

Asset Securitization: A Solution for the Non Performing Loans (NPLs) of Commercial Banks in Bangladesh

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Abstract: Asset securitization is an alternative in handling NPLs. This paper presents a brief picture of the link between sources of funding and end uses of funding, the problem of NPLs in the banking sector of Bangladesh, a proposal of how asset securitization can be introduced in Bangladesh, and the benefits of introducing asset securitization, especially for banks and non-bank finance companies.

Keywords: Asset Securitization, Non-Performing Loans, Commercial Banks.

I. Introduction

Bond market links issuers having long term financing needs with investors willing to place funds in a long term, interest bearing securities. A matured domestic bond market offers wide range of funding for the government and the private sector. While fixed income instruments are the epitome of long term finance options, the size of tradable government bonds is small, secondary trading is rare, and more critically, public issue of corporate bonds may remain suspended, as it has been the case in Bangladesh since 1996 [Hossain and Azim, 2005]. Thus the financial sector in Bangladesh now demands new financing tools like asset securitization. As a method for using the predictable cash flows from receivables as the basis for issuing debt, securitization involves producing securities or investment instruments, which are supported by specific assets. As a financial product, securitization has gained popularity for providing a method of issuing bonds that ensures maximum safety for investors. Securitization can also circumvent the restrictions placed on bank lending by the size of their balance sheets. More importantly, securitization addresses the fundamental asset liability maturity mismatch problem by providing true long term funds [Purker, 2004].

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Comparing to other sectors of the economy of the country, the banking industry is strictly regulated, and part of the regulatory framework is capital requirements. In spite of all their intricacies and complexities, the regulatory capital requirements essentially impose limits on how much leverage banks and non-banking financial institutions (NBFIs) can have. Banks and NBFIs can use securitization as a way to make their leverage smaller. Moreover, securitization can also be used for getting relief of non performing loans (NPLs) of commercial banks in Bangladesh.

II. Rationale of the Study

Asset backed securities (ABS) were first introduced in 1970 when the Government National Mortgage Association (GNMA) of USA had purchased mortgage loans and issued securities on them. In Western Europe, the securitization market developed in the late 1980s. It has rapidly expanded in the 1990s particularly in the United Kingdom, France, Spain, the Netherlands, Belgium, Germany and Italy [IFC, 2004].

Asset securitization is currently riding a wave of momentum in the Indian sub-continent. In fact, between 2002 and 2005, India's asset backed securitization volume has grown by a staggering 151% while mortgage backed securitization is expected to evolve at a phenomenal 261% within the same time period. While there has been a lot of discussion about the potential of securitization in Bangladesh, actual deal activity has recently kept place.

However, little studies have been done in Bangladesh about asset securitization. Shipon [2004] and Siddiqui et al [2006] studied the issue in a limited scale, emphasizing more on theoretical framework of asset securitization and although they raised so many practical issues, they didn't study the impact of securitization on commercial banks in Bangladesh.

The present study aims at presenting the state of NPLs of commercial banks in Bangladesh and looking at whether asset securitization can be a practical solution for overcoming this problem.

III. Methodology

The present study focuses on asset securitization as a tool for overcoming NPL problems of commercial banks in Bangladesh and the research question put has been whether the commercial banks in Bangladesh can get rid of bad loans by using this tool. The issue has been studied in the context of the structure of the financial markets in this country and by analyzing the possibility of using securitization through sale of NPLs.

The data of this exploratory research is gathered from secondary sources. Helpful information from books, journals and online publications produced by both academicians and consulting firms were used to develop the theoretical framework regarding asset securitization. Moreover, the desk study covered different local newspapers to see the present condition of securitization in Bangladesh. The publications of Bangladesh Bank, including its annual report and regular bulletins and journals were also used for analyzing the present NPL status of commercial banks in Bangladesh. The design of information architecture of asset securitization has been developed by using Microsoft Visio 2003.

