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Political Influence on the Level of Non-performing Loans in Bangladesh

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Abstract:

The objective of this study is to develop a framework that explains how political influence shapes the level of Non-Performing Loans (NPLs) in the banking sector through a literature review approach. NPLs pose a significant threat to financial stability, and political interference through directed lending and regulatory pressure can exacerbate the problem. The study also examines the political influence on NPLs by including specific moderating factors, i.e., political campaign staff, nepotism, anti-corruption legislation, audit committees, boards of directors, political interference, regulatory quality, corporate governance, bank ownership structure, and political patronage, alongside the independent variable, political influence. The study concludes that political party affiliation, personal guarantees of collateral, borrowers' political and social backgrounds, reliance on politically aligned boards of directors and audit committees, insufficient training and development regarding problematic loans, and misguidance from the central bank play crucial roles in increasing NPLs. The findings suggest that political stability is essential for keeping NPL ratios low, based on theoretical discussions, although no empirical results have been presented.

Keywords: Non-Performing Loan, Corporate Governance, Central Bank, Credit Analysis

1. Introduction

Financial institutions play a vital role in any economy, as they mobilise savings for productive investments and facilitate credit flow to various sectors, thereby stimulating investment and enhancing productivity (Richard, 2011). They are the primary source of finance for millions of households and small, medium, and large organisations, and they play a critical role in developing countries where access to capital markets is limited (Greuning & Bratanovic, 2003). Despite their valuable contributions, banks worldwide have faced significant challenges regarding default loans—also known as Non-Performing Loans (NPLs)—over the past few decades.

According to the International Monetary Fund (IMF, 2011), NPLs refer to loans where payments of interest or principal are overdue by 90 days or more, or where interest payments overdue for 90 days or more have been capitalised, refinanced, or rolled over. A loan can be classified as non-performing when payments of principal and interest are 90 days or more overdue, or when future payments are not expected to be received in full. The ratio between NPLs and total loan portfolios is also called "bad debts" or "bad loans" (World Bank, 2022). Higher levels of NPLs can hinder monetary policy and reduce the effectiveness of the financial system (Pop & Chicu, 2018). Moreover, the proportion of NPLs indicates the overall stability of the banking sector, which aims to achieve long-term profitability while minimising bad loans through effective monitoring (Kuzucu & Kuzucu, 2019).

The topic of NPLs has gained increased attention in recent decades, and numerous researchers have offered varying insights. Some focus on the conceptual nature of NPLs within economic cycles; others examine determinants such as macroeconomic performance, economic growth, unemployment, lending rates, and exchange rates. Behavioural determinants, including social, cultural, psychological, and political factors, have also been explored. Additional research emphasises causes such as poor management, inadequate credit analysis, and fraudulent practices. Moreover, corruption, government failure, economic policy uncertainties, and weak legal systems are commonly cited contributors to high NPL levels. However, despite the global significance of political influence on NPLs, the existing literature has offered limited attention to this issue.

Non-performing loans are a key indicator of financial distress within the banking industry and can significantly undermine economic stability and growth. While many studies have focused on the economic and financial determinants of NPLs, insufficient attention has been given to the political variables influencing bad loans in emerging economies. Political decisions heavily shape regulatory frameworks, banking supervision, and fiscal and monetary policies—which in turn influence lending behaviour, especially in state-owned financial institutions.

The primary research gap identified in prior literature concerns the limited focus on the political influences affecting NPLs in the banking industry. This study aims to establish the relationship between political influence and non-performing loans in the banking sector of Bangladesh. Additionally, the study highlights both internal and external factors that contribute to the growth of bad loans.

This research is qualitative and based on a review of existing literature. Research articles related to NPLs in the banking sector were collected from various academic journals. The study examines political influences on NPLs using selected moderating variables. Trend analysis was used to assess NPL levels in Bangladesh's banking industry between 2014 and 2023. The research also analyses the NPL ratio across different categories of banks using data from Bangladesh Bank's annual reports.

2.Literature Review

The main research gap identified relates to the influence of politics on NPLs in the banking sector. The study arises from the current economic challenges in Bangladesh, an emerging economy. According to a report by H. Ahsan (The Daily Star, 2024), Bangladesh has experienced rising NPLs due to political interference and deficiencies in corporate governance. In recent years, a significant number of businesspeople and corporate personnel, many affiliated with major political parties, have become involved in the banking sector. Following the ninth parliamentary election, 59% of elected members were businesspeople, and 44% had assets exceeding USD 10 million (Chowdhury, 2021). These politically connected businessmen have been linked to bad loans and corruption in the banking industry.

