Credit Exposure and Lending Decision Quality of Private Commercial Banks in Bangladesh: An Empirical Analysis

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Abstract
The main focus of this paper is to examine empirically the level of credit exposure and lending decision quality of local private commercial banks in of Bangladesh during the period of 2007-2011. Five financial ratios are selected for measuring credit performances of selected banks. By applying one way ANOVA it is found that NPLTL. LSRTL and LSRNPL ratios differ significantly while CAR and Tire_1 ratio do not differ significantly between conventional banks and Islamic banks in last five years. The empirical study also found that there is a satisfactory improvement in banks' credit quality in last five years despite of certain fluctuations. It is also worth mentioned that level of credit exposure and quality of Islamic banks is much better than that of conventional banks in Bangladesh in last.
Keywords: Credit Exposure, Lending decision, Non-performing loan, Capital Adequacy ratio

1.0 Introduction:

Banks play a positive role in the socio-economic development of country. Modern trade and commerce would almost be impossible without the availability of suitable banking services. First of all, banking promotes savings. All manner of people, from the ordinary laborers and workers to the rich land owners and businessmen, can keep their money safely in banks and saving centers. Secondly, banking promotes investments. Banks easily invest the money they get in industry, agriculture and trade. They either invest it directly or create credit to other investors. Thirdly, it is most through banks that foreign trade is carried on. Credit creation has always been prominent and most profitable function of banks. The banking business, compared to other types of business, is substantially exposed to risks, especially in this ever-changing competitive environment. Banks no longer simply receive deposits and make loans. Instead, they are operating in a rapidly innovative industry with a lot of profit pressure that urges them to create more and more value-added services to offer to and better satisfy the customers. Risks are much more complex now since one single activity can involve several risks. Risks are inside risks. Risks overlap risks. Risks contain risks.

As of June 2011, 47 scheduled commercial banks which include 4 Nationalized commercial bank, 4 specialized banks, 30 local private commercial banks and 9 foreign commercial banks are operating in Bangladesh through a network of 7712 branch across the country. Local commercial banks are operated under the both conventional and Islamic system where as 30 commercial banks, 23 banks are operating under conventional system and 7 banks are operated under Islamic system. Some conventional banks also operating under the Islamic shariah through Islamic banking branch and Islamic banking window. There is no bank which runs under Islamic Shariah Law in both the NCBs, Specialized and FCBs banks operating in Bangladesh and subject to irrelevant to compare. Again, policy and government treatment to NCBs and FCBs are not as same as to PCBs. However, it will be sever if approved additional 9 commercial banks start their operations in coming days. In this context of competitions it is natural and interesting to know the credit performance status of commercial bank. The present study is motivated by this idea.

To comply with international best practices and to make the bank's capital more resilient to unforeseen shocks as well as to build the banking industry more risk sensitive and stable, Bangladesh Bank (BB) commenced implementation of Basel II capital adequacy framework from January 2010 as a regulatory requirement for banks. It is noted that banks inside Bangladesh maintained capital on the basis of risk weighted asset in line with Basel I wherein only credit risk was taken into account. However, under Basel II, credit risk as well as market risk and operational risk are being considered for calculating minimum capital requirement. BB has fixed up minimum Capital Adequacy Ratio (CAR) and minimum capital requirement for banks 8 percent up to June 2010, 9 percent up to June 2011 and 10 percent from July 2011. It is natural for all relevant parties of commercial banks, bank customers and investors in particular, to know how Basel II implementation affects credit performance of the commercial banks in Bangladesh. The paper, thus, wants to assess empirically credit performance of commercial banks of Bangladesh.

