lower non-performing loan ratio. Avkiran (1995), in his study said that the trend of commercial banking is changing rapidly. Competition is getting stiffer and, therefore, banks need to enhance their competitiveness and

efficiency by improving performance. Normally, the financial performance of commercial banks are measured using a combination of financial ratios analysis, benchmarking, measuring performance against budget or a mix of these methodologies. Hassan & Reza (1997) prepared a study on "Efficiency through competition comparison of commercial Banks of Bangladesh in respect to several dimension of deposit, they identified, in 1983 PCBs are allowed to start the banking activities for the betterment than the services of NCBs. Practically activities of PCBs were increased day-by-day to face the challenging situation with the NCBs in Bangladesh through the deposit, loan & other dimensions. Alam et al. (2011) in their study conclude that ranking of banks differ as the financial ratio changes. Baral JK (2005) concluded in his study that Credit risk is one of the factors that affect the health of an individual bank while asset quality analysis involves taking account of the likelihood of borrowers paying back loans. The extent of the credit risk depends on the quality of assets held by an individual bank. The quality of assets held by a bank depends on exposure to specific risks, trends in non-performing loans, and the health and profitability of bank borrowers. Muniappan (2002) argues that a bank with high level of NPLs is forced to incur carrying costs on non-income yielding assets that not only strike at portability but also at the capital adequacy of a bank, and in consequence, the bank faces difficulties in augmenting capital resources. Bonin and Huang (2001) also state that the probability of banking crises increases if financial risk is not eliminated quickly. Such crises not only lower living standards but can also eliminate many of the achievements of economic reform overnight.

3. OBJECTIVES OF THE STUDY:

The main objective of the study is to compare the status of classified loans and recovery performance of SOCBs and PCBs of first generation. The objectives of the study can be stated as below-

- i) to compare the amount of classified loans between State-Owned Commercial Banks and first generation Private Commercial Banks in Bangladesh.
- ii) to compare the amount of non-performing loans between State-Owned Commercial Banks and first generation Private Commercial Banks in Bangladesh.

iii) to test the significance of spread and loan & advances on classified loans.

iv) to test the impact of classified loans on net profit, bad debts and investment.

4. METHODOLOGY

The purpose of this study is to compare the amount of classified loans and non performing loans between State-Owned Commercial Banks and First Generation Private Commercial Banks in Bangladesh. The study is descriptive based on only secondary data. The data are mainly obtained from the Annual Reports of the State-owned Commercial Banks and four selected first generation Private Commercial Banks of Bangladesh, Annual Reports of Bangladesh Bank and Bangladesh Bank Bulletin. Data of eleven years from 2000 to 2010 have been evaluated to assess the amount of classified loans and non performing loans of the selected commercial banks in Bangladesh. All (four) state-owned commercial banks, which have been established in 1972 in Bangladesh after liberation and four first generation Private Commercial Banks which have been established in 1983 are selected purposively for the analysis in this study. The financial data have been used to assess the amount of classified loans and non performing loans of the banks. Data of different years have been used to test the hypothesis for inference. The researchers have applied a multivariate regression model to test the significance of variables on classified loans and simple regression to show impacts of classified loans on net profit, bad debt and investment of the selected banks of Bangladesh. The classified loan is assumed as dependent variable while spread and loan & advances are as independent variables for multiple regression and again for simple regression, classified loan as independent variable while net profit after tax, bad debt and investment as dependent variables. The collected data have been analyzed by using SPSS 20.

5. ANALYSIS AND FINDINGS:

5.1 Analysis

State-owned commercial banks have been suffering from huge classified loans since inception of Bangladesh. Government took various actions to reduce the classified loans levels. Levels of classified loans were increased up to 1998 and then trend is decreasing.

Percentage of Classified Loans of SBL is found highest compared to other state-owned followed by ABL. JBL and RBL have lower percentage of classified loans. (calculation of collected data by researcher)

Percentage of Classified Loans of IFICBL is found highest compared to other Private Commercial Banks. POCL of UCBL is the lowest. (calculation of collected data by researcher)

The next table exhibits non-performing loans levels of state-owned & private commercial banks in Bangladesh from 2000 to 2010.

