Some Recent Trends of Bangladeshi Commercial Banking System

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Banks are most probably the most important type of financial institutions in Bangladesh. Although there are two fully operating stock exchanges in Bangladesh still the majority portion of demand for financial services are addressed by commercial banks. Banks traditionally, contributes the economy through intermediation. Though intermediation is the most important task of commercial banks, in recent years in some developed countries it experienced a declining trend. In this paper, we tried get an overview of different trends of commercial banks in Bangladesh. We also looked into the dynamic relationship between banks and Non-bank Financial Institutions (NBFIs). We have found that different reform projects carried through last two decades have a beneficial effect on banking. We also found that NBFIs, although still relatively less significant compared to banks are growing and they are taking away shares from banks in both loan and deposit market. The paper, however, has not taken into consideration the effect of thrifts, which operate among less privileged section of the economy.

Keywords: Bangladesh, Commercial Bank, Non-bank Financial Institutions, Intermediation.

INTRODUCTION

Financial system is one of the most important systems of an economy. Although it can be primarily considered as a nominal sector, yet for smooth and efficient functioning of real sector a strong and resilient financial system is imperative. A well functioning financial system experiences signals of impending problems (within the economy) long before the real sector. This service is crucial and places financial system to a distinct position in the landscape of economic institutions.

The main responsibility of a financial system is to transfer funds from savers to borrowers. In that process, there is no scope for coercion and/or benevolence. People in financial world aggressively look for profit and marginal change in expected return can induce them to reverse their decision. Therefore, it is the responsibility of a financial system to create a comfortable environment for savers to park their extra money and encourage responsible investors to take loan.

This is an enormous job and banks, stock markets, non-bank financial institutions are all engaged in this process to accomplish this smoothly. Governments of many countries have a tendency to control financial market rather than relying on free competition based market system. Such practice stems on the motivation that under central planning system government can control and allocate resources better. This intuitively appealing argument has not proved itself effective.
in reality. Governments mostly fail to manage money market efficiently and in the process of exerting control, they typically repress their financial systems. Such result is in accordance with the theoretical arguments of McKinnon-Shaw hypothesis (McKinnon, 1973 Shaw, 1973) which argued that suppressing lending rate (administratively) can make deposit rate suppressed, which can eventually hamper domestic savings and dry up the sources of funds.

Bangladesh is a small developing country in South Asia trying hard to cope up with its growing population with limited resources. Due to lack of sufficient natural resources, the country is shifting its focus to complicated mechanical production from production of primary goods. Therefore, real investment becomes important and so is the financial system. Financial system of Bangladesh is dominated by banks despite presence of two stock exchanges and a set of non-bank financial institutions. Insurance companies and leasing firms provide specialized services.

Non-bank financial institutions in Bangladesh are mostly focused towards large long-term investments (although they go for small working capital type investments as well) and share markets are mostly for qualified people (although expecting windfall gain many people invest there without having proper knowledge of finance).

Main products offered in Bangladeshi financial system are different types of bank accounts, term deposits, Treasury bills of different maturities, commercial papers, stocks, mutual funds etc. Bangladesh bank, which is the central bank of Bangladesh is in control of banks charter and supervise them. Apart from that, there is a Securities Exchange Commission (SEC) that oversees local stock markets.

The country has 47 commercial banks of which 4 (four) are Nationalized Commercial Banks (NCBs), 4 (four) are Specialized Banks (SBs), 30 (thirty) are domestic Private Commercial Banks (PCBs) and the remaining 9 (nine) are Foreign Commercial Banks (FCBs). There are also 29 (twenty nine) Non-bank Financial Institutions (NBFIs) as of 2010. The number of banks and non-bank financial institutions are in some sense adequate as they are engaged in a healthy competition. However, what is missing is the provision of financial services in rural area. Other than NCBs and SBs, PCBs and other NBFIs do not show interest to open branches in rural areas possibly due to fear of low level of operation there. Two stock exchanges of the country are, Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE). Bangladesh also has a number of micro credit organizations and cooperatives.

