Macrothink Institute™

Journal of Management Research
ISSN 1941-899X
2014, Vol. 6, No. 1

A Comparative Study of Prudential Regulation on Loan Classification and Provisioning of the Southeast Asian Countries

Md. Ariful Islam (Corresponding author)

Deputy Manager, BASIC Bank Limited

Khulna Branch, 107 Sir Iqbal Road, Khulna, Bangladesh

Tel: 88-017-1752-9503 E-mail: arifrussell@yahoo.com

Luthful Karim

Assistant Manager, BASIC Bank Limited

Khulna Branch, 107 Sir Iqbal Road, Khulna, Bangladesh

Tel: 88-019-1212-5098 E-mail: shajiblks@gmail.com

Md. Rayhan Islam

Business Administration Discipline

Khulna University, Khulna, Bangladesh

Tel: 88-017-1333-1982 E-mail: rayhan_07@gmail.com

Received: Nov. 3, 2013 Accepted: December 5, 2013 Published: January 1, 2014

doi:10.5296/jmr.v6i1.4507 URL: http://dx.doi.org/10.5296/jmr.v6i1.4507

Abstract

The process of economic development of Bangladesh has been seriously constrained by the continuing crisis of the accumulation of classified loans. This paper has been prepared for describing the regulatory regime of Southeast Asian countries like Bangladesh, India, Nepal, Pakistan and Sri Lanka and there regulatory measure regarding Loan classification and provisioning. Loan is the prime asset of a bank. So it is essential to know the asset quality of a bank and regulation helps to determine the financial health and efficiency of the banking sector. Besides, a proper loan classification and provisioning system ensures credibility of the

financial system that in turn restores trust and confidence in the mind of depositors. Loan classification and provisioning system is also essential for regularizing follow-up, monitoring activities and improving the recovery position. However, the criteria for classifying and provisioning loan portfolios depend on the prudential policies of the central bank. There are several reasons of classified loans in our banking sector. A comparative analysis in this study among Southeast Asian countries shows the regulatory measure and corresponding deviation from international standard. There is huge amount of classified loans in our banking sector. But at present the trend of classified loans has begin to decline. So it is needed to maintain a standard asset quality and so need to follow related prudential regulation. The Bangladesh Bank has also given the guidelines regarding the provisioning system against classified loans through the BCD and BRPD (Banking Regulation and Policy Department) circulation. Due to increasing default risks of loans, the provisioning system has been revised several times. For protecting the depositor's interest and keeping the bank's financial condition solvent huge amount of provisions are kept against the classified loans. For the causes of classified loans, provision of the banking sector is increasing. As a result the profit of the banks is coming down. Besides, this government has also been deprived from current year taxes due to higher rate of provisioning. There are various practices regarding provisioning among Southeast Asian countries especially from the unclassified part. Risk exposure limits are also different among the concerned countries. All the concerned countries are not following the write off policy even. Directed lending is vital for India and Nepal for economic and regional development. But other concerned countries are not following the directed lending. From the comparative study we found that Bangladesh is maintaining a high rate of provisioning for unclassified loan. Risk exposure is also high in relation to other countries. There is specific guideline regarding write off policy in Bangladesh but there is no specific guideline in Nepal and Sri Lanka. There is specific regulation regarding directed lending in India and Nepal that may cause over investment in low return projects often result in low profitability and poor asset quality.

Keywords: Southeast Asian countries, Classified loans, Provisioning system, Risk exposure

1. Introduction

1.1 Background of the Study

Lending function of a bank needs to add value to the bank. The lending function comprises origination, funding, monitoring and servicing of loan. Loans are deemed as assets of a bank. To maintain asset to a standard quality various prudential regulation from various angle, issued by central bank such as, loan classification criteria, provisioning requirement , income recognition, write-off policy, risk diversification, directed lending, debt restructuring etc.

Since 1980s, the central banks of the developing countries, following the practices of the developed countries, have adopted the "prudential norms for asset classification" with a view to ensuring "transparency" and "quality" of the loan portfolios of the banks. It is a part of Financial Sector Reform Program (FSRP).

Almost all countries of the world have been undertaking reform measures for their financial sectors since 1970s, though the motivation for reforms varies from country to country. The reforms of the financial sectors in the industrially advanced countries were triggered to a major extent by the phenomenon called "globalization" of banks and financial markets, which again was influenced by factors like restrictive regulations in domestic banking, development of Euro-dollar market, collapse of Brettonwoods system adoption of floating exchange rate system, abolition of capital control resulting in cross-border exchange and trade, technological development, debt-crisis of early 80s leading to a series of financial crisis etc(Rangrajan-1994). But the financial sectors reforms in the developing countries especially of Latin America and Asia were introduced as part of their overall program of economic stabilization and growth. Due to adoption interventionist development strategy by the period preceding the reforms, mainly in terms of directing the resources of financial institutions (which were largely owned by the governments) to state enterprise and priority sectors at below market interest rates left them (financial institutions) financially "repressed" as well as "distressed". Therefore, a major aim of financial sector reforms in the developing countries is to "liberalize" the financial sector (from repression) for the matter of improving saving-investment process and thus enhancing the efficiency of the workings of the financial systems of developing countries.

The experiences of developing countries in financial sector reforms have been mixed: some were successful, while others were less so. In particular, Latin American countries, including Argentina, Chile, Columbia, Brazil, Mexico and Uruguay initiated radical financial reforms beginning in mid-1970s, but their efforts generally ended with financial distress, which caused the reimposition of regulations (Lee-1991). In contrast to quick and sudden dismantling of all financial regulations in Latin American countries, financial liberalization progressed very cautiously in Korea and Taipei, China and yet achieved a reasonable amount of success. Cho and Khatkhate (1989) analyzed the experiences of five Asian Countries: Korea, Philippines, Sri Lanka, Indonesia, and Malaysia. They found that though reforms greatly contributed to the financializations of savings, yet overall savings-investment activities as well as asset quality of the banks did not improve significantly in those countries. In the meantime (in 1990s), a number of African countries as well as transitional economies

(ex-Centrally Planned Economies) have also undertaken wide-ranging reform measures for their financial sectors, the results of which are yet to be available in published documents.

The experiences of many developing countries in relation to their financial reforms provided an opportunity to reconsider varies aspects of it. Indeed, the experiences gathered so far forced the attention of the policy makers and practitioners from financial reforms per se to the identification of appropriate preconditions and proper timing and sequencing of financial reforms. It is now suggested that for successful financial liberalization, the most important preconditions are:(a) macroeconomic stability (in the sense of price stability, balanced budget, realistic exchange rate and favorable investment climate) and (b) appropriate financial infrastructure to have proper foundation of finance such as accounting and auditing, legal systems (procedures for enforcement of contracts), disclosure requirements and the structure of prudential regulation and supervision. In regard to the sequencing of liberalization, an important issue is the proper order between domestic and external liberalization (the opening up of current and capital accounts). It is now widely believed that domestic financial liberalization should be accomplished before external liberalization is undertaken. Moreover, in the context of external liberalization, trade and current account be liberalized first and the capital account afterwards. Some authors have also favored a gradual but steady process of liberalization in developing countries rather than sudden dismantling of all regulations.

Bangladesh, too, has started adopting a number of financial sector reform measures since 1990 as a part of its overall economic stabilization and structural adjustment program. Though privatization (allowing new private commercial banks to operate) and denationalization (selling out government banks to private entrepreneurs) of the financial institutions (as well as other real sector enterprises) started well before (in 1983) the adoption of stabilization and structural adjustment program by Bangladesh Government. However, even if we consider 1990 as take-off year in regard to financial reforms, we have by this time passed 15 years of reforms. The main features of Financial Sector Reforms Program (FSRP) in the context of banking sector of Bangladesh are: liberalization of interest rate policy, abolition of refinance and introduction of rediscounting scheme, introduction of new system of loan classification and provisioning, capital adequacy requirement, strengthening of Central Bank, improvement in the operation of NCBs, computerization of banks, development of human resources, reforms in the legal environment, reforms in foreign exchange regime and development of capital market.