Table: Percentage of Non-Performing Loan of State-owned & Private Commercial Banks

YEAR	State-owned commercial Banks				Private Commercial Banks			
	SBL	JBL	ABL	RBL	NBL	CBL	IFICBL	UCBL
2000	68.84	30.55	50.94	27.59	11.43	23.1	38.45	43.02
2001	64.78	26.35	48.8	32.72	14.98	23.21	32.19	46.85
2002	58.47	29.51	54.33	39.69	14.91	21.72	15.14	50.11
2003	55.55	22.32	48.58	42.92	19.56	22.64	15.58	37.62
2004	47.17	16.68	51.53	42.11	17.96	15.88	14.71	26.93
2005	22.93	11.44	23.04	44.43	20.25	14.53	20.95	21.49
2006	43.05	13.9	22.03	43.9	21.18	21.52	20.16	19.83
2007	119.09	16.38	36.85	44.63	24.73	22.39	15.49	21.33
2008	117.94	10.54	37.36	48.06	20.72	23.00	18.06	26.54
2009	86.72	8.44	53.16	50.29	20.42	21.20	22.48	25.46
2010	85.98	5.24	63.61	67.65	14.99	18.99	21.85	22.02
Average	70.05	17.40	44.57	44.00	18.28	20.72	21.37	31.02

Source: Annual Reports of the State-owned & Private Commercial Banks

Percentage of Non-Performing Loans of SBL is found highest (70.05%) compared to other state-owned Commercial Banks followed by ABL (44.57%) and RBL (44.00%). JBL (17.40%) has the lowest NPL. That means JBL has the best recovery performance among the State-owned Commercial Banks.

Percentage of Non-Performing Loans of UCBL is found highest (31.02%) compared to other Private Commercial Banks followed by IFICBL (21.37%) and CBL (20.72%). NBL (18.28%) has the lowest NPL. That means NBL has the best recovery performance among the selected Private Commercial Banks.

Multiple Regressions (for state own commercial banks)

We have conducted multiple regression to see the influence of all the independent variables on the dependent variable by using SPSS 20 and accordingly our regression model is -

$$Y = a + b_1 X_1 + b_2 X_2 + \text{error.}$$

Where, a = Constant, X_1 = Total loan and Advances, X_2 = Spread, Y = Classified loan and b_1 , b_2 = Regression Co-efficient.

We have developed a null hypothesis which is -

Ho1: Two independent variables taken together do not affect the volume of classified loans.

From the multiple regression analysis we observed that R square is .437, F-ratio is 15.891 and significance level is .000 which means that our null hypothesis is rejected. So, it is evident that 43.7 per cent of the variability in the volume of classified loans can be explained by total advances, and spread.

Ho2: The volume of total advances does not affect the volume of classified loans.

From regression analysis we observed that regression co-efficient = .383 and significance level is .004.

The significance level of F-ratio is .004 which means that our null hypothesis is rejected. F-test denotes that more advances tend to give rise to more classified loans.

Ho3 : The volume of spread does not affect the volume of classified loans.

From the analysis we observed that regression co-efficient = -.676 and significance level is .000.

Thus we observed that F-ratio is highly significant which means that our null hypothesis is rejected. F-test supports the argument that regression analysis provides reliable explanation for the behavior of the variable spread.

We can comment that the co-efficient of determination of the multiple regression is less than 1 which indicates that there are some other explanatory variables that we could not identify through the extent of influence of that or those variables is very high.

We have so far treated classified loan as dependent variable but this variable can also exert influence on other variables such as investments, net profit before tax and bad debt.

Impact of classified loans on Net Profit

In order to test the influence of classified loan on net profit we have conducted simple regression analysis to see the extent of influence of each

independent variable on the dependent variable and accordingly we developed a null hypothesis which is -

Ho4 : The volume of classified loan does not affect the volume of net profit.

From the regression analysis we observed that R square is .024, F-ratio is 1.044 and significance level is .313.

Test result shows that the regression equation between classified loan and net profit is insignificant which means our null hypothesis is accepted. The volume of classified loan does not significantly affect the volume of net profit.

Impact of classified loans on Bad Debt

Ho5: Classified loan does not affect the volume of bad debt

From analysis we observed that R square is .313, F-ratio is 19.174 and significance level is .000.

F-test result shows that the regression equation between classified loan and bad debt is found to be highly significant which means our null hypothesis is rejected.

Impact of classified loans on Investments

A simple regression analysis taking investments as dependent variable and classified loans as independent variable is attempted and accordingly we developed a null hypothesis which is -

Ho6: Classified loan does not affect the volume of investment.

From regression analysis we observed that R square is .044, F-ratio is 1.947 and significance level is .170 which means our null hypothesis is accepted. That is classified loans does not significantly affect the volume of investment.

Multiple Regressions (for first generation private commercial banks)

We have so far conducted simple regression analysis to see the extent of influence of each independent variable on the dependent variable. Now we shall conduct multiple regressions to see the influence of all the independent variables on the dependent variable and accordingly our regression model is -

$$Y = a + b_1 X_1 + b_2 X_2 + \text{error.}$$

Where, a = Constant, X_1 = Total loan and

Advances, $X^2 = \text{Spread}$ and $b_1, b_2 = \text{Regression Co-efficient}$.

