NPL: Sources of malaise and possible remedies

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EXCESSIVE volume of non-performing loan (NPL) in the banking sector is a major weakness of the Bangladesh economy. When a loan is sanctioned, it includes a repayment schedule comprising principal and interest amounts. According to Bangladesh bank regulations, a loan becomes non-performing when the borrower fails to pay the scheduled principal and interest amounts for more than 90 days. If the proportion of NPL grows, it reduces the capacity of banks to sanction further loans, their capacity to repay the depositors, and their ability to earn profit. Continuation of large size of NPL may lead to liquidity crisis in the overall banking sector and even failure of banks.

NPL in our banking sector stood at Tk 112,425 crore as of June 2019, which is 19.71 percent higher than the NPL amount at the end of December 2018. Rising NPL is, no doubt, a threat to the stability of the financial health of the country and we need effective remedy to this problem.

The proximate reason behind the high volume of NPLs in Bangladesh is "adverse selection". The financial institutions (FIs) often end up selecting the wrong borrower and funding the wrong activity. What leads to such adverse selection? A straight-forward summary response to that would be "poor lending practices of the FIs".

The FIs usually do not have any effective research or business intelligence units to collect, monitor and analyse business information to assess the true potential of diverse business activities under changing local and global economic and policy environments.

There is also very little effort on the part of these institutions to seek out promising entrepreneurs, particularly new ones. Attempts to determine the characteristics of the entrepreneurs through "Know your customer (KYC)" screening are often inadequate. For example, information is collected on the credit status of the borrower from the Credit Information Bureau (CIB) and an unclassified status is considered satisfactory. But questions are rarely asked regarding the number of times the borrower may have rescheduled the loan or created forced loan in the past.

One factor influencing the loan portfolio of the financial institutions is the bandwagon effect. Many borrowers try to set up enterprises with institutional finance influenced by the success of others in particular types of activities. This happened in Bangladesh in the past in the case of power loom, readymade garments, ship breaking, cement etc. and recently such a craze is observed in setting up automated rice mills, brickfields, and hotels and holiday resorts. In the absence of proper evaluation of the key determinants of success in these activities, financial institutions often get carried away by the enthusiasm of the potential borrowers based on others' success stories. To the extent that market saturation, size of operation, location, varying entrepreneurial traits and a host of other factors may have bearings on the outcome of the investment, financial institutions run the risk of making adverse choices in such cases.

The second shortcoming embedded in the lending process is poor appraisal of the credit proposal. Even when the activity (for investment) and the borrower are selected properly, problems may arise due to faulty estimation of the optimum credit need, which often leads to over-financing, creating scopes for fund diversion, over-invoicing and even money-laundering. Problems happen at the other end as well. Sometimes the size and duration of loan is inadequate and puts the borrower into serious cash flow problems, particularly because of compounding high interest rate. Another aspect of deficient appraisal is faulty assessment of collateral, resulting in under-coverage of the loan or acceptance of collateral of dubious quality.

These instances of system failures and lack of due diligence get compounded when there is collusion between the lender and the borrower or undue pressures are exerted by influential borrowers. In a few extreme cases of collusion or pressure from influential quarters, funds are siphoned off against little or no collateral or against false documents with the intention of money-laundering or diversion of funds to unauthorised uses.

A genuine entrepreneur with a properly designed credit proposal is unlikely to collude with lenders as payoffs involved in such collusion will not be financially worthwhile for the borrower. In contrast, swayed by the bandwagon effect, a large number of overenthusiastic borrowers tend to over-design their credit proposals either in collusion with lenders or through support from influential quarters. If credit proposals with such flawed design dominate the choice set faced by the financial institutions, adverse selection becomes a more likely outcome.

Implementation bottlenecks raise further the menace of NPLs. The most alleged implementation snag seems to be delay in fund disbursement and the corruption associated with it. Other than these aspects of poor lending practices, many genuine cases of business failures, which occur due to personal mishaps, accidents, adverse policy changes, market failures etc. also contribute towards creation of default loans.

