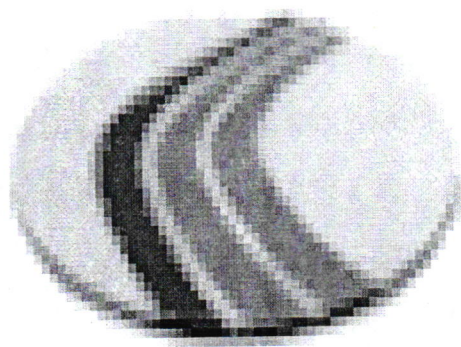


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**Internship Report on:
*Credit Risk Management: An
Empirical Study on Dutch-Bangla
Bank Limited***



**Prepared By
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April 29, 2008

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Dear Sir:

Here is my internship report on "**Credit Risk Management: An Empirical Study on Dutch-Bangla Bank Limited**" that was assigned by the organizational supervisor, Mr. K. M. Awlad Hossain Senior Assistant Vice President, Dutch-Bangla Bank Limited, Mirpur Branch, and approved by you.

As you will see, this is a research report on the credit risk management system at Dutch-Bangla Bank Limited (DBBL). This is an in-depth study based on empirical review of secondary data. The research has been conducted from two perspectives: a qualitative analysis on the credit risk management practices and a quantitative performance analysis of the system. An overview on the Bank and the present regulatory and policy framework for credit risk management in Bangladesh has also been presented in the report. There is also a humble effort to suggest some measures which may help the Bank in establishing a robust and effective credit risk management system.

This assignment helped me in understanding the credit risk mitigation mechanisms that are used in the business of lending. It also gave me a scope to develop a general overview on the banking sector in Bangladesh. I had little knowledge on these issues before writing this report. I thank you and my organizational supervisor for giving me the opportunity for such an eye-opening. I enjoyed writing this assignment.

Sincerely,

Sadiyah Tabassum
Roll No. 05264013

ACKNOWLEDGEMENT

Let me express my immense gratitude to almighty Allah and a number of persons who have extended enormous support and guidance in writing this report.

I express my heartfelt thanks to my organizational supervisor Mr. K. M. Awlad Hossain, Senior Assistant Vice President and Branch Manager of Dutch-Bangla Bank Limited, Mirpur Branch, who assigned me with this project and extended valuable advice time-to-time during writing the report.

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This report could not have been materialized without the continuous help and suggestions extended by all and In-charge of Loans and Advance Section, General Accounts and Card Division of the Branch. My heartiest gratitude is for them.

I owe to thank others, in Credit Administration Division and Credit Monitoring and Recovery Division of Dutch-Bangla Bank Limited Head Office respectively for their valuable support in providing me relevant facts and figures.

Most importantly, I express heartfelt thanks and gratitude to my Faculty Adviser, Mr. Mojib U Ahmed, Instructor, MBA Division, BRAC University, for his invaluable advice and guidance in writing this assignment.

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Executive Summary

An Introduction to the Report

This research report is an individual assignment as a part of the internship programme under the MBA curriculum in the BRAC University. The primary objective of the report is to study the general account and credit risk management (CRM) practices at DBBL with particular reference to the Bank's Mirpur Branch and recommend measures for further improvement. But the quantitative analysis part of this report is not up to the requirement of research design due to non-availability of relevant data from the Bank.

The banking sector in Bangladesh is plagued with myriads of problems. Among these, the loan default problem is the most severe one. Over the last decade many structural, prudential, regulatory and legal measures were initiated by the government to curb the loan default problem. Yet all these measures could not produce any significant outcome in dealing with the problem, especially in case of government banks and financial institutions. The private banks, though, have shown considerable improvement in the credit management system which is evident from their low level of classified loans. Dutch-Bangla Bank Limited (DBBL) is one such private bank having a strong and efficient credit management system supported by robust CRM strategies. This research report is an empirical study on the CRM practices at DBBL.

This report involves a descriptive research based on empirical review of secondary data. The target populations for the study were: (1) the general accounts of DBBL Mirpur Branch and (2) past credit related financial data of DBBL. The past five years' credit related data were also taken as sample for the study. A subjective judgemental analysis was conducted on the credit information of selected sample borrowers, and the selected quantitative credit related data were put to a judgemental interpretation by the researcher.

So far little empirical study was conducted on the CRM practices in the banks of Bangladesh as systematic management of credit risk in the business of lending is almost a new concept in our banking sector. Yet some literatures on the related subjects are available which discuss credit risk mitigating measures in general.

An Overview of Dutch-Bangla Bank Limited

Dutch-Bangla Bank Limited is a Bangladesh-Netherlands joint venture scheduled commercial bank established under the Bank Companies Act 1991 and incorporated in 1995 as a public limited company under the Companies Act 1994. The corporate philosophy of the Bank focuses on enterprise and creativity in business and industry with a commitment to social responsibility.

The authorized and paid-up capitals of DBBL are Taka 400.00 million and Taka 202.14 million respectively. The Bank is run by an 8-member Board of Directors. There are 13 divisions at the DBBL Head Office and at present 19 branches of DBBL are operating in the country.

DBBL provides a range of services and facilities to its customers, which include general banking, retail banking, credit facilities, and foreign trade services. The services provided under general banking include deposit schemes, purchase/sale of bonds and instruments, remittance, and payment/collection of bills. The retail banking services provided by DBBL includes Locker Service and Consumer Credit Scheme. The Bank extends a range of credit facilities which include general loans, demand loans, continuing advances and contingent financing. DBBL has also some specialized credit schemes which include Small Shop Owners' Credit Scheme, Public Transport Credit Scheme, Rescue Transport Credit Scheme and Students' Transport Credit Scheme. The foreign trade facilities provided by DBBL include import finance, export finance, and foreign remittance.

Besides banking activities, DBBL takes part in different nation-wide socio-cultural activities for promoting sports, culture, social awareness, etc. The Bank also extends humanitarian assistance during national disasters. To implement its social agenda, the organization has set up the Dutch-Bangla Bank Foundation (DBBF).

Dutch-Bangla Bank Limited has demonstrated significant operational performance since its inception. The financial facts and figures on the volume of deposit, loans and advances, after-tax profit and earning per share and ratios imply a growing trend of the Bank's operational achievements over the years.

The Mirpur Branch of DBBL was established in 2003 . The branch is headed by a Branch Manager and he is assisted by a Second Manager. The branch has three

departments: (1) General Banking Department, (2) Loans and Advance Department and (3) Foreign Trade Department. The General Banking Department deals with the functions of accounts management, cash deposit and withdrawal, local remittance and clearing. The Loans and Advance Department is responsible for the functions of assessment, processing, monitoring and recovery of the loans and advances. The Foreign Trade Department carries out the functions of export finance, import finance, and foreign remittance.

The Regulatory and Policy Framework for Credit Risk Management

The banking sector in Bangladesh is exposed to five core risks: (1) credit risk, (2) asset and liability/balance sheet risk, (3) foreign exchange risk, (4) internal control and compliance risk and (5) money laundering risk. Among these, credit risk is the most severe one. Credit risk can simply be defined as the probability that a bank's borrower or counterparty will fail to meet its financial obligations in accordance with agreed terms. The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by minimizing its credit risk exposure. The credit risk management in Bangladesh banking sector involves two main dimensions: (1) sector's overall credit related regulatory and policy framework within which the banks operate and (2) individual bank's credit risk mitigation practices.

The banking sector in Bangladesh comprises five types of scheduled banks: (1) nationalized commercial banks (NCBs), (2) development finance institutions (DFI), (3) non-Islamic private commercial banks (PCBs), (4) Islamic PCBs and (5) foreign commercial banks (FCBs).

During the 1970s, the banking activities were directed at massive credit disbursement to help increase industrialization and productivity in the war-ravaged country. But no attention was paid to ensure credit quality and portfolio management. Rather a huge volume of default loans piled up in the country. Since the 1980s, a rapid deregulation and privatization was initiated in the banking sector in order to increase efficiency, productivity, and competition. But no significant improvement was visible in these aspects. The Government undertook a number of reform measures in the 1990s, to eradicate the accumulated problems in the banking sector. Such measures include new rules and regulations for screening, monitoring

and recovery of loans and new laws against loan defaulters. But even after adopting many measures neither loan quality nor recovery situation improved.

The Government has been working with further reforms in the banking sector and till today newer policies and regulations are being instituted and older ones are being repealed or amended in this regard. Even at present, loan delinquency is the number one problem for the banks and such a problem can be attributed to a number of causes which include ineffective credit management by the banks, weak and lengthy judicial procedure against the defaulters, and insufficient regulatory enforcement by Bangladesh Bank, etc.

Thus the banking environment is still endowed with high credit risk potential and high probability of loan default necessitates the prudential regulation and policy support and the efficiency of the bankers to ensure sound credit risk management.

In recent years, Bangladesh Bank has taken many steps to enable the commercial banks to minimise their exposure to risks. Such steps include prudential regulations and policies for enhancing risk management capacity of the banks as well as legal recourse against loan defaulters. The prudential policies and guidelines for credit assessment include:

- **Lending Risk Analysis (LRA):** A credit screening tool for analyzing the business risks and security risks involved with a credit application.
- **Risk Grading System (RGS):** The system of assigning a risk grade to each individual borrower.
- **Financial Spread Sheet (FSS):** Involves analysis of borrower's past financial statements and ratios.
- **Interest Rate Deregulation:** Interest rates are based on market forces of demand and supply rather than government control.
- **Risk-weighted Loan Pricing:** Determining loan interest rate basing on the risk-rating of individual borrower.
- **Credit Information Bureau (CIB):** CIB of Bangladesh Bank maintains and provides credit information on any borrower.
- **Credit Restrictions for Bank Insiders and Their Relatives:** These restrictions ensure that loans are not given at arm's length to the bank directors or their relatives.

- **Large Loan Restriction:** A system of imposing large loan ceilings for the banks based on their classified loan volume.

The prudential regulations and policies for credit administration include:

- **New Loan Ledger Card (NLLC):** An improved accounting practice for recording loan status.
- **Large Loan Review Cell (LLRC):** LLRC of Bangladesh Bank reviews all newly sanctioned, renewed and rescheduled loans by scheduled banks.
- **Performance Planning System (PPS):** A tool for planning managerial responsibility in credit management.
- **Management Information System (MIS):** MIS ensures timely and accurate credit information collection, preservation and dissemination.
- **CAMEL Rating for Off-Site Supervision:** Bangladesh Bank ranks each bank basing on the bank's Capital adequacy, Asset quality, Management capability, Earning and Liquidity level.

Bangladesh Bank has also given new regulations and guidelines for credit transparency and provisioning which include risk-weighted capital adequacy requirement, loan classification and provisioning system and loan rescheduling system. On the other hand, the legal measures against the loan defaulters include Money Loan Court Act 1990 and Bankruptcy Act 1997.

The credit screening and monitoring tools like LRA, FSS, RGS, etc are yet to put into implementation by the banks properly due to three reasons: (1) lack of compatibility of the tools in our economic and financial systems, (2) lack of enforcement by Bangladesh Bank and (3) lack of adequate knowledge, skills and willingness on part of the bankers. There were problems and limitations with other prudential policies and guidelines as mentioned below:

1. The interest rate deregulation could not ensure desired inter-bank competition and efficient resource allocation due to market distortions and other imperfections.
2. The technology backwardness impedes timely information exchange with Credit Information Bureau.

3. The large loan policy is also not consistent with the objective of rewarding best performers and punishing worst performers in the banking sector.
4. The present loan classification system is not up to the international standard.
5. The system of loan rescheduling allows window-dressing of bad loans by the banks and extension of further loans to the loan defaulters.
6. The effective on and off-site supervision by Bangladesh Bank is hampered by lack of autonomy and manpower deficiency.
7. Due to the inadequacies in the legal and judicial systems, loan defaulters, particularly the big and powerful ones, could not be brought to justice.

Credit Risk Management at Dutch-Bangla Bank Limited

A bank must have a sound credit risk management system encompassing the functions of credit assessment, sanction, disbursement, monitoring and recovery in order to reduce its loss from risk of default on loans and advances. Generally, Bangladeshi banks have been using the traditional tools for credit screening and assessment. Now the credit officers are even equipped with sophisticated prudential tools like LRA, FSS, RGS, etc for effective credit management purpose. But how far these are used effectively by the bankers is a big question. An attempt is made in this study to answer this question in the light of credit risk management practices at DBBL.

A qualitative analysis was conducted on the CRM practices of DBBL. A quantitative analysis was also carried out to evaluate the effectiveness of the Bank's CRM system. The summary of the findings from these analyses are as follows:

- **Strengths of CRM at DBBL**

1. The credit officers of DBBL at the branch level as well as at the Head Office are professionally sound and experienced. The professional competence and experience of credit officers is said to be the first line of security against credit risk at any lending institution.
2. DBBL has a well-composed and comprehensive Credit Manual which provides prudential guidelines to the credit officers for day-to-day credit operations.

3. In general, the credit screening and approval procedure at DBBL is systematic, rigorous and conservative. All walk-in clients are not welcome here to get a loan.
4. The Directors/Sponsors of the Bank are not allowed to get loans from the Bank, whereas they can avail such credit facilities as long as these are within the restrictions imposed by regulation on loans to insiders.
5. DBBL diversifies its loans and advances in different sectors and this loan portfolio management helps the Bank to mitigate the credit risk to a great extent.
6. The Bank maintains a higher risk-weighted capital adequacy than the regulatory requirement imposed by Bangladesh Bank.
7. The large loan percentage at DBBL also signifies the Bank's strict compliance with the large loan regulation of Bangladesh Bank which ultimately helps the Bank in reducing the credit risk exposure from large loan concentrations.
8. The loan provisioning rates of DBBL are also maintained above the regulatory rates specified by the central bank.

• **Weaknesses of CRM at DBBL**

1. The credit assessment system at DBBL is mostly qualitative and prejudiced by the subjective judgement of the credit officers as well as the management. This practice may lead to inaccurate credit decisions some times and put the Bank in trouble with excessive credit risk exposures and consequent accumulation of large volume of NPAs.
2. The assessment of valuation and coverage of securities and collaterals against the loans is not pragmatic and prudential which may lead to huge losses from the recovery of defaulted loans.
3. The perfection of documentary and legal formalities in relation to the loan agreements and security arrangements gets delayed and remains incomplete in most cases even much after the disbursement of loans. Such practices may cause severe credit risk exposure for the Bank.
4. Many of the prudential guidelines and regulations of Bangladesh Bank are not strictly adhered to by the Bank. Such instances include guidelines and regulations on conducting LRA on large loan applicants, obtaining CIB report on borrowers before sanctioning large loans, extending no loans to the defaulters, etc.

5. The degree of credit risk exposure from some of the credit schemes of DBBL does not signify sound risk assessment ability of its top management and consequently, the Bank faced much trouble with the loans and advances extended under these schemes.
6. Many of the big and powerful borrowers seem to have strong grip over the top management of DBBL for which they are in a position to dictate their credit terms and conditions and take undue advantages from their dealings with the Bank. This phenomenon may bring unprecedented jeopardy for the Bank in the days to come.
7. The manpower deficiency impedes sound credit management practices, particularly, credit administration and recovery activities.
8. Above all, DBBL is yet to formulate a consolidated and well-defined credit policy which would help in better credit risk management through better credit screening and decision-making.

Recommendations

The following recommendations are put forward which may help the Bank in further improving the credit risk management system:

1. DBBL should formulate a consolidated credit policy which will encompass the top management's credit philosophy, risk tolerance attitude, asset quality standards, portfolio management and credit budgeting directives which are consistent with the overall corporate philosophy.
2. The top management of the Bank should develop proper control and supervisory mechanism to ensure that the credit officers strictly comply with the prudential guidelines and regulations (e.g. LRA, FSS, NLLC, RGS, PPS, etc) set by Bangladesh Bank.
3. DBBL should adopt the system of risk-weighted loan pricing and loans to all types of borrowers (including big and powerful ones) should be priced accordingly.
4. Adequate manpower should be allocated for the credit management functions at branch level. The Bank's top management should consider that the cost of default on loans may, otherwise, surpass the cost of maintaining adequate manpower for credit management someday.

5. Adequate emphasis should be given to ensure proper valuation of securities and collaterals and their coverage against the risk of default.
6. The management should ensure timely perfection of documentary and legal formalities before any loan is disbursed. They should also ensure that the insurance coverage against the securities/collaterals is adequate and up-to-date.
7. DBBL has to stop/minimize the cases of post facto sanctioning in case of renewal of existing and expired credit facilities as these cases increase the exposure to credit risk.
8. DBBL should strive to make its MIS stronger and up-to-date. The Bank has to maintain its central database in a well-organized manner and all past financial and operational data should be easily available and accessible.
9. The Bank should develop an in-house databank on selected business and industry statistics where all up-to-date data on different industries including the major business firms will be maintained. There should also be a research wing in order to analyze and interpret the data on regular basis.
10. DBBL, along with other banks, should develop reciprocal banking cooperation in order to exchange information on prospective corporate borrowers. In addition to the CIB report on clients, this reciprocal information exchange among banks will certainly help in mitigation of credit risk and ultimately, more efficient resource allocation.
11. The Bank should employ Relationship Managers (RM) of mid level status at branch level in order to attend all corporate clients so that each client's personal and business profile can be tracked and maintained up-to-date.
12. DBBL should verify the credit information on prospective borrowers from some third party credit rating agencies (like two private credit rating agencies, Credit Rating Information and Services Limited and Credit Rating Agency of Bangladesh) in addition to the CIB.

1.0 INTRODUCTION

1.1 Prolegomenon

Financial sector in Bangladesh comprises mainly of banks, insurance companies, stock markets, non-bank financial institutions and micro-financing institutions. Out of these, banking sector dominates the financial system, accounting for more than 95% of its total assets. Banking sector in Bangladesh suffers from chronic inefficiency. According to the World Bank's Financial Sector Adjustment Credit (FSAC) Report (World Bank, 1995), problems in banking sector in Bangladesh can be generally categorized into four main groups:

- **Economic** – such as the loan rate of interest does not reflect real risk and price because of excessive control.
- **Prudential** – such as the capital adequacy requirements are not effectively enforced, or there is no appropriate loan classification mechanism.
- **Institutional** – such as the weaknesses in loan screening and supervision system or weak management information system (MIS).
- **Legal** – such as the perpetuation of loan default system because of the delays and inadequacy originating the system.