2.0 Literature review:

The extent of literature relating to Bank is vast. However, the studies relating to credit exposure and lending quality of commercial bank is very limited. Berger and DeYoung (1997) found lagged risk-weighted asset

(RWA) is significantly and positively related to credit risk measured by NPL to total loans and thinly capitalized banks take more risky loans, which potentially could lead to higher NPLs. Al-Shamrnari M. and Salirni M.(1998) profitability ratio especially return on equity (ROE) signals the earning capability of the organization. They also suggest that higher return on equity (ROE) ratio is appreciable as it is the primary indicator of bank's profitability and functional efficiency. Ranjan and Dhal (2003) provided an empirical analysis of commercial banks' non-performing loans (NPL) in India. The empirical result shown that expectation of higher interest rate induce rise in NPLs and maturity of credit horizon, better credit culture, favorable macroeconomic and business conditions lead to lowering of NPLs. Goddard J., Molyeux P. and Wilson J.O. (2004) analyzed the determinants of profitability of European Banks during the 1990s is investigated using cross-sectional, pooled cross-sectional time-series and dynamic panel models. The authors found a considerable endurance of abnormal profits from year to year and a positive relationship between the capital-to-asset ratio and profitability. Ahmed and Ahmed (2004) examined the factors affecting credit risk in conventional and Islamic banks in Malaysia. The findings shown that management efficiency, risk-weighted assets and size of total assets have significant influence on credit risk of Islamic banking, while conventional banking credit risk were significantly affected by loan exposure to risky sectors, regulatory capital, loan loss provision and risk-weighted assets. Samy and Magda (2009) focused on the impact of capital regulation on the performance of the banking industry in Egypt. The study concluded capital regulation enforcement is needed to improve the performance of the banking sector. Wasiuzzaman S. and Tarmizi H. B. A. (2011) attempted to examine the impact of bank characteristics as well as macro-economic determinants on the profitability of Islamic banks in Malaysia. The study found that capital and asset quality have an inverse relationship with bank profitability while liquidity and operational efficiency have a positive influence. Kargi (2011) evaluated the impact of credit risk on the profitability of Nigerian banks and found that banks' profitability is inversely influenced by the levels of loans and advances, non-performing loans and deposits thereby exposing them to great risk of illiquidity and distress. Epure and Lafuente (2012) examined bank performance in the presence of risk for Costa-Rican banking industry found that performance improvements follow regulatory changes and that risk explains differences in banks and non-performing loans negatively affect efficiency and return on assets while the capital adequacy ratio has a positive impact on the net interest margin. Chen and Pan (2012) examined the credit risk efficiency of 34 Taiwanese commercial banks over the period 2005-2008 using Data Envelopment Analysis (DEA) in term of credit risk technical efficiency (CR-TE), credit risk allocative efficiency (CR-AE), and credit risk cost efficiency (CR-CE). The DEA results show relatively low average efficiency levels in CR-TE, CR-AE and CR-CE in 2008 except one bank. Choon, Thim and Kolapo, Ayeni and Oke (2012) investigated the effect of credit risk on the performance of commercial banks in Nigeria and found that Nonperforming loan and Loan Loss Provision have negative relation with profitability and Total loan and advance has positive relation on profitability. Boahene S.H. Dasah J. and Agyei S.K.(2012) attempts to reveal the relationship between credit risk and profitability of some selected banks and found that credit risk has a positive and significant relationship with bank profitability.

Interestingly, most of these studies were conducted to the context of finding the determinant/s of bank profitability for testing structure conduct performance hypothesis. And the studies relating to Banking sector of Bangladesh is very rear in the best of my knowledge. Since the studies relating to the level of credit exposure and lending quality of commercial banks is very rear, the present study will bring a significant contribution to the existing stock of knowledge of Credit Risk management of commercial Banks.

2. Objectives of the study:

The objective of the paper is to know whether credit exposure and lending decision quality have change significantly among the commercial banks in Bangladesh in last five years.

3. Methodology of the study:

Hypothesis of the study:

Null Hypothesis: There is no significant difference in between conventional and Islamic banks in terms of credit exposure and lending decision quality.

Research Approach of the study: The study is conducted by using deductive approach as the author refers to the research questions and do not intend to go beyond these. Also the research aim is based on previously existing theories and studies in this area.

