Chapter-5

Banking Sector Performance, Regulation and Bank Supervision

5.1 Industry Statistics of the banking sector and the performances trends have been discussed in this chapter. The banking sector of Bangladesh comprises of four categories of scheduled banks. These are nationalized commercial banks (NCBs), government owned development finance institutions (DFIs), private commercial banks (PCBs) and foreign commercial banks (FCBs). The number of banks remained unchanged at 48 in 2006. These banks had a total number of 6562 branches as of December 2006. The number of bank branches increased from 6402 to 6562 due to opening of new branches by the PCBs mainly during the year. Structure of the banking sector with breakdown by type of banks is shown in Table 5.1 below:

Table 5.1 Banking system structure

(billion Taka)

Bank types	2005						2006					
	Number of banks	Number of branches	Total assets	% of industry assets	deposits	% of deposits	Number of banks	Number of branches	Total assets	% of industry assets	deposits	% of deposits
NCBs	4	3386	763.1	37.4	621.3	40.0	4	3384	786.7	32.7	654.1	35.2
DFIs	5	1340	197.2	9.7	89.5	5.8	5	1354	187.2	7.8	100.2	5.4
PCBs	30	1635	934.3	45.6	731.3	47.0	30	1776	1147.8	47.7	955.5	51.3
FCBs	09	41	148.2	7.3	112.6	7.2	09	48	284.9	11.8	150.8	8.1
Total	**48**	**6402**	**2042.8**	**100.0**	**1554.7**	**100.0**	**48**	**6562**	**2406.7**	**100.0**	**1860.6**	**100.0**

5.2 In 2006 the nationalized commercial banks (NCBs) held 32.7 percent of the total industry assets as against 37.4 percent in 2005. Evidently, NCBs' domination in this area is showing a declining trend, while PCBs' share rose to 47.7 percent in 2006 as against 45.6 percent in 2005. The foreign commercial banks held 11.8 percent of the industry assets in 2006, showing a satisfactory increase by 4.5 percentage points over the previous year. The DFIs' share of assets was 7.8 percent in 2006 against 9.7 percent in 2005.

5.3 Total deposits of the banks in 2006 rose to Taka 1860.6 billion from Taka 1554.7 billion in 2005 showing an overall increase by 19.7 percent. The NCBs' (comprising of 4 largest banks) share in deposits decreased from 40.0 percent in 2005 to 35.2 percent in 2006. On the other hand, PCBs' deposits in 2006 amounted to Taka 955.5 billion or 51.3 percent of the total industry deposit against Taka 731.3 billion or 47.0 percent in 2005. FCBs' deposits in 2006 rose by Taka 38.2 billion or 33.9 percent over the previous year. The DFIs' deposits in 2006 were Taka 100.2 billion against Taka 89.5 billion in 2005 showing an increase of 12.0 percent over the year.

Aggregated Balance Sheet

5.4 **Assets:** Aggregate industry assets in 2006 registered an overall increase by 17.8 percent over 2005. During this period, NCBs' assets increased by 3.1 percent and those of the PCBs' rose by 22.9 percent. Loans and advances played a major role on the uses of fund. Loans and advances amounting to Taka 1543.6 billion out of aggregate assets of Taka

Chart 5.1

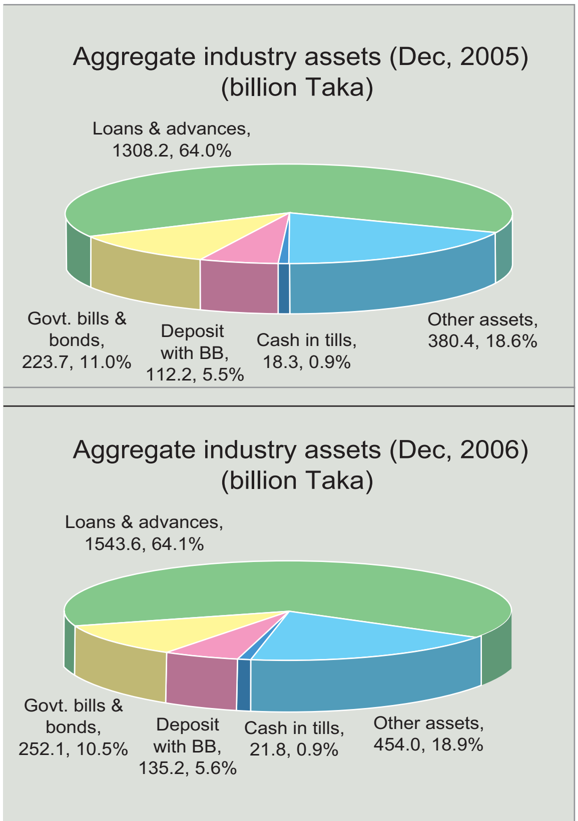
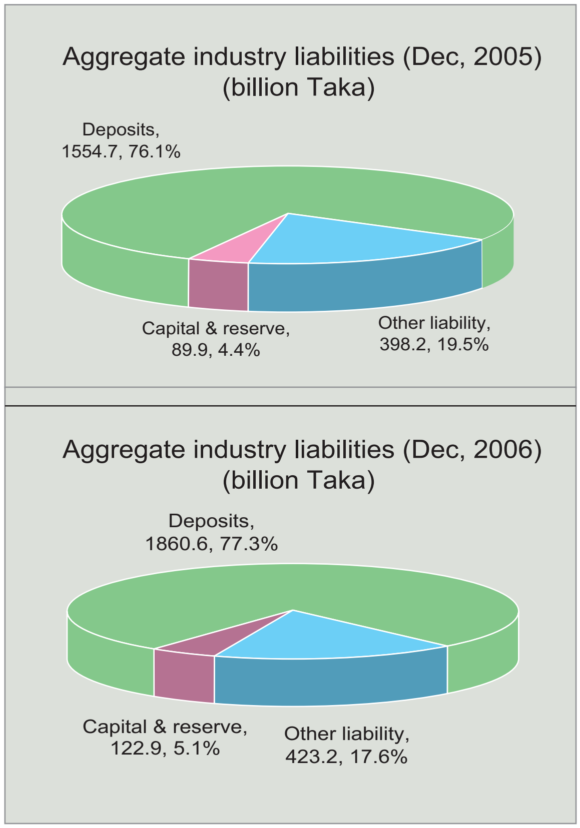


Chart 5.2



2406.7 billion constituted a significant portion (64.1 percent). Cash in tills were Taka 21.8 billion (below 1.0 percent); deposits with Bangladesh Bank were Taka 135.2 billion or 5.6 percent; other assets were Taka 454.0 billion or 18.9 percent and investment in government bills and bonds accounted for 10.5 percent (Taka 252.1 billion) of the assets.

5.5 **Liabilities:** The aggregated liability portfolio of the banking industry in 2006 was Taka 2406.7 billion of which deposits constituted Taka 1860.6 billion, or 77.3 percent and continued to be the main sources of fund of banking industry. Capital and reserves of the banks were Taka 122.9 billion or 5.1 percent of aggregate liabilities in 2006, as against Taka 89.9 billion or 4.4 percent in 2005.

Performance and Rating of Banks

5.6 Performance of the banking sector under CAMELS framework, which involves analysis, and evaluation of the six crucial dimensions of banking operations, has been discussed in this chapter. The six indicators used in the rating system are (i) Capital adequacy, (ii) Asset quality, (iii) Management soundness, (iv) Earnings, (v) Liquidity and (vi) Sensitivity to market risk.

Capital Adequacy

5.7 Capital adequacy focuses on the total position of bank capital and protects the depositors from the potential shocks of losses that a bank might incur. It helps absorbing major financial risks like credit risk, market risk, foreign exchange risk, interest rate risk and risk involved in off-balance sheet operations (Box 5.1). Banks in Bangladesh have to maintain a minimum Capital Adequacy Ratio (CAR) of not less than 9.0 percent of their risk-weighted assets (with at least 4.5 percent in core capital) or Taka 1.00 billion, whichever is higher.