While comparing the depth and width of financial system compared to its neighbors in SAARC region we can have the following table with some standard ratios. The table shows that in most cases India and Nepal are ahead of Bangladesh but Pakistan and Sri Lanka lag behind.

| TABLE 1 HERE |

In this paper, we intend to discuss some the recent trends of Bangladeshi banks and compare those with similar trends of Non-Bank Financial Institutions (NBI). Banking industry, like most of the industries is a dynamic one. Economy changes and in response to that banking sector offers new product and services. In last two decades or so Bangladeshi economy has experienced substantial growth. Private investments came up with increased level of risk taking and ventured into new sectors exploring opportunities not only locally but also globally. This certainly should have an effect on financial sector. By investigating growth pattern of different indicators of bank and non-bank sectors we hope to reach to some important conclusions.

The reminder of this paper is organized as follows; the next section discusses some regular activities of banking institutions. A discussion on Bangladeshi bank and non-bank financial institutions is presented in the subsequent section. After a brief discussion on methodology and data sources, we compared some attributes of bank and non-bank financial institutions along with recent trends of banking industry. Concluding section will summarize the results found.

**TRADITIONAL ACTIVITIES OF BANKS**

There are two views regarding banks’ activities. The first one (Benston 1965, Ferrier et al., 1993) is
the production view where it is assumed that banks are production units and produce different types of financial products. The other view (Sealey and Lindley, 1977) is the intermediation view where banks’ are assumed as production units that convert deposits into loans. This conversion is technically known as intermediation. Banks make money from the difference between lending rate and deposit rate of interests. However, it has been documented that, banks, especially in developed countries are now moving away from their traditional activities and are diversifying their holdings into other complicated forms of assets. However, this is a trend, though distinct and intermediation still continues to be the primary source of their earning. Declination of intermediation among banks was first identified in the USA and later many studies found commercial banking to be at least a transforming industry if not a declining one.

Boyd and Gertler (1994) initiated this discussion stating that non-bank credit alternatives have made the role of banking sector in US economy less important. They found that US banks have faced substantial competition from its non-bank counterpart but have not lost its ground. Rather it developed new products and strategies to combat the evolved situation. However, they admitted that banks experienced a minor decline in total intermediation but a major change in their approach and composition of intermediation. Similar conclusions were found by Kaufman and Mote (1994).

In recent years it was again felt that bank might have picked up such trend so Boyd and Gertler (1994) was updated by Feldman and Lueck (2007) where they found result similar to the original paper. They found that though banks are not dying it now faces increased competition from non-bank institutions. They acknowledged data problem to compare banks and non banks on the same datum.

Edwards and Mishkin (1995) found clear evidence of declination of banking industry. They found that the share of US banks gradually declined from 39% (year 1960) to 29% (year 1994). This trend continued among savings and loan association. However, in this period credit unions registered a small increase in their market share. They also found that profitability from traditional banking activities also diminished over time. They stated that banks are now moving towards non-traditional activities to maintain their status as financial intermediaries. Since profitability from traditional banking has been declining banks face two alternatives in order to survive: First, it can maintain traditional banking by taking greater risks and lending to less creditworthy borrowers and second, banks can diversify by increasing off-balance sheet activities, which are more profitable but more risky at the same time. Apparently banks took the second approach.

Samolyk (2004) found that US banks are shifting from traditional intermediation to securitization of assets. The research identified that this shift from traditional intermediation towards asset securitization reflects not only changing in credit technologies but also the activity of government-sponsored enterprises. The paper also reports that market share of banks measured based on balance sheet data understates banks’ share in the economy and implies that banks are declining. However, measures based on income does not imply decline in the importance of commercial banks.