Comparison among countries in relation to classified loan and provisioning is very difficult not only because of non-availability of comparative data, but also because of differences in objective situation (actual lending environment) prevailing in the different countries. Keeping in mind the above constraint, the study has focused on prudential norms of related country such as Bangladesh, India, Nepal, Pakistan and Sri Lanka. These countries are selected as they are the member country of SAARC and all the countries adopted “prudential norms” for loan classification and provisioning more or less in the same time. Besides this, other Southeast Asian countries are not take into account as there prudential norms are not available.

1.2 Objectives of the Studies

a) To study the loan classification and provisioning system in Bangladesh, India, Nepal, Pakistan and Sri Lanka

b) To compare the prudential regulation of the countries under this study

c) To compare the current classification system with the international standard.

1.3 Methodology of the Study

The study has been conducted by extensive review of related literatures and collections such as various book, publications, circulars, periodicals and journals. For this purpose, the help from the website containing information relevant to the study has also been sought. Besides this, prudential norms of India, Nepal, Pakistan and Sri Lanka are taken from "The financial performances and soundness indicators of South Asia" published by The World Bank. After analyzing the prudential regulation of the concerned countries and international standard, a comparative study has been made to achieve a conclusion regarding the regulatory framework of Bangladesh.

1.4 Organization of the Report

In order to achieve the objectives of this research, it is organized as follows: after the introductory part, conceptual framework part discusses the Regulatory Regime in Bangladesh, India, Nepal, Pakistan and Sri Lanka. Besides this other concepts such as non performing asset, provisioning, Write-off, directed lending also discussed in this part. Comparative studies on prudential regulation of Southeast Asian Countries have been discussed in the part titling "Comparative Analysis of Prudential Regulations of Bangladesh, India, Nepal, Pakistan and Sri Lanka". Then in Analysis and Findings part based on comparative analysis of the previous parts a discussion is stated. Finally in conclusion part are drawn with some recommendations.

1.5 Limitation of the Study

Comparative analysis of NPA and Provisioning in Southeast Asian countries are limited due to non availability of current data of the concerned countries. Data of Bangladesh Bank is available but other concerned countries data in the same form could not be collected. Due to time and recourse constrain, other means of communication can not be done. Besides this comparison among countries is difficult due to differences in objective situation (actual lending environment) prevailing in the different countries.

2. Conceptual Framework

In Southeast Asia, like other Countries of the world, Central Bank is the supreme authority of a financial system and its scope vary from country to country. Central Bank is the regulator for issuing and supervising the implementing of the Prudential Regulation regarding loan classification and provisioning.

In Bangladesh, the *Bangladesh Bank (BB)* is responsible for licensing and supervising

financial institutions and banking companies, as well as non-banking financial institutions. Established in 1971, BB is vested with extensive powers under the Bangladesh Bank Order1972 and The Banking Companies Act, 1991, to monitor and regulate all commercial banks including Nationalized Commercial Banks (NCBs), Specialized Banks (SBs), Private Commercial Banks (PCBs), and Foreign Commercial Banks (FCBs) in Bangladesh.

In India, *The Reserve Bank of India (RBI)* is responsible for regulating the operations of commercial banks and non-bank financial institutions in India including scheduled commercial banks, all India Development Banks and deposit accepting non-banking financial companies. Established in 1934, the RBI is vested with extensive powers under The RBI Act, 1934 and The Banking Regulation Act, 1949 to monitor and regulate all commercial banks and banking activities in India.

In Nepal, *Nepal Rastra Bank (NRB)* is responsible for regulating the operations of all the commercial banks, financial institutions and non-banking financial companies in Nepal. Established in 1956, NRB is vested with extensive powers under the NRB act, 1955 and the Commercial Bank's Act 1974 to monitor and regulate all commercial banks (government controlled banks, joint venture banks and local banks), and banking activities in Nepal including those of specialized finance institutions (Agriculture Development Bank of Nepal and Nepal Industrial Development Corporation). NRB is also empowered under the amendments made to the NRB ACT, 2001 to regulate the operations of non-bank financial institutions including finance companies, micro finance companied, and rural development banks.

In Pakistan, the *State Bank of Pakistan (SBP)* is entrusted with the responsibility of supervising the banking sector under the provision of the Banking Company Ordinance, 1962. The SBP is also empowered by the provisions of State Bank of Pakistan Act, 1956 and the Bank's Nationalization Act, 1974. The Financial Institutions (Recovery of finances) Ordinance, 2001, Companies Ordinance,1984 and Statutory Regulatory Orders (SROs) to exercise its supervisory powers over commercial banks, development finance institutions (DFIs), and micro-finance Banks(MFBs) SBP has issued separate prudential regulations on corporate/ commercial banking, consumer financing and Small and Medium Enterprises (SMEs) financing.

In Sri Lanka, *The Central Bank of Sri Lanka (CBSL)* exercises supervisory powers over licensed commercial banks (LCBs), licensed specialized banks (LSBs), leasing companies and finance companies under the provisions of the Banking Act. The Act empowers CBSL to issue directions backed by the force of law. However the CBSL which was set up under the Monetary Law Act of 1949 (MLA)is not a juristic person and so all directions are made on behalf of the Monetary Board, which is the governing body of the CBSL. The MB has five members including the Governor of the CBSL and the Secretary to the Treasury. Amendments to the MLA to, among other things, incorporate the CBSL, is currently under consideration.

The regulator of commercial banks continues to be the central bank in each country and so the move from a specialist regulator to a single powerful regulator has not taken hold in Southeast Asia as is evident from the table below:

Table 1. Regulatory Regime

Bangladesh	India	Nepal	Pakistan	Sri Lanka
Bangladesh Bank [BB]	Reserve Bank of India [RBI]	Nepal Rastra Bank [NRB]	State Bank of Pakistan [SBP]	Central Bank of Sri Lanka [CBSL]

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank)

Central Bank that issues circulars to preserve asset quality of a bank known as prudential regulation. It refers to control of risk taking activity by banks. According to Professor Gardener, "Prudential regulation should ensure that banks do not follow imprudent policies to the extent that their operational viability is threatened." So Prudential regulations are related with the: asset quality of the bank, capital adequacy, rules of banking, investor protection, legal and Accounting framework and information disclosure.

One issue of Prudential Regulation is Loan classification. It means giving each and every loan case a status like Unclassified, Substandard, Doubtful or Bad/Loss through verification of borrower's repayment performance on a particular date while provisioning means setting aside fund from profit (profit before provision and taxes) against possible loan loss. Provisioning is a balance sheet account with a net credit balance. The balance in the account represents the estimated uncollectible amount of loans included in the bank's portfolio. The balance in this account is deducted from the total amount of loans on the balance sheet. The resulting balance represents the estimated cash value of the bank's loans. The allowance account is both a valuation account and a contra asset account. As a valuation account, the account reflects the estimated loss or decrease in value of certain loan accounts. As a contra asset account, the account presents a net audit balance that should be subtracted from a related debit balance-sheet asset account.