All these problems give rise to a bigger problem in the banking sector – the loan default problem which reached its apex in the 1990s. Till today the biggest problem of Bangladesh banking system is the bank loan default problem. There are various reasons for loan delinquency in Bangladesh, such as, inefficient loan classification mechanism, inadequate banking supervision, lack of accountability on the part of bank officials, high loan price, risky economic environment, corruption, unethical use of political power, ineffective and inadequate judicial remedy for financial corruption or frauds, etc.

During the 1990s various initiatives were undertaken by the Government of Bangladesh to tackle the loan default problem in Bangladesh. Initiatives included prosecuting wilful defaulters; imposing prohibitions against defaulters holding public offices or bank directorships; putting limitations on access to new loans; denying import licenses to industrial loan defaulters; shaming defaulters by

publishing lists; setting up Credit Information Bureau (CIB) to record the performance of borrowers; establishing a Large Loan Review Cell (LLRC) at Bangladesh Bank to review all newly sanctioned bank loans over Taka 10 million, etc. The weak legal infrastructure, which was mainly responsible for non-recovery of defaulted loans and deterioration in the quality of overall credit management in Bangladesh, was also strengthened by enacting a number of new acts (such as Money Loan Court Act 1990, Bank Company Act 1991 and Bankruptcy Act 1997) and amending the old Acts time to time.

But all these measures seemed to be inadequate and as such could not produce significant outcome in dealing with the loan default problem. Still many of the wilful large defaulters could not be brought to justice; a bigger part of the bad loans is yet to be recovered; and the banks still extend new loans to potential defaulters due to poor credit management system. Our banks, especially the Nationalized Commercial Banks (NCBs) and Development Finance Institutions (DFIs) are yet to make significant improvement in their poor credit management systems that deal with screening, sanctioning, administration, and recovery of loans.

The loan default scenario in the Private Commercial Bank (PCB) sector is rather encouraging. Many of the PCBs have demonstrated noteworthy improvement in their credit management systems over the last couple of years which have resulted in their low loan default rates as against a high average rate for the overall industry. For instance, Dutch-Bangla Bank Limited (DBBL), a private commercial bank, has attained a very low classified loan rate of 2.88% in the year 2006 (DBBL Annual Report 2006) in comparison to the industry average of 25.50% (Bangladesh Bank Annual Report 2003). This reflects a strong and efficient credit management system at DBBL.

Credit Risk Management (CRM) is a part of the overall credit management system of a financial institution. Credit risk is the probability that a borrower or counter party will fail to meet its obligations in accordance with agreed terms. Credit risk, therefore, arises from the bank's dealings with or lending to corporations, individuals, and other banks or financial institutions. CRM enables a bank to proactively manage its loan portfolios in order to minimize losses and earn an acceptable level of return for shareholders.

“Credit Risk Management: An Empirical Study on Dutch-Bangla Bank Limited” – is a research report that makes an attempt to study the CRM practices at DBBL and find out how the Bank could maintain a very low loan default rate over the last few years.

1.2 Origin of the Report

This research report was an individual assignment as a part of the internship programme under the MBA curriculum in the BRAC University. The project proposal was submitted to the Faculty Advisor, Mr. Khaleq Newaz, Instructor, MBA Division, BRAC University on March 04, 2008 and was accepted by him. The final report was submitted on April 29, 2008.

1.3 Problem and Purpose

Following are the research problem and objectives:

1.3.1 Problem Statement. The report addresses the following problem:

“To carry out an empirical analysis on the credit risk management practices at Dutch-Bangla Bank Limited”.

1.3.2 Objectives of the Study. The broad and specific objectives of the study are as follows:

1.3.2.1 Broad Objective. The broad objective of the report is to study the credit risk management practices at DBBL.

1.3.2.2 Secondary Objective. The specific objectives are:

- To carry out a qualitative analysis of the credit risk management practices at DBBL.
- To carry out a quantitative performance analysis of the credit risk management system at DBBL.
- To suggest some measures for further improvement of the credit risk management system of DBBL, if required.

1.4 Scope of the Report

The project part of this report focuses on the credit risk management practices at DBBL with particular reference to the Bank's Mirpur Branch where the intern was placed for a period of 12 weeks. The credit risk management practices at DBBL have been evaluated from a qualitative perspective, whereas a quantitative performance analysis was carried out on the Bank's past credit related financial data. The entire study was conducted keeping the regulatory and policy framework set by Bangladesh Bank at the backdrop.

1.5 Limitations of the Study

The report suffers from the following limitations:

- DBBL is yet to develop a well organized management information system (MIS) and centralized database for which it was difficult to obtain relevant data required for the study. The Credit Monitoring and Recovery Division at DBBL Head Office could not provide necessary credit related data of last five years. The quality of quantitative analysis in this report was thus not up to the requirement of the research design.
- There was also difficulty in conducting deeper probe into the credit risk management practices at DBBL due to informal and invisible corporate barrier.

1.6 Report Preview

The report has four main parts:

- **Part One:** Report introduction including research methodology and literature review.
- **Part Two:** An overview of Dutch-Bangla Bank Limited including its brief history, organizational and operational structure, banking services and facilities provided by the Bank, and past performance.

- **Part Three:** The regulatory and policy framework for credit risk management in Bangladesh banking sector including an overview of the sector.
- **Part Four:** The qualitative analysis of credit risk management system at DBBL and the quantitative performance analysis of the system including conclusions and recommendations.

1.7 Research Methodology

Following are the details of research type, method and sampling plan:

1.7.1 Type of Research. This is a descriptive research designed to evaluate the credit risk management practices at DBBL based on empirical facts and figures.

1.7.2 Basic Research Method. As the study is based mostly on secondary data, the basic research method is empirical review method. The empirical review was carried out on selected sample borrowers of the Bank and past credit related information.

1.7.3 Sampling Plan. The sampling plan is described below:

1.7.3.1 Target Population. The target population for the study was considered as follows:

- **For Qualitative Analysis:** The individuals, groups and firms who have availed credit facilities from DBBL through its Mirpur Branch.
- **For Quantitative Analysis:** DBBL's past financial data on credit matters.

1.7.3.2 Method of Sampling. The non-probability judgemental method of sampling was used for this research. As the major part of the study involves qualitative analysis on the subjective practices and

activities of credit officers of DBBL, this method of sampling seemed to be the most appropriate one.

1.7.3.3 Samples Selected. Following samples were selected for the study:

1.7.3.3.1 Samples for Qualitative Study. The following 10 sample borrowers were selected who have taken loans and advances from DBBL Mirpur Branch:

- Garments Sector:
- Construction Sector:
- Energy Sector:
- Miscellaneous Sector:

1.7.3.3.2 Samples for Quantitative Study. The researcher intended to conduct a quantitative performance analysis on the credit risk management system of DBBL within a five-year spectrum. But all relevant data were not available from DBBL end. However, following data on DBBL were considered for the study as were available:

- Sector-wise loan portfolio (2001-2003).
- Large loan to total loan ratio (2000-2003).
- Risk-weighted capital adequacy (1999-2003).
- Classified loan percentage (1999-2003).

1.7.4 Data Analysis

1.7.4.1 Qualitative Analysis. A subjective judgemental analysis was conducted on the credit information of selected sample borrowers in order to ascertain the good and bad CRM practices at DBBL in the light of existing regulatory and policy framework and industry best practices.

1.7.4.2 Quantitative Analysis. The selected credit related parametric ratio data were arranged graphically and put to a judgemental interpretation by the researcher.

1.8 Literature Review

The systematic and scientific management of credit risk in the business of lending is a near-recent phenomenon in the banking sector of Bangladesh. In fact, until the 1990s, the banks were more concerned with increasing the lending volume irrespective of the credit-worthiness of the borrowers, rather than increasing the quality of the loan portfolios. So not surprisingly, there had been no organized and systematic credit risk management environment in the banking sector supported by prudential regulations and guidelines from the central bank before the reform measures were initiated at the beginning of the 1990s. Particularly, Bangladeshi banks became aware of the credit risk management only a few years ago. That explains why so far little definitive and empirical study was conducted on the credit risk management practices in the banking sector of Bangladesh.

Yet there have been some literatures on credit assessment tools and mechanisms, prudential lending regulations and guidelines, loan quality and portfolio management, loan classification and provisioning system and legal recourse against defaulted lenders. **Saha, Rahman, and Alam (2001)** evaluated the lending risk analysis (LRA) practices of our banks in a study. They opined that though LRA had been prescribed by Bangladesh Bank as a credit screening tool for the banks, hardly any bank used this prudential instrument properly for minimizing and averting credit risk of lending due to a number of reasons, including incompatibility of LRA with our financial system, non-availability of relevant data, reluctance and ignorance of bankers in using LRA, etc.

Mahmud et al. (2001), in a financial sector task force report, observed that new prudential guidelines on lending risk analysis (LRA), new loan ledger (NLL) system, performance planning system (PPS), etc could not ensure credit discipline in the banking sector due to lack of supervision by Bangladesh Bank, lack of commitment by bank managements and lack of required skill or unwillingness on part of the credit officers. They also stated that the new legal recourses could not ensure sufficient

punitive actions against big and influential defaulted borrowers and such a situation led to further deterioration in the overall credit environment in Bangladesh.

CPD (2002), in a report on a dialogue on financial sector reforms in Bangladesh, quoted a participant, eminent economist Professor Abu Ahmed who emphasized on introducing the securitization of banks' collateralized loans and advances and creating a market for trading such securities. He also suggested the formation of an asset management company by the Government which would take over the non-performing assets (NPAs) or bad loans of banks for speedy recovery purpose. Such measures would help in improving the overall credit management situation in the banking sector.

2.0 AN OVERVIEW OF DUTCH-BANGLA BANK LIMITED

2.1 Introduction

Dutch-Bangla Bank Limited (DBBL) is a Bangladesh-Netherlands joint venture scheduled commercial bank established under the Bank Companies Act 1991 and incorporated as a public limited company under the Companies Act 1994. DBBL is the first European-Bangladesh joint venture private commercial bank in Bangladesh. The registered head office of the Bank is located at Senakalyan Bhaban, 195, Motijheel Commercial Area, Dhaka.

This part of the report focuses on the brief history and current profile of DBBL. An overview of the organization and operations of Banani Branch of DBBL, where the internship was done, has also been presented here.

2.2 Brief History

DBBL was incorporated as a private-sector banking company on July 04, 1995. Besides the Bangladeshi sponsors, the Netherlands Development Finance Company (FMO) has been the international co-sponsor of the Bank. DBBL obtained license from Bangladesh Bank on July 23, 1995, and commenced its banking operations from June 3, 1996 with only one branch at Dilkusha Commercial Area, Dhaka. The Bank went public in the year 2001. DBBL is listed with Dhaka Stock Exchange Limited (DSE) as well as Chittagong Stock Exchange Limited (CSE).

2.3 Current Profile

This section describes the corporate philosophy, capital and shareholding structure, organizational structure and operational network of the Bank.

2.3.1 Corporate Philosophy. The corporate philosophy includes the mission, vision and core objectives of the Bank:

2.3.1.1 Mission of DBBL. Dutch-Bangla Bank engineers enterprise and creativity in business and industry with a commitment to social

responsibility. “Profits alone” do not hold a central focus in the Bank’s operation; because “man does not live by bread and butter alone”.

2.3.1.2 Vision of DBBL. Dutch-Bangla dreams of a better Bangladesh, where arts and letters, sports and athletics, music and entertainment, science and education, health and hygiene, clean and pollution free environment and above all a society based on morality and ethics make all our lives worth living. DBBL’s essence and ethos rest on a cosmos of creativity and the marvel-magic of a charmed life that abounds with spirit of life and adventures that contributes towards human growth and development.

2.3.1.3 Core Objectives. Dutch-Bangla Bank believes in its uncompromising commitment to fulfil its customer needs and satisfaction and to become their first choice in banking. Taking cue from its pool of esteemed clientele, Dutch-Bangla Bank intends to pave the way for a new era in banking that upholds and epitomizes its vaunted marque: “**Your Trusted Partner**”.

2.3.2 Capital and Shareholding Structure. The capital and shareholding structures are as follows:

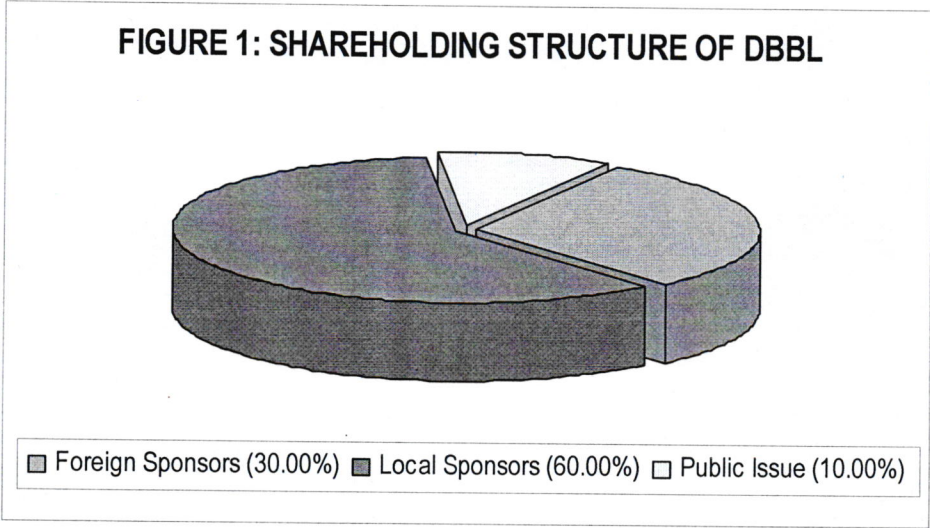
2.3.2.1 Capital Structure. The authorized capital of DBBL is Taka 400.00 million. At present the issued, subscribed and paid-up capital of the Company stands at Taka 202.14 million.

2.3.2.2 Shareholding Structure. Though DBBL is a public limited company, lion’s share in the Company is held by the sponsors as against a small portion issued to the public. The present shareholding stands as follows:

- **Sponsors:**
 - Foreign : 30.00%
 - Local : 60.00% 90.00%
- **Public Issue:**
 - Institutional : 1.45%
 - Investment Accounts : 0.33%

▪ General Public	: <u>8.22%</u>	<u>10.00%</u>
		<u>100.00%</u>

The shareholding structure is shown in Figure 1.



2.3.3 Organizational Structure and Operational Network. The present organizational structure and operational network of the Bank are described below:

2.3.3.1 Board of Directors. At the apex of the organizational structure of DBBL is an 8-member Board of Directors. Among the Directors, one is the Chairman of the Board, one is the nominee of the Netherlands Development Finance Company (FMO), one is elected by the general shareholders of the Company, one is the Ex-officio Director (Managing Directive), and the others are Company’s Sponsor Directors. Mr. Md. Yeasin Ali is the present Managing Director and Chief Executive of DBBL. Under him there are two Deputy Managing Directors: Deputy Managing Director (Operations) and Deputy Managing Director (Administration).

2.3.3.2 Divisions. There are 13 divisions at the Head Office of DBBL. These are:

- General Service Division.
- Credit Division.

- Credit Administration Division.
- Credit Monitoring and Recovery Division.
- Corporate Banking Division.
- Retail Banking Division.
- International Division.
- Treasury Division.
- Human Resources Division.
- Accounts Division.
- Information Technology Division.
- Marketing and Development Division.
- Internal Control and Compliance Division.

An organogram of the DBBL Head Office is shown in Appendix A.

2.3.3.3 Branch Network. DBBL has so far established 39 branches around the country. Among them, 13 are in the Dhaka City, 3 are in Chittagong, 2 are in Narayangonj, and one is in Narshingdi. Besides them, the Bank is planning to open 7 more branches soon at various locations including Sylhet, Bogra, Khulna, and Barisal.

2.3.3.4 International Network. DBBL has been very successful in establishing an effective correspondence relationship across the globe and continuing its endeavour to reach every corner of the world to deliver prime services to its valued clients. At present, DBBL has coverage of more than 110 countries through 100 correspondent banks.

2.3.3.5 On-line Banking Network. Spending Taka 250.00 million, DBBL has started its ambitious on-line banking service since September 2004. Now the customers of DBBL get 'any branch banking service' around the country. As part of the truly on-line banking programme, the Bank is planning to launch Internet Banking, DBBL NEXUS Debit Card, DBBL-Maestro/Cirrus Debit Card and DBBL Credit Card soon. At present, a network of Bank's own ATMs and POS terminals is being set up at strategic points throughout the country. This will facilitate the customers to pay their utility bills through these ATMs and internet banking. Through DBBL-Maestro/Cirrus Debit

Card, customers will be able to access more than 300,000 Cirrus ATMs in around 100 countries.

2.4 Banking Services and Facilities Provided

DBBL provides a range of services and facilities to its customers, which include general banking, retail banking, credit facilities, and foreign trade services.

2.4.1 General Banking. The services provided under general banking include deposit schemes, purchase/sale of bonds and instruments, remittance, and payment/collection of bills.

2.4.1.1 Deposit Schemes. At present, DBBL offers the following Deposit Schemes/Liability products in its all branches:

- **Current Deposits (CD):** A Current Deposit Account may be opened by any individual, firm, company, and club, association, corporate body etc. The common features are:
 - Withdraw able on demand.
 - No interest is paid.
 - No limit in frequency and amount of transactions.
- **Savings Bank Deposits (SB):** Savings Bank Account may be opened in the names of individuals, clubs, societies, association and similar institutions and even by government and semi-government offices. Interest rate is 8.5% calculated on daily product basis.
- **Fixed Deposits (Term Deposit):** Deposit accepted on fixed term basis issuing a Fixed Deposit Receipts (FDR). The usual features are:
 - FDR is neither transferable nor negotiable.
 - Individual, firm, company, corporate body etc may open account.
 - Usual maturity range from 3 months to 36 months.

- The interest rates differ as per maturity.
- **Short Term Deposits (STD):** Account may be opened by corporate body, bank, financial organizations and individuals. The features include:
 - Deposits held in STD Account can be withdrawn in 7 days notice.
 - Interest is payable on balance held on daily product basis.
 - The interest rates differ according to terms and maturity.
- **Monthly Term Deposits (MTD):** This is a unique product of DBBL offering customers comparatively high returns against short term deposits.
 - MTD is a high-return fixed deposit account.
 - It is similar to FDR but with higher interest rate.
 - Rate of Interest under this Scheme is 9.00%.
 - The minimum balance to be maintained in the account is Taka 50,000.
 - One can withdraw monthly interest over the deposited amount or can renew the MTD receipt adding the interest with principal amount at the prevailing rate.

2.4.1.2 Sale/Purchase of Bonds and Instruments. From the counters of all DBBL branches, customers can avail the following facilities:

- Purchase and Sale of Prize Bonds.
- Sale and Encashment of Sanchaya Patras.
- Sale and Re-purchase of ICB Unit Certificates.