IV. Findings and Discussion

a) Structure of the Financial Markets in Bangladesh

The financial sector of Bangladesh is dominated by commercial banks. The main stream of funds flows from general public to commercial banks as deposits and from banks to government as credit (See: Figure-1). In April 2006, total deposits with deposit money banks (DMBs) constituted Tk 1616.95 billion, the largest part of which had been attached by nationalized commercial banks (NCBs). At the same period, credit to government from the banking system stood at Tk 362.57 billion which was 22.42% of deposits and had been used in providing subsidies to the state-owned enterprises (SOEs) and running

the state machinery [Source: Bangladesh Bank (b)]. Fixed income securities including non-transferable instruments constituted 27.81% of domestic debt. Corporate debentures accounted for less than 1% of the debt securities market. Therefore, there is a huge gap in the market, providing an opportunity for floating private sector bonds.

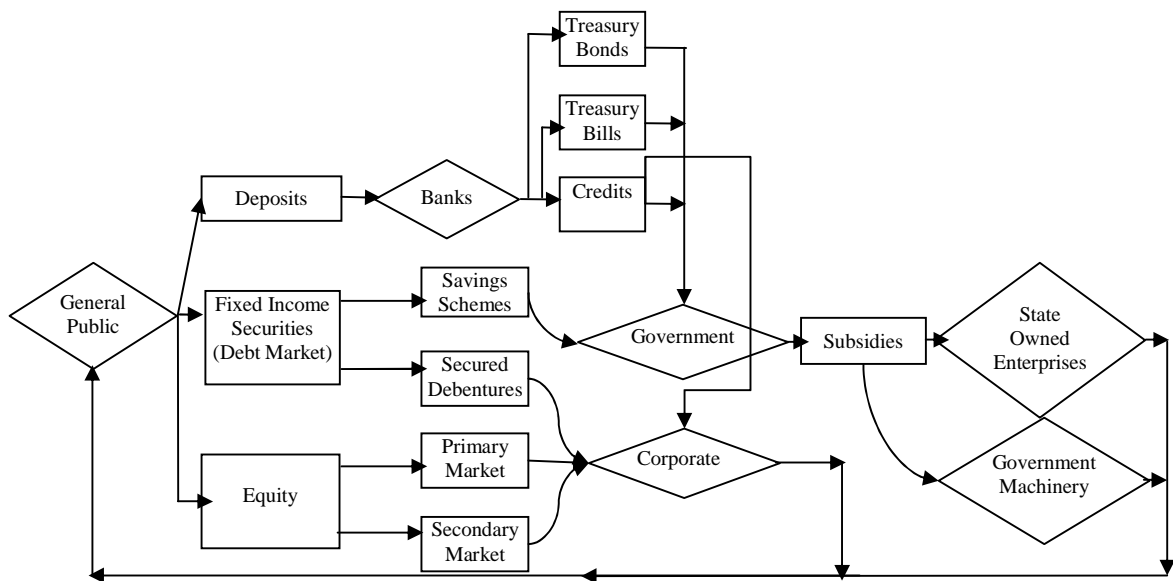


Figure-1: Structure of Financial Markets

b) Local Bond Market

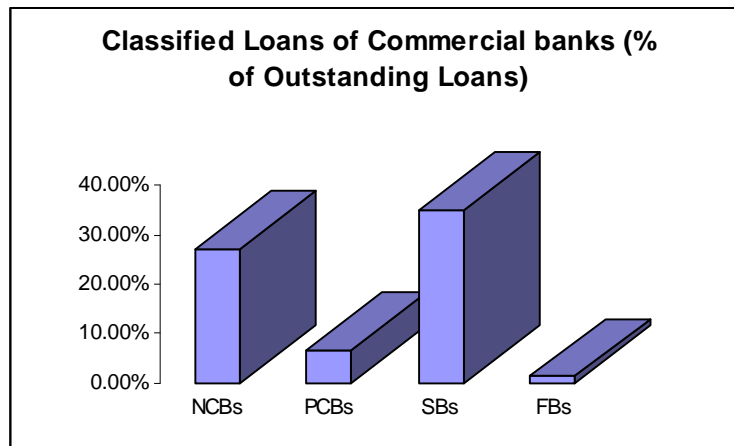
In recent past, Bangladesh Bank has taken a number of initiatives to promote bond market development, such as changing legal and regulatory framework and also the tax regime for securitization, or issuing of zero-coupon bonds. But there are some major problems in development of bond market in the country: weak governance at the institutional and market levels; high non-performing assets of the nationalized commercial banks (NCBs); poorly defined and overlapping responsibilities of Securities and Exchange Commission (SEC) and Ministry of Finance; and the lack of incentives and private initiatives to drive market developments. The

government is aware of these problems, and international organizations such as World Bank, IMF and some agencies such as IFC or ADB have been observing to push for possible solutions.