But what is the picture regarding recovery of default loan?

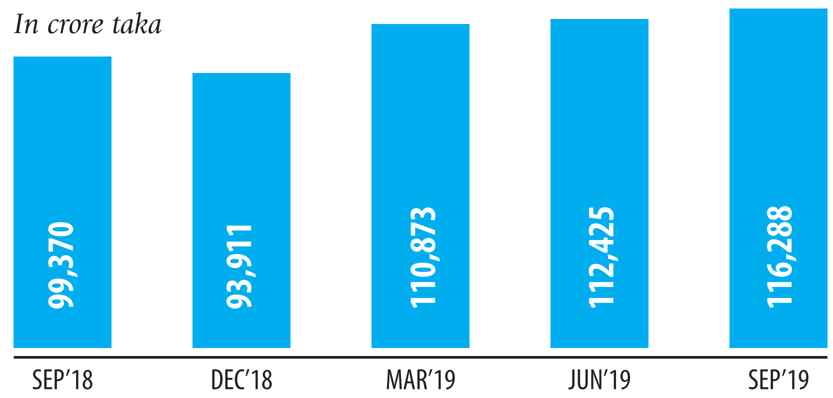
The recovery picture does not appear to be very encouraging either. In the cases where the loan is well covered by adequate collateral, recovery efforts are often frustrated by weak and lengthy legal proceedings. During this period the outstanding debt continues to escalate, overshooting the value of the collateral ultimately. Through the legal measures, the loan defaulters not only get legal proceedings against them stayed, they also manage to get court orders to strike out their names from the CIB classified list, which gives them opportunity to indulge in more borrowing.

In the cases where the loan is not properly covered by collateral, the financial institutions are on even weaker grounds to pursue recovery.

Where loan default involves gross irregularities, criminal proceedings are initiated against the offenders who often land in jails. But then the loan recovery process gets completely thrown out of line. As the banks cannot take custody of the assets of the defaulter until the criminal cases are disposed of, the assets are often lost and any hope of bank recovering a significant amount of the loan disappears. An appropriate example is the Hall-Mark case, where one accused died in jail and others are still behind bars, but the prospect of bank recovering the loan is almost nil.

DEFAULTED LOANS AT BANKS

In crore taka



SOURCE: BB

So, how does one get out of this messy NPL situation? What is the remedy?

Well, as they say, "prevention is better than cure". The first thing that must be done is to ensure that no new loan gets classified. For this, one needs to strengthen lending discipline in the FIs. This will involve intervention at four levels:

First, with strong and independent internal control and compliance (ICC), the FIs must ensure proper KYC and due diligence to satisfactorily evaluate a loan proposal and correctly determine market potential, value of the collateral and optimum credit needs.

Second, the board of directors must ensure that management has satisfactorily resolved all issues flagged by the ICC. Third, selection and appointment of board members should be done on the basis of strict objective criteria and there should be a mechanism in place to monitor the performance of the board members. Fourth, there is a need to strengthen the supervisory capability of the Bangladesh Bank.

For improvements on the recovery front, necessary legal reforms to strengthen and expedite the legal process should be undertaken immediately. Two measures can bring about significant immediate improvements in the situation: loan defaulters should be required to pay a certain percentage of their outstanding debt before they seek stay order on legal proceedings against them, and a dedicated bench should be set up at the high court to dispose of loan-related writ cases.

Effective Bankruptcy Act and Asset Management Company should be put in place as alternative NPL resolution mechanism, in particular to deal with default cases under-covered by collateral and those involving influential borrowers.

Finally, for a large proportion of cases, where the default is due to genuine business failure or fund disbursement delays by the bank, the existing rescheduling facility needs to be made more accommodative.