2.4.1.3 Remittance. DBBL's remittance services include:

- Issue and payment of Demand Drafts (DD) against:

- Cash.
- Cheque.
- A letter of instruction on account.
- Issue and payment of Telegraphic Transfer (TT) against:
 - Cash.
 - Cheque.
 - A letter of instruction on account.
- Issue and payment of Pay Orders (PO) against:
 - Cash.
 - Cheque.
 - A letter of instruction on account.

DBBL takes no commissions or service charges for the above-mentioned remittance services, but the customer must have an account with the Bank to avail these services.

2.4.1.4 Payment/Collection of Bills. DBBL's services in this regard are as follows:

- Payment/Collection of Outstation Cheque.
- Payment/Collection of Outward Documentary Bills.
- Payment/Collection of Inward Bills.
- Payment/Collection of Inward Documentary Bills.

2.4.2 Retail Banking. The retail banking services provided by DBBL includes Locker Service and Consumer Credit Scheme.

2.4.2.1 Locker Service. DBBL provides international standard fire-proof locker facility to our valued customers at comparatively lower charges for safe deposit of their valuable belongings. The annual rents for different sizes of lockers are:

- Small Locker : Taka 1000.00.
- Medium Locker : Taka 1500.00.

- Large Locker : Taka 2000.00.

Other than rent, a one time key deposit for Taka 500.00 is required which is refundable at the time of surrender of the Locker and the Key.

2.4.2.2 Consumer Credit Scheme. The DBBL Consumer Credit Scheme is designed primarily to facilitate the purchase of different consumer items. Starting at a small scale, DBBL plans to expand this scheme after full automation of its operational network.

2.4.3 Credit Facilities. DBBL extends a range of credit facilities to different types of customers.

2.4.3.1 Types of Credit Facilities. DBBL offers the following types of loans and advances to its customers:

- **Loans:** Loans are allowed for various purposes and granted for short, mid or long term maturities. Types of loan include:
 - Loan General (usually short term in nature).
 - Transport Loan.
 - House Building Loan.
 - Term Loan (Industrial/Project Financing).
 - Working Capital.
 - Consumer Credit.
 - Bridge Loan/Underwriting Advance.
 - Others.
- **Demand Loans:** Loans which are payable when a demand is made. Such loans include:
 - Advance against Accepted Documentary Bill.
 - Local / Foreign Documentary Bills.
 - Payments against Documents (PAD).
 - Inland/Foreign Bill Purchased (Clean).
- **Continuing Advances:** Continuing advances are the revolving lines of credit which are extended to the borrowers

for continuing business activities. The forms of continuing advance are as under:

- Secured Overdraft including collateralized overdraft (SOD).
 - Cash Credit (CC).
 - Loan against Trust Receipts (LTR).
 - Loan against Imported Merchandise (LIM).
 - Export Cash Credit (ECC).
- **Contingent facilities:** These are off-balance sheet activities which include:
 - Letters of Credit (Sight/Back to Back).
 - Letters of Guarantee (Bid Bond, Performance Guarantee, Advance Payment Guarantee, Security Guarantee).
 - Other.

The details of credit facilities will be discussed in the later part of the report.

2.4.3.2 Types of Borrowers. DBBL extends credit to different types of customers which include:

- **Individual:** A single person/persons or a sole proprietorship concern having valid trade license issued by competent authority can avail DBBL credit fulfilling the pre-requisites.
- **Partnership:** All Partnership concerns having necessary partnership deed can also take credit from DBBL.
- **Public/Private Limited Companies:** Any registered company can avail loans and advances against corporate/personal guarantee.

- **Trusts/Clubs/Societies:** Trustees of a trust can borrow from DBBL only if they have explicit authority given by the Trust Charter/Deed to borrow and to offer assets of the trust as security against the loans. DBBL does not offer any advance including temporary overdraft to any unincorporated societies or clubs as because they cannot be sued for a debt.

2.4.3.3 Specialized Credit Schemes. Besides its general credit facilities, DBBL has some specialized credit schemes which are unique in nature. Such schemes include:

- **Credit Scheme for Small Shop Owners:** DBBL offers this unique service to the small shop owners who were so far denied credit from banks due to their lack of adequate collateral security and were dependent on informal credit usually with very high interest rates. This Bank has brought them under the umbrella of banking service by offering them loan facilities without any security. The average loan amount is Taka 5 lacs.
- **Public Transport Credit Scheme:** DBBL has extended credit to the following public transport systems:
 - **Duranta and Rider Transport Services:** In collaboration with Meghna Automobiles Limited and Khansons Automobiles Limited.
 - **Taxi-cab Transport Services:** In collaboration with Comfort Cab Limited.
- **Rescue Transport Credit Scheme:** This is another unique service in which DBBL finances the purchase of emergency medical transports like ambulances, mobile clinics and first aid stations for hospitals and clinics around the country. Under this scheme, 70% of the initial purchase price is borne by DBBL and the rest amount by the

borrowing hospital or clinic. The loan amount is to be repaid by the borrower in maximum 36 monthly instalments at 13% interest rate.

- **Student Transport Credit Scheme:** The Bank has undertaken a new credit scheme named “Student Transport Scheme” with an objective of financing transports at a lower cost (12% interest rate) for the educational institutions. The financing scheme will provide loans to Educational Institutions covering government and private schools, colleges and universities for purchasing transports for the students.

2.4.4 Foreign Trade. The foreign trade facilities provided by DBBL include import finance, export finance, and foreign remittance.

2.4.4.1 Import Finance. DBBL extends finance to the importers in the form of:

- Opening of Import L/C.
- Credit against Trust Receipt for retirement of import bills.
- Short term and medium term loans for installation of imported machineries and production thereof.
- Payment against document

2.4.4.2 Export Finance. The export finance facilities are given in the following two forms:

- **Pre-Shipment Finance:** Pre-Shipment finance in the form of:
 - Opening of Back-to-Back L/C.
 - Export Cash Credit (ECC).
- **Post-Shipment Finance:** Post-Shipment finance in the form of:

- Foreign/Local Documentary Bills Purchase.
- Export Credit Guarantee.
- Finance against cash incentive.

2.4.4.3 Foreign Remittance. The foreign remittance services include:

- Foreign Demand Draft (FDD).
- Cash Dollar (Buy and Sale).
- Travellers' Cheque (Buy and Sale).
- Inward Telegraphic Transfer (ITT).
- Outward Telegraphic Transfer (OTT).
- Foreign Bill Collection (FBC).

2.5 DBBL's Social Agenda

Besides progressive banking activities, DBBL has been taking part in different nation-wide socio-cultural activities promoting sports, culture, social awareness, etc. With this end in view, the Bank rendered contribution to Mini World Cup Cricket Tournament-1999, National Youth Fair-1999, National Olympic Day Run, 3 Day Cricket Match between Bangladesh and West Indies, etc.

DBBL extended its humanitarian service during the widespread Dengue epidemic in 2000 by supporting treatments of Dengue patients and creating awareness of the general people through seminar, symposium and newspaper campaign. The Bank donated Dengue Detection Kits to Bangabandhu Medical University and a Centrifugal Machine with Refrigerator (Blood Cell Separator) to Sandhani. DBBL has also played a significant role in flood-relief activity in the year 2000.

DBBL has set up the Dutch-Bangla Bank Foundation (DBBF) in 2001 to extend non-profitable financial support to scholarly pursuit, arts and culture, foreign and local medical treatment for the needy people, free medical facilities under its "Rural Health Service Programme", distributions of winter blankets to the cold-hit people, and helping people affected by natural disasters both at home and abroad. The significant contributions of DBBF include:

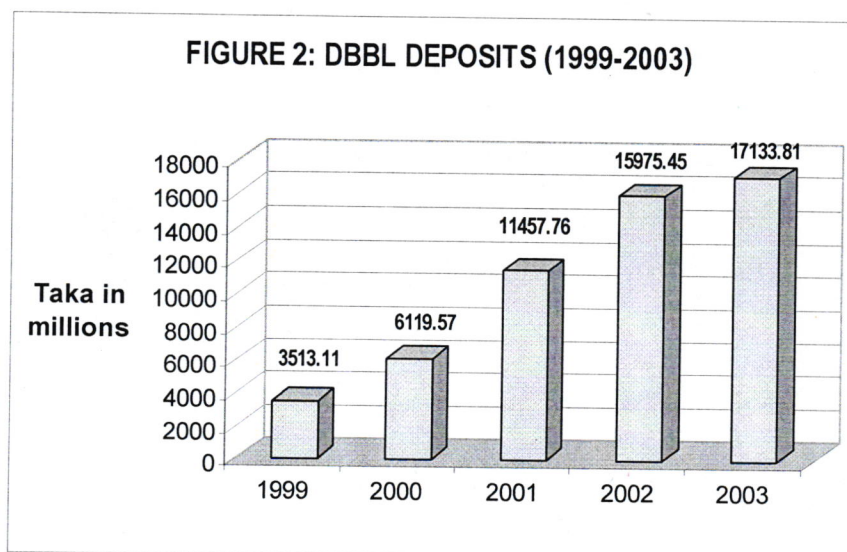
- Distribution of 30,000 winter blankets to the cold-stricken poor people of North Bengal in 2003.
- Donation of 5,000 blankets and Taka 1.00 million to the earthquake stricken people in Iran in 2003.
- Donation of Taka 5.00 million to the Prime Minister's Relief Fund for the flood victims in 2004.
- Scholarship to 250 meritorious and deserving students of H.S.C., Degree and Masters levels in every year.

DBBF is funded from the Bank's pre-tax profit at the rate of 2.5% per annum.

2.6 Operational Performance

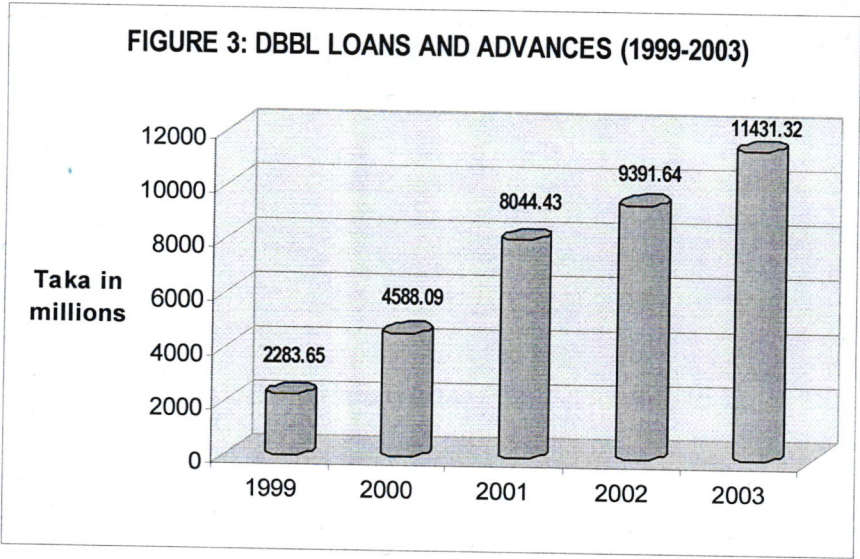
DBBL has demonstrated significant operational performance with its limited branch network. The various financial figures and ratios imply a growing trend of the Bank's operational achievements over the years.

2.6.1 Deposits. The rising trend of DBBL's deposit base displays its good business performance and strong customer confidence on the Bank. The annual deposit amounts for the years 1999-2003 are shown in Figure 2:



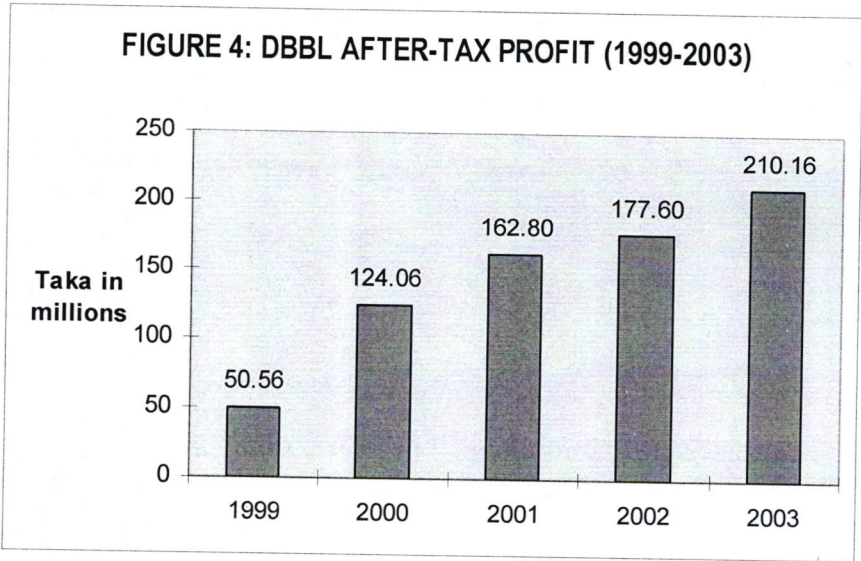
Source: DBBL Annual Report 2003

2.6.2 Loans and Advances. The annual figures of loans and advances for the last 5 years also signify a growing asset base of DBBL as depicted in Figure 3:



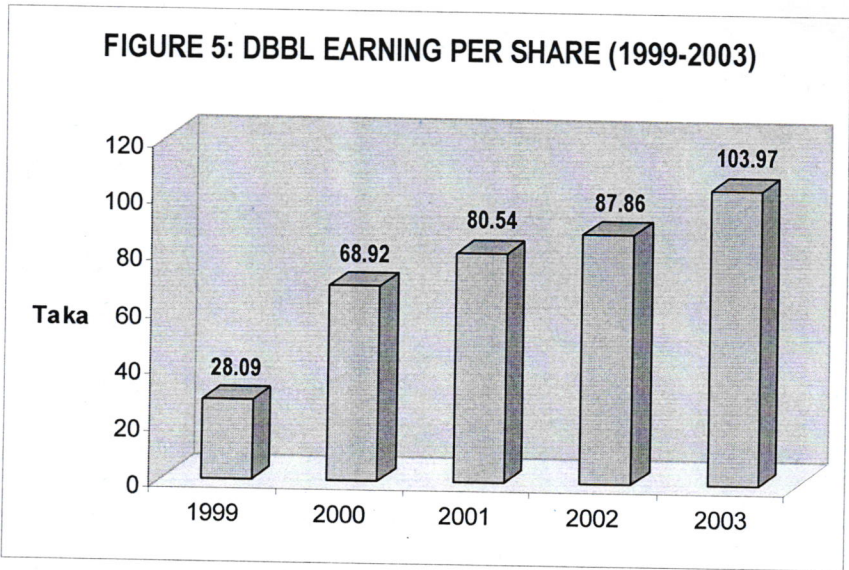
Source: DBBL Annual Report 2003

2.6.3 After-tax Net Profit. The annual after-tax net profit over the last 5 years is the most vivid indication of DBBL’s excelling operational performance as shown in Figure 4:



Source: DBBL Annual Report 2003

2.6.4 Earning Per Share. This ratio for the last five years also displays a rising trend as portrayed in Figure 5:



Source: DBBL Annual Report 2003

2.7 DBBL Mirpur Branch

The Mirpur Branch of DBBL started its banking operations in 2002. The branch is located at 8, Darus Salam Road, Mirpur-1, Dhaka-1216.

2.7.1 Organization. The Mirpur Branch is headed by the Branch Manager, K. M. Awlad Hossain, Senior Assistant Vice President. He is assisted by a Second Manager, Mr. Sumon Assistant Vice President. The branch has three departments:

2.7.1.1 General Banking Department. This department has three Sections to carry out accounts management, cash deposit and withdrawal, local remittance, clearing and other general banking functions:

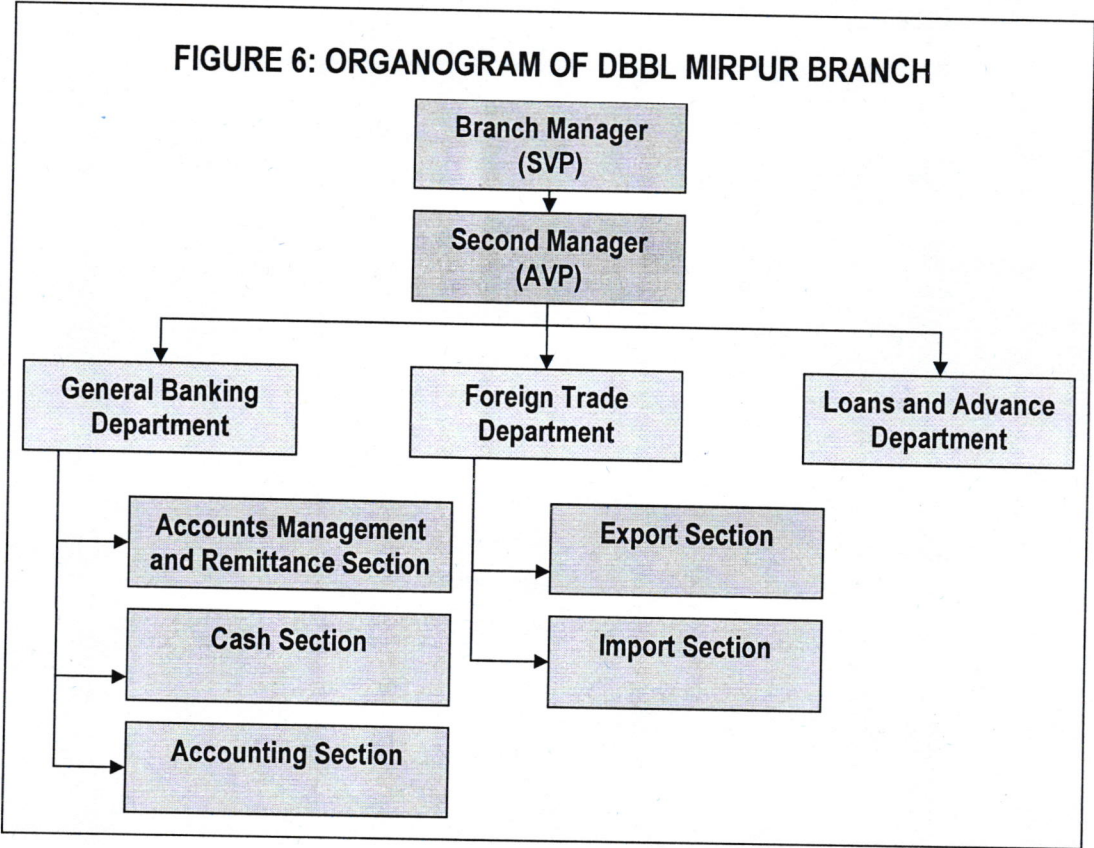
- Accounts Management and Remittance Section.
- Cash Section.
- Accounting Section.