Box 5.1

Risk Management Practices in the Banking Sector of Bangladesh

Banking industry is vulnerable to numerous risks as akin to credit, market, operational, supervisory etc. risks. The industry performs lot of diversified and complex financial activities in the Economy. Possibility of obligor's failure of agreement, adverse movement in market price, exchange rate, interest rate etc. can incur loss of a banking company. On the other hand, risk of loosing resources resulting from unprofessional conduct, loss causes out of failed internal processes, unskilled people and erroneous systems or from external events, mismatch of assets & liabilities, fraud-forgery, irregular & connected lending etc. grip operational risk. Board of Directors & Senior Management are extremely responsible for drawing business strategy, management, supervision & business oversee. Knowledge and skill of these moderators of banking company contribute a lot to the banking activities and protect business from risks. Other than risk mitigation to meet possibility of unforeseen losses, banks maintain adequate capital & reserves.

Bangladesh Bank has adopted several initiatives to handle the banking industry with international best practices for risk management. To introduce risk analysis culture in the banking industry loan classification was a wide scheme for assessing the status of banking assets (vide BCD circular no. 34/89). In the year 2003, BB forwarded "Guidelines on Managing Core Risks" to the banks for complying with five core risks management in banks. Those were a) Credit Risk Management, b) Internal Control & Compliance, c) Asset & Liability Management, d) Foreign Exchange Risk Management, and e) Money Laundering Risk Management. The guidelines were minimum instructions for the banks and were asked to build up their own risk management manuals on the basis of those guidelines.

At present banks are required to make general provision for meeting any risk of unexpected losses. Thus banks are keeping specific provision at 5, 20, 50 and 100 percent against SMA, Sub-standard, Doubtful and Bad/Loss loan respectively to meet expected losses resulted from the obligor's failure of agreement.

The Credit Risk Grading (CRG) is an outcome of collective information based on the pre-specified scale and reflects the underlying credit-risk for a given exposure. This grading system is used for assessing the credit risk status before a bank lend to its borrowing clients including banks & NBFIs. CRG scale for the banks consists of 8 categories i.e., Superior, Good, Acceptable, Marginal/ Watch-list, Special Mention, Sub standard, Doubtful, Bad & Loss.

Internal Control & Compliance is a focal risk area of banks. Effective internal control system, corporate governance, transparency, accountability are significant issues to ensure smooth performance of the banking industry.

Asset & Liability management is part of operational and supervisory activity of a bank. The Asset Liability Committee (ALCO), comprising of the senior management of a bank, is primarily responsible for Balance Sheet Management or more specifically Balance Sheet Risk Management. The results of balance sheet analysis along with recommendation is placed in the ALCO meeting by the Treasurer where important decisions are made to minimize risk and maximize returns.

Bangladesh Bank has developed a strategy paper regarding how to address the major risk elements involved in the foreign exchange activities and forwarded it to the banks in order to take the local foreign exchange market more ahead. All treasury functions require clear demarcation.

Money Laundering Prevention Act 2002 was enacted in April 2002 . For proper compliance of the provisions of the Money Laundering Prevention Act 2002, the Bangladesh Bank has made 'Know Your Customer' (KYC) mandatory for all banks and asked them to preserve correct and full information of their customers. BB also instructed banks to record all transactions in each account and control and report any unusual/suspicious

Box 5.1

Risk Management Practices in the Banking Sector of Bangladesh

Contd.

transactions. To monitor closely money laundering as well as illegal financing and preventing these activities, Bangladesh Bank has advised all commercial banks to report STR. Further, Bangladesh Bank has instructed all commercial banks to submit CTR of both deposit and withdrawal amounts of Taka 0.5 million or above in a single account after reviewing daily transactions in the prescribed format effective from 1 January 2006. Recently, Financial Intelligence Unit (FIU) has been established under Anti Money Laundering Department of BB to detect and investigate financial crime in the banking system of Bangladesh.

The revised policy on capital adequacy takes account of different degrees of credit risk and covers both on-balance sheet and off-balance sheet transactions. For the purpose of supervision, capital are categorized into two tiers: Tier 1 i.e., Core Capital comprises the quality capital elements and Tier 2 i.e., Supplementary Capital represents other elements which fall short of some of the characteristics of the core capital but contribute to the overall strength of a bank. With a view to strengthening the capital base of banks and make them prepare for implementation of Basel II, BB has advised banks vide BRPD circular no. 05/2007 that henceforth they will require to maintain capital to risk weighted assets ratio 10 percent (with at least 5 percent in core capital) which will have to be achieved by 31 December 2007. Both balance sheet assets and off-balance sheet exposures are to be weighted according to their relative risk. Presently, there are 4 (four) categories of risk weights zero percent, 20 percent, 50 percent and 100 percent. From January 2009 Basel II will be implemented in Bangladesh and accordingly banks will maintain capital covering market and operational risk in addition to credit risk.

5.8 Table 5.2 shows that as on 31 December 2006 the DFIs, PCBs & FCBs maintained CAR of 9.5, 9.8 and 22.7 percent respectively. The 4 NCBs could not attain the required level due to shortage in owner's equity, provision shortfall and overburdened expenditure incurred from operation time to time. One of the DFIs and 2 PCBs listed as Problem Bank could not maintain required CAR. FCBs maintained 22.7 percent CAR in 2006. The CAR of the banking industry was 8.3 percent in 2006 as against 7.3 percent in 2005.

Asset Quality

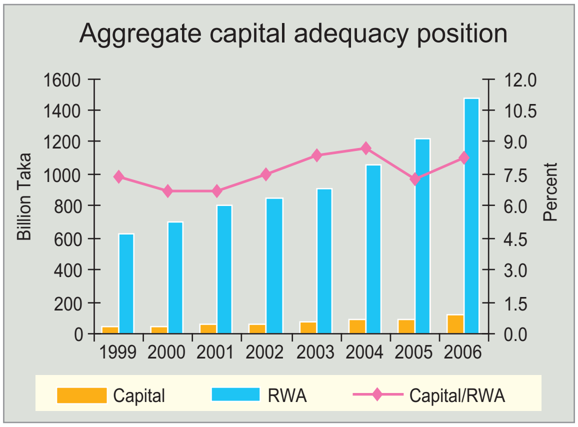
5.9 The asset composition of all commercial banks shows the concentration of loans and advances (64.1 percent) in total assets. The high concentration of loans and advances indicates vulnerability of assets to credit risk, especially since the portion of non-performing assets is significant. A huge infected loan portfolio has been the major predicament of banks particularly of the state-owned banks. In the total assets the share of loans and advances is followed by the investment in government securities and bills covering 10.5 percent.

Table 5.2 Capital to risk weighted assets ratio by type of banks

(Percent)

Bank types	1999	2000	2001	2002	2003	2004	2005	2006
NCBs	5.3	4.4	4.3	4.1	4.3	4.1	-0.4	1.1
DFIs	5.8	3.2	3.9	6.9	7.7	9.1	9.2	9.5
PCBs	11.0	10.9	9.9	9.7	10.5	10.3	9.1	9.8
FCBs	15.8	18.4	16.8	21.4	22.9	24.2	26.0	22.7
Total	**7.4**	**6.7**	**6.7**	**7.5**	**8.4**	**8.7**	**7.3**	**8.3**

Chart 5.3



5.10 The most important indicator intended to identify problems with asset quality in the loan portfolio is the percentage of gross and net non -performing loans (NPLs) to total advances. FCBs have the lowest and DFIs have the highest ratio of NPLs. NCBs have gross NPLs to total loans of 22.9 percent whereas in case of PCBs, FCBs and DFIs, the ratios are 5.5 percent, 0.8 percent and 33.7 percent respectively. Similarly NPLs net of provisions and interest suspense to the total loans is 14.5 percent, 1.8 percent and 23.6 percent for NCBs, PCBs and DFIs. FCBs are having excess provision for loan losses.

5.11 The ratio of NPL to total loans of all the banks shows an encouraging trend since its decline from the peak (41.1 percent) in 1999, although the aggregate ratio was still as high as 13.2 percent in December 2006. The reason is being very high NPL of the NCBs and the DFIs.

5.12 The NCBs and DFIs continue to have very high NPLs mainly due to substantial loans provided by them on considerations other than commercial and under directed credit programmes during the 70s and 80s. Poor appraisal and inadequate follow-up and supervision of the loans disbursed by the NCBs and DFIs in the past eventually resulted in massive booking of poor quality assets which still continue to remain significant in the portfolio of these banks. Furthermore, the banks were reluctant to write off the historically bad loans because of poor quality of underlying collaterals and to avoid any possible legal complication due to lacunas in the judicial framework. Recovery of NPLs, however, witnessed some signs of improvement; mainly because of the steps taken with regard to internal restructuring of these banks to strengthen their loan recovery mechanism and recovery drive and write off measures initiated in recent years.