Similar studies took place in other countries. An international comparison between the financial systems of France, Germany and United Kingdom by Schmidt, Hackethal and Tyrell (1999) reported that there is no general tendency towards disintermediation or decline in the role of banks. France is the only country which showed tendency towards changes. However, the paper supports increase in securitization and decline in the role of banks as mobilizers of savings.

DeYoung and Rice (2004) reported that interest margin is still the primary source of income for banks but banks also earn a large amount of fee income from both traditional and non-traditional activities. Non-traditional activities like investment banking, securities brokerage, insurance agency and underwriting and mutual funds are generating large amount of non-interest income for the banks. It was also reported that fee generating activities are uneven across the banking sector and small banks are more into
relationship banking. As explained in DeYoung and Rice (2003) small banks charge high interest on loans and pay less on deposits based on relation so they earn high interest margin and therefore non-interest income is not so important for them. On the other hand large banks enjoy economies of scale and earn high amounts of non-interest income; interest margin is low for these large banks.

Non-interest income earnings by banks are not only increasing in US but also in other countries. A time series analysis of the relationship between non-interest income and interest margin in Australian banks has been done by Williams and Rajaguru (2009) where they found interest margin to be declining and non-interest income to be increasing over time. Mujeri and Younus (2009) explained that higher the ratio of non-interest income to total assets lower is the interest spread. They also stated that interest spread has been declining in recent years in Bangladesh.

In another line of argument, several studies conclude that banks are moving towards non-traditional activities following deregulation and advancement in technologies. This transformation is increasing the risk for banks and lowering their risk adjusted profits (DeYoung and Rice, 2003, 2004; Stiroh 2004; Stiroh and Rumble, 2006; Piciu, Chitiga, Mihaila and Trica, 2011). Piciu, Chitiga, Mihaila and Trica (2011) also states that systemic risk is high in case of banks because they are interdependent and therefore a failure of one bank may lead to failure of other banks and this in turn might have macroeconomic impacts. Hirtle (2009) explains that credit derivative is the recent financial instrument just like loan sales in 1980s and securitization in the 1990s.

Following these studies, we are tempted to investigate the recent trends of banking industry and their response to growing competition from non-bank financial institutions in Bangladesh. Our study aims to analyze the position of banks in the financial system of Bangladesh in recent days and its comparison with NBFI.

**BANKING SYSTEM OF BANGLADESH**

Bangladesh along with India and Pakistan inherited their branch banking system (as opposed to single branch banking system) from the British colonial regime. Shortly after liberation in 1971 there were 6 NCBs, with 1078 branches, 3 FCBs with 14 branches and 2 SBs with 82 branches. However, national banks at that time were not doing well and subsequently in 1980s, government privatized two of the national banks (in 1982) and accommodated a number of private banks. This initiative developed into a larger movement of overhauling the whole banking system under the guidance of International Monetary Fund (IMF) starting from early 1990s. The program made a number of very useful recommendations and pushed local banking system towards international standard. Such changes also enhanced acceptance of banking system among local depositors and Bangladesh economy become financialized through banks. Some of the important parameters of the extent of banking are given in the following table.

**TABLE 2 HERE**

Now banks along with non-bank financial institutions are engaged in providing financial services. However due to higher level of efficiency and better customer service private banks are gaining more grounds from nationalized banks both in local loan and deposit market. The figure 1 shows relative share of different types of banks in deposit market and figure 2 shows the same figures for loan market.

**[Figure 1, Figure 2]**

In last two decades, banking system of Bangladesh has achieved remarkable growth and now is closer to international standard more than ever. This means that now it has more rational standard in practice as well as more market based approaches. However, it also means the system is now prone to flaws that are common among advanced (market based) financial system. Banks of Bangladesh are increasingly getting themselves engaged in off balance sheet activities and actively finance riskier projects.

**NON-BANK FINANCIAL INSTITUTIONS (NBFIS)**

As the economy develops demand for financial services increase and as a result banks, non-bank
financial institutions and capital markets grow over time. According to Goldsmith (1969) banks tend to dominate the financial system but with the development of the financial system over time NBFIs develop and operate along with the banks. The same pattern can be seen for the financial system of Bangladesh.