Table: 1: Amount of NPLs by types of banks in BDT in billions & percentage

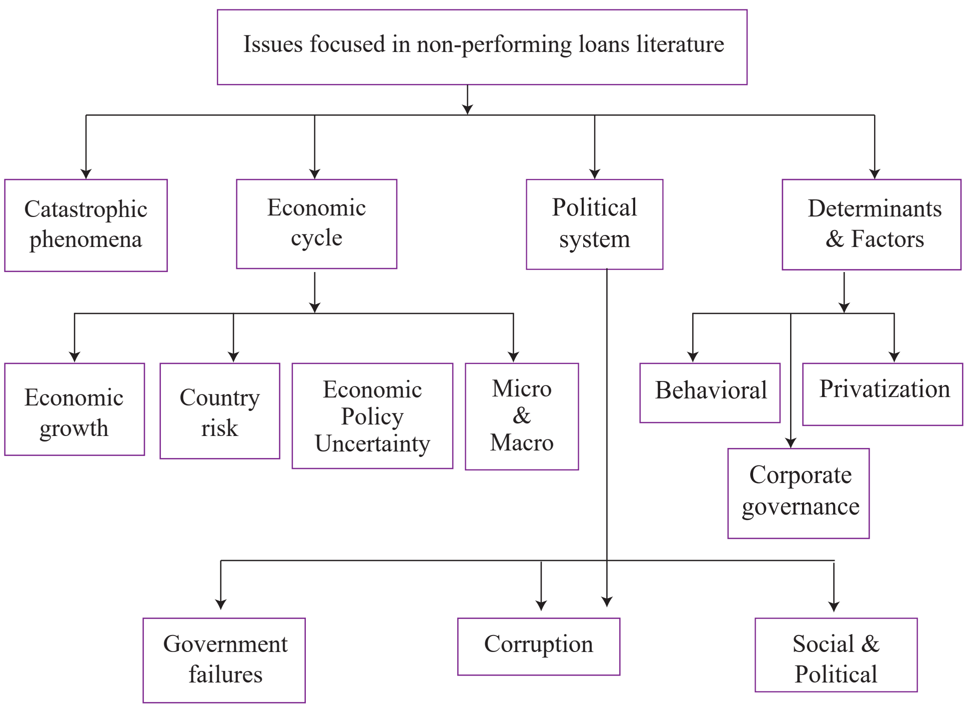
Year	SCBs		DFIs		PCBs		FCBs		Total
	BDT	%	BDT	%	BDT	%	BDT	%	
2014	227.6	45.37%	72.6	14.47%	184.3	36.74%	17.1	3.41%	501.6
2015	237.5	46.23%	49.7	9.67%	207.6	40.41%	18.9	3.68%	513.7
2016	310.3	49.90%	56.8	9.13%	230.6	37.09%	24.1	3.88%	621.8
2017	373.3	50.24%	54.3	7.31%	294	39.56%	21.5	2.89%	743.1
2018	487	51.85%	47.9	5.10%	381.4	40.61%	22.9	2.44%	939.2
2019	439.9	46.63%	40.6	4.30%	441.7	46.82%	21	2.23%	943.3
2020	422.7	47.64%	40.6	4.58%	403.6	45.49%	20.4	2.30%	887.3
2021	449.8	43.56%	39.9	3.86%	515.2	49.89%	27.9	2.70%	1032.7
2022	554.3	44.25%	41.9	3.35%	626.8	50.04%	29.6	2.36%	1252.6
2023	658	45.17%	56.7	3.89%	710	48.74%	32	2.20%	1456.33

Source: Bangladesh Bank Annual report,2023

The World Bank (2022) reported that the total outstanding written-off loans in Bangladesh reached nearly Tk 3.78 lakh crore by the end of 2022 due to political influence.

Several studies have focused on bad loans and examined the impacts of bad loans in banking industries from different perspectives.

Figure 4: Non-performing loans literature



According to the literature, non-performing loans are one of the most cataclysmic phenomena for the banking industry. Additionally, the lack of corporate governance, weak supervision, corruption with country risk, political interference, and professional ineptness of bankers played an important role in causing bad loans. Bristy & Alam (2020) emphasised the challenges of NPLs with the classification of loans, ways to improve debt recovery, and cracking down on bad loans in the banking industry. It also highlights the cause and effect of bad loans on the bank's profitability. This study claimed that information with moral hazard, adverse selection with borrowers, and legal actions default—politicians and influential businessmen—are the main reasons for bad loans, with recommendations that improve the efficiency of legal and judicial systems in both banking sectors and the country.