5.13 It appears from the Table 5.3(a) and Chart 5.4 (a) that the net non performing loans to total loans after adjustment of actual provision and interest suspense stands at 14.5 percent (NCBs), 23.6 percent (DFIs), 1.8 percent (PCBs) and 7.1 percent

Table 5.3 NPL ratios by type of banks

(Percent)

Bank types	1999	2000	2001	2002	2003	2004	2005	2006
NCBs	45.6	38.6	37.0	33.7	29.0	25.3	21.4	22.9
DFIs	65.0	62.6	61.8	56.1	47.4	42.9	34.9	33.7
PCBs	27.1	22.0	17.0	16.4	12.4	8.5	5.6	5.5
FCBs	3.8	3.4	3.3	2.6	2.7	1.5	1.3	0.8
Total	41.1	34.9	31.5	28.0	22.1	17.6	13.6	13.2

Chart 5.4

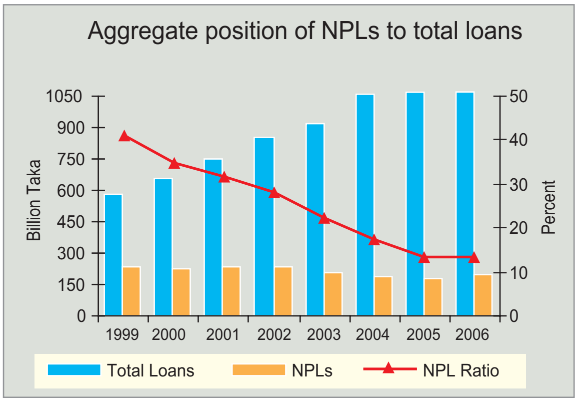


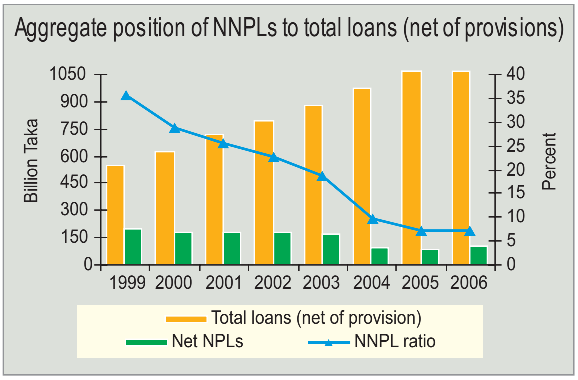
Table 5.3(a) Ratio of net NPL to total loans* by type of banks

(Percent)

Bank types	1999	2000	2001	2002	2003	2004	2005	2006
NCBs	41.3	34.1	32.8	30.1	28.3	17.6	13.2	14.5
DFIs	58.5	54.6	54.5	48.0	38.3	23.0	22.6	23.6
PCBs	21.2	15.5	10.5	10.5	8.3	3.4	1.8	1.8
FCBs	0.9	-0.1	-0.3	-0.4	0.1	-1.5	-2.2	-2.6
Total	35.6	28.8	25.6	22.6	18.8	9.8	7.2	7.1

* Net of actual provision and interest suspense.

Chart 5.4 (a)



(Banking Sector) in 2006. NCBs' and DFIs' non-performing portfolio is still high after adjustment of actual provision and interest suspense, whereas FCBs have exces provision on their classified loans.

5.14 Chart 5.5 displays the amounts in NPLs of the 4 types of banks since 1999 through 2006. Amount of NPLs of the NCBs decreased from Taka 128.9 billion in 1999 to Taka 115.0 billion in 2006 and the ratio had also declined. The PCBs also recorded a total decrease of Taka 1.6 billion in their NPL accounts, which stood at Taka 43.7 billion in 2006 as against Taka 45.3 billion in 1999. The amount of NPLs of the DFIs decreased to Taka 41.4 billion in 2006 from Taka 63.3 billion in 1999. The decline in NPL ratios in the recent years can be attributed partly to some progress in recovery of long outstanding loans and partly to write-off of loans classified as 'bad' or 'loss'.

Loan Loss Provisioning of the Banks

5.15 The Table 5.4 shows the aggregate amounts of NPLs of all banks, amounts of provision required to be maintained and the amounts actually provided by the banks from 1999 to 2006.

5.16 Table 5.4 and Chart 5.6 depict that in aggregate, the banks have been continuously failing to maintain the required level of provisions against their NPLs. During the years from 1999 through 2006, the banks could maintain 60.5 percent of the required provision in 2001; which declined thereafter to 49.9 percent in 2006. The main reasons for the continuous shortfall in provision adequacy is the inability of the NCBs and some of the PCBs including those in problem bank category to make sufficient provisions due to inadequate profits and also transferred provision for write-off. Notably the FCBs are much better in that they have been able to make adequate provisions in the recent years. A comparative position as of end 2005 and 2006 is shown in Table 5.5.

Chart 5.5

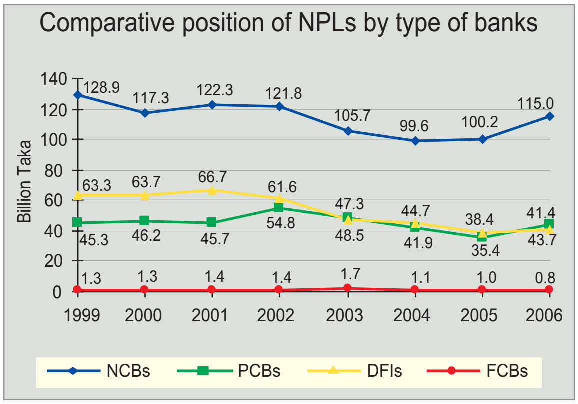


Table 5.4 Required provision and provision maintained - all banks

(billion Taka)

All banks	1999	2000	2001	2002	2003	2004	2005	2006
Amount of NPLs	238.8	228.5	236.0	238.6	203.2	187.3	175.1	200.1
Required provision	100.2	98.4	101.6	106.8	92.5	87.8	88.3	106.1
Provision maintained	51.5	58.1	61.4	59.6	37.3	35.9	42.6	52.9
Excess(+)/ shortfall(-)	-48.7	-40.3	-40.2	-47.2	-55.2	-51.9	-45.7	-53.2
Provision maintenance ratio	51.4%	59.1%	60.5%	55.8%	40.3%	40.9%	48.2%	49.9%

Chart 5.6

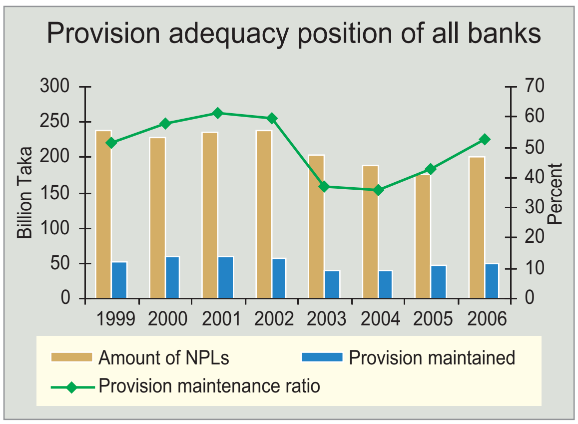


Table 5.5 Comparative position of provision adequacy

(billion Taka)

Year	Items	NCBs	DFIs	PCBs	FCBs
2005	Required provision	52.8	13.4	20.5	1.6
	Provision maintained	13.2	9.3	17.8	2.2
	Provision maintenance ratio	25.0%	69.4%	86.8%	137.5%
2006	Required provision	61.6	14.8	27.5	2.2
	Provision maintained	18.2	9.1	22.6	3.1
	Provision maintenance ratio	229.5%	61.5%	82.2%	140.9%

5.17 Out of 30 PCBs, 28 PCBs could make adequate provisions, other 2 failed to maintain adequate provision due to their poor assets portfolio and earning level.

