

The Effect of Non-performing Loans on Performance and Profitability: A Comparative Analysis from Banking Sector of Bangladesh

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Abstract:

The purpose of this paper is to assess the intensity of 'Non-performing Loan' and its adverse impact on the performance and profitability of the banking sector of Bangladesh. A comparative scenario of state-owned commercial banks and private commercial banks have also been presented in this study. The foregoing discussion of NPL from the perspective of Bangladesh reveals that the amount of defaulted loans have reached an alarming position which degrades the banking industry and makes the economy stagnant. The comparative analysis showed that SOCBs have a higher amount of total NPL, gross NPL ratio and net NPL ratio than that of PCBs. Share in industry total assets, share in deposit and also change in the contribution of industry assets of SOCBs are very lower in comparison to PCBs. Capital adequacy, capital to risk-weighted assets, ROA, ROE and maintained provision of SOCBs are very poor while PCBs have satisfactory performance. Active implementation of policies, proper and adequate surveillance of SOCBs, qualified and neutral board members and non-executives, improved lending process, enforcement of punishable measures and most importantly strong ethical attitude are some of the possible and effective recommendations that should be implemented to eradicate the root of NPL from this emerging economy.



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Introduction

The economy of Bangladesh greatly depends on the banking sector for a balanced financial environment and intermediation. Its importance can be realized heavily when there is absence of an efficient capital market. Business world nowadays largely depends on the banking sector for collecting funds. But all the loans that are provided by banks cannot be recovered. Irrecoverable loans can be termed as NPL (Non-performing Loans). NPL is an asset for the bank which ceases to yield return and any accrued income from that particular asset shall not be treated as income until that income is realized. Based on the record of recovery, the classification of loans as NPL has been done. Various types of loans are the prime assets of a bank. The qualities of these assets should be maintained by following some mandatory and prudential regulatory steps issued by the central bank. These necessary steps can be such as the criteria of loan classification, the requirement of provisioning, recognition of income, diversification of risks, debt restructuring, write-off method, directed lending and so on. However, NPLs are the prime reason for reducing the profitability of banks and also for lowering the capital base. Because banks cannot receive interest on classified loans. NPLs stop recycling and decrease loanable funds. Banks have to reserve certain amount as 'loan loss reserve' for making up their bad debts and NPLs also erode total number of capital. Despite of having these shortcomings for such a long time, banking sector of Bangladesh is unable to find a suitable solution. Though a wide range of reform initiatives have been taken, the problem of Non-performing Loan is considered as the greatest problem in the banking sector of Bangladesh.

Background of the Study

Banking industry of Bangladesh has been facing a huge crisis of collection of the non-performing loans for many years. Since 1990 (which we can consider as take-off year for financial reform), Bangladesh has begun to adopt a wide range of financial sector reform programs. But before this adoption of structural adjustment program and stabilization by the government of Bangladesh, the denationalization and privatization were started. The highlighted features of Financial Sector Reform Programs (FSRP) with respect to the banking sector of Bangladesh are: interest rate policy liberalization reforms in the legal environment, reforms in foreign exchange regime and development of capital market. In 1989, loan classification system was introduced. After introduction, this system has faced a lot of changes from time to time. At present loan classification system of Bangladesh is a little bit flexible compared to that of international system. According to the latest BRPD (Banking Regulation and Policy Department, 2012) circular no. 19 of Bangladesh Bank, it has been seen that 12% of total loan is classified. Although, this ratio was 9.9% in 2016, 10.5% in 2017, 10.8% in 2018 and it increases gradually to the present level of 12%. Some prudential initiatives have been taken by Bangladesh Government for mitigating the effect of defaulted loan and minimizing the number of Non-performing loan. Government has tried to strengthen up the regulatory measures so that banks can be able to recover the defaulted loans. Also enactment of Artha Rin Adalat Ain (Money Loan Court Act 2003) has also been introduced for the purpose of improving legal framework and making the recovery of overdue loans and advances easier. Issuance of guidelines for managing core risks by Bangladesh Bank in October 2003 is another rational initiative. Some other initiatives are- prohibition of approving loans to individual or group of borrowers in excess of 50 percent of their total capital and written off loans which have been classified as bad or loss for 5 years or even more with full provisions to clean the books of banks.