In order to calculate the amount of provision on the classified loan, a base for provision needs to be determined first for applying the required percentage. The base for provision is to be determined by deducting the amount of interest suspense and the value of eligible security from the outstanding amount. The general provision will be kept on the whole outstanding amount of unclassified loan. The amount of interest of substandard and doubtful loan will not be considered as income of the bank and will be kept separately as "interest suspense". If any amount is received against sub-standard and doubtful loan, the said amount will be deducted from the total interest suspense amount. In the case of Bad/Loss loan, the interest on such loan will be kept in the interest suspense account if a suit is filed in the court. This interest will also not to be considered as an income of the bank.

Classified loans are also known as non performing asset (NPA) of a bank. Loans that are 90 days (180 days for consumer loans) past due or more are described as nonperforming loans

by banks and bank examiners. Non accruals loans are loans switched to a cash basis-unless payments are received before they are not recorded. Bank regulators usually allow a 29 days grace period before a loan is required to be classified as past due.(Woelfel,1994).

Asset quality is a major-risk factor of great concern to bankers, bank investors, and bank regulators. In recent years, non-performing loans have become of increasing importance when evaluating asset quality.

As a general principle, non accrual status for an asset should be determined based on an assessment of the individual asset's collectibility and payment ability and performance. Thus, when one loan to a borrower is placed in non accrual status, a depository institution does not automatically have to place all other extensions of credit to that borrower in non accrual status.

Loans can be classified in three ways-(a) On the basis of Risk Structure, (b) On the basis of Term Structure and (c) On the basis of Purpose. For Loan Classification and provisioning, loans are classified on the basis of Term structure and on the basis of purpose.

To categories loan as non performing asset, various criteria are followed and the criteria vary from country to country. To recognize problem assets, banks use qualitative and quantitative criteria. Qualitative criteria are simply the personal judgment regarding the asset quality and quantitative criteria are on the basis of record of recovery.

Another Prudential norms regarding classified loan is the write-off policy, to reduce the book value of an asset in order to bring it into agreement with its present going , estimated, appraised, or market value. To write off, change off, and write down are practically synonymous, except that the first two are customarily used when the entire value of the asset is charged as a loss, e.g., a bad fully reserved against by allowance for bad debts.

Debt Restructuring refers a situation that occurs when a creditor for reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider at a point earlier than the scheduled maturity date. Two principle types of debt restructuring are: a transfer of assets or equity interest from a debtor to a creditor in full settlement of a debt and a modification of terms.

Risk Diversification or risk exposure is another issue of prudential regulation which means giving loans to an individual or a group at a certain percentage of its capital.

Directed Lending also related with asset quality of a bank which means lending a certain portion of loan on priority sectors that are imposed by the central authority.

Adhikary (2003) argues that proper loan classification and provisioning system ensures operational soundness and liquidity of a bank. He also states that the rate of provision is to be charged according to various time slaps. After practicing this technique, when the provisioning shortfall of the banks will be over, banking sector should finally adopt international standard. More and more asset management company need to be set up for liquidation of non-performing loans and management buy-out option could be exercised to the sick but viable industries.

Choudhury & Adhikary (2002) states that both Bangladesh and India started to adopt loan classification system objectively (based on length of overdue) almost at the same time in early 1990s. Bangladesh has proceeded very rapidly (since 1994) towards achieving international standard of loan classification and in fact by 1998 Bangladesh also managed to achieve that level. On the other hand, India did not move so fast (though they were observed to adopt "Health Code" system during last 6/7 years before adopting overdue criteria based loan classification system in 1992). During 1992-97, they have reduced the overdue criteria of a sub-standard loan from 4 quarters (12 months) to 2 quarters (6 months) and ultimately they have a target of reaching international standard of 1 quarter (3 months) by 2004. It indicates that what India has achieved in 12 years, Bangladesh has done it within only 5 years. It is also argued that introducing loan rescheduling facility in Bangladesh in 1996, a considerable amount of loans have been avoided classification status. In India, all rescheduled loans are considered as sub-slandered. They also argue that the strategy of attacking NPA problem must be concerned with how to arrest fresh NPAs as well as to recover existing NPAs.

In this study, prudential norms are also compared with International Standard. International Standards are those that are followed by Developed Countries specially the OECD countries. International Standards are shown in table below:

Table 2. Loan classification system (International Standard)

Length of overdue	Status of classification	Rate of provision	Frequency of classification
Less than 3 months	Unclassified	1%-5%	At least
Loans overdue for 3 months but less than 6 months	Substandard	10%-25%	Quarterly
Loans overdue for 6 months but less than 9 months	Doubtful	50%-75%	Usually
Loans overdue for 9 months or more	Bad/Loss	100%	Monthly

Source: Bank for International Settlement

3. Comparative Analysis of Prudential Regulations of Bangladesh, India, Nepal, Pakistan and Sri Lanka

3.1 Categories of Loans

All loans and advances are grouped into various categories for the purpose of classification. Term loans are popular in all the countries across Southeast Asia. Consumer loans are not much prevalent in Bangladesh where short-term agriculture and micro credits are common. Various categories are shown in table below:

Table 3. Categories of Loans

Bangladesh	India	Nepal	Pakistan	Sri Lanka
Continuous Loan These are within certain limit and have an expiry date like overdraft or a cash credit account	**Overdrafts/ Cash credits**	**Overdrafts/ Cash credits**	**Short Term facilities** Facilities with maturities up to one year. **Medium and long term facilities** Facilities with maturities of more than one year. **Credit Cards** Cards which allow a customer to make payments on credit.	Overdraft Term loan, Block loan, packaging credit, pledge loans, revolving loans, discounting facilities, Hire purchase loans and other loans.
Demand Loan Loans which become repayable on demand	**Bill purchased/ discounted**	**Bill Purchased/ discounted**	**Auto loans** Loans to purchase vehicle for personal use	Trust receipts, Bill of exchange, Bankers Acceptance or other instrument of similar nature.
Fixed Term Loan Loans repayable within a fixed period under a specific repayment schedule.	**Term Loans**	**Term Loans**	**Housing Finance** Loans provided to individuals for the purchase of house/land and loans for improvements in house/land.	
Short Term Agriculture and Micro Credit Short term micro credits include any micro-credit less than BDT 10000 and repayable within 12 months.	**Other Loans**	**Other Loans**	**Personal Loans** Loans to individuals for the payment of goods, services and expenses including revolving credit.	Rescheduled credit facilities

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank) and BRPD Circular 16/1998

3.2 Criteria for Loan Classification

Banks need to recognize problem assets using a quantitative definition of non-performing and then properly treat such assets with regard to accrual of interest, classification according to ultimate collectibility and to make adequate provisions on such classification. The recognition of such non-performing assets stimulates collection efforts and thus helps reduce the possibility of loss on such assets.