2.7.1.2 Loans and Advance Department. This department deals with the functions of assessment, processing, monitoring and recovery of the loans and advances.

2.7.1.3 Foreign Trade Department. Foreign Trade department carries out the functions of export finance, import finance, and foreign remittance. It has following two sections:

- Export Section.
- Import Section.

The organogram of DBBL Banani Branch is shown in Figure 6.



Source: Primary

3.0 REGULATORY AND POLICY FRAMEWORK FOR CREDIT RISK MANAGEMENT

3.1 Introduction

One unique characteristic of the banking sector is its exposure to the diversity and complexity of risks that sets it apart from other types of businesses. Thus risk management is one of the most serious concerns in the banking sector. The rapid pace of deregulation and globalization of the financial services has opened new frontiers that warrant risk management even a greater priority. The failure in sound risk management not only exposes a bank to business losses but also threatens its survival. The five core risks that exist in the banking operations in Bangladesh are as follows:

- Credit risk.
- Asset and liability/balance sheet risk.
- Foreign exchange risk.
- Internal control and compliance risk.
- Money laundering risk.

Among these, credit risk is the most severe one. Credit risk can simply be defined as the probability that a bank's borrower or counterparty will fail to meet its financial obligations in accordance with agreed terms. The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by minimizing its credit risk exposure. Banks need to manage the credit risk inherent in its entire credit operation as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation.

The credit risk management in Bangladesh banking sector involves two main dimensions: (1) sector's overall credit-related regulatory and policy framework within which the banks operate, and (2) individual bank's credit risk mitigation practices. The regulatory and policy framework for credit risk management in Bangladesh will be examined in this part of the report. The next part will focus on the

credit risk management practices of Dutch-Bangladesh Bank Limited itself.

3.2 Overview of Bangladesh Banking Sector

Before analyzing the regulatory and policy framework for credit risk management, it is imperative to portray a general picture of the banking sector in Bangladesh.

3.2.1 Banks in Bangladesh. At present there are 49 banks with 6253 branches operating in Bangladesh (Bangladesh Bank, 2004). The banking sector in Bangladesh comprises five types of banks as shown below:

- **Nationalized Commercial Banks (NCBs):** There are four: Sonali Bank, Rupali Bank, Janata Bank, and Agrani Bank. These are depository institutions holding a diversified loan portfolio. They are wholly owned and operated by the Government of Bangladesh.
- **Development Finance Institutions (DFI):** There are five DFIs: Bangladesh Krishi Bank, Bangladesh Shilpa Bank, Raishahi Krishi Unnayan Bank, Bangladesh Small Industries and Commerce Bank Limited, and Bangladesh Shilpa Rin Sangstha. They are government agencies that funnel government and donor development funds to specific sectors of the economy. There are therefore four plus five or nine state owned banks (SOBs).
- **Non-Islamic Private Commercial Banks (PCBs):** These are private sector depository institutions with normal diversified loan portfolios and asset bases. Private Islamic Banks (PIBs) are normally considered to be part of PCB segment.
- **Islamic PCBs:** These are private sector depository institutions that decry interest charges or interest payments and replace them with financial innovations that may be described as a variant of preferred share dividends. There are total 30 PCBs (including PIBs) in Bangladesh.
- **Foreign Commercial Banks (FCBs):** There are ten foreign banks operating in Bangladesh.

A list of banks operating in Bangladesh appears in Appendix B.

3.2.2 Evolution of the Banking Sector. After the independence on December 16, 1971, the Provisional Government of Bangladesh promulgated a law called Bangladesh Bank (Temporary) Order 1971 (Acting Presidents Order No. 2 of 1971) by which the State Bank of Pakistan was declared as Bangladesh Bank and the offices, branches and assets of the said State Bank were declared to be deemed as offices, branches and assets of Bangladesh Bank. The Government also merged existing 12 banks inherited from the Pakistan regime and constituted 6 new nationalized banks: Sonali Bank, Janata Bank, Rupali Bank, Agrani Bank, Pubali Bank, and Uttara Bank. During the 1970s, the banking activities were directed at massive credit disbursement to help increase industrialization and productivity in the war-ravaged country as per the Government's economic priority. But little attention was placed to identify problem loans and making provisions for them, although there was a significant amount of hidden default loans.

Since the beginning of 1980s, a rapid deregulation and privatization was initiated in the banking sector in order to increase efficiency, productivity, and competition. Two out of six nationalized commercial banks (Uttara Bank and Pubali Bank) were denationalized and a number of private commercial banks were allowed to operate. But the efficiency and credit discipline of the banking sector did not increase, rather loan default situation further worsened. In fact, there were no clear-cut policy guidelines and prudential regulations from the central bank on provisioning of classified loans and recovery of defaulted loans.

Recognizing the need to reform the financial sector, the Government formed a commission named National Commission on Money, Banking and Credit to undertake a major study of the financial sector in late 1984. Commission made its recommendation for financial sector reform in 1986. The loan default problem was recognized as the most serious issue that needed to be addressed. The World Bank also started a long term project named Financial Sector Reform Project (FSRP) in 1990 with a view to conduct an in-depth study on the financial sector of Bangladesh and to suggest necessary reform measures.

As per the FSRP recommendations, the Government launched a number of measures including new rules and regulations for screening, monitoring and recovery of loans, and also enacted new laws and amended the old ones to ensure lenders' recourse. Even after adopting many measures neither loan quality nor recovery situation improved. This was mainly due to the weak and lengthy judicial procedure which failed to ensure adequate punitive actions against the defaulted borrowers. The FSRP reform measures also had their own inconsistencies. For instance, there existed a mismatch between loan screening and monitoring standard and loan classification standard. The loan monitoring and screening system was less enforcing and remained far below the international standard, while the loan classification and other prudential requirements were asked to be complied at international standard. As a result of such inconsistency, proportion of classified loan appeared to be magnified.

After the expiry of FSRP in 1996, the Government formed Banking Reform Committee (BRC) with the objective of continuing further reform in the banking sector. Almost simultaneously, another World Bank project named Commercial Banking Restructuring Project (CBRP) started working since 1997. BRC opined that the supervisory and regulatory forbearance of Bangladesh Bank has been one of the main reasons for the accumulated banking problems and BRC's recommendation thus put highest importance on strengthening the supervisory and regulatory capacity of Bangladesh Bank for amelioration of the default loan situation. As per the recommendations made by BRC and CBRP, reform and restructuring initiatives have been undertaken by the Government to improve the banking sector condition. Till today newer policies and regulations are being instituted and older ones are being repealed or amended in this regard.

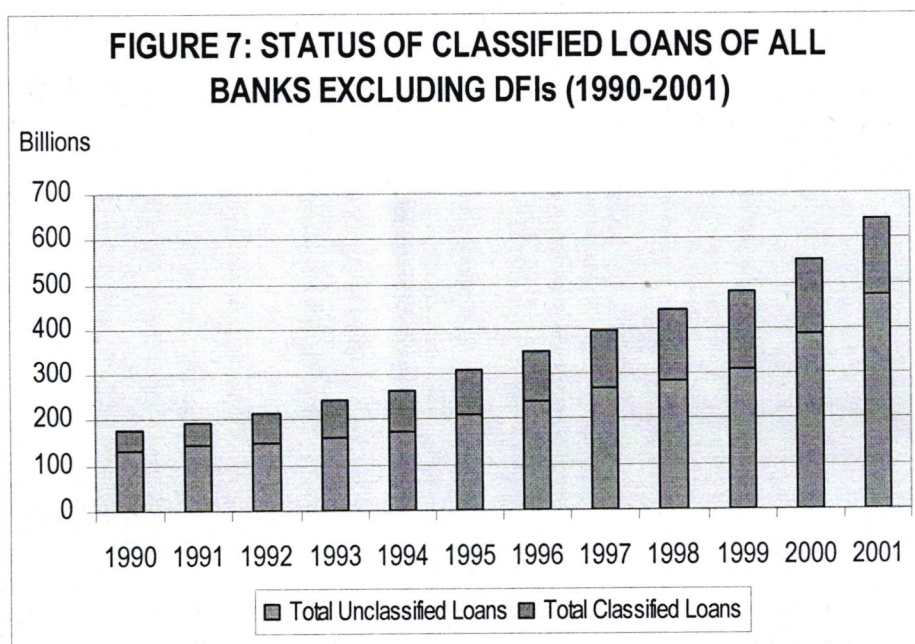
The evolution and reform in the banking sector over the last three decades signify a continual effort directed mainly towards the eradication of default loan problem. But this objective was not achieved as expected which is evident from the grim picture of the classified loans over the period 1990-2001 as shown in Table 1.

**TABLE 1: STATUS OF CLASSIFIED LOANS OF ALL BANKS
EXCLUDING DFIs (1990-2001)**

Year	Total Loans	Total Classified Loans	(Taka in billions)
			Classified Loans as % of Total Loans
1990	177.11	46.47	26.24
1991	192.78	50.39	26.14
1992	214.38	65.81	30.70
1993	244.92	85.45	34.89
1994	262.88	91.56	34.83
1995	310.29	99.42	32.04
1996	351.00	110.54	31.49
1997	395.75	129.61	32.75
1998	438.67	155.24	35.39
1999	483.43	175.46	36.29
2000	552.65	164.84	29.83
2001	641.64	169.35	26.39

Source: Banking Regulation and Policy Department, Bangladesh Bank, 2001 (Quoted in Choudhury and Adhikary, 2002)

The proportion of problem loans, therefore, remained almost one-third of the total loans over the stated period as can be easily visualized from the graphical representation of Table 1 in Figure 7.



The huge loan delinquency in the banking sector may be attributed to a number of factors as summarized below:

- Inefficient credit screening, monitoring and recovery actions by the banks.
- Weak and lengthy judicial procedure which can not ensure lenders' recourse on defaulted borrowers. The ineffectiveness of the legal system also sometimes encourages borrowers to refrain from paying the legitimate dues of the banks.
- Political and strong pressure-group connections of the large wilful defaulters.
- Inconsistency/frequent change in the financial sector policies, rules and regulations.
- Poor business performance due to adverse domestic and global macroeconomic and political environment.

The overview of the banking sector reflects a banking environment endowed with high credit risk potential due to different politico-legal, economic and intra-sector factors. The high probability of default in case of bank loans, thus, necessitates prudential regulatory and policy enclave as well efficiency of the staffs at individual banks to ensure sound credit risk management.

3.3 Present Regulatory and Policy Framework

In recent years Bangladesh Bank has taken many steps to enable the commercial banks to minimise their exposure to risks. Such steps include prudential regulations and policies for enhancing risk management capacity of the banks as well as legal recourse against loan defaulters. This section takes a closer look at the present regulatory and legal structure for credit risk mitigation and sound loan portfolio management by the banks.

3.3.1 Prudential Policies and Guidelines. Following prudential guidelines and instructions were given by Bangladesh Bank for credit risk management by the banks:

3.3.1.1 Credit Policy. Bangladesh Bank circulated a Credit Risk Management Manual for the banks in October 2003. This manual is a

comprehensive compilation of industry best practices in credit risk management, and Bangladesh Bank instructed all banks to adhere to the guidelines given in the manual in order to develop and maintain sound credit risk management systems. According to the manual, in the first and foremost place:

- All banks should have established Credit Policies that clearly outline the top management's view of business development priorities and the terms and conditions that should be adhered to in order for loans to be approved.
- The Credit Policies should be updated at least annually to reflect changes in the macroeconomic environment and the evolution of the bank's loan portfolio.
- The Credit Policies should be approved by the Board of Directors/Managing Director/Chief Executive Officer of the bank.

The credit policy is a statement of the bank's basic credit philosophy. It provides a framework for achieving asset quality and earnings objectives, sets risk tolerance levels, and guides the bank's lending activities in a manner consistent with the bank's strategic direction. Credit policy sets standards for portfolio composition, individual credit decisions, fair lending, and compliance management.

In all banks, the credit policy will be written. The policy should provide a realistic description of where the bank wants to position itself on the risk/return spectrum. It needs to provide sufficient latitude for a bank to respond to good business opportunities while concurrently controlling credit risk.

3.3.1.2 Credit Assessment and Sanction. The critical elements of the prudential policies and guidelines of Bangladesh Bank include credit screening tools which effectively contribute in improving the loan portfolio management by selecting healthy and less risky loan opportunities. The credit screening tools include:

- **Lending Risk Analysis (LRA):** LRA analyses risks before lending. This tool can be used to analyze the essential risk elements of a credit facility in a systematic way which helps the banker to select a good risk combination of business risks and security risks. This enables to direct the loan portfolio management in banks in proper way with risk and return analysis. The commercial banks have to carry out LRA for extending credit of Taka 10 million and above as per Bangladesh Bank instruction (BRPD Circular o8, Dated March 18, 2003). Some of the banks are even using LRA for loans of Taka 2.5 million and above.
- **Risk Grading System (RGS):** Bangladesh Bank has circulated a Risk Grade Matrix and a Risk Grade Scorecard to the banks and instructed them to follow these tools for grading the clients in terms of degree of credit risk. The risk grading system defines the risk profile of borrowers to ensure that credit structure, volume, tenor and pricing are commensurate with the risk involved. All credit facilities should be assigned a risk grade. Where deterioration in risk is noted, the risk grade assigned to a borrower and his loan should be immediately changed. Borrowers' risk grades should be clearly stated on credit proposals sent for head office approval. In addition to the bank's internal grading, at least top twenty five clients/obligors of a bank should be rated by an outside credit rating agency.
- **Financial Spread Sheet (FSS):** The past financial statements of a company are a primary indicator of its future financial performance. The financial spread sheet is an integrated credit analysis tool that makes use of the historical financial statements in assessing: (1) borrower's business trend and efficiency, (2) his ability to repay, (3) comparative positions of the industry competitors. FSS has the following main sections:

- Balance sheet and profit and loss statement analysis.
 - Cash flow statement analysis.
 - Financial ratio analysis.
 - Credit scores (“Z” Score and “Y” Score) based on combination of financial ratios.
- **Interest Rate Deregulation:** Since 1990, interest rate structure was gradually deregulated. At present, there is no ceiling, floor or band for the determination of interest rate. It reflects that banks can fix up their own prices for financial services/products including deposits and credits depending on the market forces of demand and supply. Interest rate deregulation was sought for bringing competition in the banking sector as well as achieving efficient credit allocation by the banks. Efficient credit allocations in diversified sectors/industries, in turn, increase the quality of loan portfolio by minimizing the credit risk from concentration of loans to a few borrowers/groups.
 - **Risk-weighted Loan Pricing:** As per the recommendation of FSRP, Bangladesh Bank has suggested other banks to adopt risk-weighted loan pricing system. In this system, each borrower would require to pay risk premium in addition to the base interest rate on his loan according to the risky-ness of his business/project. Higher the risk involved, the higher would be the rate of interest charged on the borrower. The risk-weighted loan pricing helps a bank to get compensated for the degree of credit risks it takes for extending funds to the borrowers. But in practice, this sort of risk based pricing is yet to get root in our banking system.
 - **Credit Information Bureau (CIB):** A Credit Information Bureau was established at Bangladesh Bank with a view to maintain an up to date database on all borrowings by the individuals/groups/companies from all banks in Bangladesh. CIB collects borrowers’ information from all banks and

disseminates to any commercial bank as and when it asks for credit information on any particular borrower. This information from CIB assists the commercial banks to know the status of a loan applicant in regard to his liabilities outstanding with any other banks/branches before considering his credit proposal. Obtaining CIB report was made mandatory by the central bank (Bangladesh Bank, BRPD Circular No. 13 Dated 26 October 2000) for the banks prior to sanctioning, renewal or rescheduling of large loans. In recent years, two private credit rating agencies namely, Credit Rating Information and Services Limited (CRISL) and Credit Rating Agency of Bangladesh (CRAB) have started providing credit rating services in Bangladesh. They publish credit ratings of well-known companies regularly. Besides they also provide credit rating information about any business entity on request and many of the local banks have already started taking their service in relation to their prospective clients.

- **Credit Restriction for Insiders and Their Relatives:** A frequent cause of loan default problem in Bangladesh has been the credit granted to bank insiders and their relatives who have the ability to exert control, whether direct or indirect over the bank management. Such credits may not meet the standard screening criteria and the amount of credit often exceeds prudent levels. To preclude the problems of connected lending, the Section 45 of Bank Companies Act 1991 has been enacted which states that any loan facility or guarantee or security provided to a Director of a bank or to his relatives must be sanctioned by the Board of Directors of the bank, and approved in the general meeting, and has to be specifically mentioned in the Balance Sheet of the bank. However the total amount of the loan facilities extendable to a Director or to his relatives should not exceed 50% of the

paid-up value of the shares of that bank held in Director's own name.

- **Policy on Large Loans:** In order to prevent the tendency of concentration of loans in favour of small number of individuals or groups and to prevent banks from taking excessive credit risk of extending such loans, Bangladesh Bank has set the following guidelines to be complied with:
 - According to Section 27 (3) of Bank Companies Act 1991, any credit facility above 15% of a bank's capital is defined as large loan. In case of the loan facilities covered by encashable securities the percentage is 25% of the capital. Prior permission from Bangladesh Bank had to be obtained by a bank before sanctioning any loan facility defined as large loan to any client. This provision of pre-sanction approval by Bangladesh Bank was repealed by the Bank Companies (Amendment) Act 2003 (Bangladesh Bank BRPD Circular No. 8 Dated, March 18, 2003).
 - In order to remove the singular credit risk of large loan, no bank shall extend large loan in favour of any individual, organization or group (excluding public limited companies having public issue at least 50%) in excess of 50% of their total capital. The amount of funded loan in the approved large loan shall not be more than 25% of bank's total capital.
 - If a bank has classified loans/advances, it can not extend large loans more than specified limits as shown below (Bangladesh Bank DBOD Circular No. 4, Dated May 12, 2002):

Net Classified Loans and Advances Held by the Bank	Maximum Allowable Limit of Large Loans as % of Total Loans
0% - 5%	56%
6% - 10%	52%
11% - 15%	48%
16% - 20%	44%
Above 20%	40%

- While determining the large loan percentage of a bank, 50% of the all kind of non-funded facilities including Letter of Credit and Letter of Guarantee issued by the bank would be considered as credit equivalent. But total non-funded facilities of the client should be taken into account in calculating the client's loan exposure.
- **Large Loan Restructuring Scheme (LLRS):** In order to lessen the burden of potential risks involved in large loans, Bangladesh Bank has recently introduced LLRS to encourage banks to go for inter-bank loan syndication or consortium loans. LLRS helps banks to go for voluntary syndicated loans in case of a very large loan amount (Taka 500 million and above) with a view to ensuring a transparent loan restructuring and rescheduling mechanism involving the banks participating in the syndication.