Literature review

A large number of studies have been conducted for solving and addressing the loan default phenomenon. A number of authors have discussed in their studies about the emergence and accumulation of NPLs after the independence of Bangladesh commencing from the nationalization of banks. Parven (2011) described the situation of NPLs in the economy of Bangladesh through focusing on the commercial banks. In the paper the researcher used 22 years of data to make the data analysis. The findings of the paper dictated that the current situation of nonperforming loans is alarming. It is found that among the different criteria of banks SCBs (State-owned Banks) and DFIs (Development Financial Institutions) have increasing amount of nonperforming loans. She also showed that problem related to slow recovery is the ineffective execution of the framework. Kumar (2006) showed the magnitude of nonperforming asset in Bangladesh after the implementation of loan classification and provisional norms in his paper. The paper indicates that the present scenario of nonperforming loans is alarming in the nationalized commercial banks and development financial institutions. The paper also indicates that the loan loss provisions are not adequately maintained which reduces overall credit quality of Bangladesh. The laws are not implemented in the effective way and thus the debt recovery steps are not adequate. There are some suggestions made regarding the current situation of non-performing loans which are to mitigate the extreme problem of bad loans, to halt the operations of the SOCBs and DFIs, to ensure accountability of involved parties, to implement robust NPL management system, and to emphasize on the ethical standards in the banking profession. Kumar (2019) published a journal making a comparative analysis of NPLs in the banking sector of Bangladesh. The purpose of the journal is to analyze the comparative situation of all the four banking categories on NPL. The study is prepared by considering the data of 12 years. The variables used in the study are NPL to total loans ratio and trend of net nonperforming loan. Descriptive statistics, ANOVA test and the test of homogeneity of variance are used to analyze the data. The findings of the journal indicates that the number of nonperforming loans of SCBs and DFIs continues to increase and remains in the highest level than other categories. A number of recommendations are provided to improve the current scenario of nonperforming loans in Bangladesh. Maria et al. (2017) discussed the impact of board composition on NPL considering the banking sector of Pakistan in their article. The purposes of the article are to determine the influence of board composition on nonperforming loans of the banks and to find out the impact of asset concentration, total assets and GDP growth rate on banks loans. In that study, 18 major banks' data set are used to perform the study. The connection between NPL and board composition is measured through econometric model. The findings of the study indicate that board size has negative impact on NPL's of the bank which is significant in proportion. The study also indicates that the rise in bank size and GDP growth have negative impact on nonperforming loans of the bank. Ahmed et al. (2006) published a study regarding the comparative analysis of loan recovery among private, state owned and Islamic commercial banks of Bangladesh. The paper describes the factors that govern the banking practices including the lending practices adopted by NCBs (Nationalized Commercial Banks), PCBs (Private Commercial Banks), and ICB (Islami Commercial Banks). The findings of the study indicate that the recovery of Islamic banks is quicker than other categories of banks. The better performance of recovery rate is due to the effective portfolio management. The comparative analysis indicates that there is no significance difference in the lending policies between Islamic and conventional banks. Omar and Saiful (2015) conducted a study regarding analytical review of nonperforming loan covering both Bangladesh and Global perspectives. The study describes the current status of nonperforming loans. It also describes

the long term trends of nonperforming loans status in Bangladesh. It also dictates the major problems behind the increasing NPL over the years. The study also includes the instruments of loan recovery and the write of steps in the recent years as a sign of improvement. Saba et al. (2012) published a journal regarding the determinants of nonperforming loans of US banking sector. The journal indicates that there are lots of factors responsible for NPL ratio. The independent factors considered in this study are Real GDP per capital, inflation, and total loans. The dependent variable is nonperforming loan ratio. The findings indicate that independent variables have significant impact on dependent variable.

