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Non-Performing Loan and its Impact on the Banking Sector of Bangladesh

Murshida Khatun
School of Business Administration, San Francisco Bay University, Fremont, CA, USA

Tariqul Islam
The School of Business and Economics, North South University Dhaka, Bangladesh

Mehidi Hasan Suvo
School of Business Administration, San Francisco Bay University, Fremont, CA, USA

Jubair Bin Sharif
Brac Business School,
Brac University, Dhaka-1212, Bangladesh

Md. Kwosar
National University, Bangladesh, Gazipur, Bangladesh
Institute of Cost and Management Accountants of Bangladesh (ICMAB), Dhaka-1205, Bangladesh.

ABSTRACT
Non-Performing Loans or NPLs have become a major risk factor for sustainable growth and healthy profit margins for the banking industry of Bangladesh. Another cost of loans is Non-Performing Loans (NPLs) which are given when borrowers are unable to repay back the loan amount to the banks. For this purpose, this paper aims at facilitating an analysis of sectors that led to elevated non-performing loan ratios in Bangladesh based on; economic crises, bad credit risk assessment, and poor corporate governance. The effect of NPLs on the banking sector is explored in terms of decreased profits, deteriorated asset quality, as well as elevated production costs. To overcome these negative impacts, this paper recommends the following: Credit policies; more strict credit evaluation procedures, proper loan repayment methods, and sound credit-risk management. Thus, by managing the sources that contribute to the NPLs and implementing preventive measures the banking sector of Bangladesh shall have improved conditions for development and the state's economic boost.

Keywords
Non-Performing Loans, banking sector, credit risk, loan default, financial stability, economic growth, asset quality, risk management, regulatory framework.

1. INTRODUCTION
The banking industry serves as a vital conduit for economic growth, acting as an intermediary between those with surplus funds and those in need of financing. In Bangladesh, the banking sector plays a particularly significant role, contributing substantially to the nation's GDP. Banks offer a diverse range of services, including savings accounts, current accounts, and loans tailored to various needs such as home loans, student loans, and business loans.

In recent years, Bangladesh's banking sector has experienced remarkable growth. In 2012 the total banking sector assets were 7030.7 billion BDT. In 2013 the total banking sector increased to 8000.2 billion dollars. In 2020 the total banking sector asset is 18406.01 billion. As of 2023-2024, the total banking sector assets have exceeded 20 trillion BDT, marking a substantial increase from previous years. This expansion is indicative of the increasing trust in the banking system and the growing demand for financial services across the country. This growth is fueled by various factors such as economic development, increasing disposable incomes, and government initiatives to promote financial inclusion.

However, the sector also faces challenges such as non-performing loans, cyber security threats, and regulatory compliance. To sustain its growth trajectory, the banking industry in Bangladesh must continue to innovate, adapt to changing market dynamics, and prioritize customer satisfaction.

2. LITERATURE REVIEW
Credit risk is one of the most critical challenges faced by banks, as it significantly influences the stability and survival of financial institutions. Non-performing loans (NPLs) are a major factor impacting credit risk, with studies highlighting their ability to potentially drive banks toward insolvency if not managed effectively (Zelalem, 2010). Thus, understanding and addressing NPLs is essential for accurately assessing and mitigating credit risk.

Numerous studies underscore the correlation between NPLs and macroeconomic conditions. Poor economic performance adversely affects borrowers' income, leading to delays in the repayment of loan principal and interest, or even outright defaults. These findings illustrate how economic downturns, by weakening clients' financial capacity, directly increase the volume of NPLs in the banking sector.

The relationship between NPLs and internal bank-specific factors has also been thoroughly analyzed. Research highlights the role of a bank's policies, organizational culture, and employee efficiency in influencing the level of NPLs. For instance, the study by Louzis (2012) on Greek banks revealed that NPL levels were significantly affected by both the quality of bank management and prevailing macroeconomic conditions. These results emphasize the importance of sound management practices and robust operational frameworks in reducing NPL rates.

Similarly, research by Eurak (2013) on South European banks concluded that macroeconomic factors such as high interest rates, economic recessions, and inflation are the primary drivers of increased NPL levels. The study, which analyzed data from 69 banks across ten countries, underscores the critical interplay between macroeconomic stability and the health of the banking sector.

Bank-specific characteristics, including size, performance, and solvency, also significantly impact credit risk by influencing NPL volumes. Reddy (2014) observed that banks with elevated levels of NPLs face financial strain due to the carrying costs of non-income-generating assets. This situation not only undermines profitability but also weakens a bank's capital adequacy, making it harder to secure additional capital.