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Lackluster US retail sales dim fourth quarter economic growth outlook

REUTERS, *Washington*

US retail sales increased less than expected in November as Americans cut back on discretionary spending despite a strong labor market, raising fears the economy was slowing a bit faster than anticipated in the fourth quarter.

The report from the Commerce Department on Friday bucked a recent raft of fairly upbeat data on the labor market, housing, trade and manufacturing that had suggested the economy was growing at a moderate speed in spite of headwinds from trade tensions and slowing global growth.

The Federal Reserve on Wednesday kept interest rates steady and signaled that borrowing costs were likely to remain unchanged at least through next year amid expectations the economy would continue to grow modestly and the unemployment rate remain low.

"Just as the Fed was in the middle of a victory dance, convinced they have returned the economy to a position of strength after just three rate cuts, the consumer waves a red flag," said Lindsey Piegza, chief economist at Stifel in Chicago. "Any signs the consumer is waning could have sizeable negative consequences for growth at year-end and into next year."

REUTERS/FILE

Shoppers walk through the King of Prussia Mall Pennsylvania, US.

Retail sales rose 0.2 percent last month. Data for October was revised up to show retail sales increasing 0.4 percent instead of climbing 0.3 percent as previously reported.

November's sales gains were meager despite reports from retailers of brisk Black Friday business. Some economists blamed a late Thanksgiving this year compared to 2018, which pushed Cyber Monday shopping into December. The late Thanksgiving could also have thrown off the model that the government uses to strip seasonal fluctuations from the data, holding back sales.

Economists polled by Reuters had forecast retail sales would accelerate 0.5 percent in November. Compared to November last year, retail sales increased 3.3 percent.

Excluding automobiles, gasoline, building materials and food services, retail sales edged up 0.1 percent last month after rising by an unrevised 0.3 percent in October. These so-called core retail sales correspond most closely with the consumer spending component of gross domestic product. Consumer spending accounts for more than two-thirds of the economy.

Even accounting for the Thanksgiving-related distortions, retail sales have slowed considerably after rising by an average of 0.7 percent per month in the first eight months of this year. Economists believe sales are cooling as wage growth has stalled despite the lowest unemployment rate in nearly half a century.

"As we have been asking, is this just noise or an early sign that cracks in the strong consumer story are starting to form?" said Michelle Girard, chief US economist at NatWest Markets in Stamford, Connecticut. "We are watchful it is the latter."

Consumer spending grew at a 2.9 percent annualized rate in the third quarter. November's slim gain in core retail sales left economists to expect that consumer spending would rise at around a 2.0 percent rate in the fourth quarter. But slowing consumer spending is boosting inventories at retailers, which could limit the downside to fourth-quarter GDP growth.

Indian gold sold at discount as wedding demand disappoints

REUTERS, *Bengaluru/Mumbai*

GOLD dealers in India offered a discount this week due to plentiful supplies and slack demand during the wedding season, with other regions in Asia expecting improvement in buying ahead of the Christmas and Chinese New Year festivities.

Dealers in India offered a discount of up to $2 an ounce on official domestic prices, compared to a premium of $1 last week. Domestic prices include 12.5 percent import tax and 3 percent sales tax.

"Demand is modest from jewellers, but there is ample supply from refiners that are aggressively selling in the market," said Harshad Ajmera, a gold wholesaler in Kolkata.

India's gold imports in November jumped 78 percent from a month earlier to the highest level in five months as jewellers in the world's second-biggest market for the metal restocked after a fall in prices.

"Assuming good demand during wedding season, banks and refiners have raised imports in the last few weeks," said a Mumbai-based dealer with a private bullion importing bank.

Weddings are one of the biggest drivers of gold purchases in India as bullion in the form of jewellery is a popular gift.

Demand is expected to recover in top consumer China, where traders charged premiums of $4-$6 an ounce over benchmark prices from $4-$5.5 last week.