Overview and Framework of NPL

In recent time NPL is increasing at a very high rate. Some driving forces work behind the growing number of NPL. There is inefficiency in the selection of borrowers and judging their character, capacity, capital and purpose of taking loan. Managerial deficiencies during work, lack of knowledge in the areas of handling, lack of timely actions and lack of adequate effort for recovery are the most influencing factors of NPL. Wrongdoings in collusion is another reason which indicates dishonesty of the borrowers and internal employees of the banks. In the context of Bangladesh, there exists inadequate penalty and improper judicial proceeding. Political and economic instability as well as political patronage to defaulters also act as a driving force. Concealment of influencing information in the loan sanctioning process by the borrower, improper supervision from the government or the regulatory authority, improper valuation of collateral by the banks, ignorance of the guidelines provided by the central bank, inappropriate use of loans and advances, lack of inter-bank coordination and cooperation in exchanging information over list of defaulters, delaying in assessing proposal of loan etc. are the common and influential forces of increasing number of NPL. It has widespread impacts on banking sector and economy as well. Economists have found that failing banks have a tendency to locate very far from the efficient frontier. With the increase in NPL, total interest earnings of banks decreased. Though interest income is decreased, associated cost of fund and managerial cost do not get stopped. Eventually the lending price increases. Banks usually set a risk tolerance limit before. When NPL goes beyond that limit, it affects the rebalancing activities of the bank and also has negative effects on lending. However, in all kinds of commercial operations, especially in banks and other financial institutions, risk is inherently related to the operations. Among all the risks, credit risk is the most crucial factor for banks. Effective way of managing credit risk will help banks to rearrange loan portfolios in an active manner and also to reduce loan losses. NPL of banks does not arise itself, it is not a spontaneous event. A robust process should be started before any loan turns into a NPL.

Preventive Strategy: Prevention of non-performing loan is far better than healing an NPL. Three mostly used preventive strategies are screening, surveillance and loan review. Screening is the first preventive strategy for managing NPL. Proper screening is needed before disbursing loan to borrowers. Selection of right borrowers, identification of project's viability, assessment of the need for credit, obtainment of adequate securities, maintenance of proper discipline for credit are the major tasks under screening. Again surveillance indicates effective and optimal follow-up which is mandatory for recovering credit amount from borrowers.

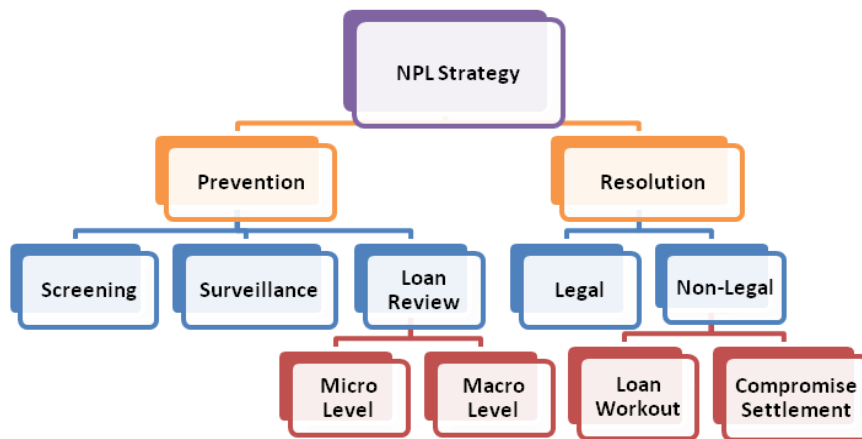


Figure 1: NPL Management Strategy

Supervision helps to control borrowers' operation. Effective supervision ensures proper use of borrowing funds. It has assumed that follow-up is a very significant function for banks as there is an increasing trend of NPL in this sector. At last, loan review which starts after providing loans to borrowers. The process of regular review of loans mitigates the possibility of loan defaulting. Recording related to borrower's payment, assessing the value and condition of collateral securities, documentation of loan related papers, checking the usage of loan money are the important aspects of loan review process. Loan should be reviewed in both macro and micro level.