Research Method of the study: The study is a Secondary Research covering a significant amount of publicly published data pertaining to the credit risk indicators. A considerate amount of data and empirical results from the academic resources including academic books, academic journals from both printed and electronic databases have been used in the study.

Sample selection of the study: Banks in Bangladesh can be categorized based on their operations and hence purposively categorized into two main types-Conventional Banks (CBs) and Islamic Banks (IBs). The following

table explains the selection criteria of sample banks;

Out of total 47 banks, the selected sample of 12 will represent 25.53 percent of the total population. Out of the total 12 selected banks 9 banks selected from 23 CBs and 3 banks selected from 7 IBs for ensuring uniformity in representativeness of both the types of banks.

There is no bank which runs under Islamic Shariah Law in both the NCBs, Specialized and FCBs banks operating in Bangladesh and subject to irrelevant to compare. Again, policy and government treatment to NCBs and FCBs are not as same as to PCBs.

So, the study will fully concentrate on data from Private Commercial Banks in Bangladesh. Three Islamic banks from seven are selected for the study. A number of nine PCBs are randomly selected from total 23 banks based. The following table shows the sample banks which are considered for the study-

Variable determination for the study:

This study uses financial ratios for measuring credit performance of commercial banks in Bangladesh. The use of ratio in measuring credit risk and profitability performance is common in the literature of finance and accounting practices. Berger and DeYoung (1997), Al-Shamrnari M. and Salirni M.(1998), Demirguc-Kunt and Huizinga H. (1999), Samad and Hasan (1999), Ranjan and Dhal (2003),Wetmore (2004), Samad (2004), Ahmed and Ahmed (2004), Goddard J., Molyeux P. and Wilson J.O. (2004), Ahmed E., Rahman Z. and Ahmed R.I. (2006), Waymond (2007), Joetta C (2007), Ahmad and Ariff (2007), Felix and Claudine (2008), Ben-Naceur and Omran (2008), Samy and Magda (2009), **Kithinji** (2010), Kargi (2011), Al-Khouri (2011), Wasiuzzaman and Tarmizi (2011), Epure and Lafuente (2012), Chen and Pan (2012), Choon, Thim and Kyzy (2012), Kolapo, Ayeni and Oke (2012), Boahene, Dasah and Agyei (2012) used ratio index in measuring credit risk and performance of commercial bank. The greatest advantage for using ratio for measuring banks' performance is that it compensates bank disparities created by bank size Samad (2004). The study has considered the six financial ratios five ratios relating to banks' credit exposure and lending decision quality and one relating to profitability performance. The description of financial ratios are as follows:

Ratios relating to credit exposure and lending decision quality:

1. **Non-performing Loan to total loan (NPLTL):** Non-performing loan/ Total loan.

   This is one of the important criteria to assess the quality of loans or asset of a commercial bank. It measures the percentage of gross loans that are doubtful in banks' portfolio. The studies of Berger and DeYoung (1997), Ranjan and Dhal (2003), Samad (2004), Ahmed E., Rahman Z. and Ahmed R.I. (2006), Kolapo, Ayeni and Oke (2012), Boahene, Dasah and Agyei (2012) used NPLTL as credit risk indicators. The lower the ratio of NPLTL, the better is the asset/ credit performance for the commercial banks and vice versa.

2. **Loan Loss Reserve to Total Loan (LSRTL):** Loan loss reserve/ Total loans.

This ratio indicates what percentage of the total portfolio has been set aside but not charged off. The studies of Samad (2004) Boahene, Dasah and Agyei (2012), Kolapo, Ayeni and M.O. (2012) used LSRTL for measuring credit performance of commercial banks. Historically a higher the ratio of LSRTL indicates the poorer quality of loan portfolio and vice versa.

3. **Loan loss reserve to non-performing (impaired) loan ratio (LSRNPL):** Reserve amount for loan loss/ total impaired (non performing loans) loan.

It measures the percentage of reserve held against total impaired loans. The studies of Samad (2004) Boahene, Dasah and Agyei (2012), Kolapo, Ayeni and M.O. (2012) used LSRTL for measuring credit performance of commercial banks. The higher the ratio of LSRNPL, the better is the quality of asset. Bank can feel more comfortable about the soundness of its assets.