In the literatures, models linked to credit risk and economic activity are not new things, in which theoretical concepts are developing with the help of economic cycles. Beck et al. (2023) concluded that economic cycles are the primary determinants of bad loan behaviour globally, as well as exchange rates, share price, and interest rates matter depending on a country's financial and structural characteristics.

In general, the research adopted in the development of economics to know the factors that affect NPLs includes macroeconomic and bank-specific variables, in which gross domestic product (GDP), inflation, unemployment rate, and interest rates are consistently mentioned as macroeconomic factors. On the other hand, factors like inefficiency, profitability, return on assets, capital adequacy ratio, and variables of loan losses are the indicators of bank-specific factors. The study of Messai & Jouini (2023) showed that GDP growth, capital adequacy, and return on assets have a negative impact, but the unemployment rate and interest rates affect bad loans positively. They also provided recommendations that banks should give interest to many variables to decrease NPLs when they offer loans to assess the soundness and stability of banking systems.

Most of the studies highlighted that the micro and macro levels impact bad loans. Saliba et al. (2023) addressed the gap in related literature by examining the impact of country-specific risks—political risks, financial risks, as well as economic risks—on bad loans in the banking sector. The study used two types of independent variables for the research: banking sector-specific variables, i.e., profitability, capital regulations, liquidity, inefficiency, and income diversification, while country and global-level variables include the country risk index, financial market development, lending interest risk, and global risks. The findings of the study demonstrate that banking sector-specific variables, without inefficiency, negatively impact NPLs, but inefficiency has a significant positive impact on bad loans. On the contrary, the country's risk harms bad loans with political, financial, and economic risks. The researchers recommend that policymakers pay more attention to some related components of the country's risk, i.e., reducing inflation, increasing GDP, reducing exchange rates, and so on.

Economic policy uncertainty is defined as uncertainty about the economic policies of the private sectors, including inflation uncertainty, negative economic growth, financial crisis, abnormal lending cuts, pandemics, rising unemployment rates, foreign exchange, and unexpected changes in monetary policy rates (Chen et al., 2020). A survey of EPU (Ozili, 2022) finds that EPU affects banks through loan pricing and reduction in credit policy to mitigate the effect of EPU on profitability and investigates the correlation of EPU with NPLs and loan loss provisions. The findings show no significant correlation between EPU and loan loss with bad loans, but EPU is negatively correlated with bad loans, while loan loss provisions are more responsible. The findings imply that regional characteristics drive the correlation between EPU and loan loss provision with bad loans to ensure balanced profitability when lending to borrowers.

In line with Schumpeter (2011), the impact of NPLs on economic growth is mostly unanimous that the resources are stuck in unproductive sectors, detrimental to economic growth and the efficiency of the economy. In the past decades, a lot of studies have been prepared linking finance and economic growth with the four schools of thought—supply-lending, demand-following, bi-directional, and independent. Sengupta (2020) found that investment and economic growth have a close connection with political governance in NPLs, while it concludes that bad loans hamper investment and economic growth; in addition, this can be mitigated by a political governance structure. The study also showed that investment and economic growth hurt bad loans, whereas they are strengthened by political governance. The impact of NPLs can be mitigated by strong political governance in addition to creating safer banking and financial environments.

Accordingly, a study by Keshani & Jayatilake (2021) focused on institutional-related factors, customer-related factors, and remedial mechanisms for dealing with non-performing loans in the banking systems. The study found that institutional-related factors, i.e., size of institutions, credit growth, bad management, credit monitoring and terms, and lack of communications and other skills, have a significant impact on NPLs. However, the researchers pointed out that customer-related factors, i.e., loans to unprofitable investments, delay in project completion, customer dishonesty and awareness, high debtors, and excessive borrowings, also have crucial effects on bad loans. To minimise bad loans, the researchers recommend a reduction of interest and risk assessments, as well as close monitoring of borrowers and so on.

Rehman (2015) stated that corporate governance practices are an important factor in the banking sectors and affect the banking industry more severely than other sectors. Nyor & Mejabi (2013) examined the relationship between bad loans and corporate governance indicators, and they showed that board size and composition are positive; still, the audit committee and power separation have negative associations with NPLs. The study of Khatun & Ghosh (2019) investigated the impact of corporate governance practices on bad loans using independent variables—board size, number of independent directors, audit committee, and chairman of banks—in addition to control variables—the age of the firm and total assets of the firm. The results of the study showed that independent variables without a chairman have a positive impact on bad loans and recommended that efficient governance and the activeness of members ensure integrity, sincerity, and trustworthiness, which may reduce bad loans.