Resolution: Resolution of non-performing loan can be both in legal and non-legal ways. Loan workout and compromise settlement are the non-legal strategies of managing NPL. The main purpose of loan workout should be to recover the maximum amount of funds from borrowers. Regular and timely repayment of installment with interest amount should be recorded. Banks have to identify problem accounts and have to take quick managerial steps. Banks should have to keep in mind some points, when they enter into compromise settlement, these are – recovering maximum amount of loans and lowering costs, making a distinction between habituated defaulters and defaulters for any adverse unusual situation, examining compromise proposals by the top executive of the banks and setting up of special recovery cells for monitoring NPL.

Research Method

This is a descriptive study based on historical data analysis through data mining and relevant evidences had been collected mainly from annual reports of Bangladesh Bank and BRPD circular. This is basically an analysis of past events data for picturing the current situation and predicting the future of NPL. For this research purpose, data has been collected from both primary and secondary sources. Initially, 2 state-owned commercial banks, 3 private commercial banks and 3 islami commercial banks have been selected in a random way for collecting primary data. And then in-person interview of the branch managers of selected 8 banks have been taken. Also data has been collected from various secondary sources. These sources are- some research works related to NPL of different individuals, journals of different publications and institutions, website of Bangladesh Bank, website of private and public commercial banks, books of some authors. This research has covered a short period of time from 2010 to 2019. Relevant data of these 10 years has been used for the analysis purpose of this study. At the end, manual way of data processing has been used after collecting data from various sources.

Findings and Discussion

Current Situation of NPL in Bangladesh: Banking sector of Bangladesh is now facing a growing trend of NPLs. In recent times, total amount of NPL has increased at a high speed. According to financial stability assessment report of Bangladesh Bank, gross NPL ratio reached 12% of its total loan in the third quarter of 2019 which was 11.7% in the second quarter of that year. In 2019, NPL amount increased significantly. It raised by BDT 1,108.7 billion in first quarter, BDT 1,124.3 billion in second quarter and BDT 1,162.9 billion in third quarter. In the first quarter of 2019, most of the banks had NPL ratios starting from 5% to 10%. 26 banks were in this range. Other 9 banks were in the range of 20% - above. In the second quarter of 2019, 24 banks had NPL ratio ranging from 5%-10%. All other quarterly reports have the same result. So, 5%-10% of NPL ratio is the peak zone for the banking sector of Bangladesh as per the reports of Bangladesh bank. And NPL ratio 20% - above and 3%-5% is second and third highest zone respectively. From the quarterly report of aggregate bank, it has been seen that the ratio of classified loans to total loans are increasing at a nearly stable rate. It was 9.9% as at March 2016 and 12% as at September 2019. In the classified portion of total loans, a huge percentage is bad loan. In 2016, nearly 81.58% of classified loans were bad or loss and in 2019, it was 86.5%.

NPL: Comparative Scenario of SOCBs and PCBs-

Gross NPL is the most important indicator of measuring assets quality in the portfolio of loan. This is calculated as total NPL (Non-performing loan) divided by total amount of loan. A table of gross NPL is given below from 2010 to 2019 (June) –

Table 1: Gross NPLs to Total loans of SOCBs and PCBs of Bangladesh (in percent)

Bank types	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 June
SOCBs	15.7	11.3	23.9	19.8	22.23	21.5	25.1	26.5	30.0	31.6
PCBs	3.2	2.9	4.6	4.5	4.98	4.9	4.6	4.9	5.5	7.1

Source: Department of Off-site Supervision (DOS), Bangladesh Bank.

From the above data it can be seen that SOCBs have much higher gross NPL ratio than that of PCBs.

Net NPL is the net of provisions and interest suspense. It is another important indicator of measuring assets quality of loan portfolio. A table of data related to Net NPLs of SOCBs and PCBs from 2010 to 2019 is given below-

Table 2 : Net NPL Ratios of SOCBs and PCBs of Bangladesh (in percent)

Bank types	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 June
SOCBs	1.9	-0.3	12.8	1.7	6.1	9.2	11.1	11.2	11.3	8.7
PCBs	0.00	0.2	0.9	0.6	0.8	0.6	0.1	0.2	0.4	1.5

Source: Department of Off-site Supervision (DOS), Bangladesh Bank.