The entrance of NBFIs took place in Bangladesh in 1981 with the establishment of Industrial Promotion and Development Company (IPDC), the first private sector NBFIs. Now there are 29 NBFIs in Bangladesh of which 1 is government owned, 15 are local (private) and the other 13 are established under joint-venture arrangements with foreign institutions. The NBFIs in Bangladesh are covered by the “Financial Institutions Act 1993” and under this act they are allowed to make loans and advances for industries, commerce, agriculture or building construction, carry out the business of underwriting, receiving, investing and reinvesting shares, stocks, bonds, debentures issued by the government or any statutory organization or stocks or securities or other marketable securities, carry out installment transactions including the lease of machinery and equipments, finance venture capital and shall include merchant banks, investment companies, mutual associations, mutual companies, leasing companies or building societies.

The financial institutions are required to raise capital through Initial Public Offerings (IPO) and the minimum capital requirement for the financial institutions has been raised to Taka 0.5 billion from 4 December 2009. Most of the NBFIs, except for two, have raised the required capital.

Compared to commercial banks, the non-bank financial institutions play a limited role in the financial landscape of Bangladesh. It accounts for less than 5% of financial system assets. They are mainly involved in leasing (about 40% of assets) however, they are gradually making headway into other forms of businesses such as term lending (about 21% of assets), housing finance (about 14% of assets), working capital financing (16% of assets), merchant banking, equity financing, venture capital financing, etc. They are not concentrated in a particular sector. Broadly, 42 percent of investment share goes to industrial sector and 33 percent to service sector. (Ahmed and Chowdhury, 2007)

Non-bank financial sector has been growing over the years. Their total assets as a percentage of GDP has increased from 8.37 percent in 2003-04 to 18.74 percent in 2009-10 and their deposits and advances are also rising. Since these institutions provide long term financing it can fill the resource gap present in Bangladesh and can mobilize funds necessary for the development of equity and corporate debt markets. Moreover, non-banks provide a variety of products and services which can meet financial needs of the country and can help the financial system of the country to develop.

**METHOD OF DATA ANALYSIS**

Since our main objective is to get an idea about the growth pattern of banks and NBFIs over time, therefore we took the simple yet insightful method of comparing ratios. In particular we used the following ratios:

- Total Bank Assets/ GDP
- Total Non-Bank Assets/ GDP
- Total Bank Advances/Total Non-Bank Advances
- Total Bank Deposits/Total Non-Bank Deposits
- Total Bank Borrowings/Total Non-Bank Borrowings

Our key variables from the income statement of banks are interest and non-interest income and interest and non-interest expenses. Interest income and interest expense are considered to be a representation of intermediation. We use ratios like:

- Interest Income/Total Income
- Interest Expense/Total Expense

We compared ratios and draw graphs to make meaningful conclusion from those.

Data of aggregate balance sheet figures for both banks and non-bank financial institutions is collected from Bangladesh Bank from where we got all the. We used Bangladesh Bank Bulletin,
Scheduled Banks Statistics, Annual Reports of Bangladesh Bank, etc as published source and visited Bangladesh bank to fill out missing series. We also collected few series from Bangladesh Bureau of Statistics. All data for banks have been observed over the period 1991 to 2010 and for non-bank financial institutions from 2003 to 2010. The shorter period of data for non-banks is partially due to their unavailability and partially due to their relative insignificance in the previous years.

FINDINGS

We divided our sample period into three periods, they are 1991-92 to 1995-96, 1995-96 to 2000-01 and 2001-02 to 2009-10, and compared statistics of the third period with the first period. The reason behind doing so is to get a clear comparison between two states, first when NBFIs were not in the picture and the second when the NBFIs are more matured.