The distinction between state-owned and private commercial banks in managing NPLs has been highlighted in studies. Banik and Das (2015) reported a consistent rise in classified loans among commercial banks, with state-owned banks experiencing a higher % of classified loans compared to private banks. This disparity suggests differing operational efficiencies and risk management practices between the two sectors.

Ulfat-Ara-Joya (2017) demonstrated that the spread between interest rates and the volume of loans and advances significantly affects classified loans in both state-owned and first-generation private commercial banks. These findings emphasize that operational strategies and loan management policies are critical in controlling NPL growth.

Žunić et al. [9] examined the factors influencing non-performing loans (NPLs) in Bosnia and Herzegovina's banking sector, particularly considering the effects of the COVID-19 pandemic. Their study used variables such as GDP, loan loss provisions, NPLs, and a dummy variable for COVID-19. They discovered that the pandemic's impact on NPLs was delayed.

Rachmadi and Suyono [10] highlighted the significant negative impact of credit restructuring on NPLs. They explained that changes in accounting practices, specifically in recognizing restructured credit interest income, along with reduced interest rates, contributed to this effect. Their study emphasized credit restructuring as a strategy to mitigate the pandemic's economic effects, particularly on the MSME sector, which significantly impacted banking performance in terms of profit, credit quality, and interest income.

Chen et al. [11] compared the COVID-19 pandemic's effects on NPLs to those of past crises, such as the 1990 crisis. They observed differences in the resolution pace of NPLs and highlighted how unresolved NPLs exacerbate post-crisis recessions. Using machine learning, they identified weak macroeconomic, institutional, corporate, and banking sector conditions as pre-crisis predictors of NPL vulnerabilities post-pandemic.

Ari et al. [12] found that NPLs increased during the COVID-19 crisis. Drawing comparisons with the 2008 financial crisis, they noted that while factors like higher bank capital and forward-looking accounting standards (e.g., IFRS 9) favor NPL resolution, challenges persist due to elevated government debt, weaker bank profitability, and fragile corporate balance sheets.

Gourinchas et al. [13] analyzed COVID-19's impact on SME business failures across 17 countries, estimating that failure rates could have risen by 9.1% points without government support. They found that resulting NPLs modestly reduced banks' Tier-1 capital ratios. They recommended targeted government interventions, which, while less costly, were equally effective compared to broad policies like guaranteed loans, which incurred higher fiscal costs.

Haynes et al. [14] explored the implications of the COVID-19 crisis on the EU corporate sector. Comparing the pandemic's impact to the global financial crisis (GFC), they suggested a more tailored policy response focusing on directly affected sectors and companies with higher continuation value than liquidation value.

Kasinger et al. [15], in their research "Non-performing loans - new risks and policies? NPL resolution after COVID-19: Main differences to previous crises," assessed potential NPL scenarios due to the pandemic. They emphasized the need for early and realistic loan loss assessments to avoid adverse bank incentives. Their study also advocated for secondary loan markets to facilitate effective NPL resolution in line with BRRD guidelines, even under extreme circumstances.

Bodellini and Lintner [16] argued that the economic crisis triggered by COVID-19 could lead to a significant increase in NPLs due to borrowers' inability to repay debts. They underscored the importance of having effective bank crisis management regimes to limit spillover effects. They also recommended greater flexibility in financing from deposit guarantee schemes to support bank resolutions.

Barua and Barua [17] analyzed the pandemic's impact on Bangladesh's banking sector, which already had a high level of NPLs. Using stress testing, they estimated significant declines in firm value, capital adequacy, and interest income under various NPL shock scenarios. They warned that large banks were more vulnerable, and severe NPL shocks could breach BASEL-III capital adequacy requirements.

Similarly, Lalon [18] discussed the economic challenges posed by the COVID-19 pandemic for Bangladesh. He highlighted the pandemic's impact on major economic indicators, including trade, revenue, private sector investment, and NPLs, stressing the need for comprehensive recovery plans to sustain socio-economic progress.

In summary, NPLs are influenced by a complex interplay of macroeconomic conditions, internal bank policies, and management quality. Addressing these factors through sound governance, effective risk management, and adaptive policies is vital to reducing credit risk and maintaining the financial stability of banks.

3. CHALLENGES IN BANKING SECTOR FOR NPL

Non-performing loans (NPLs) continue to pose a significant challenge to the stability and growth of Bangladesh's banking sector. The latest data and insights reflect both structural inefficiencies within the banking system and macroeconomic pressures affecting repayment capacities.