4. **Capital Adequacy Ratio (CAR): Total Capital/ Risk Adjusted Assets.**

The ratio measures the quality of a bank's capital and is required by Basel II to be no less than 10%. The ratio is recommended by Basel (1998). The higher the ratio, the more adequate the bank's capital and better assets quality will be.

5. **Tier_1 capital ratio(Tier_1):** Tier_1 capital/ Risk adjusted assets.

This ratio is for measuring the capability for Tier_1 capital to absorb bank losses and 5% is the minimum level required by Basel II.

Method of Data Collection of the study:

The secondary data source of the study is Annual reports of the selected banks for 5 years from 2007- 2011. The study necessitates looking into credit risk management disclosure, financial statements and notes to financial statements within the annual report. Besides, the study collected the data from newspaper, the peer reviewed scientific articles, academic journals, online and printed published books.

Data Analysis of the study:

In order to get a general understanding of credit risk management level of private commercial bank in Bangladesh through comparison of their credit exposure and lending decision quality performance in the last

five years from 2007-2011, ratio analysis are adopted, together with the method of One-way Anova. Here, the financial ratios identified earlier part is used to determine the level of credit risk management. The major hypothesis for testing is whether there exists significant difference among the last five years' credit risk exposure and quality level of private commercial banks in Bangladesh after the implementation of Basel II in 2010. The result of the analysis is obtained in this segment by using SPSS-20 version.

Reliability and Validity of the study:

Secondary data have been collected from the peer reviewed scientific articles, journals, books, the audited annual reports by the authorized accounting firms. In addition, we have used the capital adequacy and risk management reports of banks to collect our data. Furthermore, CAR and Tier_1 CAR are taken from the annual reports directly in order to avoid the mistakes of calculation. However, NPLTL, LSRTL, LSRNPL are not available for all the banks in the annual reports So we have taken the amount of NPLs, LSR and the TLs from the financial statements and the related notes, and then, used the formula of NPLTL (NPLs/TLs), LSRTL(LSR/TL) and LSRNPL(LSR/NPL) to obtain the values. To ensure the accuracy of the results, we triple checked the data collection and calculation processes. Next, we have used the statistical analysis tool SPSS to obtain results and conduct analysis of the regression model that we have adopted in our study. The reliability of the SPSS results has been proved by many researchers in their studies. We have also used several articles to get the idea how to analyze the SPSS outputs.

4. Discussion

In order to understand the level of Credit exposure and lending decision quality among 12 local commercial banks in Bangladesh (9 from conventional Banking System and 3 from Islamic Banking System), a comparison of five different financial ratios is made among last five years and the major results from the One Way ANOVA are shown the following table including the mean and statistical significant result. The Null Hypothesis is that the mean values for different ratios do not show significant difference in between Conventional Banks and Islamic Banks respectively during last five years.

So far from the result, it can generally conclude that the null hypothesis for NPLTL, LSRTL and LSRNPL ratios cannot be accepted at 5% level of significance. This means that NPLTL. LSRTL and LSRNPL ratios differ significantly between conventional banks and Islamic banks in last five years. Whereas, the Null hypothesis for CAR, Tier_1 ratios cannot be rejected rather accepted at 5% level of significance. This means that these ratios do not differ significantly in between Conventional Banks and Islamic Banks. Therefore, this result indicates that credit risk exposure and quality level of 12 private commercial banks is not stable but steadily improving over the years. Certain changing trends can be inferred by comparing the means of the ratios in each year, which will be explained below:

Firstly, Non-performing loan ratio to total loan ratio is decreasing from 2007 to 2011 for 12 local private commercial banks in Bangladesh, which is a good sign of loan quality improvement in those banks. Highest NPLTL ratio is 4.11% in 2007 which is decreasing consistently until 2011 which is 2.65%. By analyzing the ratio individually (See Annexure---) it is found that this ratio of Uttara Bank Limited is highest in every year than that of other sample banks which indicates the weakness of Uttara Bank Limited in controlling bad loans. But if we analyze this ratio of UBL in yearly basis, it is found that the trend of this ratio is declining. This ratio of the bank has been decreased from 12.40% in 2007 to 5.20% in 2011 which is the indication of significant improvement of the bank in controlling Non-performing loans. IFIC bank is also found weak in managing bad loans as it's lowest NPLTL ratio is found in 4.07% in 2011 which is almost equal to the highest NPLTR ratio of all banks. Alike all other banks, IFIC banks also has made a significant improvement in controlling bad loans which is evident from the sharp decline of this ratio from 8.11% in 2007 to 4.07% in 2011. It is worth mentioned that, the NPLTL ratio of Prime Bank Limited is comparatively lower in every year among the sample banks which shows the strength of PBL in controlling bad loan. Highest and lowest NPLTL ratio of PBL is found as 1.76% and 1.17% in 2008 and 2010 respectively, which is the indicator of sound and stable credit risk management quality of the bank.

Secondly, coming to Loan Loss Reserve to Total Loan and Non-performing loan ratio respectively, a general decreasing trend is found by comparing the means of the ratios in last five years. If we consider the P values of the ratios, it is indicated that there is a significant difference in these two ratios in between sample conventional banks and Islamic banks. The average mean values of these ratios indicate that the sample local private commercial banks are keeping less loan loss reserve to total loan and non-performing loans now. By studying the 12 banks one by one, it is found that ten banks follow this trend expect Uttara Bank Limited. Loan loss reserve to non-performing loan ratio of UBL is increasing from 23.39% in 2007 to 38.69% in 2011. Though some banks are maintaining consistency in keeping Loan Loss Reserve to Total loan but inconsistency is found in keeping Loan Loss Reserve to Non-performing loans in some banks. It is found that LSRNPL of DBBL is only 4.84% in 2008 but it is 26.10% in 2007 and it has become 35.87% in 2009. LSRNPL ratio of EXIM bank is also found

inconsistent in different years. It is found that PBL maintains higher Loan Loss Reserve to Non-performing Loan in different years from 2007 to 2011 comparing that of other sample local commercial banks. And PBL maintains lower Loan Loss Reserve to Non-performing loan in all years comparing that of all other sample banks. Keeping lower amount of Loan Loss Reserve cover Bad Loans may be a sign of weakening credit risk management but it also an indication of the improvement of default controlling.

Finally, now coming to two capital adequacy ratios: CAR and Tier_1 ratio of sample conventional and Islamic banks. In considering P values of these two ratios, it infers that the mean difference of these ratios in between conventional banks and Islamic banks is insignificant in last five years. By analyzing these two rations in different years separately, it is found that CAR of commercial banks in Bangladesh is experiencing a sharp decline from 12.21% in 2007 to 10.79% in 2010 after implementation of Basel II accord in Bangladesh, but it is higher than the minimum 10% level. The ratio is started to increase in the next year. By studying different banks separately, it is found that DBBL, JBL, IFIC, EXIM and Bank Asia fail to maintain the minimum 10% CAR in 2010 in the year of the introduction of Basel II accord in Bangladesh. Whereas, PBL, IBBL, ALAIBL, SBL and UBL are found strong in maintaining required CAR. The mean Tier_1 ratio is declining started from 10.05% in 2007 to 7.88% in 2010 but which is still more than the minimum requirement of 5% as per the Basel II accord. Here it is should be pointed out that all banks able to maintain the minimum Tier_1 ratio in all years. Both of the two ratio analysis is the evidence of banks' performance in keeping adequate capital, which indicates that the ability of sample local private commercial banks to absorb the losses and confidence in assets is not highly satisfactory. Therefore, it is can be said that banks performance in keeping adequate capital is good and they have the ability to absorb the loss and confidence in assets quality.

Besides the above analysis, a little more analysis should be applied to know the level of performance of banks' credit exposure and quality of two different banking systems in Bangladesh. Means of five ratios of sample banks working under two different systems in last five years are shown in the following table-3.