Weighted Average Deposit and Lending Rates

5.18 The weighted average deposit rate increased from 5.56% to 6.19% and weighted average lending rate of banks increased from 11.24% to 12.12% during the year 2006. The spread between lending and deposit rate is the measure of intermediation cost of banks, which has increased over time. It was 5.93 percentage points at the end of the year 2006, which increased from 5.68 percentage points in the year 2005.

Weighted average deposit and lending rate along with the spread during 30/06/2001 to 31/12/2006 have been depicted in Table 5.6 and Chart 5.7.

Writing off Bad Debts

5.19 To impede unnecessarily and artificially inflated size of balance sheet, uniform guidelines of write off have been introduced in 2003. The total amount of bad debts written off from June 2003 to June 2007 by the different bank catagories complying policy guideline is shown in Table 5.7. It is revealed from the Table that banks have been able to write off an amount of Taka 13.8 billion bad loans during 1 July 2006 to 30 June 2007.

Management Soundness

5.20 Sound management is the most important pre-requisite for the strength and growth of any financial institution. Since indicators of management quality are primarily specific to individual institution, these cannot be easily aggregated across the sector. In addition, it is difficult to draw any conclusion regarding management soundness on the basis of monetary indicators, as characteristics of a good management are rather qualitative in nature. Nevertheless, the total expenditure to total income, operating expenses to total expenses, earnings and operating expenses per employee, and interest rate spread are generally used to

Table 5.6 Weighted average deposit and lending rates (30/06/2001 - 31/12/2006)

(Percent)

Date	Weighted average		Spread
	Deposit rate	Lending rate	
30/06/01	7.03	13.75	6.72
31/12/01	6.75	13.42	6.67
30/06/02	6.74	13.16	6.42
31/12/02	6.49	13.09	6.60
30/06/03	6.30	12.78	6.48
31/12/03	6.25	12.36	6.11
30/06/04	5.65	11.01	5.36
31/12/04	5.56	10.83	5.27
30/06/05	5.64	10.92	5.28
31/12/05	5.56	11.24	5.68
30/06/06	6.02	11.34	5.32
31/12/06	6.19	12.12	5.93

Chart 5.7

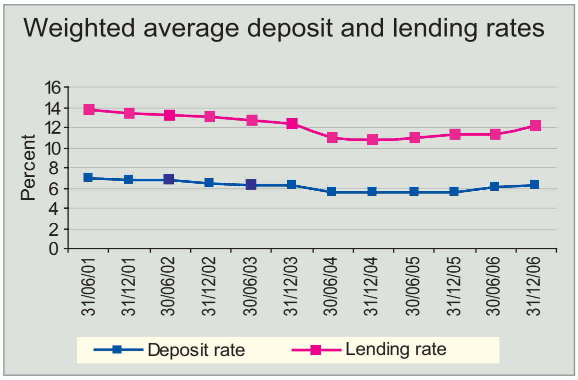


Table 5.7 Writing off bad debts in different bank categories (30/06/2003 - 30/06/2007)

(billion Taka)

Bank types	30/06/03	30/06/04	30/06/05	30/06/06	30/06/07
NCBs	11.4	26.3	29.7	35.7	42.8
DFIs	12.8	17.4	27.6	28.6	30.4
PCBs	12.6	21.2	32.9	40.7	45.5
FCBs	0.5	0.9	1.1	1.5	1.6
Total	**37.3**	**65.8**	**91.3**	**106.5**	**120.3**

Table 5.8 Expenditure-income ratio by type of banks

(Percent)

Bank types	1999	2000	2001	2002	2003	2004	2005	2006
NCBs	100.5	99.4	99.0	98.5	98.8	102.3	101.9	100.0
DFIs	145.2	175.3	89.1	95.9	101.1	104.0	103.9	103.5
PCBs	90.4	90.8	88.1	91.9	93.1	87.1	89.3	90.2
FCBs	67.4	77.7	75.7	78.3	80.3	76.3	70.8	71.1
Total	**96.6**	**99.9**	**91.2**	**93.3**	**93.9**	**90.9**	**92.1**	**91.4**

gauge management soundness. In particular, a high and increasing expenditure to income ratio indicates the operating inefficiency that could be due to flaws in management.

5.21 It transpires from Table 5.8 and Chart 5.8 that expenditure-income (EI) ratio of the DFIs was very high with 145.2 percent in 1999 and 175.3 percent in the year 2000. This was mainly because the DFIs made loan loss provisions by debiting 'loss' in their books. The position however improved after 2000 and the ratio came down to 89.1 percent and 95.9 percent in 2001 and 2002 respectively but again rose to 101.1 percent in 2003 and later on 103.5 in 2006 due to operating loss incurred by BKB & RAKUB. The EI ratio of the NCBs exceeded 100.0 percent in 1999 before falling to below 99.0 percent by end 2003 but again rose to 100.0 percent in 2006 considering provision shortfall. Very high EI ratio of NCBs was mainly attributable to high administrative and overhead expenses; suspension of income against NPLs. EI ratio of PCBs is substantially high due to deduction of provision for loans, other assets and corporate tax from current income.

Earnings and Profitability

5.22 Strong earnings and profitability profile of a bank reflect its ability to support present and future operations. More specifically, this determines the capacity to absorb losses by building an adequate capital base, finance its expansion and pay adequate dividends to its shareholders. Although there are various measures of earning and profitability, the best and widely used indicator is returns on assets (ROA), which is supplemented by return on equity (ROE) and net interest margin (NIM).

Chart 5.8

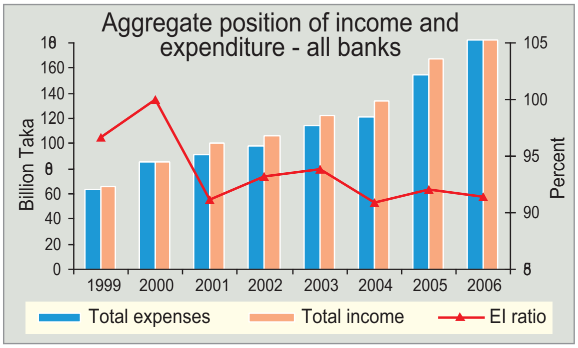
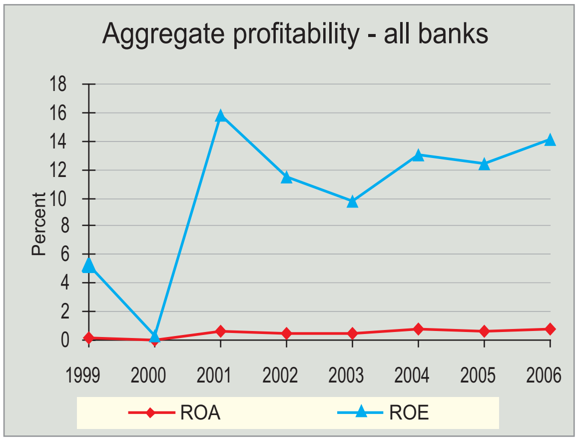


Chart 5.9



5.23 Earnings as measured by return on assets (ROA) and return on equity (ROE) vary largely within the industry. Table 5.9 shows ROA and ROE by type of banks and Chart 5.9 shows the aggregate position of these two indicators for all banks. Analysis of these indicators reveals that the ROA of the NCBs have been almost zero percent considering huge provision shortfall and that of the DFIs even worse. PCBs had an inconsistent trend but satisfactory and FCBs' return on assets ratio consistently declined from 3.5 percent in 1999 to 2.2 percent in 2006.