c) Heavily Burdened Banking Sector

The banking sector in Bangladesh faces a severe problem created by the high volume of classified loans, which increased from Tk 175.09 billion in December 2005 to Tk 207.16 billion in March 2006 [Source: The Daily Star, 6/6/2006]. Bankers attributed the rise to the failure of Bangladesh Petroleum Corporation (BPC) to pay back its huge amount of loans to the NCBs. BPC took about Tk 60 billion loan from Sonali Bank of which more than Tk 20 billion became classified in March. The amount of classified loans in the private commercial banks (PCB) has also risen by Tk 2.53 billion during the period. However, the volume of such loans in the Development Financial Institutions (DFI) has come down by Tk 0.71 billion [Byron, 2006].

Of the total outstanding loan of Tk 1347.36 billion in the banking system, the amount of classified loans was Tk 207.16 billion or 15.38 per cent on 31 March 2006, compared to 13.55 per cent on 31 December last year (See: Appendix-1). The share of classified loans (March, 2006) is shown in the following figure:



The problem becomes more critical because banking sector falls short of the required provisioning and the default culture is discouraging endeavors towards development of a healthy debt market. In such a situation resolution of NPLs in countries like Bangladesh ultimately lies in developing a secondary bond market, improving corporate governance, implementing appropriate legal frameworks, and inaugurating alternative financing tools like factoring and asset securitization.

V. Asset Securitization in Bangladesh

Debt securitization offers an opportunity to the banks to augment the fee-based Income. It is an efficient way of raising resources in order to finance higher volume of lending portfolio. Commercial banks in Bangladesh often do not have adequate long-term funds to meet the growing credit requirements of the various sectors of the economy. But there are investment sources such as insurance companies, provident funds, gratuity funds and pension funds. However, institutionalization of these sources has not attained the desired level of efficiency, largely because of lack of expertise. One relatively easy way of handling the problem is debt securitization which performs the important function of bringing together the lending

expertise of the commercial banks and financial institutions and the long-term funds available with the investment institutions.

Asset backed securities are issued in Bangladesh by the Industrial Promotion and Development Company (IPDC), Industrial Development and Leasing Company (IDLC), United Leasing Company (ULC), and Bangladesh Rural Advancement Committee (BRAC). IPDC formally launched the country's first asset backed securitized bond on 8th November, 2004, opening a new era of fund mobilization. Investment Corporation of Bangladesh (ICB), which has been made trustee for the special purpose vehicle, has a target of issuing Tk 0.359 billion worth zero coupon bonds against debt receivables of IPDC. IDLC issued Tk 0.13 billion worth asset backed zero coupon bonds and ULC issued Tk 0.40 billion worth asset backed zero coupon bonds in 2005 through private placement. Recently, BRAC, the world's largest NGO with over 5 million borrowers and 100,000 employees, has issued securities against micro-credits extended to low-income individuals, which is world's first micro-credit securitization. However, no commercial bank in Bangladesh has so far issued asset backed securities.

VI. The Proposal of 'Securitization through NPL sale'

Despite the restrictions imposed on the commercial banks that accept funds, the infusion of public funds is essentially a direct subsidy to the banks. The infusion of public funds provides the banks with the necessary capital needed to write-off the non-performing loans on an accounting basis; however, the non-performing loans, as well as the collateral, remain with the banks. Therefore, the banks need to dispose of these assets to truly solve the NPL problem.