3.3.1.3 Credit Administration. The following guidelines and policies have been introduced by Bangladesh Bank to help the banks in effective monitoring and recovery of the loans and advances:

- **New Loan Ledger Card (NLLC):** Bangladesh Bank has instructed banks to introduce NLLC for improving the accounting practices in recording the loan status that would ensure easy identification of problem loans. NLLC records entries posted to “date due” “total due”, “date paid”, “total paid”, “over due” (days-wise), “total amount due (principal

and interest)". It enables the banker to know the status of a loan account. It records loan performances of borrowers with an early warning system through overdue aging and also keeps the banker alert for loan monitoring and loan recovery.

- **Large Loan Review Cell (LLRC):** Bangladesh Bank has set up LLRC to review all newly sanctioned, renewed and rescheduled loans by scheduled banks over Taka 10 million. LLRC helps banks in the credit monitoring and recovery process.
- **Performance Planning System (PPS):** PPS plans for lending on good and profitable loan portfolios. This system calls for setting of goals with performance measures quantified. This system helps monitoring progress and improving managerial effectiveness and also managerial control for achievement of goals and objectives within a specified period. The banks are using this PPS in securing low cost deposits and recovery of bad loans.
- **Management Information System (MIS):** MIS ensures timely and accurate credit information collection, preservation and dissemination. The computerized MIS report is a one page bank's performance report which measures key performances ratios like gross margin, return on assets, yield on loan and advances, capital adequacy etc. This report has been designed to aid in credit planning by the banks' top management.
- **Off-site Supervision (CAMEL Rating):** In the context of off-site supervision, Bangladesh Bank determines a composite rating for each bank, known as CAMEL rating, based on the respective bank's Capital, Asset quality, Management capability, Earning and Liquidity level. Basing on CAMEL rating, Bangladesh Bank identifies the problem

banks and if necessary also provides Early Warning Signal (EWS) to such banks.

3.3.1.4 Credit Transparency and Provisioning. The following regulations and policies are given by the central bank for ensuring transparency in reporting and provisioning of loans by the banks:

- **Risk-weighted Capital Adequacy:** Risk-weighted capital adequacy is a measure to protect the interests of depositors and stockholders in case of a bank's business failure due to excessive credit defaults. The existing capital adequacy requirements for the banks on the basis of risk-weighted assets replacing the capital-to-liabilities approach were introduced by Bangladesh Bank in 1996. Under the risk-based capital system, the required level of capital for each bank is dependent on the degree of exposure of the bank to the risks associated with its assets. Assets with low risk are assigned relatively low weights, and assets with high risk are assigned high weights. Then the capital level is set as a percentage of the risk-weighted assets. The revised policy on capital adequacy specifies that:

- Each bank will maintain a ratio of capital to risk weighted assets of not less than 9% with at least 4.5% in core capital.
- The minimum capital requirements (paid up capital and reserve) for all banks will be Taka 1 billion as per Bangladesh Bank Companies (Amendment) Act 2003.

The risk-weighted capital adequacy considers different degrees of credit risk and covers both on-balance sheet and off-balance sheet transactions.

- **Loan Classification and Provisioning:** Classification of loan means giving each and every loan case a status like unclassified, sub-standard, doubtful or bad/loss through

verification of borrower’s repayment performance on a particular date, while provisioning means setting aside funds from the profit against possible loan loss. This is done to safeguard depositors’ interests as well to ensure strong capital base in case of large credit defaults. During 1994-98, the loan classification and provisioning norms were changed five times in order to raise them to the international standard. The present loan classification and provisioning norms were introduced in 2001 which are more relaxed and fall below the international standard set previously in 1998. The present loan classification and provisioning standards are shown in Table 2 as compared to the international ones shown in Table 3.

TABLE 2: LOAN CLASSIFICATION AND PROVISIONING SYSTEM IN BANGLADESH			
Length of Overdue	Status of Classification	Rate of Provision	Frequency of Classification
Less then 6 months	Unclassified	1%	Quarterly
Loans overdue for 6 months but less than 9 months	Substandard	20%	
Loans overdue for 9 months but less than 12 months	Doubtful	50%	
Loans overdue for 12 months or more	Bad/loss	100%	
Source: Bangladesh Bank, BRPD Circular No. 9, 2001.			

TABLE 3: LOAN CLASSIFICATION AND PROVISIONING SYSTEM: INTERNATIONAL STANDARD			
Length of Overdue	Status of Classification	Rate of Provision	Frequency of Classification
Less then 3 months	unclassified	1%-5%	At least quarterly, usually monthly.
Loans overdue for 3 months but less than 6 months	substandard	10%-25%	
Loans overdue for 6 months but less than 9 months	Doubtful	50%-75%	
Loans overdue for 9 months or more	Bad/loss	100%	
Source: Choudhury and Adhikary, 2002			

3.3.2 Lenders' Recourse. The legal action is the last option of the banks against the loan defaulters. Since the 1990s, a number of legal and judicial measures have been taken to curb the loan default problem. The measures include:

- **Money Loan Court Act 1990:** Before enactment of Money Loan Court Act 1990, there was no special law for recovery of defaulted loans. Banks had to file cases in Sub-judge Courts, Commercial Courts, Assistant Judge Courts and Certificate Cases to the authorized Certificate Officer in the thanas and districts under Public Demands Recovery Act 1913. Thousands of cases of different banks were pending for years together in the above courts. As a result, banks were suffering badly from excessive amounts of defaulted loans. The Money Loan Courts have been established under the new law to expedite the legal action against defaulted loans and at present, 90 Money Loan Courts are working in the country. Every financial institution, other than the DFIs, must institute suits for the recovery of defaulted loans in such a Court.
- **Bankruptcy Act 1997:** The Bankruptcy Act 1997 was enacted with a view to expediting the realization of bank's dues from defaulted borrowers through declaring them bankrupts. Under this Act, the Government has set up two exclusive bankruptcy courts in Dhaka and Chittagong.

3.4 Analysis of the Regulatory and Policy Framework

All these prudential regulations and guidelines suffer from some inherent limitations and inadequacies which are dissected below:

- **Use of Credit Screening and Monitoring Tools:** Though Bangladesh Bank introduced many prudential guidelines like Lending Risk Analysis, Risk Grading System, Financial Spread Sheet, New Loan Ledger Card, Performance Planning System, etc in order to facilitate credit screening and monitoring, many of the banks are yet to incorporate and practise

these tools as prescribed. The causes of such reluctance on part of the banks include:

- **Non-compatibility of the Credit Screening Tools:** The use of tools like Lending Risk Analysis, Risk Grading System and Financial Spread Sheet require detail information on the industry, business or market in which the prospective borrower operates. In the context of our economic and financial system, where flow and availability of information is far from perfect, the credit officers at the banks face difficulty in gathering required information to make effective use of these credit screening tools. In many a cases, the loan applicants are also found reluctant or unable to provide required information.
 - **Lack of Enforcement by Bangladesh Bank:** The central bank is not also very committed to ensure the proper compliance of these prudential guidelines.
 - **Lack of Adequate Knowledge, Skill and Willingness of Credit Officers:** Using the credit screening and monitoring tools require adequate skill and knowledge on statistical and other analytical procedures. Considerable time and effort is also necessary to make effective use of these elements. The absence of these two factors on part of the credit officers also contributes in averting the exercise of the prudential guidelines.
- **Interest Rate Deregulation:** Interest rate was deregulated with a view to increase competitiveness among the banks and to ensure efficient credit allocation by them. But the increasing spread between the lending rate and the deposit rate in Bangladesh over the years indicates that the desired competitiveness is yet to be achieved, rather market distortions have increased instead of being declined. The high rate of defaulted loans, high rate of interest on government debentures and misconceived deposit and loan pricing strategies of the bank managements are among the reasons for such market distortions. The efficiency in resource allocation and the quality of the loan portfolio of the banks also did not reach the desired levels due to market distortions and lack of competitiveness.

- **Obtaining Credit Information from CIB:** The Credit Information Bureau’s data collection and dissemination is not yet based on information and communication technology (ICT). Consequently, obtaining CIB reports by the banks before making credit decisions is time-consuming, which hinders efficient credit management by them (presently it takes almost a month to obtain a report from CIB after requisition).
- **Large Loan Policy:** The regulation on large loan ceilings was revised by Bangladesh Bank in 2002 (Bangladesh Bank DBOD Circular No. 4, dated May 12, 2002) from the previous policy of 2000 (Bangladesh Bank BRPD Circular No. 13, dated October 10, 2000). The comparable figures of large loan ceilings prescribed by these two regulations are shown below:

Net Classified Loans and Advances Held by the Bank	Maximum Allowable Limit of Large Loans as % of Total Loans	
	Previous Policy	Present Policy
0% - 5%	80%	56%
6% - 10%	60%	52%
11% - 15%	40%	48%
16% - 20%	30%	44%
Above 20%	20%	40%

As shown above, for the best performing banks at one end, the latest policy allows them to sanction a maximum of only 56 percent of the total loans and advances as large loans if they hold net classified loans up to five percent, whereas the previous policy allowed them to sanction large loans up to 80 percent of the total loans. At the other extreme, the worst performing banks having more than 20 percent of net classified loans are now allowed to sanction large loans up to 40 percent of the total loans as per the present policy, whereas the previous policy allowed them to sanction large loans only up to 20 percent of the total loans. So it is clearly evident that the best performing banks are most affected by the revised policy while the worst performing banks are given more latitude in sanctioning large loans. This has given rise to the apprehension that this new rule will retard lending growth of the banks by punishing those with low classified loans while keeping the worst performers untouched.

- **Rescheduling of Classified Loans:** The present system of loan rescheduling in Bangladesh allows a bank to reschedule its classified loans, and thereby creates a scope for window-dressing of its loan portfolios without actually improving the quality of the loans or recovery situation. A classified loan, once rescheduled, is removed of its classification and is considered a fresh loan. Thus rescheduling allows a defaulted borrower to avoid classification status on his existing loans and to apply for fresh loans. This practice seems to encourage the wilful defaulters in obtaining new loans and making further defaults. In comparison, in India, any classified loan, even if rescheduled, remains classified as 'substandard,' and thereby the defaulted borrower is forced to clear this loan in order to obtain further loans (Mahmud et al., 2001).
- **On and Off-site Supervision by Bangladesh Bank:** Bangladesh bank, being the central bank of the country, is not yet capable of exercising its full regulatory and supervisory control over the banks, for which the banking sector is still being plagued by a lot of mismanagements and malpractices. The lack of proper on and off-site supervision by Bangladesh Bank can be attributed to two main reasons: (1) absence of autonomy for the central bank (free from the influences of political parties and vested interest groups), (2) deficiency of manpower. Particularly in recent days, the autonomy of Bangladesh Bank is badly felt for enforcing effective supervision and regulatory control over the banks.
- **Lenders' Recourse:** Though a number of legal and judicial steps have been taken to curb the loan default practice, the outcomes of these steps are still far from satisfactory. The performance of the Money Loan Court and Bankruptcy Court is utter frustrating. The number of loan default cases so far settled is a very small fraction of the total cases. Most importantly, most of these settled cases dealt with small loan defaulters, while the big and influential defaulters are still outside the ambit of legal framework. The following factors may be held responsible for such a situation: paucity of judges (as compared to number of judges), frequent stay-orders and undue delays of the courts, unethical support of administration, political connection of the defaulters, and a class of corrupt bank officers.

4.0 CREDIT RISK MANAGEMENT AT DUTCH-BANGLA BANK LIMITED

4.1 Introduction

Credit risk refers to the risk of loss due to default on financial assets. The fundamental business of lending exposes a bank to credit risks and thereby increases its level of non-performing assets (NPAs). The large accumulation of NPAs severely limits a bank's earnings and ultimately, the shareholders' returns. So a bank must have a sound credit risk management system encompassing the functions of credit assessment, sanction, disbursement, monitoring and recovery in order to maintain an optimal level of NPAs.

Generally, banks in this country conduct credit assessment through the traditional tools of project financing which include projected cash flow analysis, past balance sheet analysis and financial ratio analysis. Now the credit officers are even equipped with sophisticated analytical tools like lending risk analysis (LRA), credit scoring and financial spread sheet (FSS) in order to make sound credit assessment. The banks also share CIB database for evaluating the credit-worthiness of a borrower. But how far these tools are being practised by the individual banks accurately and effectively is questionable. Unfortunately in reality, these mechanisms have become mere paperwork which hardly plays any role in effective credit assessment and decision-making. Bypassing CIB credit rating and window dressing of LRA have become the most common practices in the banking sector due to insiders' influence, pressure from big borrowers, fierce inter-bank competition and lack of proper knowledge and commitment on part of the credit officers. There is also a common practice among the banks to accept inadequate collateral security against disbursed loans which can not fully cover the risk of default and can realize only a portion of the bad loan. The capital adequacy, loan loss provision, loan classification, rescheduling and recovery systems of many banks are also questionable.

Does DBBL fall within or make an exception to these allegations? How effective is the Bank's credit risk management system? Can the present practices of credit officers at DBBL efficiently mitigate the Bank's credit risk exposure while earning a suitable return from loan portfolios? How good is the Bank's credit performance over the last

couple of years? This part of the report seeks to find some answers to these questions and recommend some measures for better credit risk management at DBBL.

4.2 The Need for Credit Risk Management

Loans are the largest and most obvious source of credit risk for most banks. A bank makes a loan to an individual or corporate client and it faces the credit risk as there is a probability that the borrower will fail to make timely repayment of the principal or interests. There are other sources of credit risk which include banking book and trading book transactions as well as on and off balance sheet activities. Thus, banks are increasingly facing credit risk in various financial instruments other than loans, which include bank acceptances, inter-bank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions. However, loans and advances remain to be the major and most crucial elements in terms of a bank's degree of exposure to credit risk.

The exposure to credit risk reduces a bank's asset quality and consequently, the return on assets. Thus, banks must strive to reduce its level of exposure to credit risk. But in practice, such risk element can never be eliminated fully from a bank's operations; rather it can only be controlled within optimal limits. Banks should have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to ensure that adequate capital is held against these risks and that they are adequately compensated for risks incurred. A comprehensive credit risk management programme will address the following key areas:

- A sound credit assessment, processing and sanctioning procedure.
- An appropriate credit administration, monitoring and recovery system.
- A team of professional and committed credit officers.
- Risk-weighted capital adequacy and loan loss provisioning system.
- A favourable credit management environment supported by a well-defined credit policy.

All these elements require organizational setup and functions at a bank's branch level as well as at its corporate head office. At DBBL, while credit policies are formulated by the top management, these are implemented and practised by the individual

branches as well as concerned divisions at the Head Office. The following two sections constitute the major analytical part of the report containing qualitative analysis of the credit risk management practices at DBBL and quantitative analysis of the performance of Bank's credit risk management system.

4.3 Qualitative Analysis of Credit Risk Management

The Loans and Advance Section at DBBL Mirpur Branch is responsible for credit management at branch level. The Credit Division, Credit Administration Division and Credit Monitoring and Recovery Division at DBBL Head Office are also the organizational elements of bank's overall credit management system. Professional and experienced credit officers constitute the human resource component of this system at DBBL. The Bank's credit management system involves the following main stages:

- **Credit Assessment:** Scrutinizing and screening loan applications received from prospective borrowers, and preparing and forwarding credit proposals to the Head Office for sanction.
- **Credit Sanction, Documentation and Disbursement:** Approval of the loan by competent authority and completion of the legal and other documentary formalities with respect to the sanctioned credit facilities and disbursement of credit to the borrowers.
- **Credit Administration:** Monitoring and recovery of the disbursed credit.

A qualitative analysis on the credit risk management practices at these stages follows next.

4.3.1 Credit Assessment. The credit assessment stage involves submission of credit application by the borrowers and preparation of credit proposal by the credit officers:

4.3.1.1 Submission of Credit Application. A borrower seeking credit facility from the bank is required to submit an application on a bank's prescribed form. The prospective borrower has to provide

relevant information in the credit application including his personal profile, business performance statistics, project details and fund requirements. When the loan applicant submits all required data, it becomes easier for the credit officers to assess the feasibility of the credit facility.

4.3.1.2 Preparation of Credit Proposal. After receiving the credit application from the client the credit officers prepare a credit proposal for sanction by the DBBL Head Office. The credit proposal is the outcome of a deliberate assessment on the prospective borrower and his credit requirements by the credit officers. The analyses include the following:

- **Credit-worthiness of the Borrower:** The credit-worthiness of the loan applicant/applicants is assessed basing on the following:
 - Personal net worth of individual borrowers/sponsors/directors of the firm.
 - Net worth of the firm.
 - Status of existing loan liabilities with this Bank or other banks including CIB credit information.
- **Industry Analysis:** An overview on the industry in which the client or his firm is operating including its problems and prospects. This is more or less a qualitative analysis.
- **Business Analysis:** This is an assessment of the client's business or firm which includes the analyses on:
 - Management ability, technical skill and expertise.
 - Past balance sheet and income statements.
 - Financial ratios.
 - Projected cash flows.
- **Security Analysis:** In order to cover the risk of default, the Bank takes securities against the loans and advances. A borrower is required to offer some asset as security to the

bank for availing the loan. The main categories of securities that the Bank accepts against the loans are as follows:

- **Liquid and Near-liquid Assets:** This category of securities include:
 - Lien on funds.
 - Life insurance policies.
 - Stocks, shares and bonds.
- **Current Assets:** The current assets accepted as securities include:
 - Hypothecation of stocks-in-trade.
 - Pledge of goods.
- **Fixed Assets and Real Estates:** These are normally taken as collateral securities and include:
 - Land property.
 - Building.
 - Plant and machinery.

The degree of credit risk exposure varies from one type of credit product to another. So the types and values of securities also vary with the different types of credit facilities. The types of credit facilities offered by DBBL and the security/collateral requirements for each type of credit are shown in Appendix C.

The values of the securities offered by the prospective borrower are assessed in order to ascertain the coverage against probable risk of default. The basis of security valuation is the expert third party assessment in terms of: (1) current market price and (2) forced sale value.

- **Risk Analysis:** The risk analysis is a summary of the LRA conducted on the client which includes:

- Client's risk exposure from the level of market competition.
 - Risks due to the dependence on external sources for raw materials.
 - Foreign market and foreign currency fluctuation risks.
 - Impact of management succession.
- **Profitability Analysis:** This includes an estimation of the Bank's return from the investment.