Table 5.9 Profitability ratios by type of banks

(Percent)

Bank types	Return on assets (ROA)								Return on equity (ROE)							
	1999	2000	2001	2002	2003	2004	2005	2006	1999	2000	2001	2002	2003	2004	2005	2006
NCBs	0.0	0.1	0.1	0.1	0.1	-0.1	-0.1	0.0	-1.1	1.7	2.4	4.2	3.0	-5.3	-6.9	0.0
DFIs	-1.6	-3.7	0.7	0.3	0.0	-0.2	-0.1	-0.2	-29.4	[illegible]	12.3	5.8	-0.6	-2.1	-2.0	-2.0
PCBs	0.8	0.8	1.1	0.8	0.7	1.2	1.1	1.1	15.3	17.0	20.9	13.6	11.4	19.5	[illegible]	15.2
FCBs	3.5	2.7	2.8	2.4	2.6	3.2	3.1	2.2	41.8	27.3	32.4	21.5	20.4	22.5	[illegible]	21.5
Total	**0.2**	**0.0**	**0.7**	**0.5**	**0.5**	**0.7**	**0.6**	**0.8**	**5.2**	**0.3**	**15.9**	**11.6**	**9.8**	**13.0**	**12.4**	**14.1**

5.24 NCBs return on equity ratio rose from -1.1 percent in 1999 to 3.0 percent in 2003 but considered as zero percent in 2006. In case of DFIs, the ROE sharply rose from -68.01 percent in 2000 to 12.3 percent in 2001 and again declined to -0.6 percent in 2003 and remained worse (-2.0 percent) in 2006. The sharp rise in 2001 was due to booking of net profit amounting to Taka 1.01 billion in 2001 against net loss of Taka 5.2 billion in 2000 by the DFIs. The huge loss of the DFIs in 2000 was mainly due to making of provisions by debiting 'loss' in their books of accounts. In 2006, BKB and RAKUB and the Oriental Bank Limited incurred loss due to their huge operating expenses.

Net Interest Income

5.25 Aggregate net interest income (NII) of the industry has been positive and consistently increased from Taka 7.8 billion in 1999 to Taka 35.3 billion in 2005. However, the NII of the NCBs sharply declined from Taka 3.1 billion in 1999 to a negative amount of Taka 1.2 billion in 2000. The trend continued and the NCBs' interest income in 2001 was less by Taka 1.8 billion than interest expenses, and in 2002 by Taka 1.5 billion, in 2003 by 0.3 billion and in 2004 by 1.1 billion but in 2005 their positive NII was Taka 7.7 billion. The DFIs had a negative NII in 1999, which was reversed in 2000 to Taka 1.0 billion and thereafter was positive in 2001 (Taka 2.7 billion), 2002 (Taka 1.4 billion), 2003 (Taka 1.3 billion), 2004 (Taka 1.8 billion), 2005 (1.0 billion) and 2006 (Taka 1.7 billion).

5.26 In 2006, NCBs were able to increase their net interest income (NII) by reducing their cost of fund. The NII of the PCBs and FCBs has been very high over the period from 1999 through 2006. Overall industry NII shows a consistently upward trend. The trend of NII indicates that the PCBs and the FCBs are charging interests at very high rates on their lending as compared to the interest they are paying to the depositors.

Liquidity

5.27 Commercial banks deposits are at present subject to a statutory liquidity requirement (SLR) of 18 percent inclusive of average 5 percent (at least 4 percent in any day) cash reserve requirement (CRR) on bi-weekly basis. The CRR is to be kept with the Bangladesh Bank and the remainder as qualifying secure assets under the SLR, either in cash or in government securities. SLR for the banks operating under the Islamic Shariah is 10 percent and the specialized banks are exempt from maintaining the SLR. Liquidity indicators measured as percentage of demand and time liabilities (excluding inter-bank items) of the banks indicate that all the banks had excess liquidity.

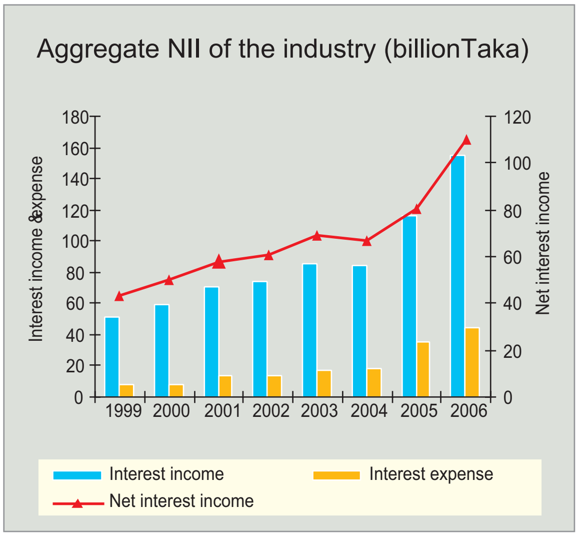
5.28 Table 5.11 and Chart 5.11 show that the FCBs are having the highest liquidity ratios followed by the PCBs. This situation of constant

Table 5.10 Net interest income by type of banks

(billion Taka)

Bank types	1999	2000	2001	2002	2003	2004	2005	2006
NCBs	3.1	-1.2	-1.8	-1.5	-0.3	-1.1	7.7	9.0
DFIs	-0.1	1.0	2.7	1.4	1.3	1.8	1.0	1.7
PCBs	3.0	6.1	9.2	10.2	12.0	13.7	21.0	25.4
FCBs	1.8	2.5	3.3	3.4	3.6	4.2	5.6	8.2
Total	**7.8**	**8.4**	**13.4**	**13.5**	**16.6**	**18.3**	**35.3**	**44.3**

Chart 5.10



surplus of liquidity warrants creation of effective demand for credit at lower costs.

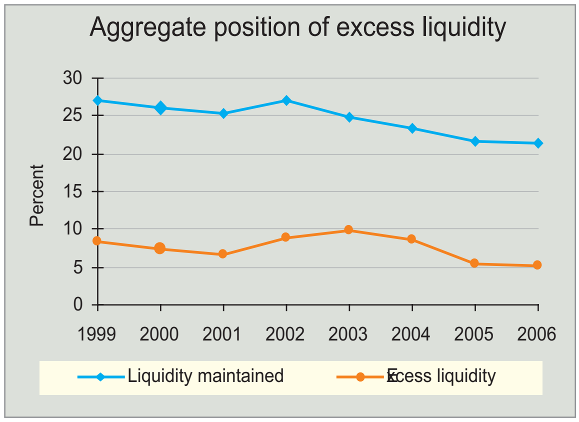
CAMELS Rating

5.29 Performance indicators of the banking industry depict a trend similar to that of the state-owned banks, which is understandable due to their predominant market share. Ratings done on the basis of the various indicators discussed hereinbefore indicate that financial performance of the PCBs and FCBs in general has been better than that of the industry average. However, 1 of the PCBs rated CAMEL 5 are still in the problems bank list out of 7 put in this category in the mid-nineties. Activities of the problem banks are closely monitored by the central bank with special guidance and care. Up to 2005, 6 such banks were taken off the problem bank list because of improved performance. Newly 3 banks were included in the problem bank list for their distressed financial position. At present 3 banks are in the problem bank list.

5.30 To assess the degree to which a bank might be exposed to adverse financial market conditions, the Bangladesh Bank added a new characteristic named as "Sensitivity to market risk " to what was previously referred to as the CAMEL rating. In particular, BB started placing much emphasis on banks sensitivity to interest rate movement through the introduction of revised CAMELS rating system since 1 July 2006.

5.31 Presently Bangladesh Bank is employing Early Warning System (EWS) of supervision to address the difficulties faced by the banks in any of the areas of CAMELS. Any bank found to have faced difficulty in any areas of operation, is brought under Early Warning category and monitored very closely to help improve its performance. Presently 8 banks are in the EW system.

Chart 5.11



5.32 Bangladesh Bank is also monitoring the NCBs through its off-site supervision tools. Government of Bangladesh (GOB), the owner of those banks also adequately monitors them. At present, the NCBs are experiencing huge capital and provision shortfall, having large amount of classified loans, low earnings and ineffective management. Various restrictions have been imposed by the Bangladesh Bank on the activities of the NCBs to put them on right track of business operation and growth. All the 4 NCBs have been made to sign Memorandum of Understandings (MOUs) with the Bangladesh Bank to improve their performance. Approvals of large loans by the banks are also monitored by the Bangladesh Bank on monthly basis to detect the irregularities.