[Figure 3]

Figure 3 shows clear dominance of banks in financial arena. It had a stable upward trend but since 2003-04 when NBFIs started getting prominence and bank assets started to fall. Although their fall is relatively too large for NBFIs to absorb but NBFIs experiences a positive growth during that period.

[Figure 4]

Figure 4 supplements the conclusion of figure 3. Assets of both banks and non-bank financial institutions grow over time (with an exception of 2007-2008 for banks). However, assets of NBFIs grow at a higher rate than the assets of bank.

Motivated by this we calculated the ratio of advances of banks and NBFIs and plotted in figure 5. This also confirms findings of figure 3 and 4. During 2003-04 the ratio was 20, which means banks gave 20 times more loans than NBFIs but in 2010 the ratio came down to around 11 indicating higher growth for NBFIs.

[Figure 5]

The story continues in deposit figures as well. Figure 6 shows that the ratio of bank deposits and NBFIs deposit was more than 52 in 2003-04 but by 2009-10 it came down to 22. It can be seen that the ratio of both bank advances to non-bank advances and bank deposits to non-bank deposits have halved over a period of only six years. This is a significant decline and if this trend continues, the non-banks will acquire a greater share of deposits and advances in the future years causing banks’ share to decline farther.

[Figure 6]

In case of borrowings (figure 7) the rate of decrease is sharper not surprising though. The ratio has fallen from 6266.19 percent to 752.69 percent over the period 2003-04 to 2009-10. Banks are not supposed to borrow and borrowing is the most prominent way of getting funds for NBFIs. So decreasing trend of this ratio is rather healthy for financial system.

[Figure 7]

Another distinct trend emerged from data is the decrease in advance to deposit ratio for NBFIs. In figure 8 we see that banks maintain a overall stable advance to deposit ratio of 0.75. However, NBFIs although had this ratio around 2.0 at the beginning but had it down to 1.5 by 2009-10. This indicates that the NBFIs have become less leveraged which is good for the overall stability of the financial system but it is also blurring the distinction between banks and non-banks.

[Figure 8]

Moving attention towards interest and non-interest income (figure 11) we have found that in recent years banks are experiencing a relatively large decline in interest income (from 79% to 65%). Since banking sector is growing this clearly shows that banks have developed an alternative source of income apart from intermediation. This trend is interesting as if it continues then banks will not consider intermediation as important as they think today.

[Figure 9]

Situation for expenses is less sharp (figure 12). Interest expenses declined in recent years just moderately. This tells that in deposit market, banks are relatively more stable but in loan market they either lost their ground or they voluntarily left their ground for some other institutions.
After observing these trends, we came to few important conclusions:

a) Financial system of Bangladesh is still dominated by banks.

b) However, their domination is challenged by NBFIs in all aspects. Until now NBFIs have managed to capture only a small share of the market but they are growing and growing faster than banks.

c) Banks are diversifying their operation into non-traditional activities.

d) Even though the share of non-traditional activities of the banks have increased yet they are dependent on intermediation and interest income from intermediation is their main source of earning.

CONCLUSION

Banks are the most sophisticated financial institutions in an economy. People of different levels of financial strength and expertise go to banks to meet their financial need. Intermediation is not only important to them it is crucial for real sector of the economy. If for some reason banks do not feel interested in intermediation then alternative institutions need to evolve to cater to the demand. NBFIs are generally for large savers and borrowers but the middle and small savers and borrowers need to have some place to go. Based on our analysis we can say that till now it is not a big problem for Bangladesh. Banks are still in intermediation but their role in intermediation is declining. They have engaged into various activities other than intermediation, which substantially improve their income potential however at a high level of risk exposure. Now it can be a very good question to investigate why intermediation is declining among banks. One possible explanation can be the higher level of efficiency demonstrated and better design of products by NBFIs have driven them away from the market. If that is the case then they can improve their efficiency and the solution is simple. However if the reason is higher level of profit from non-intermediation type activities and their retreat from intermediation is a voluntary decision then the problem is relatively serious. It is true that earning through intermediation is more difficult and sometime become messy. However, that certainly does not allow banks to leave intermediation as that is the main activity of a bank. In that case, the central bank should assume the responsibility of bringing them in intermediation. Licensing requirements of NBFIs are not as rigorous as commercial banks, they are not as closely supervised as banks either, therefore, regulators may not feel very comfortable to allow them to deal with financially less sophisticated clients.