3.1 Current NPL Levels:

- As of June 2022, the total amount of defaulted loans in Bangladesh reached a record high of Tk. 1,25,257 crore, constituting 8.96% of the total loans. This marked a

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26.5% year-on-year increase from Tk. 99,205 crore in June 2021.

- Despite relaxed loan classification policies implemented during the COVID-19 pandemic, NPLs in the banking sector increased by 16.38% year-on-year in 2021, amounting to Tk. 103,274 crore.

3.2 Bank Category Analysis:

- **State-Owned Commercial Banks (SOCBs)**: SOCBs bear the brunt of NPLs. In 2021, their NPLs totaled Tk. 44,977 crore, significantly higher than those of private commercial banks (PCBs).
- **Specialized Development Banks (SDBs)**: These banks also experience elevated NPL rates, with a reported Tk. 2,785 crore in NPLs for 2021.

3.3 Impact on Banking Metrics:

- **Capital to Risk-Weighted Assets Ratio (CRAR)**: SOCBs had a CRAR of only 6.8% in 2021, falling short of the 10% minimum requirement set by Bangladesh Bank. This reflects the capital constraints imposed by growing NPL volumes.
- **Profitability**:
  - Return on Assets (ROA) and Return on Equity (ROE) remain positive for private and foreign commercial banks but consistently negative for public sector banks, showcasing their struggle with NPL management.
  - Net Interest Margin (NIM), an indicator of the efficiency of lending operations, has been adversely affected due to high NPL levels, which reduce earnings from traditional loans.

4. NON-PERFORMING LOANS, PROVISIONS, WRITTEN-OFF LOANS AND ADVANCES IN THE BANKING SECTOR

4.1 Non-performing loans and provisions

The banking sector's asset quality, measured by the gross non-performing loan (NPL) ratio, slightly worsened in 2023. The net NPL ratio also rose to 0.59% from -0.08% in 2022. By December 2023, the gross NPL ratio reached 9.00%, up from 8.16% in the previous year, reflecting an increase of BDT 249.77 billion in gross NPLs to BDT 16,176.89 billion, alongside a rise of BDT 1,399.00 billion in total loans and advances.

This deterioration in asset quality is partially attributed to insufficient oversight of regular, rescheduled, or restructured loans and advances, as well as slow NPL recovery efforts. External factors, including the Russia-Ukraine war, the Israel-Palestine conflict, and other global and domestic challenges, likely weakened borrowers' repayment capacities, exacerbating the issue.

The gross NPL ratio of State-Owned Commercial Banks (SOCBs) rose by 0.71% points to 20.99% at the end of 2023. Similarly, Private Commercial Banks (PCBs) and Specialized Development Banks (SDBs) saw increases in their gross NPL ratios, reaching 5.93% and 13.87%, respectively. Conversely, Foreign Commercial Banks (FCBs) experienced an improvement, with their NPL ratio declining by 0.09 % points to 4.82%.

SOCBs and PCBs collectively accounted for the majority of total NPLs at the end of 2023, holding shares of 45.17% and 48.74%, respectively. In contrast, FCBs and SDBs contributed only 2.20% and 3.89% of the total NPLs.

34 banks reported gross NPL ratios below 5% in 2023, compared to 38 in 2022. Among these, all FCBs except one and all PCBs except six maintained single-digit gross NPL ratios. However, from a stability perspective, concerns arise from the nine banks (three SOCBs, four PCBs, one FCB, and one SDB) with gross NPL ratios exceeding 20%. This distressing trend reflects an overall marginal increase in the net NPL ratio during the year.