Table 5.11 Liquidity ratio by type of banks

(Percent)

Bank types	Liquid assets								Excess liquidity							
	1999	2000	2001	2002	2003	2004	2005	1998	1999	2000	2001	2002	2003	2004	2005	2006
NCBs	25.2	26.5	25.7	27.3	24.4	22.8	20.0	4.4	5.2	6.5	5.7	7.3	8.4	6.8	2.0	2.1
DFIs	15.7	16.2	15.3	13.7	12.0	11.2	11.2	9.2	8.7	9.9	8.9	6.9	5.8	4.7	6.2	3.8
PCBs	25.9	24.8	24.2	26.3	24.4	23.1	21.0	6.7	8.0	6.8	6.2	8.5	9.8	8.8	5.1	5.6
FCBs	51.3	34.7	34.1	41.6	37.8	37.8	41.5	19.9	31.4	14.8	14.3	21.8	21.9	21.9	23.6	16.4
Total	**27.0**	**26.1**	**25.3**	**27.2**	**24.7**	**23.4**	**21.7**	**6.4**	**8.3**	**7.5**	**6.7**	**8.7**	**9.9**	**8.7**	**5.3**	**5.1**

5.33 As of end 2006, CAMELS rating of 3 banks was 1 or Strong; 31 banks were rated 2 or Satisfactory; rating of 7 banks was 3 or Fair; 5 were rated 4 or Marginal and 2 banks got 5 or Unsatisfactory rating. 1 NCB had Unsatisfactory rating and other 3 NCBs had Marginal rating.

Islamic Banking

5.34 Alongside the conventional interest bearing banking system, Bangladesh entered into an Islamic banking system (profit-loss sharing) in 1983. At present, out of 48 banks in Bangladesh, 6 private commercial banks are operating as full-fledged Islamic banks and 10 conventional banks are partially involved in Islamic banking in a total of 21 branches. The Islamic banking industry continued to show strong growth since its inception in 1983 to June 2007 in tandem with the growth in the economy, as reflected by the increased market share of the Islamic banking industry in terms of assets, financing and deposits of the total banking system. The entire picture is given at Table 5.12. Total deposits of the Islamic banks and Islamic banking branches of the conventional banks stood at Taka 286.5 billion at end June 2007. This was 23.6 percent of the deposits of all private commercial banks and 14.3 percent of the deposits of the total banking system at the end of June 2007. Total investment of the Islamic banks and the Islamic banking branches of the conventional banks stood at Taka 265.4 billion at end June 2007. This was 26.9 percent of all private banks and 17.2 percent of the total banking system of the country.

Deposit Insurance Scheme

5.35 A deposit insurance system has been introduced in Bangladesh in August 1984 to act as a safety net (Box 5.2). It aims at minimizing or eliminating the risk of loss of depositors' fund with banks. Deposit Insurance in Bangladesh is now being governed by the Bank Deposit Insurance Act 2000. A Deposit Insurance Trust Fund (DITF) has also been created for providing limited protection (not exceeding Taka 1.0 lac) to a small depositor in case of winding up of any bank. The Board of Directors of the Bangladesh Bank is the Trustee Board for DITF. The DITF is now being administered and managed under the guidance of the Trustee Board. Bangladesh Bank is now a member of International Association of Deposit Insurers (IADI). As at December 2006, the total assets of the DITF stood at Taka 5.1 billion, which were invested in the Government Securities. Revised Risk based

Table 5.12 Comparative position of the Islamic banking sector (as at end June 2007)

(in billion Taka)

Particulars	Islamic banks	Islamic banking branches*	Islamic banking sector	Private commercial banks[1]	All banks[2]
1	2	3	4=2+3	5	6
1. Number of banks	6	10	16	30	48
2. Number of branches	330	21	351	1854 (18.9)	6596 (5.3)
3. Number of employees	12109	390	12499	38426* (27.73)	99287** (10.73)
4. Deposits	263.1	23.4	286.5	1214.6 (23.6)	2005.8 (14.3)
5. Investments (credits)	249.6	15.8	265.4	987.7 (26.9)	1541.9 (17.2)
6. Investment/deposit ratio	0.95	0.68	0.93	0.81	0.77
7. Liquidity: excess (+) shortfall (-)	19.2	0.07	19.27	92.4 (20.8)	142.8 (13.5)

Notes: [1] Figures in the parentheses indicate percentage share of the Islamic banking sector to the all private banks.
[2] Figures in the parentheses indicate percentage share of the Islamic banking sector to all banks.
* Those branches of the conventional banks are functioning in line with Islamic Shariah alongwith the traditional banking. **Figures as at end June 2006.
Sources: Research Department, Statistics Department and Department of Off-site Supervision, Bangladesh Bank, and Central Accounts Departments of all Islamic banks and conventional banks having the Islamic banking branches.

Box 5.2

Arrangement for Customer Protection in the Banking Sector and the Role of Deposit Insurance

The resilience of banking institutions and stability of the system are important in safeguarding depositors' interest, and ensuring uninterrupted intermediation process. So, it is essential to take comprehensive measures to protect customers in the banking sector. Under a market-oriented operating environment, it is important to ensure that the necessary infrastructure for customer protection is well in place. The following measures are in place with a view to protecting the interest of the customers of the banking industry in Bangladesh:

(a) Banks are required to establish clear procedures to handle customer complaints;
(b) Better disclosure and transparency standards have been introduced and dissemination to the public at large has been mandated;
(c) Strong regulatory oversight to ensure fair practices by banks;
(d) Establishment of Deposit Insurance Scheme.

Access to appropriate redress mechanisms is key to preserve customers' confidence. Banks have been advised to set up "Complaint Cell" to deal with all sorts of customer complaints. A Division named Foreign Exchange Inspection & Vigilance Division of Bangladesh Bank (BB) is also looking into the complaints. This division is checking the performance, effectiveness and functioning of the complaint cells of the banks and monitoring the status of customer complaints. They are also attending to the individual complaint if it is felt necessary. The bank companies have been asked to disclose more information in their financial statements as per the International Accounting Standards (IAS) with a view to providing the investors, depositors and other stakeholders with transparent and adequate information about the bank. Efforts have been made for strengthening banking companies by enhancing the development of risk management capability, promoting good governance and streamlining the prudential regulations in line with the international norms and best practices. Moreover, BB has introduced a Deposit Insurance Scheme to provide a reasonable level of protection to the depositors on their deposits held with banking institutions.

Role of Deposit Insurance

A Deposit Insurance Scheme (DIS) is designed to minimize or eliminate the risk that the depositors suffer a loss out of placing funds with a bank. The purpose of DIS is to help increase market discipline, reduce moral hazard in the financial sector and provide safety nets at the mininum cost to the public in the event of a bank failure. The direct rationale for deposit insurance is customer protection. The indirect rationale for deposit insurance is that it reduces the risk of a systemic crisis involving, for example, panic withdrawals of deposits from sound banks and breakdown of the payments system. From a global point of view, deposit insurance provides many benefits and, over the long term, appears to be an essential component of a viable modern banking system.

The DIS has been introduced in Bangladesh in August 1984 to act as a safety net. It aims at minimizing or eliminating the risk of loss of depositors' fund with banks. Deposit insurance in Bangladesh is now being governed by the "Bank Deposit Insurance Act 2000". The present coverage of the deposits is Taka one hundred thousand per depositor per bank. In accordance with the provisions of the said Act premium collected from the insured banks and all other receivables are deposited to an account called the "Deposit Insurance Trust Fund (DITF)" account maintained at the Bangladesh Bank. The Board of Directors of the Bangladesh Bank acts as the Trustee Board for the DITF which is now being administered and managed under the guidance of the Trustee Board. Bangladesh Bank is a member of International Association of Deposit Insurers (IADI). As on 30 June 2007 the balance in the DITF account was Taka 5.64 billion including Taka 5.30 billion invested in Treasury Bills/Bonds.

To enhance the effectiveness of market discipline, BB has adopted a system of risk based deposit insurance premium rates applicable for all the banks effective from the half year January-June, 2007. According to new instruction regarding premium rates, the "Problem Banks" are required to pay 0.09 percent and Private Banks other than the Problem Banks and Nationalized Commercial Banks are required to pay 0.07 percent.

The effectiveness of DIS in reducing systemic risk would be increased if the public is well aware of its existence and scope. With this end in view, BB has already advised the banks for bringing Deposit Insurance Scheme into the notice of the public through displaying the same in their display boards.

premium rate was introduced from January 2007. As per new schedule, the banks under Problem Bank category will have to pay 0.09 percent whereas other banks will pay 0.07 percent as premium on their deposits.

LEGAL REFORMS AND PRUDENTIAL REGULATIONS

Credit Ratings of the Banks

5.36 Earlier, it was made mandatory only for the banks to have themselves credit rated to raise capital from capital market through IPO. With a view to safeguarding the interest of the prospective investors, depositors and creditors and also the bank management as a whole for their overall performances it has been made mandatory from January, 2007 for all banks to have themselves credit rated by a Credit Rating Agency. Banks will disclose their credit rating prominently in their published annual and half yearly financial statements.