4.3.1.3 Findings on Credit Assessment Stage. Credit assessment involves rigorous analyses on the prospective borrower, his business and fund requirements. DBBL Mirpur Branch has a set of professionally sound credit officers who carry out the job of credit assessment with utmost meticulousness. Yet there are loopholes in their activities which may expose the Bank to severe credit risk situations. Following are the major observations:

- **Using LRA in Credit Assessment.** As per the Large Loan Regulation of Bangladesh Bank (BRPD Circular 08 Dated 18 March 2003), LRA must be carried out with respect to the loan applicant. LRA helps in assessing the credit-worthiness of the prospective borrower. At present credit officers at DBBL hardly reap the benefits of using this credit assessment tool for large loan applications.
- **Checking Political Connection of Borrower.** A significant factor in assessing the credit-worthiness of a borrower is his/her connection/affiliation with any political party or pressure group which may benefit or damage the business performance of the borrower when there is a change in political regime. In LRA too this factor is given due importance. The Credit Officers at DBBL do not seem to take into consideration this factor during credit assessment.

- **Dealing with Influential Borrowers.** Supervision of large loans by credit officers tend to be less effective because the big borrowers are influential persons in the society and seen to establish and maintain contact at the top level of the Bank. Big borrowers are in a position: (1) to exert irresistible influence on the credit officers for actions in their favour and (2) to dictate their credit terms.
- As per DBBL credit policy, a borrowing firm must seek prior approval from DBBL before changing or altering: (1) Company Memorandum, (2) Articles of Association and (3) Composition of Board of Directors/Sponsor Shareholders.
- As per DBBL credit policy, a borrower must seek prior approval from DBBL before availing any further financing/credit facility from any other banks/financial institutions.
- A borrower is required to submit provisional quarterly financial statements to the Bank regularly in addition to the audited annual financial statements.
- **Improper Valuation of Securities:** The Bank normally takes into consideration the present market value of collaterals as assessed by the nominated surveyor of the Bank. But the forced sale value of collateral, if and when recovered, may figure out to be only a fraction of the originally assessed value and would fail to cover the full amount of loan due. Thus, a bank should consider market value of mortgaged assets under forced sale situation when loans become bad and stale, and disposal of assets becomes inevitable - rather than its present market value.
- **Inadequate Collateral Security.** The collateral securities taken from the clients against their credit facilities do not always cover probable risk of default. Inadequacy in collaterals takes

place due to two reasons: (1) client's reluctance in committing adequate collateral assets against the loan taken (mostly happens with powerful borrowers), (2) bank's lenience in enforcing adequate collaterals to be committed by the borrowers. Though in modern banking scenario the practice of asset-based lending is gradually diminishing, collaterals, that cover the loan adequately, are still valuable security against probable risk of default in our banking context. The practice of relationship lending, which de-emphasizes the need for adequate collaterals against credit risk, has not also well-developed in our banking sector. Following are the instances:

- **Selection of Risky Credit Schemes.** Selecting investment projects in some sector which generally involve higher degree of credit risk and operational risk may end up in the deterioration of a bank's assets quality and the reduction of its returns on investment. Some of the loan schemes of DBBL did not turn out very successful in term of profitability due to the risks involved. Had there been detail risk and return analysis by the Bank on these projects before launching them, the Bank would not have been in trouble with them subsequently.

4.3.2 Credit Sanction, Documentation and Disbursement.

This stage involves sanctioning of the credit facilities, completion of documentary and legal formalities and disbursement of the credit to the borrower.

4.3.2.1 Credit Sanction. The duly prepared credit proposal is sent to the DBBL Head Office for necessary sanction. The following supporting documents are also sent along with the credit proposal:

- CIB credit report on the loan applicant.
- Audited/management certified financial statements of the company.
- Financial spread sheet analysis on last three years.
- Net worth statement.

- Details of acceptable securities.

After receiving the credit proposal from the branch, the Head Office Credit Division scrutinizes the proposal and if necessary, asks the branch to make required correction/modification/addition in light of the procedures prescribed in the credit operation manual. The Credit Division then places the credit proposal before the appropriate sanctioning authority along with necessary notes and recommendations. The credit sanctioning authority at DBBL is split into three levels basing on the ceilings of credit amount: (1) the Head Office Credit Committee, (2) delegated authority to the Managing Director, and (3) the Executive Committee of the Board of Directors. The sanctioning authority may then accord sanction to the credit proposal.

4.3.2.2 Documentation. After the sanction of loan, credit officers of the Branch complete the documentary and legal formalities in relation to the loan. Such formalities include:

- Loan agreement.
- Hypothecation and mortgage formalities in relation to the primary and collateral securities.
- Insurance formalities.

4.3.2.3 Disbursement. Before the disbursement, the client is asked to open an appropriate loan account with the Branch. All the disbursements and repayment instalments take place through this account.

4.3.2.4 Findings on Credit Sanction, Documentation and Disbursement Stage. The major observations on the practices pertaining to this stage are given below:

- **Obtaining CIB Report before Sanctioning Large Loans.** Obtaining CIB report from the Credit Information Bureau of Bangladesh Bank was made mandatory prior to sanctioning, renewal or rescheduling of large loans. But DBBL does not seem

to follow this prudential regulation rigorously. In many of the cases it was found that DBBL has sanctioned and disbursed credit facilities to the borrowers before the CIB reports were obtained. Even in some cases the Bank sanctioned and disbursed loans, and later on found that the borrowing firm or its allied concerns had adverse CIB reports.

- **Loan to the Defaulters.** Extending credit to a borrower, who has already defaulted in previous loan agreements, is the most risky affair. As per Section 27 AA (3) of Bank Companies (Amendment) Act 1997, no new loans can be extended, or no existing loan facilities can be renewed in favour of a borrower/group/company having classified loans in any of the banks. DBBL does not seem to follow this prudential regulation very meticulously. In number of cases it has been found that the Bank extended credit to a firm having defaulted loan against some of its allied/sister concerns.
- **Post Facto Sanction for Renewal of Loans.** In many cases DBBL accords renewal sanction to an existing credit facility much after its expiry. Such post facto sanctions takes place due to delay in: (1) submission of renewal application by the client with necessary documents, (2) processing and forwarding of credit proposal by the credit officers, and (3) sanctioning by DBBL Head Office. Meanwhile, the client continues to take credit within the period between expiry and renewal sanction. The bigger this period of post facto sanction, the higher may be the exposure to credit risk. Post facto sanction may take place in case of extreme eventualities, but this should not become a frequent practice.
- **Incomplete Collateral Formalities.** It has been found in a number of cases that the mortgage and other legal formalities against the collaterals, e.g., land and building, remain pending or incomplete much after the

borrower has taken the loan. This increases the risk exposure for the bank.

4.3.3 Credit Administration. This stage involves monitoring, control and recovery of the disbursed credits:

4.3.3.1 Credit Monitoring. The credit monitoring and control involves the followings:

- Monitoring the loan disbursements or overdrawing by the borrower.
- Monitoring the repayment instalments.
- Periodic assessment of the valuation of securities and their coverage against the loan amounts outstanding.
- Regular visits and inspections to the client's manufacturing/business facility to ascertain his business performance.
- Regular examination of the client's financial statements, stock and inventory reports to ascertain his financial performance and repayment ability.

While monitoring, if it is seen that the borrower is unable to make repayment in time, after serving sufficient notice to him the outstanding loan amount may be classified as per the classification regulation. The same may be rescheduled if the client intends to do so. But rescheduling does not free him from the obligation of repayment.

4.3.3.2 Credit Recovery. Loans and advances granted in any form are repayable either on demand or on the expiry of the validity period, or through agreed instalments. When repayment of the loan principal and accrued interests is not made by the borrower in accordance with the repayment terms, the Bank launches recovery efforts. The defaulted borrower is given adequate notice to adjust the loan. Upon failure of the borrower to make repayment, the Bank attempts to recover the loan in the following ways:

- If the recovery was allowed by way of pledge of goods, the Bank will realize the value through auctioned sale of the pledged goods.
- If the hypothecation of stocks-in-trade was taken as security against the loan, the Bank will attempt to take the stocks under own possession and then dispose off to realize the value.
- When the loan was allowed against mortgage, legal recourse will be sought by the Bank to sell the property through court decree.

4.3.3.3 Findings on Credit Administration Stage. The credit administration stage is not much concerned with credit risk management. Once a loan is disbursed to the borrower, the Bank is already exposed to the risk elements. Yet proper supervision and control on the outstanding loans can mitigate the probable risk of default. The following observation may be drawn on the credit administration activities:

- **Insufficient Credit Supervision and Recovery Effort.** Sound credit management system requires coordinated efforts directed at assessment, documentation, disbursement, monitoring and recovery of loans. The smooth performance of all these functions necessitates two things: (1) adequate number of credit officers and (2) segregation of their duties and responsibilities. But at present there are only two officers in the Loans and Advance Section of DBBL Mirpur Branch to perform the colossal tasks of credit management. So all of them have to do all the jobs and almost no job is done the way it should be done. The proper monitoring and recovery of the loans, in particular, is hampered mostly due to the less number of credit officers.

The qualitative analysis on credit risk management practices at DBBL can be concluded with the following two observations on the Bank's overall credit management:

- **No Consolidated Credit Policy.** Above all else, any bank should have an established Credit Policy formulated by the top management. But DBBL is yet to have an organized credit policy. The Bank's credit related guidelines are decided by the Executive Committee time-to-time, but these are not yet consolidated and well-set within a policy framework. Some of the significant policy guidelines in relation to credit management at DBBL are mentioned below:
 - Extending credits to single proprietorship firms is discouraged at DBBL as the risk involved is very high.
 - DBBL Directors or their family members are not allowed to avail any credit facility from the Bank since its inception.
 - The Bank maintains general provision on unclassified loans and advances at the rate of 3 percent as against the minimum requirement of 1 percent set by Bangladesh Bank.
 - DBBL provides 25 percent of its total credits as term loans and 60 percent as working capital loans to support industrial development and to boost up export earnings of the country.
- **DBBL Credit Manual:** The Bank has a consolidated Credit Operations Manual (Edition 2000) which serves as an excellent guideline for all credit management activities. If the credit officers comply with the instructions given in this manual in their day-to-day credit operations, the Bank can remain least exposed to the credit risk associated with loans and advances.

4.4 Quantitative Analysis of Credit Risk Management

The above-discussed qualitative analysis of CRM practices was followed by a quantitative analysis in order to evaluate the effectiveness of the CRM system at DBBL. The credit related parametric data were analyzed to measure the performance of CRM system at DBBL. The findings follow:

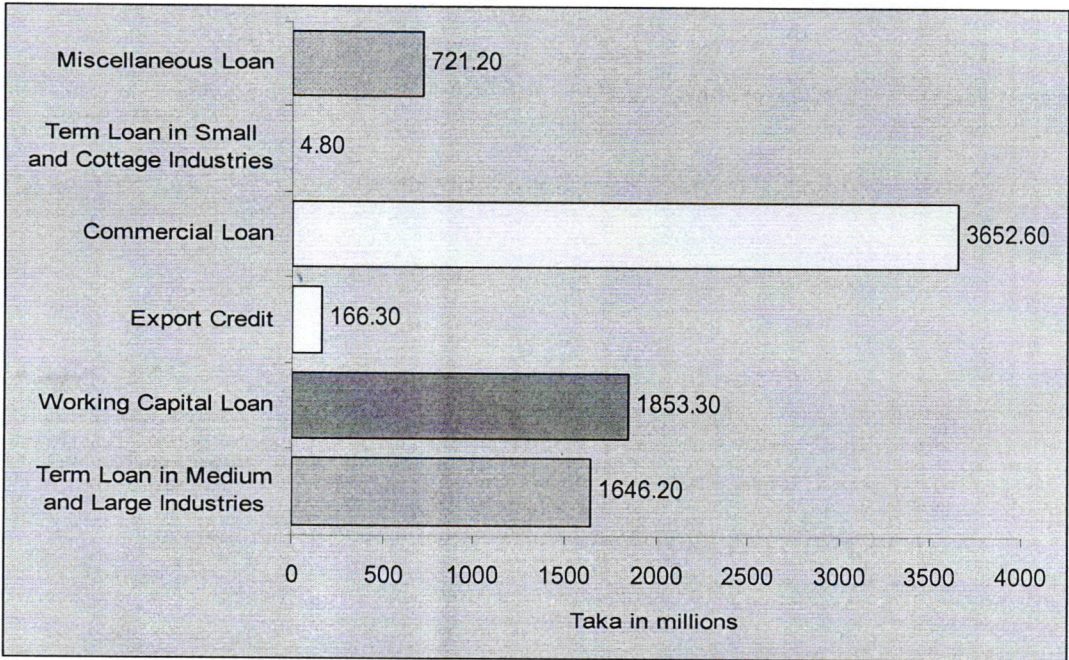
4.4.1 Portfolio Diversification of Loans. The banking business involves two types of credit risks: (1) systematic credit risk and (2) unsystematic credit risk. The systematic credit risk encompasses the entire economic and financial environment of a country irrespective of the types of industry or business in which the credits are extended and such risk elements can not be mitigated by industry or business diversification of loan portfolios. On the other hand, unsystematic credit risk arises due to differences in industry and business characteristics and such risk element can be diversified by efficient allocation of loans to different industry or sector-wise portfolios.

DBBL invests its assets in the different portfolios comprising borrowers from different industries and sectors. Usually the loans are given to the following categories/sectors:

- Term loans to medium and large industries.
- Term loans to small and cottage industries.
- Working capital loans to small and medium enterprises (SMEs).
- Export credits mostly to the garments sector.
- Commercial loans to the SMEs for trade finance purposes.
- Miscellaneous loans, e.g., transport loans, house-building loans, etc.

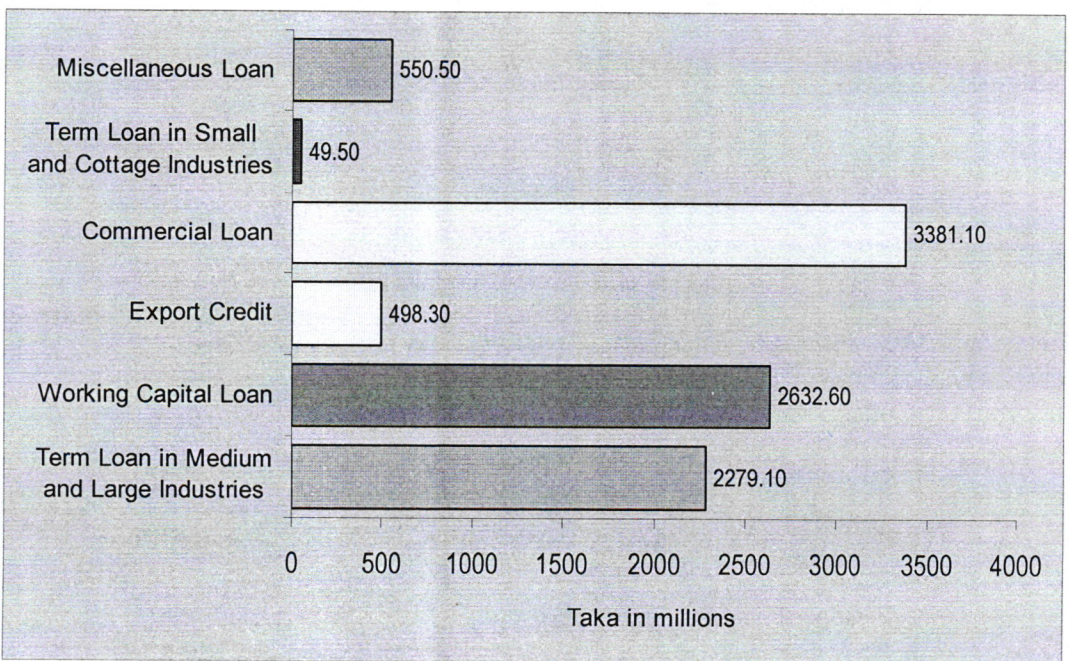
The sector-wise loan portfolios of DBBL for the years 2001, 2002 and 2003 are shown graphically in Figure 8, 9 and 10.