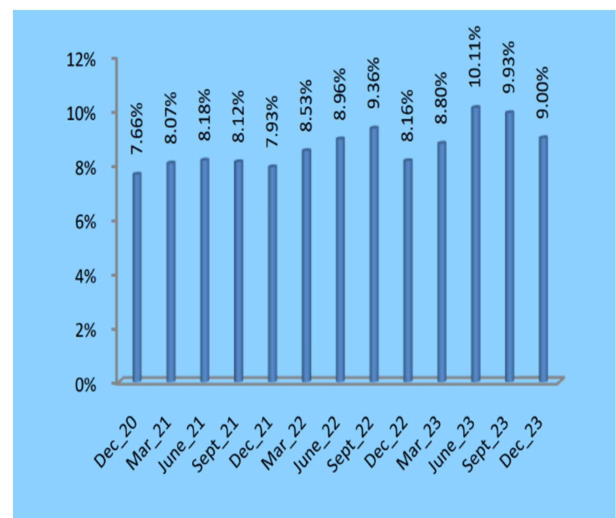

Figure 1: Gross NPL Ratio of the Banking Industry

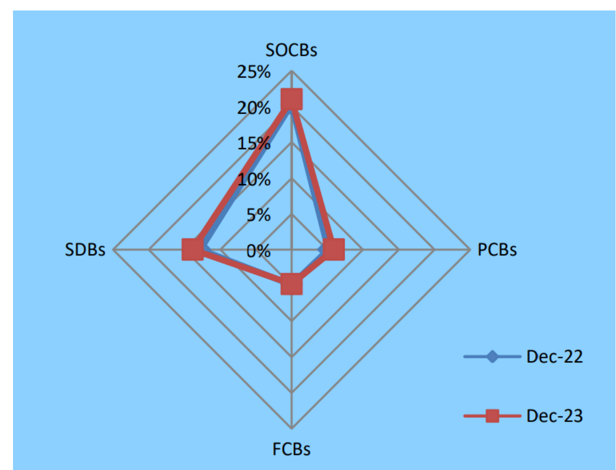

Figure 2: Gross NPL Ratio of Banking Clusters

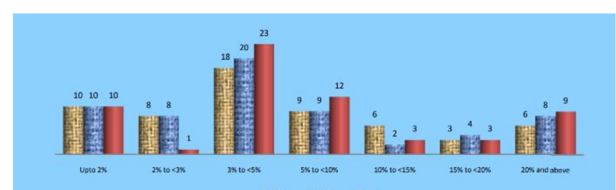

Figure 3: Gross NPL Ratio of Banks into Different Buckets

The net NPL ratios of different clusters of banks are shown in fig. 4. The PCBs, like the previous year, had negative net NPL ratio in 2023, despite holding the significant part of the banking industry's total assets. Also, FCBs had a negative net NPL ratio. These banks appeared to be resilient to a certain level of deterioration in their asset quality. On the contrary, the net NPL ratio of SOCBs and SDBs deteriorated further at the end of the review year; stood at 6.21% and 1.68% respectively.

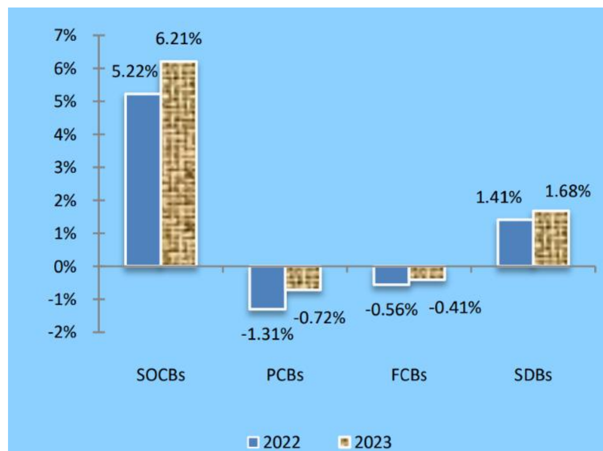

Figure 4: Net NPL Ratio of Banking Clusters

All the banks except three (03) PCBs, three (03) SOCBs and one (01) SDB kept their loan-loss provisions in accordance with the regulatory requirement of BB in 2023. The loan-loss provision maintenance scenario recorded somewhat decline in 2023. The gross NPLs stood at BDT 1,456.33 billion at end-December 2023, generating a loan-loss provision requirement of BDT 989.41 billion. However, the amount of provision actually maintained by the banks was BDT 796.80 billion as shown in fig.5. In comparison with the previous year, the provisions held by the banks got augmented by 8.93% in 2023. On the other hand, the overall provision shortfall increased from BDT 110.09 billion in 2022 to BDT 192.61 billion in 2023, indicating a degradation of loan status during the period. Also, the provision maintenance ratio declined to 80.53% in 2023 from 86.92% in 2022. Consequently, the ratio of maintained provision to gross NPL decreased from 60.63% in 2022 to 54.71% in 2023.