On the basis of record of recovery, various types of credit facilities are recognized as to when they become non-performing. International best practices require that a loan be classified as non-performing if its principal and/or interest are 3 months or more in arrears or of the loan is continuously outside its approved limit for 3 months or more. Also, the time limits should be 3, 6 and 12 months respectively for 'Substandard' 'Doubtful', and 'Bad-Debt.' All the commercial banks in countries across South East Asia consider the advances that are in arrears for 6 months or more as non-performing except in Nepal and Sri Lanka where 3 months norm is applicable. But, banks across South Asia, in general, continue to classify NPLs based on a very lax timeframe of 6 months to 2 years in Bangladesh and Pakistan, 6 months to 3 years in India, 3 months to 2 years in Nepal and 3months to 180 days in Sri Lanka. The criteria for loan classification in each of the countries in Southeast Asia are shon in table below:

Table 4. Criteria for loan classification

Bangladesh	India	Nepal	Pakistan	Sri Lanka
Continuous and Demand Loan : *Sub-standard* if overdue for 6 to 9 months. *Doubtful* if overdue for 9 to 12 months. *Bad debt* if overdue beyond 12 months **Term Loan below 5 years and after 5 years:** *Sub-standard*: installment over due for 6 to 12 months. *Doubtful*: Installment overdue for 12 to 18 months. *Bad debt*: Overdue beyond 18 months and 12, 18 & 24 months for loan above 5 years. **Short-Term Agricultural and Micro Credits:** Irregular if not	A non-performing asset (NPA) shall be a loan or advance where interest and/ or principal/installment of principal remain overdue for a period of 90 days. *Sub-standard*: is one, which has remained NPA for a period less than or equal to 18 months with effect from 31 March, 2005, a sub-standard asset would be one, which has remained NPA for a period less than or equal to 12 months. *Doubtful Asset*: Is one, which has remained NPA for a period exceeding 18 months. With effect from 31 March, 2005, an asset would be classified as doubtful	Term Loan: When interest and/or principal remains overdue for more than 3 months. Overdrafts/ Cash Credits: When the account remains out of order or irregular (overdrawn or exceeding sanctioned limits/drawing power etc.) for more than 3 months. Bill Purchased/ discounted: When the bill remains overdue and unpaid for more than 3 months. Other Loan: When any amount remains overdue for more than 3 months. With effective from FY 2004-05, Banks are required to classify advances into following	For STFP if mark-up interest or principal is overdue by 180 days or more from the due date. For LTFF if installment of principal or interest/ mark-up is overdue by one year or more. For consumer financing for auto loans, where mark-up interests or principals overdue by 90 days or more from the due date. For mortgage loans, where mark up/ interest or principal is overdue beyond 180 days or more	For term loan, block loans, packing credits, pledge loans, revolving loans discounting facilities, hire purchase loans and other loans including leases when principal and interest have been in arrears for 3 months or more. For trust receipts, bills of exchange, banker's acceptances or other instruments of similar nature, when the facility is in arrears for three months after the maturity date. For rescheduled credit facilities, when rescheduling occurs before an account is classified as non-performing, the rescheduled account shall be classified as non-performing when in

repaid within the due date as stipulated in the loan agreement; *substandard* if the irregular status continues beyond 12 months; *doubtful* if the loan stays irregular beyond 36 months and *bad debt* if it remains irregular beyond 60 months.	if it remained in the sub-standard category over 12 months. *Loss Asset*: Is one where loss has been identified by the bank internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value along it may have some salvage or recovery value.	categories based on the period for which the asset has remained outstanding: Pass Loans and advances whose principal amount are not past due for a period up to 3 months. Substandard past due for a period of 3-6 months. Doubtful past due for a period of 6 months to 1 year. Loss Past due for more than 1 year.	from the due date. For personal loans, where mark-up/interest or principal is overdue by 90 days or more from the due date.	the aggregate, the period of time the account is in arrears before rescheduling (if any) and after rescheduling is 3 months or more.

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank)

3.3 Provisioning

Commercial banks in South Asia are required to classify non-performing assets into the various categories based on the period for which the asset has remained non-performing and the realizablity of the dues and subsequently make provisions for them.

In India, Nepal and Bangladesh minimum provision for the loans even if they are performing has to be made where as no provisioning is required for performing loans in Pakistan and Sri Lanka, for commercial banks. Following the international best practices, a minimum provision of 1% has to be made in Bangladesh and Nepal whereas in India, the minimum provisioning for standard assets is only 0.25%.

Provisions for sub-standard loans vary across South Asia from 10% in India to 25% in Nepal, Bangladesh, Pakistan and Sri Lanka have 20% provision for sub-standard loans. All the countries across South Asia have provisioning requirement of 50% for Provisions for sub-standard loans vary across South Asia from 10% in India to 25% in Nepal, Bangladesh, Pakistan and Sri Lanka have 20% provision for sub-standard loans. All the countries across South Asia have provisioning requirement of 50% for doubtful assets except in India where for Doubtful assets, provision should be made for-

a) 100% of the extent to which the advance is not covered by the realizable value of the security,
b) Provision may be made at the rates 20% of the secured portion up to one year, 30% for one to three years and 50% for more than three years for which the advance has remained doubtful.

Journal of Management Research
ISSN 1941-899X
2014, Vol. 6, No. 1

Under loan classification, contrary to the international best practice of loan classification between 3-12 months (where over 12 months is considered bad), in Bangladesh most agricultural loans are classified as bad only after 60 months. Nepal as well as Pakistan Classifies NPLs based on a very laxed schedules with bad debts going well over 2 years. India classifies NPLs as bad debts over 4 years also, while Sri Lanka classification of bad debt can run over 2 years.

Hence in asset classification, it could be stated that South Asia banks follow very laxed loan classification schedules when compared to international best practices. This is further complicated by the fact that different types of credit facilities having different types of classification contrary to the international practice. Such leniency in classification would result in reduction of the provisioning requirements; hence meeting such requirements would not mean that the banks are in strong positions. The collection efforts will not be stimulated as such the possibility of incurring losses on such loans will be increased.

Classification of assets and provisioning requirement for commercial banks in each of the countries of Southeast Asia is given in the tables below:

Table 5. Loan classification categories

	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Loan Classification [NPAs]	- Sub standard - Doubtful - Bad debt	- Standard assets - Sub- standard assets - Doubtful assets - Loss assets	- Sub-standard assets - Doubtful assets - Loss assets	- Sub-standard assets - Doubtful assets - Loss assets	- Sub-standard accounts - Doubtful accounts - Loss accounts

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank) and BRPD Circular 16/1998

Table 6. Provisioning requirement

Classification Category	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Performing Asset	1%	.25%	1%	0%	0%
Substandard	20%	10%	25%	20%	20%
Doubtful	50%	100% of the extent to which the advance is not covered by the realizable value of the security 20% on secured portion up to 1 year 30% for 1-3 years 50% for more than 3 years	50%	50%	50%
Bad/Loss Asset	100%	100%	100%	100%	100%

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank) and BRPD Circular 16/1998

3.4 Income Recognition

Almost in each of the countries across Southeast Asia, income on performing assets is recognized on accrual basis whereas income on non-performing asset is realized only on cash basis.

Banks in Bangladesh and Pakistan accrue interest on sub-standard & doubtful loans and transfer such interest income to a suspense account. This is contrary to the international best practices where non-performing loans should cease to accrue interest and all unrealized interest income on such loans are either reversed or provided for.

Overall it looks if provisions are not made for the interest in suspense portions if such entries have not been reversed. Prudential regulations for income recognition in each country across Southeast Asia have been given in the table below:

Table 7. Income Recognition

Bangladesh	India	Nepal	Pakistan	Sri Lanka
Based on record of recovery i.e. on cash basis. Income on sub-standard and doubtful loans can be charged to the loan account, the interest charged cannot be transferred to the income account but maintained under 'Interest suspense account' As soon as any loan is classified as 'bad debt', charging of interest in the same account will cease. Not specified whether the interest income accrued but not received on the loans that have subsequently become non-performing has to be reversed or clawed back or provision has to be made for.	Based on the record of recovery, income from NPAs is not recognized on as accrual basis but is booked only on actual realization. Banks using their own discretion can debit interest to a NPA account taking the same to Interest Suspense Account or maintaining only a record of such interest in pro-forma accounts. If any advance becomes NPA as at the year end, interest accrued and credited to income account in the corresponding previous year, should be reversed or provided for, if the same is not realized.	The interest accruals on loans and advances shall be recognized on cash basis. Interest accrued but not received have to be debited to "Accrued Interest Account" in the assets side and credited to "Interest Suspense Account" in the liability side of the balance sheet. However, if the accrued interest on loan is realized in cash within one month from the date of closure of the fiscal year, such amount maybe recognized into income of the earlier fiscal year.	Income on loans and advances are recognized on an accrual basis and only in case of non-performing loans, unrealized mark-up/ interest to be put in Suspense Account and not to be credited to Income Account except when realized in cash. Not clear whether the interest accrued on the loans that have subsequently become non-performing has to be reversed or clawed back or provision has to be made for such amount.	All interest accrued from the date an advance is classified non-performing shall forthwith be suspended and credited to 'interest in suspense account'. Interest is recognized as income only on cash basis. It is suggested that 'interest in suspense' account may be suitable responded to by maintaining an 'interest receivable account'.