Net NPL ratios of banking sector has a mixed trend particularly in State-owned commercial banks. In 2010, SOCBs had 1.9% of net NPL ratio. But it had a decrease in next year with (0.3%). Net NPL ratios of SOCBs had a huge increment in 2012 and rose at 12.8%. In the next year in 2013, it was very low compared to the previous year. From 2014 to June 2018, net NPL ratios of SOCBs faced an increasing trend. PCBs have also faced a mixed trend in their net NPL ratios but those are very low than that of SOCBs. PCBs had less than 1% of net NPL ratios from 2010 to 2018 but it increased in 2019.

Private commercial banks maintain higher amount of provision than they required. So they have high percentage of provision maintenance ratio. On the other hand, SOCBs fail to maintain required provision. They maintain very low amount of provision than they required to maintain. Ultimately they have less provision maintenance ratio. This inability to maintain required provision increases total amount of shortfall in the aggregate banking sector performance.

Table 3: Provision Adequacy of both SOCBs and PCBs (In billion BDT)

Year	Items	SOCBs	PCBs
2016	Provision Required	174.0	144.2
	Provision Maintained	113.2	149.4
	Provision maintenance ratio (%)	65.1	103.6
2017	Provision Required	216.9	184.3
	Provision Maintained	134.3	198.2
	Provision maintenance ratio (%)	61.9	107.5
2018	Provision Required	289.3	241.1
	Provision Maintained	210.6	250.2
	Provision maintenance ratio (%)	72.8	103.8
2019 (June)	Provision Required	353.0	321.2
	Provision Maintained	284.5	293.1
	Provision maintenance ratio (%)	80.6	91.3

Source: Annual Report 2017-2018, Bangladesh Bank.

After conducting a comparative analysis between public and private banking sector, it has been found that public sector are mainly responsible for growing amount of NPL in the banking industry. The main reasons behind this are political issues, dishonesty of the government officials, biased behavior of management toward borrowers, providing loans to known individuals and organizations. On the other hand, private sector faces less intensity of NPLs for their rigid and appropriate way of sanctioning loan and also effective surveillance.

Impact of NPL on the Performance and Profitability of Banks: Performances of public and private banking sector have a huge gap due to non-performing loan. Both sectors are not similar in the contribution to banking industry. Core performance and profitability measures are share in assets and deposits, capital adequacy, CRAR, ROA and ROE.

PCBs have higher share in deposits and industry assets of banking sector than SOCBs. Their banking activities have more influential and significant impact on the overall industry, but that of SOCBs have less impact on the industry for their less contribution.

Table 4: Share in Assets and Deposits of SOCBs & PCBs

Bank Types	2017		2018	
	Share in Assets of Industry (in %)	Share in Deposits (in %)	Share in Assets of Industry (in %)	Share in Deposits (in %)
SOCBs	25.9	27.3	27.6	26.6
PCBs	67.1	65.9	65	66.0

Source: BRPD and DOS, BB.

According to the instruction of Bangladesh Bank through Basel-III, banks of Bangladesh have to maintain Minimum Capital Requirement (MCR) at 10% of their Risk Weighted Assets or BDT 4 billion, whichever is higher. Higher CRAR (Capital to Risk Weighted Assets Ratio) is desirable and expected to be achievable by all types of banks. More than 10% is termed as 'Capital Adequacy'.

Table 5: Capital To Risk Weighted Assets Ratios of SOCBs and PCBs of Bangladesh (in percent)

Bank types	2010	2011	2012	2013	2014	2015	2016	2017	2018 (up to June)
SOCBs	8.9	11.7	8.1	10.8	8.3	6.4	5.9	5.0	2.0
PCBs	10.1	11.5	11.4	12.6	12.5	12.4	12.4	12.5	12.2

Source: Department of Off-site Supervision (DOS) , Bangladesh Bank.