Our proposal is such that the commercial banks sell their non-performing loans to a jointly established SPC (Special Purpose Companies – like SPV); the SPC would then pool the loans and issue asset-backed securities (ABS). Although this proposal results in banks' recognizing a loss

when they sell the loans that are backed by collateral, the loss would create a tax-shield. Under the proposed structure, banks could mix any proportion of performing and non-performing loans, depending on market demand. Banks however, may have some reluctance to sell performing loans to the SPC due to cultural, social, political and economic reasons and to consideration of this, the proposal leaves a provision of allowing the banks to determine the proportion of performing and non-performing loans sold to the SPC.

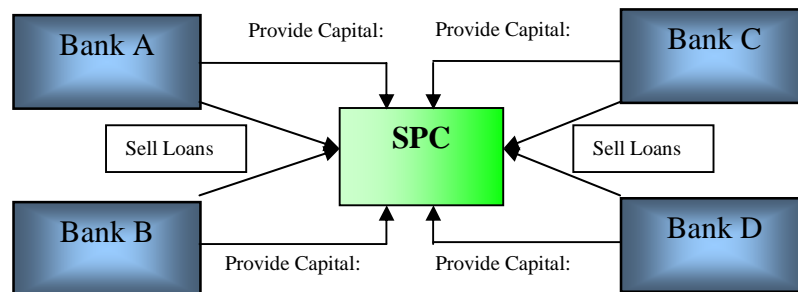


Figure 2: Banks establish and sell Loans to SPC

In the proposed plan, a group of banks will first establish a SPC by investing a small amount of capital, and then sell their loans to the SPC. For example, the book value of bank A's loans is 100; the probability of recovering the loans is very low; the loan has collateral of an estimated fair market value of 60; after establishing the SPC, bank A sells the loans to the SPC at 60; bank A will recognize a tax-deductible loss of 40 at the time of the sale and the loans (100) will be removed from bank A's balance sheet; however, SPC won't be able to purchase loans from all the banks at a time due to small initial capital; Initially it would buy loans on a pro-rata basis and gradually grasp all the NPLs of participating banks through issue proceeds of securitization. The benefits of this scheme are-

- I. Banks remove the NPLs from their balance sheet; and
- II. The loss of sale creates tax benefit immediately to the banks.

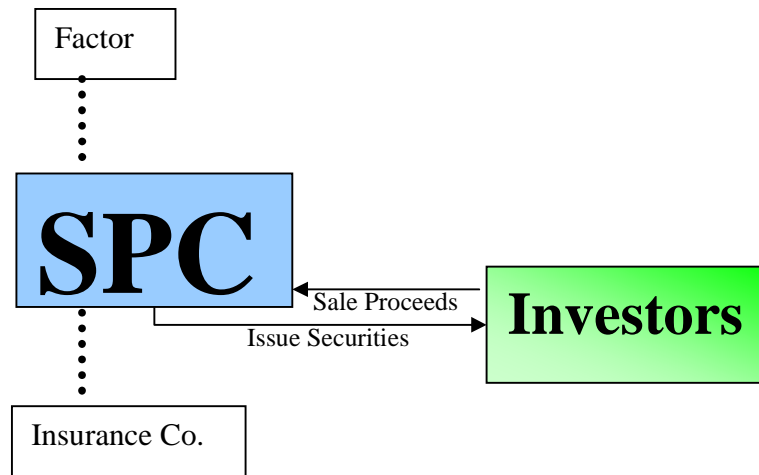


Figure 3: Banks issue ABS to the investors

The next step is for the SPC to sell the collateral underlying the loans. If the SPC tries to sell all of the collateral real estate properties in the market at once, it is likely that the weak country's real estate market would deteriorate further (assuming the loans were real estate loans). The SPC should avoid an immediate sale of the properties that may damage the real estate market. Such action may not only push the national economy further into trouble, but also decrease the proceeds from the sale of the properties. Therefore, the SPC should pool the loans and issue ABS, using the proceeds from the sale of the properties as collateral or as cash flow.