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank)

3.5 Write –Off Policy

There are no specific provisions for write off in the prudential regulations of Nepal and Sri Lanka for the non-performing assets of the commercial banks. However, the prudential regulations in Bangladesh, India and Pakistan have also allowed commercial banks to write off NPLs at their own discretion.

In Bangladesh banks may, at any time, write off loans classified as 'bad/loss'. Loans classified as 'bad/loss' for the last five years and for which 100% provision has already been made, are to be written off without delay. Banks may write off loans by debiting their current year's income account where 100% provision kept is not found adequate for writing off such loans.

In India the tax law allows 100% tax deductibility for the calculation of taxable income for banks in the case of loans written off. However, provisions for sub-standard assets are permitted as deduction only to the extent of 7.5% of the bank's total income. Because of this special tax law, Indian banks prefer to write-off the doubtful and bad assets rather than make provisions. This is shown in the reduction of gross NPLs instead of an increase in loan loss reserves.

In Pakistan, NPLs that have been classified as loss for 3 years or longer are divided into three categories:

Category A: Loans having amount up to Rs. 0.5 million,

Category B: Loans having outstanding amount of more than Rs0.5 million and up to RS. 2.5 million and

Category C: Where the outstanding amount exceeds Rs. 2.5 million.

For Category A loans, the bank management should obtain Board resolution empowering it or its committee to write off such loans on a case-to-case basis without going for litigation. However, bank/NBFI should formulate internal policy/ guidelines spelling out the criteria for writing off of these loans. For B & C, if Forced Sale Value (FSV) [evaluated by the bank/ NBFI] of the security is more than the outstanding amount, banks are required to recover 75% or more of the outstanding in cash. If FSV of the security is less than the outstanding amount, banks are expected to recover and amount in cash equal to FSV. Where no tangible security is available, efforts should be made to recover maximum possible amount.

Banks must have the latest valuation prepared by qualified professional values of properties/ stocks having value of Rs. 2.5 million and above before approving a write-off proposal. Banks must also ensure that the proposal has been audited by the internal/ external auditors who are required to expressly indicate the deviations/ shortcomings in the write-ff proposals.

Before writing off, banks must also ensure that all liquid assets including FDRs, government securities share certificated etc. held under lien and pledged goods are realized and sale proceeds applied towards the reduction of outstanding liability of the borrower. This should be legally cleared by the bank /NBFI's legal counsel.

In case the banks is not in a position to recover even 75% of Forced Sale Value of the security due to any reason, the Board of Directors/ designated authority may allow relaxation by recording reasons /justifications thereof.

Write off policy applicable in commercial banks of Southeast Asian countries are given in the table below:

Table 8. Write off Policy

Bangladesh	India	Nepal	Pakistan	Sri Lanka
Banks may, at any time, write off loans classified as 'bad/loss'. Loans classified 'bad/loss' for the last five years and for which 100% provision has already been made, are to be written off without delay. Banks may write off loans by debiting their current year's income account where 100% provision kept is not found adequate for writing off such loans.	Banks should either make full provision as per the guidelines or write-off NPAs and claim tax benefits as applicable in consultation with their auditors/tax consultants. Banks may write-off advances at head office level, though outstanding in the branch books. However, it is necessary that provision is made as per the classification accorded to the respective accounts.	No specific prudential guidelines on the write off of non-performing loans by NRB and banks can write off their loss advances at their own discretion.	Bad / irrecoverable loans may be written-off by the banks themselves with the express approval of their Board of Directors or their nominated/designated authority/committee. Before allowing write-off, all liquid assets held under lien and pledged goods should be realized and appropriated towards reduction of outstanding amount and should be legally cleared by the bank's legal counsel.	No specific prudential guidelines on the write off of non-performing loans by CBSL and banks can write off their loss advances at their own discretion.

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank) and BRPD Circular 2/2003

3.6 Risk Diversification

Exposure limits refers to the limit of one or more credit exposures t he same individual or group that exceed a certain percentage of regulatory capital, which give rise to the risk from credit concentration. All the countries across South Asia has set the exposure limit in their prudential regulations, which varies from 15% of capital fund in India to 50% of capital in Bangladesh. In order to enjoy diversification benefits, it is desirable to have smaller limits so that adverse effects of exposure could be minimized. Exposure limits as prescribed by the respective regulatory bodies on their prudential regulations in each country across Southeast Asia are given in the table below:

Table 9. Risk Diversification

Bangladesh	India	Nepal	Pakistan	Sri Lanka
Effective 10 March 2003, no bank can lend to any individual/ organization or group in excess of 50% of their total capital (previously 100% of capital), and the amount of funded portion in the approved loan should not be more than 25% of the bank's total capital. Banks that already have exposures in excess of 50% have to reduce such exposures to less than 50% by, if needed, bringing in other banks. Continuous and fixed term loans have to be reduced within 50% limit by 30 June 04 & 30 June 05, respectively.	Effective 1 April 2002, exposure limit is 15% (20% hitherto) of capital funds in case of single borrower and 40% (50% hitherto) in the case of group. Group exposure may exceed norm by additional 10%, if excess is for infrastructure projects like power, telecom, road port etc. Definition of capital fund for this purpose has been relaxed to include tier1 and 2 capitals. This limit includes both funded and non-funded credit limits, underwriting and similar commitments as well as certain types of equity investments.	Banks may extend to a single borrower or group of related borrowers the amount of fund-based advances up to 25% of its core capital and non-fund based off-balance sheet facilities up to 50% of its core capital fund.	The total outstanding to any single person shall not exceed 30% of the bank's unimpaired capital and reserves (including revaluation reserves on account of fixed assets to the extent of 50% of their value) subject to the condition that the maximum outstanding against fund based financing facilities do not exceed 20% of the capital and reserves. In case of foreign banks branches, the maximum exposure limit of 30% shall be calculated on the basis of their assigned capital free of all losses and provisions, provided that maximum exposure on the basis of fund-based facilities shall be 20% of the capital maintained or Rs 12 million. whichever is higher.	Single Borrower limit for banks is 30% of the capital funds of such banks as at the end of its preceding financial year. Aggregate of all loans exceeding 15% of the capital funds shall not exceed 50% of total advances of the bank except in the cases of loans granted to certain state owned entities, entities engaged to undertake large infrastructure projects etc.

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank) and BRPD Circular

3.7 Directed Lending

Prudential regulations of India and Nepal have clearly directed the commercial banks to lend certain portion of their credit portfolio to priority sectors. In India all banks must lend 40% of their net loan to the priority sector, out of which 18% should be given to agricultural sector, 10% to the 'weaker sections' and 1% of previous year's total advances is given under the Differential Rate of Interest (DRI) scheme. Foreign banks must make 32% of their loans to the sector, out of which, no less than 10% should be allocated to small-scale industries sector and no less than 12% to the export sector. The priority sector broadly covers businesses or schemes to which the government wants to channel credit to achieve its social objectives, including agriculture, small-scale industries small business, retail trade, small transport operators, professional and self employed persons, housing, education loans and micro-credit.