Ikram et al. (2016) identified some behavioural factors, i.e., type and quantity of collateral, credit assessment and repayment, creditors' behaviour, and so on, of NPLs. The study of Ghosh et al. (2020) revealed nepotism, moral hazard, inadequate collateral, credit assessment, lack of monitoring, and business risk with a lending interest rate as the catalysts of increasing bad loans by analysing social, cultural, psychological, as well as political context. The study found that business risk, poor credit assessment, and repayment have no significant impact on bad loans, but all other behavioural factors positively affect bad loans.

Several studies indicated that political pressure is related to banking activity. Ravina & Sapienza (2009) found that social agencies and political factors explained the performance of banking activities at lower rates in poor regions. Moreover, Rosenbluth & Schaap (2003) studied that the electoral rules explain the choice of politicians to regulate and control the banking systems.

Ofria & Mucciardi (2022) proved that government failures have been measured by analysing corruption and public debt as a percentage of GDP. On the other hand, Goel & Hasan (2011) investigated the relationship between bad loans and corruption and concluded that more corrupt countries have higher levels of NPLs in banking sectors. The study by Giammanco et al. (2023) investigates the relationship between government failures and bad loans to consider the factors—debt, GDP growth, price index, and unemployment—and concludes that there is a negative relationship between them, in addition to recommending that strict monitoring of governance is necessary to reduce bad loans.

A politically concentrated economy largely dominates the state-owned banks and private sectors (Beck, 2013). Gupta (2002) found the negative effect of corruption on foreign banks. According to the study by Mohamad & Jenkins (2020), the result shows that the level of corruption is positively and significantly associated with bad loans after considering GDP growth, bank size, corruption (CPI), and return on assets, in addition to providing implications for bad loans with economy-wide reforms and regulations.

Maksimovic & Asli (1998) revealed that there is a significant correlation between the efficiency of legal systems and bad loans, which correlates with the growth of financial sectors. The slow judicial process, legal procedures, and ambiguous judicial penalties system reduce corruption in bad loans (Goel & Hasan, 2011). The study of Farhan & Alam (2018) investigated socio-political and legal variables negative personal intentions, political influence, banker's incompetence, and judicial system which have significant positive relationships with non-performing bank loans.

3. Framework Development

The unique combination of the following frameworks checks the political influence of NPLs on banking sectors by encouraging politically motivated lending that directly contributes to bad loans. This framework shows the relationship between political influences and non-performing loans with the help of some moderating variables like corporate governance, corruption, and board ownership, etc.

- Dependent variable – Non-performing loans
- Independent variable – Political influence
- Moderating variables – Audit Committee, Board of Directors, Corporate Governance and others.

3.1. Political Campaign Staff

Political influence is considered pervasive all around the world, which shows that political interference costs the whole nation economically (Khwaja & Mian, 2005). When the government changed, the successful political party rewarded political campaign staff with board positions in banks, especially state-owned banks, using political influence so that the campaign staff acted as an intermediary between them. As a result, they push banks to make loans in favour of personal and political objectives, thereby creating bad loans.

3.2. Nepotism

The differentials of power and influence, as well as the dynamics of inequity in wealth, power, status, and personal reputation, have influenced white crime (Braithwaite, 1991). In the banking industry, most banking management bodies comprise family members, family friends, and independent directors, resulting in a lack of supervision in sanctioning and collecting related-party loans.

3.3. Audit Committee

The higher authorities of the banks take loans for their own business, or the people with powerful social and political backgrounds refuse to repay loans (Begum & Kamal, 2018). In these cases, most people with a political background commit fraud with the help of an audit committee. As a result, the audit committee commits misconduct in reviewing financial statements, related-party transactions, and risk disclosures in favour of political personnel, leading to an increase in NPLs.

3.4. Board of Directors and NPLs

The board of directors is important in the effective monitoring of management, especially in the banking industry, because they are accountable to shareholders, creditors, clients, and depositors (Macey & O'Hara, 2003). It is argued that the board's independence matters a lot for effective monitoring, but political influence on them leads to an increase in NPLs by approving loans without proper authorisation due to political pressure. Additionally, when loans are approved based on political influence rather than sound credit assessment, it leads to an increase in bad loans.