From the above table it is found that, CAR of all sample banks in both banking system is more than minimum regulatory rate of 10.0% in all years. It indicates that all banks are fulfilling Basel II requirement in managing regulatory capital which has a significant impact in managing bad loan as NPLTL ratio of all banks under the both banking system is declining every year. But it is also can be noted that Islamic banks in Bangladesh are doing well in compare to that of conventional banks in controlling bad loans as average yearly NPLTL ratio of Islamic banks is lower than conventional banks in very year.

As yearly average NPLTL ratios of Islamic banks is lower than that of conventional banks, Islamic banks are keeping less reserve to total loan and non-performing loan which is the indication of Islamic banks improvement in credit exposure control over conventional banks in Bangladesh.

5. Conclusion:

The study aimed at to know the level of credit exposure and lending decision quality of private commercial banks in Bangladesh. It is important to note that our sample size though satisfactory is not credible enough to extend the result to all commercial banks in Bangladesh. However, the results refer only to the sample to the study.

The study used five financial ratios as credit risk indicators such as NPLTL, LSRTL, NPLTL, CAR and Tire_1 ratio. The result obtained from one way Anova show that NPLTL. LSRTL and LSRNPL ratios differ significantly between conventional banks and Islamic banks while CAR and Tire_1 ratio do not differ significantly between conventional banks and Islamic banks operating in Bangladesh in last five years. To sum up through the empirical research on 12 local private commercial banks in Bangladesh, the conclusion can be drown that those banks have all mentioned a steady level of credit exposure and quality. Besides, the ratios have in general implied that a satisfactory improvement in banks' credit quality in last five years despite of certain fluctuations. It is also worth mentioned that level of credit exposure and quality of Islamic banks is much better than that of conventional banks in Bangladesh in last.

Suggestion for further studies:

The present study confined only the analysis of credit risk indicators. This study could be further developed by including liquidity risk, operational risk and profitability indicators. It will be more interesting to determine the effect of credit risk indicators on profitability by using multiple regression model.

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Table 1: Showing Banks in Bangladesh

Sl. No	Types of bank	Total	Sample
01	Nationalized Commercial Banks (NCBs)	4	-
02	Private Commercial Banks (PCBs)	30 (23 CBs & 7 IBs)	12 (9CBs & 3 IBs)
03	Foreign Commercial Banks (FCBs)	9	-
04	Specialized Bank	4	
Total		47	12

Source: Bangladesh Economic Review 2011

Table 2: Ratio Analysis Result in Percentage of 12 local private commercial bank of Bangladesh in the last 5 years

Year	NPLTL	LSRTL	LSRNPL	CAR	Tier_1
2007	4.11	1.48	39.43	12.21	10.05
2008	3.57	1.26	39.46	11.84	9.65
2009	3.18	1.00	35.47	11.92	9.55
2010	2.54	0.89	34.77	10.79	7.88
2011	2.65	0.73	25.46	12.17	8.82
Sig	0.022	0.011	0.041	0.458	0.952

Table 3: Mean of the five ratios of sample banks

Banking System	Year	NPLTL	LSRTL	LSRNPL	CAR	Tier_1
Conventional Banks	2007	4.56	1.69	42.93	12.65	10.56
	2008	3.97	1.39	40.55	12.15	10.03
	2009	3.50	1.13	37.75	12.10	9.77
	2010	2.84	1.07	39.34	10.45	7.24
	2011	2.94	0.84	27.99	12.06	8.29
Islamic Banks	2007	2.75	0.85	29.18	10.92	8.54
	2008	2.41	0.90	36.16	10.91	8.51
	2009	2.24	0.62	28.65	11.36	8.89
	2010	1.66	0.32	21.05	11.88	9.78
	2011	1.77	0.40	17.86	12.48	10.39

Table 3: The mean value of five ratios of sample banks under conventional and Islamic banking systems in the last five years. (Source: Annual report of sample banks)

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