FIGURE 8: SECTOR-WISE LOAN PORTFOLIO (YEAR 2001)



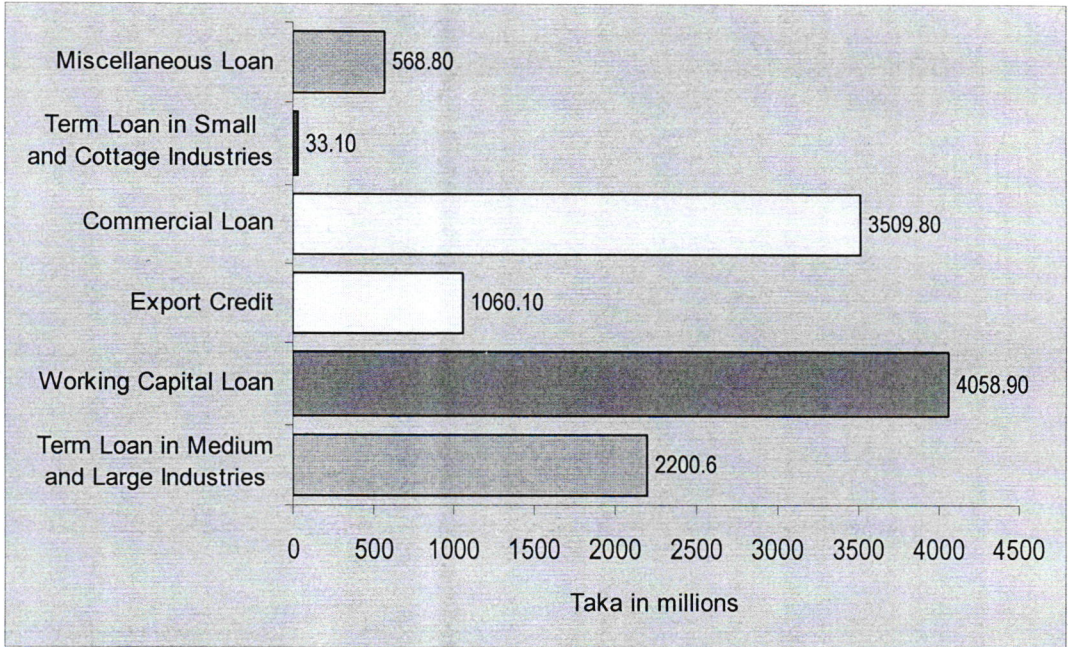
Source: Credit Administration Department, DBBL Head Office

FIGURE 9: SECTOR-WISE LOAN PORTFOLIO (YEAR 2002)



Source: Credit Administration Department, DBBL Head Office

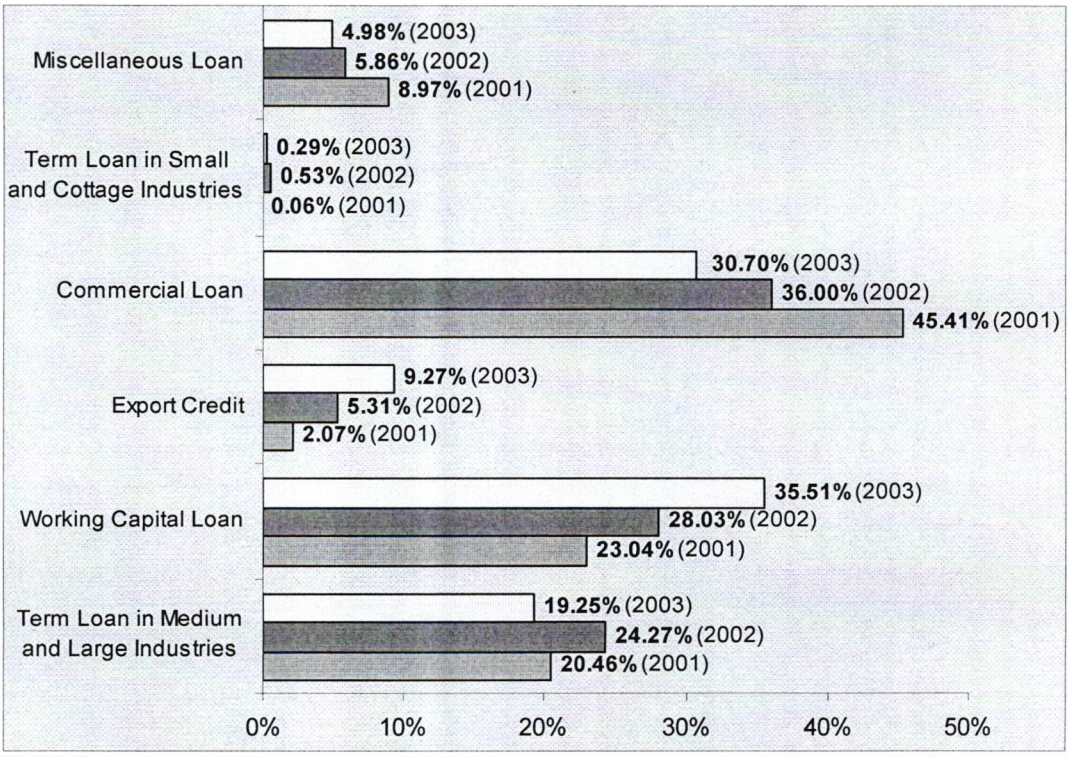
FIGURE 10: SECTOR-WISE LOAN PORTFOLIO (YEAR 2003)



Source: Credit Administration Department, DBBL Head Office

The proportions of sector-wise loans are graphically compared in Figure 11.

FIGURE 11: COMPARISON OF SECTOR-WISE LOAN PORTFOLIO (2001-2003)



The composition of the loan portfolios varied from period to period in terms of volume of loans extended to different sectors. In general, DBBL's loans were mostly concentrated in commercial loans, working capital loans and term loans to large and medium industries. As shown in the figure, the commercial loans had the highest concentration in 2001 (45.41%), which reduced to 36.00% in 2002 and further to 30.70% in 2003. The working capital loans had the next highest concentration of 23.04% in 2001, which increased to 28.03% in 2002 and further to 35.51% in 2003. The term loans in medium and large industries constituted the third largest segments in the portfolios of 2001, 2002 and 2003. DBBL had the lowest concentrations of loans in small and cottage industries in all the three periods. The comparative positions of sector-wise loan concentrations signify the following facts in relation to the Bank's credit risk management:

- **Working Capital Loans:** DBBL displays an increasing preference for working capital loans which comprise mostly of revolving lines of credit. The working capital loans inflict lower degree of credit risk upon the Bank as these are short term loans and renewed from period to period if the borrowers display satisfactory repayment behaviour. This signifies a good credit risk management strategy of DBBL.
- **Commercial Loans:** Commercial loans are normally the short term revolving lines of credit extended for importing raw materials. As these loans are given against sufficient security (e.g., title to the imported merchandise) and renewed from period to period considering the repayment performance of borrowers, credit risk exposure from such loans is less for the Bank. DBBL normally maintains a large concentration of commercial loans. Yet the proportions of such loans over the stated periods display a declining trend. This is due to the fact that the Bank has gradually reduced its credit exposure to the woven readymade garments sector because of its lack of backward linkage capacity in the upcoming context of post-MFA quota-free global apparel market from the year 2005. The Bank has also reduced its concentration of loans to the readymade garments manufacturing firms established on the rented

properties. On the other hand, DBBL is still supportive to the knitwear sector which has already developed sufficient backward linkage capacity. All these strategies demonstrate a sound risk management practice by the Bank.

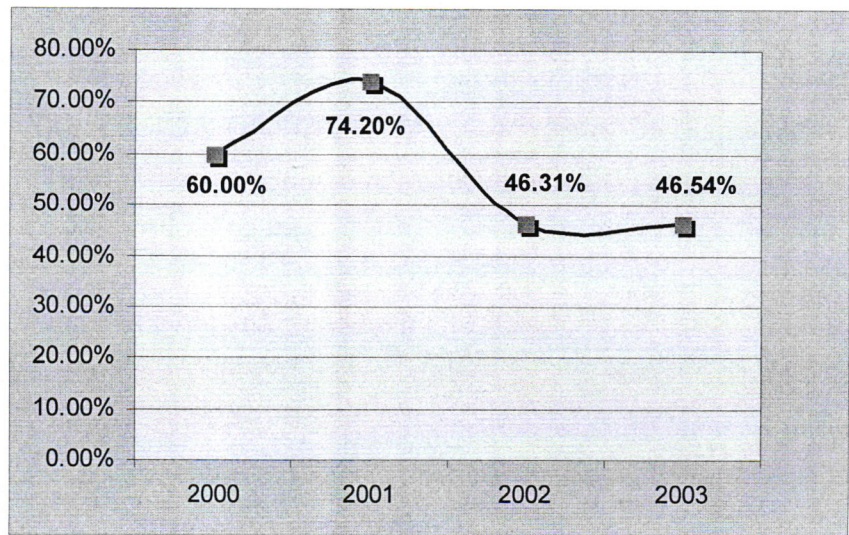
- **Term Loans to Medium and Large Industries:** Term loans to medium and large industries are mostly the large loans for which the Bank is exposed to maximum credit risk due to the probability of large volume of default from a smaller number of loans. These loans are good only when the Bank can take adequate collateral securities against them. But most of these loans are given to the big and influential borrowers who seem to be reluctant in offering adequate collaterals against their loans. Yet DBBL has been maintaining large concentrations of big-sized term loans over the periods. This is due to the fact that processing, monitoring and recovery of a small number of large loans are more cost-effective and convenient than that of a large number of small loans. But the cost of default in case of large loans may well surpass their benefits in the days to come if the Bank can not ensure adequate security against the probable risk of default.
- **Loans to Small and Cottage Industries:** Term loans to small and cottage industries are small-sized loans which, individually, expose the Bank to small quantum of credit risks. The Bank can also enforce sufficient securities against the small borrowers. Still the meagre concentration of loans in this sector implies that DBBL is less interested in extending credit to the small investors. This is due to the fact that processing, monitoring and recovery of large number of small loans require larger costs and efforts.
- **Export Credits:** These are mostly the credit facilities in the forms of letters of credit and other financing instruments extended to the exporters. There is also an increasing trend in export credits as the Bank earns handsome returns from these indirect loan facilities in relation to the degree of risk involved.

- **Miscellaneous Loans:** DBBL extended credit facilities to various other sectors in an attempt to explore new loan areas and also to diversify its loan portfolios. But there have been mixed outcomes from such ventures and consequently, the Bank has become cautious in extending loans in those sectors. This is evident from the declining volume of miscellaneous loans over the stated periods.

One worth-mentioning aspect of the Bank’s credit management system is that DBBL is yet to adopt the system of portfolio budgeting for its loans and advances. According to the modern banking concept, a bank should prepare a credit budget at the beginning of an accounting period which would specify the proportions of loans and advances to be allocated to different sectors. Such portfolio budgeting helps in mitigating credit risks through well-planned credit diversification. But DBBL, like other banks in Bangladesh, does not practise this modern portfolio management of loans and advances.

4.4.2 Large Loan Ratio. The large loan restriction imposed by Bangladesh forces a bank to diversify its loans and advances to larger number of borrowing entities and thereby, ensures that the loans are not concentrated to a few large borrowers. DBBL’s proportions of large loans as percentages of total loans for the last four years (2000-2003) are shown in Figure 12.

FIGURE 12: LARGE LOAN TO TOTAL LOAN RATIO (2000-2003)



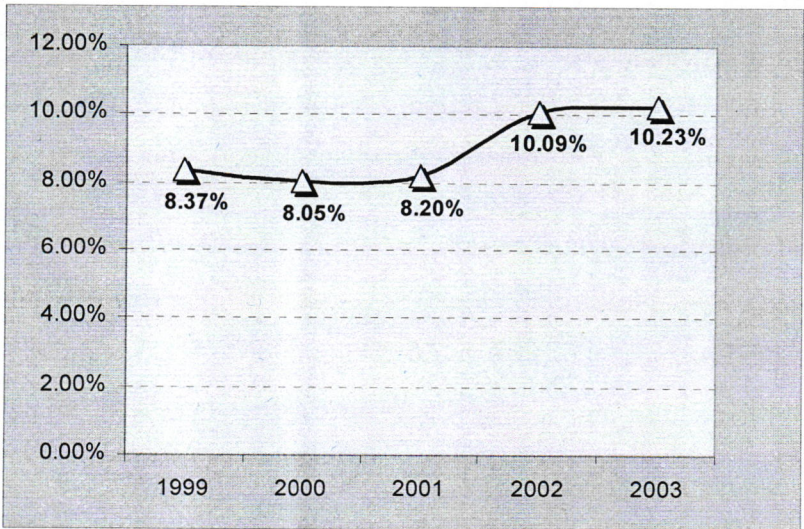
Source: Credit Administration Department, DBBL Head Office

As shown in the figure, 60% of DBBL’s loans were large loans in 2000, whereas the large loan ceiling of Bangladesh Bank was 85 at that time (Bangladesh Bank BRPD Circular No. 25, Dated December 10, 2000). In the next year, the large loan proportion of DBBL was 74.20% against the same ceiling. In 2002 and 2003, the large loan proportions were brought down to 46.31% and 46.54% respectively in order to comply with the new large loan ceiling of 56% set by the central bank (Bangladesh Bank DBOD Circular No. 4, Dated May 12, 2002).

Thus DBBL’s large loan ratios for the last four years signify that the Bank was well responsive and compliant to the large loan regulation of Bangladesh Bank. Such adherence to the prudential guidelines helps the Bank to diversify its credit risk exposure from large concentrations of loans and advances.

4.4.3 Risk-weighted Capital Adequacy. Adequate bank capital is thought to cover against a bank’s risks. If a bank holds more capital, it can more easily absorb potential losses from default of loans and is more likely to survive in the long run. Thus, capital adequacy is an indirect but important measure for credit risk management.

FIGURE 13: RISK-WEIGHTED CAPITAL ADEQUACY RATIO (1999-2003)



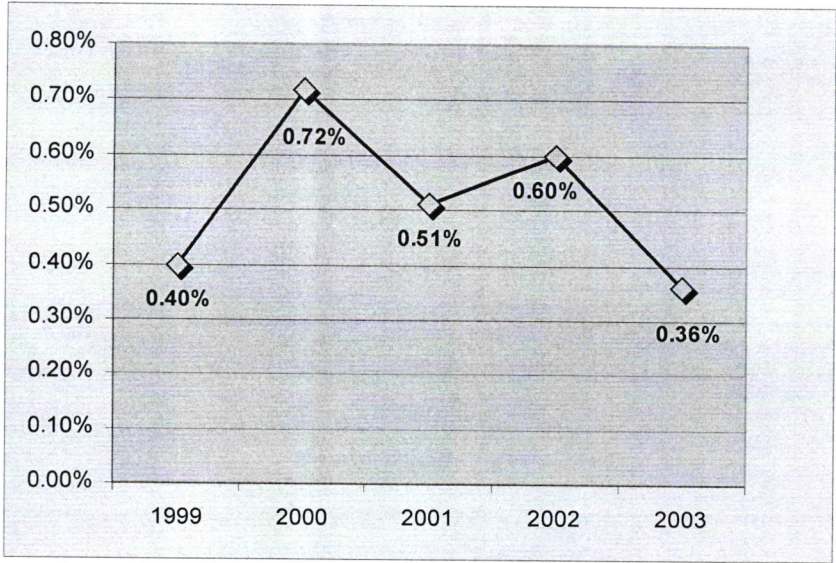
Source: DBBL Annual Report 2003

As per Bangladesh Bank regulation, as mentioned before, banks are required to maintain a capital ratio of at least 9% of risk-weighted assets. The risk-

weighted capital adequacy ratios of DBBL for the last five years (1999-2003) are shown in Figure 13. As seen in the figure, DBBL did not have the desired level of capital adequacy in the years 1999, 2000 and 2001 as required by the regulators. But in the next two years the Bank has demonstrated significant improvement in its capital adequacy situation and was able to maintain its level of risk-weighted capital adequacy ratio higher than the required ratio of 9%. This situation certainly depicts the Bank's strong capital base which can mitigate the impacts of probable loan defaults.

4.4.4 Level of Non-performing Assets. The ultimate factor that determines the soundness of a bank's credit risk management system is its level of classified loans or NPAs. Lower the volume of classified loans of a bank, the more effective is its credit risk management system. DBBL's proportions of classified loans as percentages of total loans for the last five years (1999-2003) are depicted in Figure 14.

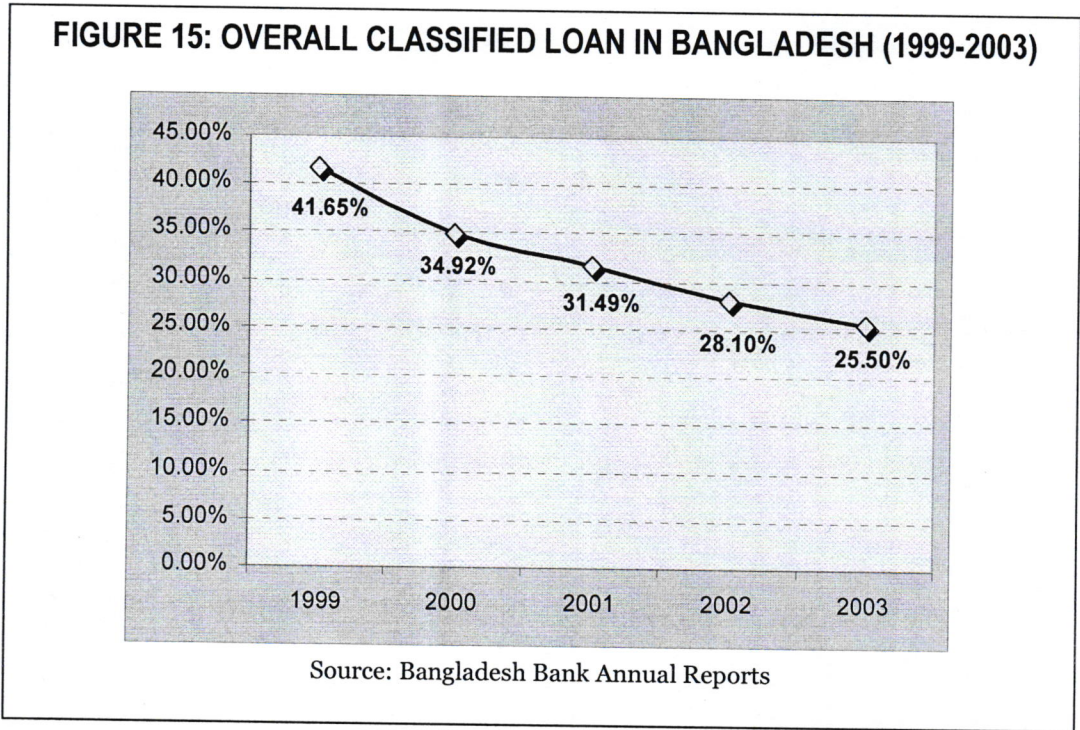
FIGURE 14: CLASSIFIED LOAN TO TOTAL LOAN RATIO (1999-2003)



Source: Credit Administration Department, DBBL Head Office

As seen in the figure, DBBL has been maintaining very low levels of NPAs over the periods. This signifies an outstanding performance of the Bank compared to any statistics or standards. To compare, the classified loan status of the

overall banking sector in Bangladesh for the same period (1999-2003) is shown in Figure 15.



As evident from this figure, though there is a declining trend, the level of classified loans in Bangladesh is still alarmingly high, whereas DBBL has been maintaining the quality of its assets at a very high level over the periods. The average level of classified loans at DBBL over the last five years was only 0.52%, even while the present international standard specifies that a bank can optimally have classified loans up to 6% of the total loans. This signifies the strength of the Bank’s credit management system.

4.5 Summary of the Findings

The credit risk management practices at Dutch-Bangla Bank Limited have been analyzed from qualitative perspective. A quantitative performance analysis of the credit risk management system has also been carried out. A review of the strengths and weaknesses of the credit risk management system of Dutch-Bangla Bank is presented next.

4.5.1 Good Practices in Credit Risk Management at DBBL.

Following are some of the strengths of credit risk management system at DBBL:

- The credit officers of DBBL at the branch level as well as at the Head Office are professionally sound and experienced. The professional competence and experience of credit officers is said to be the first line of security against credit risk at any lending institution.
- DBBL has a well-composed and comprehensive Credit Manual which provides prudential guidelines to the credit officers for day-to-day credit operations.
- In general, the credit screening and approval procedure at DBBL is systematic, rigorous and conservative. All walk-in clients are not welcome here to get a loan.
- The Directors/Sponsors of the Bank are not allowed to get loans from the Bank, whereas they can avail such credit facilities as long as these are within the restrictions imposed by regulation on loans to insiders.
- DBBL diversifies its loans and advances in different sectors and this loan portfolio management helps the Bank to mitigate the credit risk to a great extent.
- The Bank maintains a higher risk-weighted capital adequacy than the regulatory requirement imposed by Bangladesh Bank.
- The large loan percentage at DBBL also signifies the Bank's strict compliance with the large loan regulation of Bangladesh Bank which ultimately helps the Bank in reducing the credit risk exposure from large loan concentrations.
- The loan provisioning rates of DBBL are also maintained above the regulatory rates specified by the central bank.