Capital Adequacy of the Banks

5.37 Banks are required to maintain a ratio of capital to risk weighted assets not less than 9 percent, of which at least 4.5 percent in core capital, with effect from June 2003. With a view to strengthening the capital base of banks and make them prepare for the implementation of Basel-II Accord, it has been decided that banks will be required to maintain Capital to Risk-Weighted Assets ratio 10 percent at the minimum with core capital not less than 5 percent. This requirement will have to be achieved by 31 December 2007. Claims on AAA rated Multilateral Development Banks (MDBs) and Claims guaranteed by, or collateralised by securities issued by AAA rated MDBs are given risk weight @ 20 percent.

Merger/Amalgamation of Banks/Financial Institutions

5.38 A detailed guidelines for merger/ amalgamation of banks and financial institutions has been issued by Bangladesh Bank. Under the policies, a bank may be merged with another bank or a financial institution with other financial institutions/banks.

Issue and Purchase of Banking Instruments

5.39 Banks have been advised to introduce more effective, transparent and extreme internal controlling system to ensure that proper banking norms are meticulously followed by the banks in course of banking transactions related to issue and purchase of the banking Instruments (pay order, TT, DD etc.).

Reconstruction of The Oriental Bank Limited

5.40 The Oriental Bank Limited had been suffering from a huge shortfall of capital and provision, large amount of adversely classified loans, inefficient management and acute liquidity crisis which had adversely affected the interest of the depositors and therefore Bangladesh Bank superseded the Board of Directors and dismissed the Chief Executive Officer of the Oriental Bank Ltd. on 19 June 2006 and appointed a high official of the Bangladesh Bank to execute the power and responsibility of the Board of Directors and the Chief Executive Officer of the bank. In the interest of public and depositors, ensuring proper management and maintaining public confidence on the banking system, the Government of the People's Republic of Bangladesh has made an order of moratorium under Section 77(2) of the Banking Companies Act, 1991 for a period of 6 (six) months with effect from 25 January 2007 on some business activities of The Oriental Bank Limited. Framing a scheme for the reconstruction of The Oriental Bank Limited in terms of Section 77(4) of the Banking Companies Act, 1991 is under process.

Cash Reserve Requirements (CRR) of Scheduled Banks with Bangladesh Bank

5.41 In pursuance of the objectives of monetary policy, the amount of CRR of scheduled banks has been increased to 5 percent from 4.5 percent of their total demand and time liabilities effective from 1 October 2005 and remained unchanged thereafter. However, banks are allowed to maintain CRR at the rate of 5 percent daily on bi-weekly average basis subject to the condition that the amount of CRR so maintained should not be less than 4 percent in any day.

Statutory Liquidity Requirement (SLR) of Scheduled Banks

5.42 The Statutory Liquidity Requirement (SLR) for the scheduled banks, excepting banks operating under the Islamic shariah and the specialized banks, was re-fixed 18 percent from 16 percent on 8 November 2003 and remained unchanged thereafter. The SLR for the Islamic banks remained unchanged at 10.0 percent. The specialized banks continued to remain exempted from the SLR.

Interest Rate Policy

5.43 Under the Financial Sector Reform Programme, banks are free to charge/fix their deposit and lending rate other than export credit. At present, loans at reduced rates (7 percent) are provided for all sorts of export credit since January 2004. At present, banks can differentiate interest rate up to 3 percent considering comparative risk elements involved among borrowers in same lending category. With progressive deregulation of interest rates, banks have been advised to announce the mid-rate of the limit (if any) for different sectors and the banks may change interest 1.5 percent more or less than the announced mid-rate on the basis of the comparative credit risk.

Bank Rate

5.44 The Bank Rate has been revised downward from 6 percent to 5 percent on 6 November 2003 and remained unchanged thereafter.

NCB Reforms Programme

5.45 To minimize the losses and improving the financial stability and efficiency of the NCBs, the GOB has adopted a strategy to implement a broader banking sector reform, which includes; (i) the privatization of Rupali Bank Ltd; (ii) corporatization of Agrani, Sonali and Janata Banks (Box 5.3). As part of this process, remarkable efforts as mentioned below have been made with a view to increasing efficiency, achieving financial solvency and developing management & service standard for the nationalized banks:

- MOU between Bangladesh Bank and NCBs have been signed for monitoring the overall functions of the four NCBs.
- Internationally affiliated four local Audit firms have been appointed to verify asset quality of the Banks and Audit firms have completed the audit. In the mean time, draft Model Memorandum and Articles of Association for corporatization of three NCBs (Sonali, Janata & Agrani) have been approved. The said banks had been instructed to finalize the draft Memorandum and Articles of Association by 22/04/2007 and submit application to the register of the joint stock companies & firms for registration. Register of the Joint Stock Companies & Firms has completed registration function for the said three public limited company and Bangladesh Bank has approved Memorandum and Articles of Association of the three banks and issued banking license in favour of them. Bangladesh Bank also advised those banks to execute vendor agreement for operating banking function as public limited company.
- The decision for privatization of Rupali Bank has been taken and Financial Advisor has been appointed for this purpose. As per law,

Box 5.3

Corporatisation of NCBs and its Significance

Corporatisation means changing the structure of a government or semi-government body so that it operates on business lines, with a mandate to trade profitably and an obligation to account to the Government for its financial performance.

It is well understood that huge shortfall in the capital and provisioning, high volume of Non-Performing Assets, low earnings capacity and problems in the management capability i.e. management inefficiency for the last decade are the main reasons for continuous deterioration in the financial health of the Nationalized Commercial Banks (NCBs). The industry share of NCBs has declined steadily but this sector still commands about 35 percent of all scheduled bank advances in the country as of December 2006. With a view to minimizing the losses and improving the soundness and efficiency of the banking sector by divesting the ownership of the NCBs, the Government of the People's Republic of Bangladesh (GOB) has initiated a project called Enterprise Growth and Bank Modernisation Project (EGBMP). The modus operandi of this project is to bring a fundamental change of the NCBs' existing governance arrangements through the implementation of the eventual resolution plan. Under the project, the privatization of Rupali Bank is at the final stage now, and the GOB has decided to corporatise the other 3 NCBs (Agrani, Janata and Sonali Bank). Through this initiative, the Council of Advisors to the Caretaker Government in February 2007 gave its seal of approval to the draft Memorandum and Articles of Association(MAA) of the said 3 banks. Earlier, Bangladesh Bank had drafted MAA for the NCBs. Meanwhile, there has been a remarkable development in the issue and Agrani and Janata Bank have been incorporated as Public Limited Company (Agrani Bank Limited, Janata Bank Limited) by the Registrar of Joint Stock Companies & Firms in May 2007 and Sonali Bank has been incorporated as Sonali Bank Limited in June 2007. The NCBs applied to the BB for license enabling them to carry on banking business under the Banking Companies Act, 1991 and under the name they were operating banking business. Accordingly, Bangladesh Bank has issued licenses under article 31(1) and 31(2) of Banking Companies Act 1991 in favour of Agrani Bank Limited, Janata Bank Limited and Sonali Bank Limited on 30 May, 31 May and 5 June 2007 respectively to operate banking business. To complete the corporatisation, a Vendor's Agreement is under process with the newly licensed banks as per clause (i) of Article 27A of Bangladesh Banks (Nationalization) Order, 1972, to transfer/vest the entire assets, liabilities and capital of the NCBs to the new banks. The Government, though retaining government ownership for now, will not interfere in these banks' day to day activities and instead they will be more accountable to the central bank. This change may facilitate in reducing impaired assets in the NCBs and thus positively contribute to the soundness and stability of the banking sector.

After corporatisation of the NCBs, all the commercial banks are expected to have a level playing field with uniform regulatory framework. With the corporatisation, the Board of Directors (BODs) will have the responsibility to ensure that the bank is operated on a prudent and commercial basis and the MDs/CEOs who will be appointed by the BODs with prior approval of BB along-with the Board must adhere to all prudential requirements.

It reveals from the above that corporatisation is the blessings for the NCBs where Efficient Management, Accountability & Transparency, Professionalism and uniform regulation under Effective Supervision must be ensured.