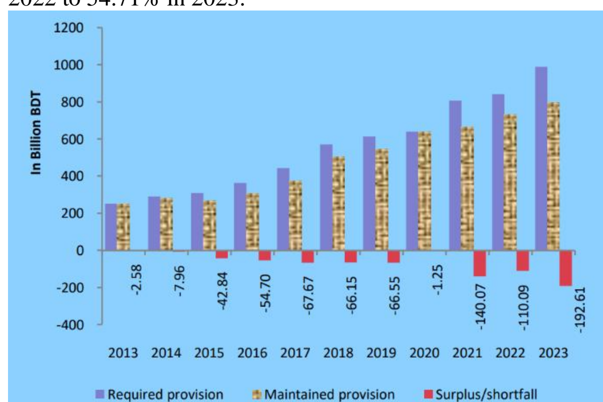

Figure 5: Year-Wise Banking Sector Loan Loss Provisions

4.2 Written-Off Loan

The outstanding balance of written-off loans stood at BDT 536.12 billion at end-December 2023. The cumulative written-off loan amount stood at BDT 716.99 billion at the end of the review year, which was BDT 653.21 billion at the end of the preceding year. The cumulative written-off loan amount was equivalent to 2.99% of the banking sectors on-balance sheet assets at end-December 2023. Indeed, out of the total written-off loans, banks have been able to recover BDT 180.87 billion by end-December 2023 and thus the total adjusted outstanding balance of written-off loans reached at BDT 536.12 billion out of which the balance of SOCBs, PCBs, FCBs and SDBs stood at BDT 181.53 billion, BDT 338.24 billion, BDT 12.93 billion, and BDT 3.42 billion respectively.

4.3 Reschedule Advances

The total amount of loans rescheduled in the review year increased compared to that of the preceding year. However, most part of the rescheduled loans remained unclassified. The banking sector's rescheduled loans in 2023 were BDT 912.21 billion, which was higher than that of the preceding year. In 2022, Bangladesh Bank introduced a temporary and somewhat lenient policy16 on loan rescheduling allowing banks to reschedule loans by taking reduced down payment and granting a relatively longer tenure to the borrower for repayment. Banks were also allowed to frame their own policy to reschedule loans based on the parameters set by the Bangladesh Bank earlier. The stated policy might have contributed to the increase in rescheduling of loans in 2023. Furthermore, banks were allowed to reschedule loans of sectors (such as ship building and cold storage related loan) for longer tenure.

5. REASONS FOR NPL

Non-Performing Loans (NPLs) have been a persistent challenge in Bangladesh's banking sector, with several factors contributing to their prevalence:

a) Weak Governance in the Banking Sector: Inadequate oversight and internal controls have led to mismanagement and fraudulent activities. Notably, the Hallmark-Sonali Bank loan scam, where over Tk 35 billion was embezzled through falsified documents, exemplifies such governance failures.

b) Inappropriate Client Selection: Banks have often sanctioned loans without thorough due diligence, leading to lending to clients with poor creditworthiness. This practice has resulted in a higher incidence of loan defaults.

c) Inadequate Business and Industry Analysis: Banks frequently overlook comprehensive business evaluations, including cash flow forecasts and historical payment behaviors, resulting in loans to ventures lacking financial viability.

d) Political Influence in Loan Sanctioning: Political pressures have compelled banks to approve loans to

e) unqualified borrowers, undermining prudent lending practices. This interference has contributed significantly to the accumulation of NPLs.

f) Insufficient Documentation: Lapses in proper documentation during loan processing have impeded banks' ability to enforce loan agreements and recover dues effectively.

g) Inadequate Collateral Coverage: Loans often lack sufficient security, making recovery difficult in cases

of default. This shortfall has exacerbated the NPL situation.

h) Weak Regulatory Framework for Loan Recovery: The existing legal and regulatory mechanisms are often slow and ineffective, hindering timely recovery of defaulted loans. This inefficiency has allowed NPLs to persist and grow.

Addressing these issues requires comprehensive reforms in governance, client assessment, regulatory frameworks, and enforcement mechanisms to enhance the financial health of the banking industry.

6. CONCLUSION

Non-performing loans (NPLs) remain a significant impediment to the stability and profitability of Bangladesh's banking sector. The study underscores that weak governance, inadequate risk management, and external macroeconomic pressures are primary contributors to the rising levels of NPLs. The detrimental effects of NPLs include reduced profitability, deteriorated asset quality, and increased risk of financial instability. Moreover, state-owned banks face a disproportionate share of this burden compared to their private and foreign counterparts, reflecting systemic inefficiencies and governance challenges.

To mitigate the challenges posed by NPLs, the document emphasizes the importance of strengthening governance structures, implementing rigorous credit assessment policies, and fostering a culture of accountability within banks. Additionally, enhancing the regulatory framework and expediting legal procedures for loan recovery are crucial steps toward curbing the growth of NPLs.

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