4.5.2 Bad Practices in Credit Risk Management at DBBL.

Following are some of the weaknesses of credit risk management system at DBBL:

- The credit assessment system at DBBL is mostly qualitative and prejudiced by the subjective judgement of the credit officers as well as the management. This practice may lead to inaccurate credit decisions some times and put the Bank in trouble with excessive credit risk exposures and consequent accumulation of large volume of NPAs.
- The assessment of valuation and coverage of securities and collaterals against the loans is not pragmatic and prudential which may lead to huge losses from the recovery of defaulted loans.
- The perfection of documentary and legal formalities in relation to the loan agreements and security arrangements gets delayed and remains incomplete in most cases even much after the disbursement of loans. Such practices may cause severe credit risk exposure for the Bank.
- Many of the prudential guidelines and regulations of Bangladesh Bank are not strictly adhered to by the Bank. Such instances include guidelines and regulations on conducting LRA on large loan applicants, obtaining CIB report on borrowers before sanctioning large loans, extending no loans to the defaulters, etc.
- The degree of credit risk exposure from some of the credit schemes of DBBL does not signify sound risk assessment ability of its top management and consequently, the Bank faced much trouble with the loans and advances extended under these schemes.
- Many of the big and powerful borrowers seem to have strong grip over the top management of DBBL for which they are in a position to dictate their credit terms and conditions and take undue advantages from their dealings with the Bank. This phenomenon

may bring unprecedented jeopardy for the Bank in the days to come.

- The manpower deficiency impedes sound credit management practices, particularly, credit administration and recovery activities.
- Above all, DBBL is yet to formulate a consolidated and well-defined credit policy which would help in better credit risk management through better credit screening and decision-making.

4.6 Recommendations

Following options may be considered in order to attain a sound and effective credit risk management system at Dutch-Bangla Bank Limited:

- **Credit Policy:** DBBL should formulate a consolidated credit policy which will encompass the top management's credit philosophy, risk tolerance attitude, asset quality standards, portfolio management and credit budgeting directives, which are consistent with the overall corporate philosophy.
- **Strict Adherence to Prudential Guidelines:** The top management of the Bank should develop proper control and supervision mechanism to ensure that the credit officers strictly comply with the prudential guidelines and regulations (e.g. LRA, FSS, NLLC, RGS, PPS, etc) set by Bangladesh Bank.
- **Risk-weighted Loan Pricing:** DBBL should adopt the system of risk-weighted loan pricing and loans to all types of borrowers (including big and powerful ones) should be priced accordingly.
- **Manpower Allocation for Credit Management:** The number of officers in the Loans and Advance Section of DBBL Mirpur Branch is meagre in relation to the task load of credit management. There should be at least another two officers in this Section to carry out the functions smoothly. The Bank's top management should consider that the cost of

default on loans may, otherwise, surpass someday the cost of maintaining adequate manpower for credit management.

- **Proper Assessment of Securities and Collaterals.** Adequate emphasis should be given to ensure that: (1) the valuation of the securities and collaterals are carried out accurately, (2) the forced sale values of securities and collaterals always adequately cover the risk of default, and (3) the security/collateral valuation and risk coverage are reviewed periodically.
- **Timely Perfection of Documentary and Legal Formalities.** This is another grey area where DBBL should improve upon its present standard. No loans should be disbursed until the documentary and legal formalities in relation to the loan agreement and security arrangement are complete. The Bank should also ensure that the insurance coverage against the securities/collaterals is adequate and up-to-date.
- **Post Facto Sanctioning:** DBBL has to stop/minimize the cases of post facto sanctioning in case of renewal of existing and expired credit facilities as these cases increase the exposure to credit risk.
- **No Loan to Defaulters.** In no case, DBBL should extend credit facilities to an individual borrower or a firm which has classified loan liabilities with this Bank or any other bank. The Bank should always ensure that no loan is sanctioned against a loan applicant until a favourable CIB report is obtained against him/her.
- **Business and Industry Databank:** DBBL should develop an in-house databank on selected business and industry statistics where all up-to-date data on different industries including the major business firms will be maintained. There should also be a research wing in order to analyze and interpret the data on regular basis. The branches of DBBL can be integrated for enriching the databank time to time and ask for the relevant data as and when required.
- **Reciprocal Banking Cooperation:** DBBL, along with other banks, should develop reciprocal banking cooperation in order to exchange

information on prospective corporate borrowers. For instance, Shahjalal Bank Limited seeks credit information on parties which include credit facilities allowed and outstanding, accounts relationship, credit worthiness, past performance and repayment behaviour. In addition to the CIB report on clients, this reciprocal information exchange among banks will certainly help in mitigation of credit risk and ultimately, more efficient credit allocation. DBBL can learn from banks like Shahjalal Bank in this regard.

- **Relationship Officer:** DBBL should employ Relationship Managers (RM) of mid level status at branch level in order to attend all corporate clients so that each client's personal and business profile can be tracked and maintained up-to-date.
- **Credit Rating Assistance from Outside Agencies:** Though this is a new practice in our banking sector, many of the banks are increasingly taking the credit rating service from private credit rating agencies, Credit Rating Information and Services Limited (CRISL) and Credit Rating Agency of Bangladesh (CRAB). DBBL should follow in their footsteps. The Credit Risk Management Manual of Bangladesh Bank also instructs banks to obtain third party credit rating information on the prospective borrowers in order to make sound credit decisions.

4.7 Concluding Remarks

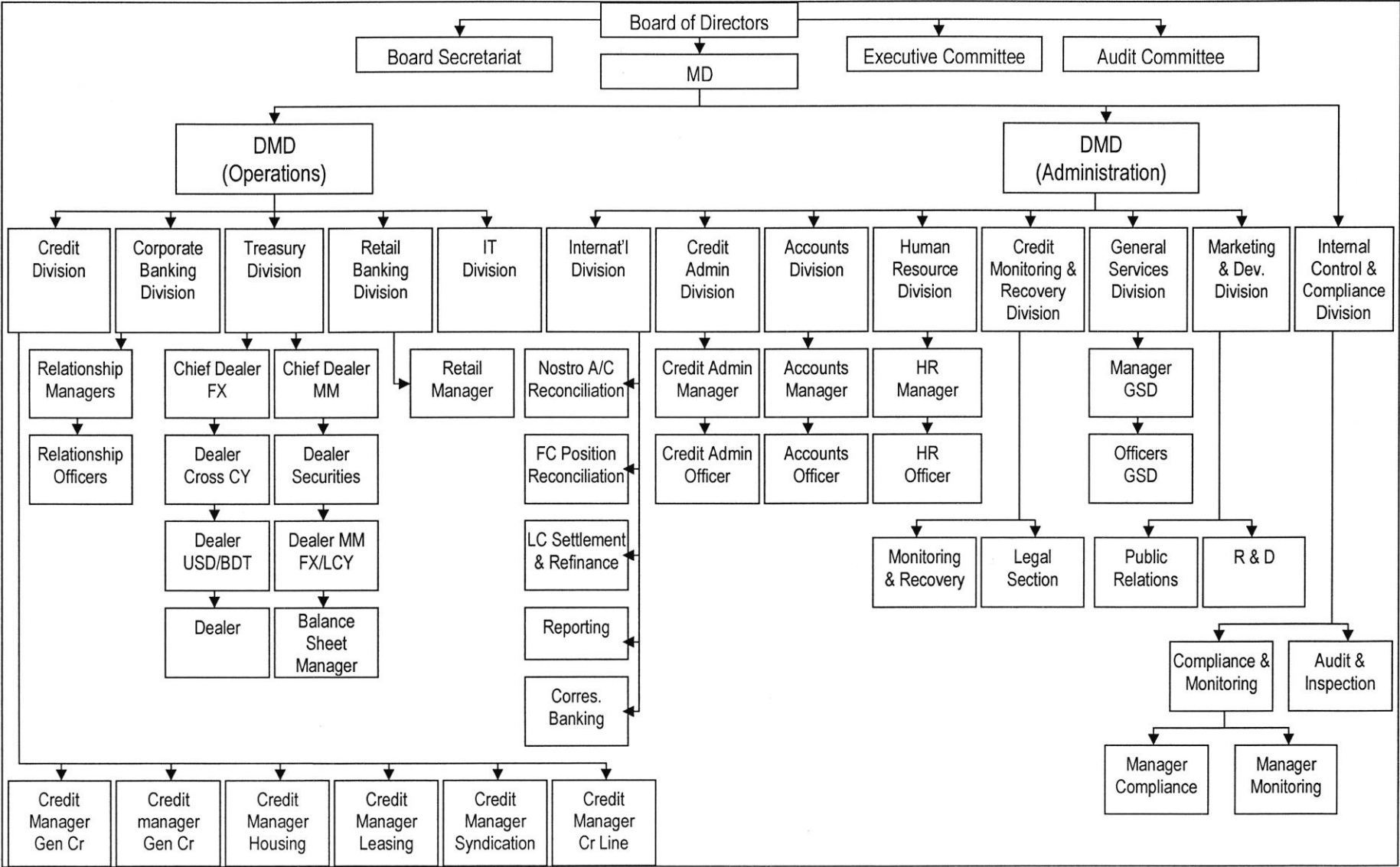
The banking system of a country is not isolated from its socio-political, economic, administrative and legal environments. Though a number of regulatory, supervisory and structural reform measures have been initiated over the years to eradicate the problems of banking sector in Bangladesh, the full benefits of such actions could not yet be derived due to lack of parallel development in other sectors. A major problem of the banks today is related to their deposit mobilization. It is becoming increasingly difficult for the banks to profitably mobilize their accumulated deposits due to intense industry competition and lack of viable investment opportunities. So, the banks invest their funds wherever they can and thus, quality of their loans gets deteriorated. On the other hand, the borrowers, particularly the big and influential ones, avail the scope of dictating their credit terms in their favour knowing that if one

bank declines to extend credit, another will not. Such a situation poses a serious challenge to the credit risk management system of any bank and, Dutch-Bangla Bank Limited is no exception to that.

Despite some loopholes and limitations, the credit risk management system at Dutch-Bangla Bank Limited maintains a high standard which is evident from the Bank's very low level of NPAs. Presently DBBL is pursuing a strategy of 'Zero Classification', that is, there should be no NPA in the Bank's loan portfolio. DBBL's management has been striving for the last three years to attain this goal. Steadily the Bank is making progress to reach that end, and it seems to be a realistic expectation of the Bank's management that within a few years there will be no classified loan in the loan inventory of DBBL. A sound credit management system coupled with robust risk mitigation strategies is, of course, the pre-condition to achieve such overarching objective.

Dutch-Bangla Bank Limited has set standards not only in credit management, many other corporate and banking activities of the Bank are the models for other banks to follow. Capital adequacy, liquidity and asset management, customer satisfaction, technology responsiveness, service diversification and innovation are some of the areas where DBBL has excelled significantly. Most notably, social commitments and responsiveness have made the Bank a class by itself. So it was hardly surprising when Dutch-Bangla Bank Limited became the best bank in Bangladesh in 2003 as per the CAMEL rating of Bangladesh Bank.

APPENDIX A: ORGANIZATIONAL CHART OF DBBL HEAD OFFICE



APPENDIX B: LIST OF BANKS OPERATING IN BANGLADESH

- **Nationalized Commercial Banks (04):**

- Agrani Bank.
- Janata Bank.
- Rupali Bank.
- Sonali Bank.

- **Specialized Banks (05):**

- Bangladesh Krishi Bank (BKB).
- Bangladesh Shilpa Bank (BSB).
- Rajshahi Krishi Unnayan Bank (RAKUB).
- Bank of Small Industries and Commerce Bangladesh Ltd (BSIC).
- Bangladesh Shilpa Rin Sangstha (BSRS).

- **Private Commercial Banks (26):**

- Arab Bangladesh Bank Ltd.
- National Bank Ltd.
- The City Bank Ltd.
- International Finance Investment and Commerce Bank Ltd.
- United Commercial Bank Ltd.
- Pubali Bank Ltd.
- Uttara Bank Ltd.
- Eastern Bank Ltd.
- National Bank Ltd.
- Prime Bank Ltd.
- Southeast Bank Ltd.
- Dhaka Bank Ltd.
- Dutch Bangla Bank Ltd.
- Mercantile Bank Ltd.
- Standard Bank Ltd.
- One Bank Ltd.

- EXIM Bank Ltd.
- Bangladesh Commerce Bank Ltd.
- Mutual Trust Bank Ltd.
- Premier Bank Ltd.
- The First Security Bank Ltd.
- Bank Asia Ltd.
- The Trust Bank Ltd.
- Shahjalal Bank Ltd.
- Jamuna Bank Ltd.
- BRAC Bank Ltd.

• **Islamic Commercial Banks (04):**

- Islamic Bank Bangladesh Ltd.
- The Oriental Bank Bangladesh Ltd.
- Al-Arafah Islami Bank Ltd.
- Social Investment Bank Ltd.

• **Foreign Commercial Banks (10):**

- American Express Bank Ltd.
- Standard Chartered Bank.
- State Bank of India.
- Habib Bank Ltd.
- City Bank N.A.
- National Bank of Pakistan.
- Muslim Commercial Bank Ltd.
- Hanvit Bank.
- The Hong Kong Shanghai Banking Corporation Ltd.
- Shamil Bank of Bahrain E.C.

APPENDIX C: SECURITY AND COLLATERAL REQUIREMENTS AGAINST CREDITS

Credit Facility	Securities/Collaterals
• Loan General: This facility is extended for various purposes including acquisition of fixed assets and granted for short, medium and long terms.	• Primary Securities: Lien of Government Securities like Bangladesh Sanchay Patra (BSPs), Pratirakkha Sanchay Patra (PSPs), Shares quoted in the Stock Exchange, Debentures, Fixes Deposit Receipts (FDRs), hypothecation of vehicles, machineries and other moveable assets, hypothecation of book debts and receivables. • Collaterals: Mortgage of immovable properties like lands and buildings.
• Secured/Collateralized Overdraft (SOD/OD): This facility is provided for different business purposes.	• Primary Securities: Pledge of instruments like FDRs, BSPs, PSPs, Unit certificates, etc, Non-Resident Foreign Currency Deposits (NFCDs), Shares, Debentures, Government Promissory Notes, Life Insurance Policies. • Collaterals: Mortgage of land and property.
• Cash Credit (CC): CC is given for financing inventories.	• Primary Securities: Pledge or hypothecation of stock-in-trade, stock-in-process, goods-in-transit, produce and merchandise, machinery, etc. • Collaterals: CC may or may not be collateralized. Collaterals may include mortgage land and building on which machineries are installed and third party mortgage of immovable property.
• Payments against Documents (PAD): A demand loan facility which is payable on demand.	• Shipping documents for imports having title to the bank.

Credit Facility	Securities/Collaterals
• Loan against Imported Merchandise (LIM): This credit facility is allowed against documents received against L/C released to an approved clearing agent at the request of the client. Goods must be stored usually in Bank's go-down or in a secured area of the go-down under effective control of Bank if they are kept on the borrower's premises.	• Pledge of imported merchandise.
• Loan against Trust Receipts (LTR): LTR facility is given to facilitate delivery of goods against retirement of import documents. The client is under obligation to pay the outstanding amount out of the sale proceeds of the goods.	• Trust Receipt obtained in lieu of import documents. • LTR may or may not be collateralized.
• Inland Bills Purchased (IBP): A demand loan facility which is payable on demand.	• Bill itself.
• Foreign Bills Purchased (FBP): A demand loan facility which is payable on demand.	• Shipping documents for exports.
• Export Cash Credit (ECC): ECC is extended to exporters as pre-shipment finance to facilitate purchase of raw materials for the purpose of manufacturing and exporting finished goods.	• Pledge or hypothecation of goods or export Trust Receipts.
• Letter of Credit (Sight): Letters of Credit is given for import of capital machinery or commodity eligible for imports.	• Cash margin.

Credit Facility	Securities/Collaterals
• Letter of Credit (Back to Back): This type of Letters of Credit is backed by master export L/C for export of garments or other goods to overseas market operating under bonded warehouse system.	• Lien over master L/C of 1st class banks acceptable to DBBL.
• Letter of Guarantee (Bid, PG, and APG): Usually guarantees can be classified under two heads: (a) Financial Guarantees towards fulfilment of financial commitment on behalf of the client, (b) Performance Guarantee when the bank guarantees the performance of the client as specified in the guarantee. Besides, Bid securities for participation in Tenders are also required.	• Margin in the form of cash, may or may not be collateralized by any other securities.
• Letter of Guarantee/Indemnity (Shipping): Bank issues guarantees in favour of the shipping company to enable the importer to obtain delivery of the goods without producing the original Bill of Lading.	• 100% cash cover margin.
• Negotiation and Purchasing/ Discounting of Bills: Discounts of purchases documentary bills drawn strictly in compliance of L/C.	• Discounted / Purchased Bills.

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LIST OF ABBREVIATIONS

ATM	Automated Teller Machine
BRC	Banking Reform Committee
BRPD	Bank Regulation and Policy Division (Bangladesh Bank)
CAMEL	Capital Adequacy, Asset Quality, Management Ability, Earnings and Liquidity
CBRP	Commercial Banking Restructuring Project
CIB	Credit Information Bureau (Bangladesh Bank)
CRAB	Credit Rating Agency of Bangladesh
CRISL	Credit Rating Information and Services Limited
CRM	Credit Risk Management
DBBF	Dutch-Bangla Bank Foundation
DBBL	Dutch-Bangla Bank Limited
DFI	Development Finance Institution
FCB	Foreign Commercial Bank
FDR	Fixed Deposit Receipt
FSAC	Financial Sector Adjustment Credit
FSRP	Financial Sector Reform Project
FSS	Financial Spread Sheet
LLRC	Large Loan Review Cell (Bangladesh Bank)
LLRS	Large Loan Restructuring Scheme
LRA	Lending Risk Analysis
MIS	Management Information System
NCB	Nationalized Commercial Bank
NLLC	New Loan Ledger Card
NPA	Non-performing Asset
PCB	Private Commercial Bank
PIB	Private Islamic Bank
POS	Point of Sale
PPS	Performance Planning System
RGS	Risk Grading System
RM	Relationship Manager
SOB	State Owned Bank

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