One limitation of this study is the non-inclusion of MFIs in our analysis. This is mostly due to data unavailability. However, given their small size, we do not expect conclusions to vary qualitatively after their inclusion.

REFERENCES


APPENDIX

Table 1: Some indicative ratios of SAARC countries\(^1\) (2012)

<table>
<thead>
<tr>
<th>Country</th>
<th>Broad money/GDP (%)</th>
<th>Market capitalization/GDP (%)</th>
<th>Domestic credit by banks/GDP (%)</th>
<th>Domestic credit to Private sector/GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>70.0</td>
<td>15.1</td>
<td>69.2</td>
<td>49.6</td>
</tr>
<tr>
<td>India</td>
<td>76.3</td>
<td>68.6</td>
<td>76.6</td>
<td>51.5</td>
</tr>
<tr>
<td>Pakistan</td>
<td>38.8</td>
<td>18.9</td>
<td>44.5</td>
<td>16.4</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>38.6</td>
<td>28.7</td>
<td>48.4</td>
<td>31.1</td>
</tr>
<tr>
<td>Nepal</td>
<td>76.5</td>
<td>21.4</td>
<td>67.0</td>
<td>55.1</td>
</tr>
</tbody>
</table>

Table 2: Banking system structure (June 2010, Billion Taka)\(^2\)

<table>
<thead>
<tr>
<th>Bank types</th>
<th>Nos. of banks</th>
<th>Nos. of branches</th>
<th>Total assets</th>
<th>% of industry assets</th>
<th>Deposits</th>
<th>% of industry deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>NCBs</td>
<td>4</td>
<td>3394</td>
<td>1272.64</td>
<td>28.85</td>
<td>952.72</td>
<td>28.62</td>
</tr>
<tr>
<td>SBs</td>
<td>4</td>
<td>1366</td>
<td>291.37</td>
<td>6.60</td>
<td>177.90</td>
<td>5.34</td>
</tr>
<tr>
<td>PCBs</td>
<td>30</td>
<td>2427</td>
<td>2539.27</td>
<td>57.55</td>
<td>1967.78</td>
<td>59.11</td>
</tr>
<tr>
<td>FCBs</td>
<td>9</td>
<td>59</td>
<td>308.70</td>
<td>7.00</td>
<td>230.68</td>
<td>6.93</td>
</tr>
<tr>
<td>Total</td>
<td>47</td>
<td>7246</td>
<td>4411.98</td>
<td>100.00</td>
<td>3329.08</td>
<td>100.00</td>
</tr>
</tbody>
</table>

\(^1\) Data collected from world bank website
\(^2\) Bangladesh Bank annual report 2009-2010
Figure 1: Deposits categorized by banks (1997-2010)

Figure 2: Advances categorized by banks (1997-2010)
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Figure 3: Bank Assets and Non-Bank Assets as a percentage of Nominal GDP (1991-2010)

Figure 4: Growth rate of Bank and Non-Bank Assets (1991-2010)
Figure 5: Ratio of Bank Advances to Non-Bank Advances (2003-2010)

Figure 6: Ratio of Bank Deposits to Non-Bank Deposits (2003-2010)
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Figure 7: Ratio of Bank Borrowings to Non-Bank Borrowings (2003-2010)

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Figure 9: Interest Income and Non-Interest Income as a percentage of Total Income of Banks (1998-2010)

Figure 10: Interest Expense and Non-Interest Expense as a percentage of Total Expense of Banks (1998-2010)