If banks are unable to meet this target, they may deposit an amount equal to the shortfall with the Small Industries Development Bank of India (SIDBI) or the National Bank for Agriculture and Rural Development (NABARD). In recent years, the government has broadened the definition of priority sector lending to include more commercially viable areas. For example, housing loans up to IRs.1 million qualifies for this type of priority sector lending.

In Nepal, banks are required to extend loans to the priority and deprived sectors up to 12% of their advances but this requirement is being phased out so that by 2002-03 it is reduced to 7% by 2003-04 to 6%, 2004-05 to 4%, 2005-06 to 2% and 2% for 2006-07. From FY 2007-08, investment in priority sector is not compulsory.

However, the regulatory bodies in Bangladesh, Pakistan and Sri Lanka have issued no such guidelines. Such heavy directed lending with over investment in low return projects often result in low profitability and poor asset quality. The table below gives the comparative guidelines on directed lending in each of the countries in Southeast Asia.

Table 10. Directed Lending

Bangladesh	India	Nepal	Pakistan	Sri Lanka
Specific targets or amounts for Directed lending have not been made public by BB.	All banks must lend 40% of their net loans to the priority sector, out of which 18% to agricultural sector, 10% to the 'weaker section' and 1% of previous year's total advances is given under the Differential Rate of Interest (DRI) scheme. Foreign banks must make 32% of their loans to the sector, out of which to SSIs should not be less than 10% and the export credit not less than 12% of the net bank credit. Priority sector broadly covers agriculture, small-scale industries and other activities such as small business, retail trade, small transport operators, professional and self employed persons, housing, education, loans, micro-credit etc.	Banks are required to extend advances in the productive, priority and deprived sectors as follows. Of the total advances: (a) 40% to productive sector, including 12% to priority sector, including deprived sector. In accordance with the time table, the minimum percent of total credit to be invested in priority sector is: (a) for the fiscal year 2002/03, the minimum 7%, (b) for fiscal year 2003/04, minimum is 6%, (c) for fiscal year 2004/05, the minimum is 4%.	No guidelines for Directed lending have been issued by SBP for the time being.	No guidelines for Directed lending have been issued by CBSL for the time being.

Source: Financial Performance and Soundness Indicators of South Asia (The World Bank)

3.8 Debt Restructuring

In Bangladesh, no specific guidelines on the provisioning of restructured loans or declassifying them after looking at their performance for a certain grace period are provided in their prudential regulation, however, prudential regulations of the other countries in Southeast Asia have some direction on debt restructuring to commercial banks. Due to the

fact that different countries use different methods for debt restructuring, it is difficult to use any kind of comparison or assess the impact of such practices on their asset quality. Prudential regulations on debt restructuring in each of the countries in Southeast Asia is given in the table below:

Table 10. Debt Restructuring

Bangladesh	India	Nepal	Pakistan	Sri Lanka
No guidelines on the provisioning of restructured loans or declassifying them after looking at their performance for a certain grace period, as in the case of other countries.	Standard asset after commencement of production should be classified as sub-standard and should remain in such category for at least 1 year of satisfactory performance under renegotiated or rescheduled terms. In case of sub-standard & doubtful assets, rescheduling does not entitle banks to upgrade the quality of advance automatically unless there is satisfactory performance under the rescheduled/ renegotiated terms.	Banks may reschedule/ restructure NPAs upon receipt of a written plan of action from the borrower with payment of at least 25% of total accrued interest up to the date of rescheduling or restructuring. Rescheduling restructuring of loan resulting in improvement in classification to least risk category (pass) is not prohibited. However, such rescheduled loan shall require provisioning of at least 12.5%.	The rescheduling/ restructuring of NPAs shall not change the status of asset classification unless terms & conditions of rescheduling/ restructuring are fully met for at least one year (excluding grace period, if any) from the date of such rescheduling/restructuring and at least 10% of the outstanding amount is recovered in cash. Further, the unrealized mark-up on such loans (declassified after rescheduling/ restructuring) shall not be taken to income account unless at least 50% of the amount is realized in cash. However, this will not impact the de-classification of this account if all other criteria are met.	Non-performing advance which has been rescheduled shall be reclassified as performing only when repayments under the rescheduled terms have been complied with for continuous period of 6 months. On the other hand, for an account which was performing at the time of rescheduling but subsequently turned non-performing, the account shall be reclassified as performing account upon full settlement of the repayments in arrears under the rescheduled terms.

Source: Financial **Performance** and Soundness Indicators of South Asia (The World Bank)

3.9 International Perspective

The central banks in Southeast Asia have issued prudential norms for income recognition, asset classification, provisioning for NPLs, and other related matters such as disclosure standards. In recent years, they have all attempted to strengthen these prudential norms to be in line with international standards. Nevertheless, prudential norms in Southeast Asia continue to fall short of international best practices in a number of areas as explained below.

Prevalent Scenario in Bangladesh:

Loan Classification: The Bangladesh Bank allows different criteria for loan classification depending on the category of loan. For example, in case of fixed term loan, if any installments or part of installment of a fixed term loan is not repaid within the due date, the amount of unpaid installment will be termed as a 'defaulted installment'. The loan will be classified as substandard, doubtful, or bad depending on the maturity of the loan and the difference between the amount of defaulted installment and the amount due over the next 6-24 months. In case of short-term agricultural and micro-credits, they will be considered 'irregular' if not repaid within the due date as stipulated in the loan agreement. The loan will be classified as 'sub-standard' if the irregular status continues beyond 12 months; classified as 'doubtful' if the loan stays irregular beyond 36 months; and classified as 'bad debt' if it remains irregular beyond a period of 60 months from the stipulated due date as per the loan agreement. Recently Bangladesh Bank circulate to maintain a fourth account, "Special Mention Account", where advances with interest overdue of up to 3 months will be record. International best practices require that a loan be classified as non-performing if its principal and /or interest are 3 months or more in arrears, ;or if the loan is continuously outside its approved limit for 3 months or more. Also, the time limits should be 3, 6 and 12 months respectively for 'Substandard', 'Doubtful', and 'Bad-Debt'. It is also an internationally accepted good practice to have a fourth category of special mention accounts involving advances with interest overdue of up to 3 months.

Provisioning: Banks are required to make provision at the following rates in respect of classified continuous, demand and fixed term loans:

a. Substandard, 20%
b. Doubtful, 50% and
c. Bad-debt, 100%.

General provision at 1% against the unclassified loans is also to be maintained. However, the provisions are maintained at the above rates after deduction 'interest in suspense' and the value of the 'eligible securities' from the balance of the classified loan, although only 50% of the value of the market value of securities is eligible for deduction. International best practices require that provisioning be made at the above rates before deducting "Interest suspense" and the value of loan collaterals. As an interim measure towards full compliance, the BB should discount the value of securities by applying the haircut to the forced sale value depending on the length of time the loan remains in the loss category as is currently being done in Sri Lanka.

Income Recognition: Under the BB's prudential regulations, banks cease to accrue interest only in the case of bad debts but continue to accrue interest on sub-standard and doubtful loan, although the interest so accrued must be transferred to the interest in suspense account. International best practices require not only that banks cease the accrual of interest on a loan once it becomes non-performing but also require interest income recognized but not received to be either reversed (i.e. clawed back) or provided for adequately.

Loan Restructuring: Under the BB's prudential regulation a loan that has been restructured can be declassified as normal loans upon being restructured. International best practices call for the restructured loan to continue to be classified as non-performing and an NPL should be restored to performing status after all arrears are settled and the borrower is expected to be able to service all future principal and interest payments on the loan.