CRAR of SOCBs are not satisfactory. In 2011 and 2013, SOCBs have more than 10% of their minimum required capital, those are 11.7% and 10.8% respectively. PCBs have more satisfactory CRAR than SOCBs of Bangladesh. It has been seen that on 31 December 2010, PCBs maintained 10.1% as their CRAR. It had a significant increment in 2011 by 11.5%. CRAR of whole PCBs remained constant in the next year (2012) which was 11.4%. In 2013, CRAR was 12.6% in PCBs which is the highest CRAR for the private commercial banks so far. From 2014 to June 2018 CRAR of PCBs remained in a constant rate, above 12%.

Measurements of earnings by ROA and ROE are different within banks. ROA and ROE of SOCBs are less than the average of industry. In 2017, SOCBs had a mere improvement than previous years.

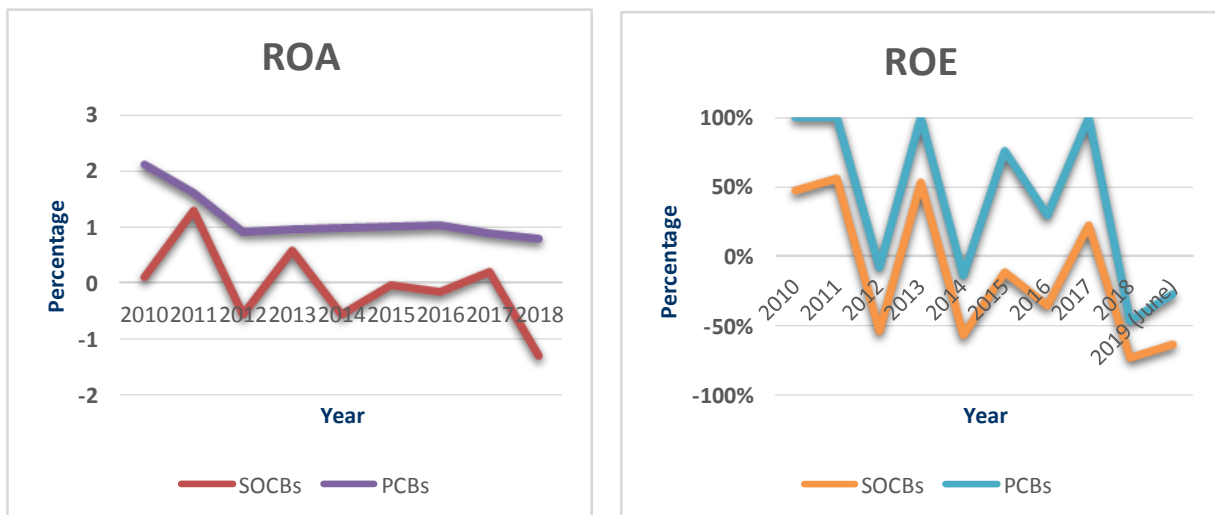


Figure 2: ROA and ROE of SOCBs and PCBs

Other than 2010, 2011, 2013 and 2017 SOCBs faced negative ROA and ROE. In contrast, PCBs have positive value. ROA, ROE of PCBs are more significant and satisfactory than that of SOCBs of Bangladesh. Aggregate ROA and ROE of SOCBs are very low. Poor profitability and uncertain future growth lead SOCBs' performance in a degrading trend.