The sale of loans to the SPC de-links the loans from the banks, and in that case, the rating of the ABS would be based solely on that of the SPC, whose only assets are the pool of properties. But the lack of liquidity in the real estate market is an obstacle to creating high demand from investors for ABS. To address the risk of default on interest payments by the SPC due to

insufficient cash flow generated by the properties, arrangements can be made with insurers such as Sadharan Bima Corporation to insure the interest payment. However, given the estimated amount of loans to be sold to the SPC and the size of the ABS program, insurers may not find it economical to insure the interest payments. Thus, the ABS issued by the SPC may be zero-coupon bonds (ABS issued in Bangladesh so far are zero coupon bonds). The use of zero-coupon bonds would compensate for the questionable timing of cash flow obtained from the sale of the properties. Finally, SPC can get relief of purely bad loans by making factoring arrangement with local factors like IDLC and ILFSL.

Unlike a direct subsidy such as purchasing banks' preferred shares, the government might provide insurance to the ABS program in the form of a contingent credit enhancement. Different government bonds or treasury bills held by the Bangladesh Bank may be used to enhance the credit of the ABS program. If the SPC fails to generate sufficient cash flow from the sale of the properties or from the properties' cash flow, the government can liquidate part of the treasuries or government bonds to make the payment.

The ABS might be issued in senior, junior and subordinate portions varying by the amount of the guarantee. For example, in Bangladesh ULC sold lease receivable of Tk 0.40 billion to the trustee (ICB) to issue asset backed zero-coupon bonds. Thereafter the trustee issued 37 class A and 3 class B bonds of which ULC purchased 3 class B bonds bearing 7.90% interest as credit enhancement to secure the interest of class A bond holders. Any loss due to non collection of lease receivable in respect of class A bonds held by the investors would be adjusted against the amount of class B bonds held by ULC.

VII. Policy Implications

Securitization is an attractive option for banks and non-bank finance companies of Bangladesh. For Bangladeshi banks plagued by non-performing loans, securitization, or specifically collateralized loan obligations (CLOs), represents an opportunity to reduce bad loans on the balance sheets, enabling them to meet the required capital-adequacy ratio. When loans are held and not securitized, banks must retain a specified amount of capital in the portfolio. However, by removing loans from the banks' balance sheets through CLOs, the capital requirement falls to the level of equity retained by the bank. For example, if the bank retains a 3% equity stake in the CLO, then the capital requirement is only 3% (100% of the 3% equity stake) instead of the 8% required by BIS standards. For non-bank finance companies, many of which have been squeezed by the banks' lowered appetite for risk, securitization offers the opportunity to obtain necessary financing. With the appropriate structure, securitized deals can obtain higher ratings than the originator's rating, resulting in lower funding costs. Furthermore, securitization transfers the risk of catastrophic loss from the originator to the investors, limiting the potential loss of the originator to the retained interest or credit enhancements.

Despite its attractiveness, especially for banks and non-bank finance companies, securitization remains an unutilized tool in Bangladesh. Although foreign banks have thinking for establishment of departments to promote securitization, other banks have done very insignificant task for reducing balance sheet assets through securitization. This is undoubtedly due to the significant legal, tax, and cultural restrictions and limitations existing in Bangladesh.

Asset and Investment Management Services (AIMS) of Bangladesh Limited suggests creating the Special Purpose Vehicle (SPV) Trust as a 'not-for-profit' entity for getting tax-exempt status. It

also suggests that the NBFIs shall not go for public issue in their several tranches, which will save their issue cost including underwriting commission to a great extent. AIMS also holds that a conduit SPV structure, pooling of assets from different NBFIs, may also reduce issue cost while enhancing credit quality of the securitized instruments.

The existing tax laws have no specific provision for dealing with securitization. The Trust Act, 1882 is too old to handle such a technically sophisticated product like asset securitization. Some changes have been made in the Act to issue ABS in Bangladesh. Bangladesh Bank is yet to circulate a policy guideline for issuance of ABS by commercial banks. The development of a stable secondary bond market can create a platform of a better securitization market in Bangladesh. The country now has only 2 rating agencies (CRISL and CRAB) and new rating agencies of international standards are essential for the development of a successful securitization market.