Contingent Liabilities: Under the BB's prudential regulations contingent liabilities such as letters of credit and guarantees are not subject to the guidelines on NPLs and loan grading systems. International standards require that contingent liabilities be treated in the same way as loans.

Prevalent Scenario in India

Loan Classification: Indian banks continue to classify NPLs based on of 3 months-3 years. Based on the period for which the asset has remained non-performing and the realisability of the dues, banks are required to classify non-performing assets into three categories:

a. Substandard assets (3-12 months overdue interest),
b. Doubtful assets (over 12 months interest overdue),
c. Loss (no time limit specified).

International best practices require that a loan be classified as non-performing if it s principal and/or interest are 3 months or more in arrears or if the loan is continuously outside its approved limit for 3 months or more. Also, the time limits should be 3, 6 and 12 months respectively for 'Substandard', 'Doubtful', and 'Bad-Debt'. It is also an internationally accepted good practice to have a fourth category of special mention accounts involving advances with interest overdue of up to 3 months.

Provisioning: For loss assets and substantial assets, Indian banks are required to make provision as a percentage of the gross loan amount. However, for doubtful assets, Indian banks are only required to make loan loss provision for 100% of the extent to which the advance is not covered by the realizable value of the security and at the rates 20% of the secured portion up to one year, 30% for one to three years and 50% for more than three years for which the advance has remained doubtful. International best practices call for making 100% and at least 50% provisions on the loans graded loss and doubtful without taking into account the value or realisability of the collateral backing such assets.

Income Recognition: Indian banks are required to cease interest accrual once a loan is classified non-performing. Until recently, a loan is considered to be non-performing if its principal and/ or interest are 3 months or more in arrears. Effective from 31 March 2004, India adopts the international best practice of 90 days norm for interest accrual. International best practices require that banks classify a loan as NPL if the interest overdue exceeds three months regardless of the type of credit facilities.

Prevalent Scenario in Nepal:

Loan Classification: Nepal adopts the international norm of 90 days for interest accrual but like its counterpart in other Southeast Asian countries, Nepalese banks continue to classify

Journal of Management Research
ISSN 1941-899X
2014, Vol. 6, No. 1

loans based on a very lex schedule (3-6 months for substandard assets, 6 months to 1 years for doubtful assets, and over 1 years for loss assets) and to set loan loss provisioning at a much reduced rates than generally accepted. International best practices generally classify substandard accounts as those advances with overdue interest of 3-6 months, doubtful accounts as those advances with overdue interest of 6-12 months and loss account as those advances with overdue interest of over 12 months.

However, Nepal and Bangladesh are the only two countries in Southeast Asia that follow international best practices in requiring banks to set aside a general provision for good assets of 1%. Both allow the general provision to be included in second-tier capital but Nepal with a limit of 1.25% of risk assets appears to be more conservative. However, Nepal also allows banks that provide for loan loss provisioning in excess of the amount as required under the directives of NRB to count such additional provision under the supplementary capital.

Nepal has a rather lenient loan loss provisioning policy for loans extended to the priority sector as prescribed by the NRB. For insured loans, the requisite provisioning will be 25% of the percentage stated. Thus, the required provisioning in the case of insured priority/ deprived sector credit is as follows:

a. Pass with 0.25% provisioning,
b. Substandard with 5.0% provisioning,
c. Doubtful with 12.50% provisioning and
d. Loss with 25% provisioning.

Prevalent Scenario in Pakistan:

Loan Classification and Provisioning: Pakistan adopts the international norm of 90 days for interest accrual but like its counterpart in other Southeast Asian countries, Pakistani banks continue to classify loans based on a very lax schedule180 days for substandard loans (except for auto loans and personal loans for which 90 days apply), 2-3 years for doubtful assets (except for credit cards for which 180 days apply and auto loans and personal loans for which one year applies), and over 2 years for loss assets and to set loan loss provisioning at a much reduced rates than generally accepted.

Income Recognition: Banks are required to recognize income on loans and advances on a cash basis in case of non-performing loans and to put unrealized mark-up interest to the Suspense Account. However, the SBP does not require banks to reverse the interest accrued on the loans that have subsequently become non-performing or to make provision for such amount. International best practices require not only that banks cease the accrual of interest on a loan once it becomes non-performing but also require interest income recognized but not received to be either reversed (i.e. clawed back) or provided for adequately.

Related Party Lending: Unlike other Southeast Asian countries, Pakistan follows international best practice of imposing a complete ban on lending by a bank to its directors or against their personal guarantees.

Prevalent Scenario in Sri Lanka:

Loan Classification: Recognizing the need for compliance through adherence of the accounting standards the revenue recognition and disclosures in the financial statements of banks is mandatory under law if they are listed in the stock exchange. In Sri Lanka a separate statutory authority is established to monitor compliance.

Banks are required to classify their non-performing loans into three main categories:

a. Substandard when advances are in arrears for 6 months or more but less than twelve months.
b. Doubtful when advances are in arrears for 12 to 18 months.
c. Loss when advances are in arrears for over 18 months.

International best practices generally classify substandard accounts as those advances with overdue interest of 3-6 months, doubtful accounts as those advances with overdue interest of 6-12 months and loss account as those advances with overdue interest of over 12 months. It is also an internationally accepted good practice to have a fourth category of special mention accounts involving advances with interest overdue of up to 3 months.

Provisioning: In conformity with the prudential norms, banks are required to make provisions on their NPLs at the rate of 20% of substandard accounts, 50% of doubtful accounts and 100% of loss accounts but in all cases the gross loan amount net of realizable security value and interest suspended will be subjected to the provision, and Sri Lanka applies a hair-cut to the value of the collateral depending on the length of time the loan remains in loss category. International best practices call for making 100% and at least 50% provisions on the loans graded loss and doubtful without taking into account the value or reliability of the collateral backing such assets.

Provisioning For Fall in Value of Investment: This is also governed by a mandatory accounting standard for institutions listed in the stock exchange. Banks are required to categorize their investments into dealing securities and investment securities. For dealing securities banks must adopt mark-to market method. Investment securities are deemed to be held to maturity and so are carried at cost but banks need to make provision for any permanent diminution in the value of investment. International best practices require that banks classify their investments into three categories:

1. Investment held to maturity
2. Investment available for sale and
3. Investment held for trading.

Related Party Lending: Like other Southeast Asian countries, Sri Lanka does not impose a ban on lending by a bank to its directors. In case of licensed specialized banks, loans will not be granted to any director or to his close relative for an amount exceeding Rs. 1 million or the outstanding amount of loan provided prior to being appointed to the board, whichever is more. Such loans have to be secured by specified security like government guarantees, bank guarantees, shares of listed companies and guarantees by international institutions, cash stock in trade, property etc. Similarly, loans to directors of LCBs or to the concern where the director has substantial interest is allowed provided it is secured by the specific securities. For

licensed commercial banks, the restrictions are less strict; loans to directors of a LCB or a company where he has substantial interest are permitted if it is backed by acceptable security. International best practices call for a total ban on lending to its directors or the concern where a director has a substantial interest.

4. Analysis and Findings

Assets those are overdue for a period of 90 days or 3 months, categories as non-performing asset in India, Nepal and Sri Lanka. That is they adopt the international standard. Bangladesh and Pakistan still away from international standard and assets are deemed as NPA if it is over due for 6 to 9 months. A considerable amount of loans have been avoiding classification status by rescheduling of NPA but in India, all rescheduled loans are considered as sub-standard.