We developed a null hypothesis which is -

Ho7: Two independent variables taken together do not affect the volume of classified loans.

From the multiple regression analysis we observed that R square is .434, F-ratio is 15.691 and significance level is .000 which means that our null hypothesis is rejected. So, it is evident that 43.4 per cent of the variability in the volume of classified loans can be explained by total advances, and spread.

Ho8: The volume of total advances does not affect the volume of classified loans.

From regression analysis we observed that regression co-efficient = .277 and significance level is .501.

The significance level of F-ratio is .501 which means that our null hypothesis is accepted. F-test denotes that advances affects classified loans slightly.

Ho9 : The volume of spread does not affect the volume of classified loans.

From the analysis we observed that regression co-efficient = -.919 and significance level is .030.

Thus we observed that F-ratio is highly significant which means that our null hypothesis is rejected. F-test supports the argument that regression analysis provides reliable explanation for the behavior of the variable spread.

Finally we can comment that the co-efficient of determination of the multiple regression is less than 1 which indicates that there are some other explanatory variables that we could not identify through the extent of influence of that or those variables is very high.

We have so far treated classified loan as dependent variable but this variable can also exert influence on other variables such as investments, net profit before tax and bad debt.

Impact of classified loans on Net Profit

In order to test the influence of classified loan on net profit we have conducted a regression run and accordingly we developed a null hypothesis which is -

Ho10 : The volume of classified loan does not affect the volume of net profit.

From the regression analysis we observed that R square is .177, F-ratio is 9.062 and significance level is .004.

Test result shows that the regression equation between classified loan and net profit is highly significant which means our null hypothesis is rejected. The volume of classified loan significantly negative impact on the volume of net profit.
Impact of classified loans on Bad Debt

Ho11: Classified loan does not affect the volume of bad debt

From analysis we observed that R square is .786, F-ratio is 154.566 and significance level is .000.

F-test result shows that the regression equation between classified loan and bad debt is found to be highly significant which means our null hypothesis is rejected. That is, classified loan has highly positive impact on the volume of bad debt.

Impact of classified loans on Investments

A simple regression analysis taking investments as dependent variable and classified loans as independent variable is attempted and accordingly we developed a null hypothesis which is -

Ho12: Classified loans does not affect the volume of investment.

From regression analysis we observed that R square is .275, F-ratio is 15.968 and significance level is .000 which means our null hypothesis is rejected. That is classified loans has significantly negative impact on the volume of investment.

5.2 Findings

This study explores that the percentage of classified loans of SBL is found highest compared to other state-owned Commercial Banks and the percentage of classified loans of IFICBL is highest compared to other Private Commercial Banks.

It is found that JBL has the best recovery performance among the State-owned Commercial Banks where NBL has the best recovery performance among the selected Private Commercial Banks.

This study uncovered that spread and loan & advances together have significant impact on classified loans in both state-owned commercial banks and first generation private commercial

banks. But loan & advances affects classified loans significantly in state-owned commercial banks only. Spread affects classified loans significantly in both state-owned commercial banks and first generation private commercial banks. This study also found that classified loans have significant impact on bad debts in both state-owned commercial banks and first generation private commercial banks. Classified loans have not significant impact on investment in state-owned commercial banks but in first generation private commercial banks, classified loans have significant impact on investment.

6. CONCLUSIONS:

Though percentage of classified loan is increasing among commercial banks, the amount of POCL is higher in state-owned commercial banks than that of private commercial banks. Average Recovery performance of private commercial banks is higher than that of state-owned commercial banks. Spread and loan & advances have together significant impact on classified loans in both state-owned commercial banks and first generation private commercial banks. Again, classified loans have significant impact on bad debts in both state-owned commercial banks and first generation private commercial banks.

For improving the debt recovery environment and solving the NPL problems of the country some recommendations are as follows-

We have to institute immediately a concrete NPL management strategy equipped with both preventive and resolution measures. It is also needed to institute sufficient measures to address the flow problem of bad loan effectively. We must ensure cooperation, sincerity and accountability of involved parties such as plaintiffs, defendants, lawyers and judges to make the settlement process vibrant and speedy. It is needed to exercise syndicated financing technique for large loans and to minimize unhealthy competition among banks in Bangladesh. The supervisory and monitoring functions of Bangladesh Bank have to be strengthened so as to discipline banks that engage in malpractice. Specific tools and techniques have to be developed to distinguish the willful defaulters from the genuine ones. Finally, emphasis must be placed on ethical standards in the banking profession from all corners to make the credit environment trustworthy and vibrant. ©

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"Go to the people. Learn from them. Live with them. Start with what they know. Build with what they have. The best of leaders when the job is done, when the task is accomplished, the people will say we have done it ourselves."

- Lao Tzu