"Demand has dried up compared to last week, but is still higher than late last month and earlier this month," said Samson Li, a Hong Kong-based precious metals analyst at Refinitiv GFMS.

The Chinese new year beginning on Jan. 25 is expected to lift demand starting the end of December, he added.

The Chinese festival is also expected to improve demand in Singapore, with many retailers offering promotions for bullion, Silver Bullion sales manager Vincent Tie said.

Sellers in Singapore charged premiums of $0.60-$0.80 an ounce over the benchmark, versus last week's $0.60-$0.70.

"If (benchmark) prices come down a little bit, we will see some buying on the wholesale side," said Brian Lan, managing director at Singapore dealer GoldSilver, adding that lower prices would also support demand during Christmas.

German central bank slashes 2020 growth outlook

AFP, *Frankfurt*

GERMANY'S central bank on Friday slashed its 2020 growth forecast for Europe's largest economy in half, but said an export-powered rebound was on the cards in the following years.

The Bundesbank predicted 0.6 percent expansion next year, half the pace it had reckoned with in its last outlook in June.

That represents little change from the expected 0.5 percent reading for 2019, one third of last year's rate.

But in 2021-22 growth should pick back up to around 1.4 percent.

"Along with noticeably supportive fiscal policy, very expansive monetary policy and above all exports will be vital to the improved economic prospects," Bundesbank president Jens Weidmann said in a statement.

Export-dependent German manufacturers above all have in recent months suffered from slowing global growth and trade and increased uncertainty over US-led trade conflicts and Brexit.

Meanwhile the powerhouse economy has enjoyed low unemployment and a strong services sector, although economists point to signs industrial weakness is beginning to spread to other areas.

Boris Johnson's resounding victory in British parliamentary elections Thursday could reduce one element of uncertainty.

The Conservative leader many now have the necessary freedom of manoeuvre to see through Brexit and strike a trade deal with the European Union after Britain's departure.

A decisive outcome in the UK would mean "an element of uncertainty which is probably loosening and will give us a bit more clarity," European Central Bank president Christine Lagarde said ahead of the results Thursday.

In her maiden press conference, she also pointed more generally to "initial signs of stabilisation in the growth slowdown" that has sapped Europe in recent months.

And even as Lagarde was speaking, US President Donald Trump tweeted that he was "getting VERY close to a BIG DEAL with China", powering American stock markets to new highs.

Bundesbank chief Weidmann nevertheless warned Friday that "there remain sources of economic danger from abroad that could prolong and worsen the industrial downturn".

Japan business confidence drops for 4th straight quarter: survey

AFP, *Tokyo*

CONFIDENCE among Japan's biggest manufacturers has slipped for the fourth straight quarter, a key survey showed Friday, reflecting lingering worries over the US-China trade war.

The Bank of Japan's December Tankan business survey -- a quarterly poll of about 10,000 companies -- showed a reading of 0 among major manufacturers, a worse-than-expected fall from +5 in the previous quarter. The market consensus was for a +3 reading.

The Tankan survey reports the difference between the percentage of firms that are upbeat and those that see conditions as unfavourable. It is considered to be the broadest indicator of how Japan Inc. is faring.

Economists have warned that worries over US-China trade frictions are forcing manufacturers to refrain from active investment.

The latest reports, however, suggested the United States and China had struck a bargain on trade, which would cancel a fresh round of tariffs on $160 billion in Chinese imports due to kick in on Sunday.

A long-planned sales tax hike in Japan to 10 percent, from eight, could also have weighed on growth, they said.

A temporary halt in factory operations due to deadly Typhoon Hagibis in October could also be a reason for a dip in confidence, said Hiroshi Miyazaki, senior economist at Mitsubishi UFJ Morgan Stanley Securities, ahead of the survey.

The index for non-manufacturers fell to 20 from 21 in the previous quarter.

Japan's economy, the world's third-biggest, grew 0.4 percent in the third quarter, the third straight period of expansion.