X. Conclusion

Securitization is an innovation in financial markets. Pooling assets and using the cash flows to back securities allow originators to unlock the value of illiquid assets and provide lower borrowing costs for consumers at the same time. Hence, selling NPLs and thereby issuing securities is feasible. The largest benefit is that it enables the banks to remove the non-performing loans from their balance sheet. The removal will relieve the capital used as reserve for the potential loss of the non-performing loans. Tax benefits comprise another gain for the banks, which cannot avail of such benefit by simply writing off the loans. Finally, securitization avoids an immediate sale of real estate properties and thus, minimizes the downward pressure on the real estate market.

Despite obstacles, there is a huge potential for asset securitization in Bangladesh in banking sector, as well as in other sectors such as housing finance companies, which can securitize their mortgages, credit card companies, which can securitize credit card receivables, micro finance companies, which can securitize micro credits (As BRAC has recently securitized), or ministry of communication can securitize toll receivables of Jamuna Bridge and other infrastructures. Securitization thus has a potential of becoming alternative to loans from foreign countries. Further, through securitizing future flows of remittances sent by the Bangladeshi workers abroad, financial institutions can issue Islamic Shariah based securities in Middle East countries and can reap the benefit of low cost financing. All these would ultimately pave the way for faster progress in financial sector reforms and a higher growth of the economy.

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Appendix

Table-1: Gross NPL Ratio of Commercial Banks in Bangladesh

Banks	2002	2003	2004	2005	2006*
NCBs	33.73	29.03	25.3	21.35	27.14
SBs	56.19	47.41	42.86	34.87	35.15
PCBs	16.38	12.43	8.53	5.62	5.64
FBs	2.61	2.68	1.5	1.26	1.2
Total	28.1	22.13	17.63	13.55	15.38

Source: Bangladesh Bank Quarterly

* First Quarter

Table-2: Net NPL Ratio of Commercial Banks in Bangladesh

Banks	2002	2003	2004	2005	2006*
NCBs	28.48	28.06	17.56	13.23	18.28
SBs	40.41	32.75	22.97	22.61	22.56
PCBs	9.73	7.96	3.35	1.75	1.63
FBs	-0.15	0.03	-1.47	-2.16	-2.23
Total	21.01	18.07	9.79	7.15	8.59

Source: Bangladesh Bank Quarterly

* First Quarter

Table-3: NPLs of Banking Sector in Bangladesh (billion Taka)

Year	NCBs	PCBs	FBs	SBs	Total
1991	33.2	13.2	0.9	0	47.3
1992	43.7	0.2	1.2	0	45.1
1993	51.1	32.7	1.4	0	85.2
1994	52.9	37.3	1.2	0	91.4
1995	59.5	38.8	1	0	99.3
1996	70.8	38.5	1	0	110.3
1997	89	39.6	0.9	43.7	173.2
1998	107.5	46.4	1.2	59.1	214.2
1999	128.9	45.2	1.2	63.3	238.6
2000	117.3	46.2	1.2	63.6	228.3
2001	122.2	45.8	1.4	66.6	236
2002	121.7	54.8	1.3	61.6	239.4
2003	105.6	48.5	1.7	47.2	203
2004	99.5	41.9	1	44.6	187
2005	100.2	35.4	1	38.3	174.9

Source: Bangladesh Bank

Table-4: Asset Securitization in Bangladesh

Originators	Type of Institution	Issue Size	Trustee	Investors
IPDC	NBFI	Tk 0.359 billion	ICB	Dhaka Bank, Jamuna Bank, Mutual Trust Bank, South East Bank, and International Leasing and Financial Services Ltd
IDLC	NBFI	Tk 0.13 billion	ICB	Commercial Bank of Ceylon Limited, BRAC Bank Limited, City Bank Limited, Green Delta Insurance Company Ltd, and Reliance Insurance Limited
ULC	NBFI	Tk 0.40 billion	ICB	BRAC Bank Limited, The City Bank Limited, Dhaka Bank Limited, Eastern Bank Limited, International Leasing & Financial Services Ltd, Jamuna Bank Limited, Mercantile Bank Limited, and United Leasing Company.
BRAC	NGO	Tk 12.6 billion	Jointly established	RSA Capital, Citigroup, the Netherlands Development Finance Company (FMO) and KfW of Germany.