In Bangladesh, India and Nepal, minimum provisions have to maintain for performing asset. But no provision requirement for performing asset in Pakistan and Sri Lanka. Various provisioning rate are followed for different loan classification status in same rate almost all the concerned countries. But in India different rate is applicable for doubtful loan depending on secured vs unsecured and different terms.

Bangladesh, in the year 1998, followed the International standard i.e. sub-standard for three months overdue. But on 2001, it changed to 6 months to become substandard. Frequent change in policy without reasonable cause is not desirable. Before changing a policy, its pros and cons have to consider first.

Write-off is an internationally acceptable procedure, Bangladesh, India and Pakistan has specific guide line for write-off but Nepal and Sri Lanka does it at there own discretion. In Bangladesh 100% provision is required for write-off and if there is a short fall than current years profit have to debited to initiate write-off but in India, banks should either make full provision as par guideline or claim tax benefit for write-off in consultation with there auditors. In Pakistan before allowing write-off, all liquid assets held under lien and pledged goods should be realized.

Risk exposure in Bangladesh is high in relation to other concerned countries in Southeast Asia. In Bangladesh maximum limit that a bank can lend to an individual/group is 50% of its total capital, out of which funded portion can not exceed of 25% of there capital. Whereas in India, exposure limit is 15% for single borrower and 40% for group borrower. In case of Pakistan and Sri Lanka exposure limit for a single borrower is 30%.

Prudential regulations of India and Nepal have clearly directed the commercial banks to lend certain portion of their credit portfolio to priority sectors; however, the regulatory bodies in Bangladesh, Pakistan and Sri Lanka have issued no such guidelines. Such heavy directed lending with over investment in low return projects often result in low profitability and poor asset quality. Directed lending may cause increase in default loan even though they ensure national/social commitment.

5. Conclusion and Recommendations

The foregoing discussion reveals that all the countries (Bangladesh, India, Nepal, Pakistan and Sri Lanka) adopt prudential regulation to reduce risk level to the commercial banks and disclosure of information to the stakeholders. Among the countries categories of loan are almost same. But criteria for loan classification vary from country to country. As our concerned countries are in the same region and their socio-economic condition are almost similar, they try to follow similar prudential regulation. Of course, this is depend on a countries own economic condition and political commitment.

All the countries trying to follow the international standard of loan classification and provisioning. Bangladesh and Pakistan are yet to international standard regarding loan classification as they still follow NPA if it is 6 months overdue. Bangladesh already adopt special mention account, which is in line with international standard.

Provision against unclassified loan is high in Bangladesh and Nepal but it is consistent with the international standard. In India required provision is only 0.25% and in Pakistan and Sri Lanka there is no need to require any provisioning against unclassified loan. It seems to be unnecessary to keep provision against unclassified loan because it causes loss of tax revenue to the government.

International best practices require that provisioning be made before deducting “Interest Suspense” and the value of loan collaterals. But Bangladesh still practicing maintain provision after deducting “interest suspense” and the value of “eligible securities”.

Real picture of classified loan is not reflected in Bangladesh as classified loan becomes a regular loan by rescheduling but in India once a loan is classified, by rescheduling its status becomes sub-standard not a regular loan. Bangladesh already take preventive measure regarding rescheduling by stating that “habitual” defaulters should not get any loan rescheduling facility.

There is no precise guideline regarding directed landing in Bangladesh, Pakistan and Sri Lanka. It is a good sign as recovery rate may slow, cause lower profitability and a potential source of NPA. In the era of free market economy, there should not be any directed landing.

Whether a country adopts international standard of loan classification earlier than other or whether it can sustain that standard are not very significant issues. Important is that whether the regulation is consistent with that country’s economic condition and ensure lower rate of NPA and maintain lower level of risk.

Write-off policy has a significant role in asset valuation. As there is a provisioning measure against NPA, so it is unnecessary to show classified loan in the financial statement year after year.

From the above conclusive remark the following recommendations can be made to increase the asset quality of Bangladesh:

a. Provisioning against unclassified loan can be reduced or can be omitted.
b. Frequent Change in classification system should be avoided and before making change, after affect have to considered.

c. As stuck up loan is high in Bangladesh, so no guideline should be issued regarding directed lending.
d. Risk exposure should be reduce further and encourage the commercial banks for group lending.
e. More and more asset management company needs to be set up for liquidation of non performing loan.

References

Aggarawl, B.P. (1981). *Commercial Banking in India.* New Delhi: Classical Publishing Co.

Ahamed, Shahabuddin. (1998). Ethics in Banking, The First Nurul Matin Memorial Lecture held on may 6, 1998 at BIBM, Dhaka.

BCD and BRPD circulation. 1989-2005, Banking Regulation and Policy Department, Bangladesh Bank.

Adhikary, Bishnu Kumar. (2003). Loan Classification and Provisioning System of the Banking Sector: A Critical Review. *Journal of the Institute of Bankers, 50*(1), June.

Choudhury, Ahmad, Toufic, & Bishnu Kumar Adhikary. (2002). Loan Classification, Provisioning Requirement and Recovery Strategies: A Comparative Study on Bangladesh and India. *Bank Parikrama, XXVII*(2&3), 134-184.

Choudhury, N.I., & Toufic Ahmad Choudhury. (1999). Financial Sector Reform: Resource, Outcome and probable future action. *Bank Parikrama, XXVII*, Dhaka.

Choudhury, Toufic Ahmad, & Md. Liakat Hossain Moral. (1999). Commercial Bank Restructing in Bangladesh: From FSRP to BRC/CBRP. *Bank Parikrama, XXIV*(1), Dhaka.

Debnath, R., M. (2003). *Bank and Legal Environment,* Nabajuga Prokashoni, Dhaka, PP 271-279.

Fraser, R.D., G.E., Benton, & K.W. Jame, (1995) Commercial Banking: The management of risk USA: West publication, PP 351-599.

FSRP, T. A. & Bangladesh Bank. (1993). *Lending Risk Analysis Manual,* Dhaka, Bangladesh.

Hashem, M, A. (1997). Impact of new Loan Regulations on Loan portfolio Management in Banks. *Bank Parikrama, XXII*(1), 67-74.

Islam, Moinul, A.T.M Abdus Shahid, Abdul Jalil Choudhury, & Md Mohiddin Siddique. (1999). Bank Default Problem in Bangladesh , Issue for a Dialogue between borrowers and lenders, Seminar paper, BIBM, Dhaka, Bangladesh.

Kout, W., Timthy, & S. Soctt Macdonald. (1995). *Bank Management.* 4th ed., Harcourt College Publishers, U.S.A, PP. 645-687.

Lee, Jungsoo. (1991). F*inancial sector and economic Development: A survey. Asian Development Bank*. September.

Journal of Management Research
ISSN 1941-899X
2014, Vol. 6, No. 1

Loan Classification Manual. (1991). Bangladesh Bank.

Peter, S., Rose. (1999). *Commercial Banks Management.* 4th ed., U.S.A: McGraw Hill, PP. 517-548.

Rahaman, Muhammad Habibur. (1999). Ethics in Banking The Second Nurul Matin Memorial Lecture held on July 11, 1999 at BIBM, Dhaka.

Rangaranjan, C. (1994) The Reform of the Financial Sector: Choices and Lessors. RBI Bulletin. December.

Woelfel, Charles J. (1994). *Encyclopedia of Banking and Finance.* 10th edition. Cambridge: Probus publishing Company.

World Bank. (2004). Financial Performance and Soundness Indicators of South Asia. A Brief Report. South Asia Finance and Private Sector Unit.

Copyright Disclaimer

Copyright reserved by the author(s).

This article is an open-access article distributed under the terms and conditions of the Creative Commons Attribution license (http://creativecommons.org/licenses/by/3.0/).