Privatization Commission (PC) has been involved in the process of privatization. Financial Advisor has drafted an Information Memorandum (IM) for Rupali Bank and "Fit & Proper Test for pre-qualification of strategic investors" which was approved by the GOB. An expression of interest was invited by the Privatization Commission and seven entities were short listed. After evaluation, the tender of the HRH Prince Bandar Bin Mohammed Bin Abdulrahman Al-Saud was accepted by the GOB and currently Sale and Purchase Agreement (SPA) is being negotiated.

Basel II and Plan for its Implementation in Bangladesh

5.46 The G-10 countries have agreed to implement the Basel II in 2006 while non G-10 countries will take three more years starting from 2007. Keeping in view the global response towards Basel II, the Bangladesh Bank has decided in principle to adopt Basel II in Bangladesh. With a view to ensuring migration to Basel II in a non-disruptive manner, Bangladesh Bank has adopted a consultative approach. A high level National Steering Committee comprising of senior officials from banking industry, Bangladesh Bank, and Chartered Accountant firms has been constituted. Furthermore, a Coordination Committee and a Basel-II Implementation Cell have been established. The Bangladesh Bank intends to implement the new accord in early 2009. The Steering Committee is now working on preparation of a roadmap for implementation of the same. The Coordination Committee is assisting the steering committee for preparing such roadmap, consideration is being given on the existing capacity of banks and their financial position to meet the additional capital requirement.

The Basel-II Implementation Cell has completed a self-audit on compliance with Basel Core Principles for Effective Banking Supervision which shows that in 2006, BB has achieved 9 compliant and 14 largely compliant status out of 25 Basel Core Principles for effective banking supervision as against 1 Compliant and 1 largely compliant in 2002. The BB has conducted a Quantitative Impact Study (QIS) with a view to assessing awareness and preparedness of the banks regarding Basel II implementation. It is to mention that all scheduled banks have formed a Basel-II Implementation Unit as instructed by Bangladesh Bank.

Activities of Credit Information Bureau

5.47 In the backdrop of huge non-performing loan of the banks/financial institutions of the country during the decade of the 1980s, a full-fledge credit Information Bureau (CIB) was set up in 18 August 1992 in Bangladesh Bank under Financial Sector Reform Project (FSRP) of the World Bank. The main objective behind setting up of the Bureau was to minimize the extent of default loan by facilitating the banks and financial institutions with credit reports of the loan applications so that the lending institutions do not encounter any credit risk while extending any lending or rescheduling facility.

5.48 The workload of the Bureau kept on increasing unabated in terms of number of requests, number of borrowers and owners, number of reporting banks/financial institutions as well as number of branches. CIB database consists of detailed information in respect of individual borrowers, owners and guarantors; the total number of which was 13,18,594 (end June 2007) recording an increase of 15.01 percent over the previous period (11,46,437 as of end June 2006). The number of CIB reports supplied during FY07 stood at 5,65,957 as compared to 4,45,756 in the FY06 showing an annual increase by 26.97 percent. As per existing service standard the credit reports are supplied within 5 working days of receiving the request, the volume of which was around 2215 per day during FY07.

5.49 The achievement of Credit Information Bureau in fulfilling its objectives of bringing down the extent of default loan has been found quite remarkable. As per reporting of scheduled banks/financial institutions, the classified loan decreased during FY07. The classified loan decreased to 12.35 percent at end June 2007 compared to 15.70 percent in the preceding year (end June 2006). The percentage of such classified loan was 34.9 percent in December 2000. It may be mentioned that with effect from June 2004 quarter the amount of "Written-off" loan was excluded from both classified and outstanding loans, and after exclusion the percentage of classified loan stood at 12.35 percent as on 30 June 2007.

5.50 In order to ensure prompt collection of credit data from the sources as well as instantaneous delivery of credit report to the users by applying latest computer technology, the CIB started diagnostic analysis of the customer and the central bank with effect from 13 July 2007 under DFID financial assistance programme aimed at implementing on-line services between the Bureau and the lending institutions. The project of implementing on-line connectivity between CIB and the Head Offices of the banks and financial institutions is expected to be completed by the year end June 2008.

Inspection of Banks

5.51 Bangladesh Bank, being the Central Bank of the country, is entrusted with the responsibility to regulate and supervise the banks and financial institutions of the country. Inspection of banking companies is assigned to Bangladesh Bank under section 44 of Bank Company Act 1991. Two departments of the Bank namely Department of Banking Inspection-1 and Department of Banking Inspection-2 are conducting the inspection activities. These two departments conduct on-site inspection on Nationalized Commercial Banks (NCBs), Specialized Banks, Private Commercial Banks (including banks under Islamic shariah), Foreign Banks and other institutions including Investment Corporation of Bangladesh (ICB) and Money Changers. Basically, two types of inspections are conducted namely (i) comprehensive inspection and (ii) special inspection. In comprehensive inspection, overall performance/conditions of the banks such as capital adequacy, asset quality, liquidity, earnings, management competence etc. are evaluated. Based on their performance banks are rated between 1-5 grades in ascending order. Inspection is done according to the Annual Inspection Programme (AIP) chalked out by the departments well ahead of the beginning of each calendar year. These departments also monitor implementation of the suggestions/recommendations made in the inspection reports. Special inspections are conducted on the banks on specific/particular issue(s) as well as to investigate complaints received from the depositors, general public or institutions. Moreover, to oversee risk management practice of the banks/ implementation of core risk management guidelines by the banks, systems inspection were also conducted.

5.52 Commercial banks having CAMEL rating between 3-5 are inspected every year. Banks rated 1 or 2 are inspected once in two years. But foreign commercial banks rated 1 or 2 are inspected every year. Branches of scheduled banks covering around 60-70 percent of total loans and advances are normally brought under the comprehensive inspection programme. Inspections of the banks have been conducted based on four reference dates: 31 December, 31 March, 30 June and 30 September instead of only one reference date i.e. 31 December of the previous year. This system has been adopted to enhance the effectiveness of on-site inspection and to reduce the time-gap between on-site and off-site supervision.

5.53 These departments inspected a total number of 1955 branches of bank companies under comprehensive inspection programme during FY07 including 40 head offices, 1915 big and small branches. Under the special inspection programme, a total number of 1798 inspections were carried out regarding money changers, risk-based audits and cash vaults etc. during FY07.

5.54 Foreign Exchange Inspection & Vigilance Division having been separated from its previous affiliation with the Department of Banking Inspection-1 and newly restructured with the incorporation of inspection on Foreign Exchange aspects of banking/financial transactions, commenced functioning from 1 July 2006. Under the purview of this Division, comprehensive and special inspections are conducted on banks, financial institutions and sometimes on different offices which deal in money/foreign exchange. Comprehensive inspection is conducted on the basis of complaints lodged by individuals or complaints published in newspapers or received from any other sources. Since inception, this Division conducted 101 comprehensive inspections under annual inspection programme while 251 special inspections on the basis of different complaints. Apart from these, 164 Money Changer (approved buying and selling house of foreign exchange) firms have been taken under regular inspection programme for the quarter ended on 30 June 2007 by this Division.

Financial Institutions (FIs)

5.55 FIs represent one of the most important segments of financial system and play very important role in mobilizing and channeling resources in Bangladesh. The financial institutions comprise investment and finance companies, leasing companies etc. The Financial Institutions (FIs) numbering 29 as of June 2007 (starting from IPDC in 1981) are regulated by the Financial Institutions Act, 1993 and the regulations made thereunder. In view of their increased role in financing industry, trade and commerce, transport, information technology, housing etc. the minimum capital requirement of the FIs was raised to Taka 0.25 billion vide FID circular 2, dated 29 June 2003. Most of the FIs have raised their required capital. All FIs were asked to raise their capital through IPO (Initial Public Offering) within December 2005 and then the time limit for IPO issue was extended up to June 2007. The amount of paid up capital and reserve of FIs thus increased up to Taka 17.85 billion as of June 2007. FIs are allowed to collect fund from the call money market up to 15 percent of their total net assets for their investment purpose. The financing modes of FIs are long term in nature. Total investment by the FIs up to June 2007 was Taka 91.97 billion, which was 25.75 percent higher than that of the previous year (Taka 73.14 billion as of June 2006). The rate of default in the financial institutions is quite low. As of June 2007, classified loans and leases of the FIs in aggregate were 6.06 percent (1.15 percent after deduction of provision and interest suspense).