Recommendations

Improvement of current NPL situation should be a matter of great concern for banking sector of Bangladesh. All the parties involved in loan sanctioning and in loan section of banks should be very careful of defaulting. All bank should be under proper and adequate surveillance of Bangladesh bank. Appropriate supervision of central bank can help reduce the extent of NPL in the economy of any country. Policies of Bangladesh Bank should be implemented in an active way to all the commercial banks operating in Bangladesh. Also public banking sector has to be monitored very carefully. Board of directors of SOCBs must have to be neutral and free from any fraudulent activities. Qualification of BODs of SOCBs as well as PCBs must be in consistent with Bank Companies Act 1991 (Amended at 2013). Approval of non-executive

members at the time of loan sanctioning should be taken strongly. Their opinion must be accepted willingly by all the members of the board. Again banks have to make bound to follow the rules and regulations provided by Bangladesh bank and in case of any ignorance in abiding the rules, appropriate punishable measures should be adopted by related authorities. Lending process must be in accordance with the instruction of Bangladesh bank. Loan proposals should be scrutinized carefully. Capacity, covenants, purpose of taking loan, characters of borrowers and all other related information must be reviewed by the members of loan section. Finally it can be said that a strong ethical standard of the people in the banking profession can mitigate the intensity and frequency of loan defaulting. Their strong ethics can improve the credit environment of the banking sector. It will introduce a fair practice of lending in the economy that no law or legal step can do.

Concluding Remarks

The current situation of NPL in the banking sector of Bangladesh is quite alarming and special attention needs to give for addressing this issue. The intensity of defaulted loans is pretty much higher in the public sector compared to the private sector. Also, the nature and effect of defaulted loans are quite different in these two sectors. However, the profitability of the banking sector is low due to the ineffective management of the assets. Still, the banking system of Bangladesh is facing severe loss compared to the neighbor countries due to NPL. Even though Bangladesh has implemented global standards of loan provisioning as well as loan classification, the credit functioning team is turned out as unsuccessful. The credit management team shall adopt all the modern strategies to recover loans from customers. All the measures concerning prevention and resolution must be followed through a chain of command. The legal rules and regulations must be followed according to the judicial system under the resolution criteria. This study has identified some possible steps that should be taken to mitigate the intensity of NPL from the current severe position in the banking industry.

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Appendix

Table 1: Sample of selected 8 banks for interview purpose

Bank Type	Name of the Banks	No. of Selected Banks
SOCBs	Janata Bank Ltd.	2
	Agrani Bank Ltd.	
PCBs	Eastern Bank Ltd.	3
	Standard Bank Ltd.	
	Mercantile Bank Ltd.	
ICBs	Shahjalal Islami Bank Ltd.	3
	Islami Bank Bangladesh Ltd.	
	Al-Arafah Islami Bank Ltd	

Table 2: NPL Ratio of Banking Sector

Time Period	NPL Ratio of Banking Sector			
	Total amount of NPL (BDT in billion)	Gross NPL Ratio (NPL/TL) (%)	NPL (net of LLP and IS) Ratio (%)	NPL (net of LLP and IS)/ Reg. Cap. (%)
Mar-16	594.1	9.9	2.9	21.2
Jun-16	633.7	10.1	2.8	21.1
Sep-16	657.3	10.3	2.8	20.8
Dec-16	621.7	9.2	2.3	18.0
Mar-17	734.1	10.5	2.9	22.7
Jun-17	741.5	10.1	2.6	19.7
Sep-17	803.1	10.7	2.9	22.4
Dec-17	743.0	9.3	2.2	17.2
Mar-18	885.9	10.8	3.3	27.6
Jun-18	893.4	10.4	2.7	22.7
Sep-18	886.0	11.5	3.3	26.0
Dec-18	939.1	10.3	2.2	17.8
Mar-19	1,108.7	11.9	3.0	22.6
Jun-19	1,124.3	11.7	2.5	18.6
Sep-19	1,162.9	12.0	3.7	27.3

Source: Financial Stability Assessment Report (January- March 2018), Bangladesh Bank.

Table 3: Range of NPL Ratio & Number of Banks

Range	Range of NPL Ratio & No. of Banks		
	Mar-19	Jun-19	Sep-19
Up to 2.0%	7	8	7
2.0% to <3.0%	6	4	4
3.0% to <5.0%	12	13	10
5.0% to <10.0%	18	19	24
10.0% to <15.0%	3	3	1
15.0% to <20.0%	1	1	0
20.0% & above	10	9	11
Total	57	57	57

Source: Financial Stability Assessment Report (January-March 2018), Bangladesh Bank.

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