3.5. Political Interference

The interference of politicians, bureaucrats, and military officials in banking sector lending decisions causes heavy loan loss and banking distress. In Asian countries, the impact of political connections in a transitional economy has a significant impact on both banking sector performance and economic growth (Masood et al., 2010). In the case of democracy, state-owned banks must follow the orders of the higher management, but the management is recruited by the politicians (Fan & Ding, 2011). Therefore, they use them for their political goals and objectives, resulting in a rise in the size of bad loans.

3.6. Regulatory Quality

Regulatory quality captures the government's attitudes toward promoting private-sector development and inward investment, ensuring that projects are up and running properly and protected from incurring loan loss (Sengupta, 2020). In the context of bad loans, financial regulators act in the public interest rather than align with the interests of powerful political personnel. Besides, state-owned banks receive regulatory leniency on bad loan recognition and provisions from political parties.

3.7. Corporate Governance

Corporate governance is the widest control device, which is a combination of internal and external control mechanisms for the proper authorisation of corporate resources (Chowdhury, 2021). In emerging countries, politics heavily influence banking sectors due to weak governance, particularly in state-owned banks. Politicians pressure banks to provide loans to offer an enhanced future with motivating factors politically. Besides, the state-owned banks' governance is appointed and controlled by the political influence of the government for their personal and political objectives, thereby increasing NPLs.

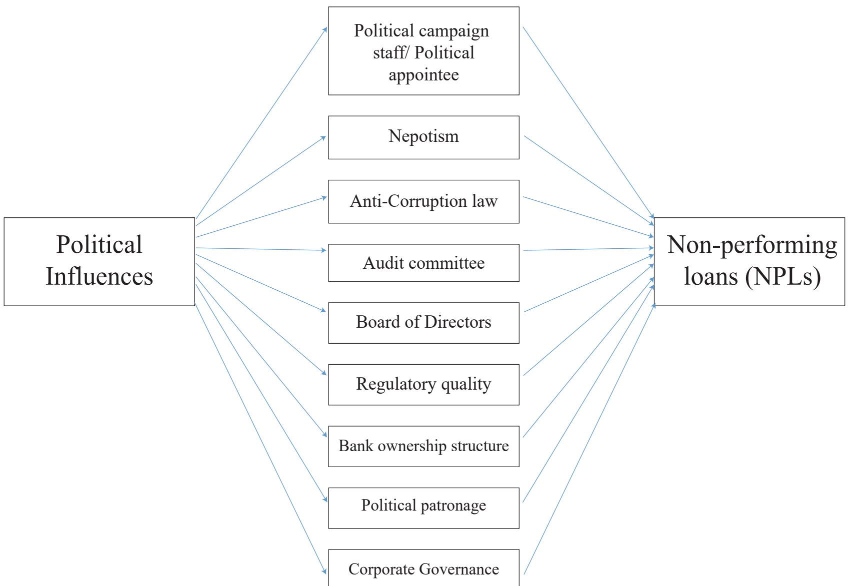
3.8. Bank Ownership Structure

The association between bank ownership and performance is unresolved, with a significant body of literature available on this issue and suggesting that private enterprises perform better than public enterprises (Alessi, 1998). From this point of view, it indicates that the weak ownership structure of public banks, as well as the concentrated ownership that holds a significant portion of shares due to political influences, creates a way for NPLs in the banking industry.

3.9. Political Patronage

The administrators engage in dishonesty when they look for their benefits and political gains, where these benefits are provided to these people at the expense of the national interest (Bhargava, 2005). The practice of political patronage—the politically beneficial personnel giving government jobs, contracts, or rewards to civil sectors as well as public-sector positions for a long time—means that these political persons, linked to corruption in banking industries, contribute to increasing NPLs.

Figure 5: Association of political influence with NPL



4. Conclusion

As a descriptive study, this study summarises prior literature that focused on political influences on NPLs across the banking system. This study develops a framework that explains the nature of political influence on the level of non-performing loans in the context of banking industries, employing specific moderating factors identified through a literature review. The model indicates that political issues play a significant role in the extent of non-performing loans. The framework illuminates that every moderating factor, including political campaigns, patronage, nepotism, anti-corruption regulations, audit committees, boards of directors, political interference, regulatory quality, corporate governance, and the structure of bank ownership, is affected by political interference that contributes to a rise in non-performing loans (NPLs) within the banking sector. This paper also emphasises the current situation of Bangladesh regarding NPLs by analysing trends and the ratio of NPLs from 2014 to 2023, along with evidence indicating that political instability contributes to the country's ongoing economic decline.

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