Performance, Regulation and Supervision of NBFIs

6.1 Non-bank Financial Institutions (NBFIs) in Bangladesh have been playing a significant role in the financial system of the country. This sector has emerged as an increasingly important segment of the financial system because of the rapidly rising demand for long term financing and equity type services. NBFIs added differentiation to the bank based financial market of Bangladesh. The inevitability of the NBFIs has created a new phase to strengthen the financial system of the country in parallel with the saturated banking industry. Thus, this sector has become a distinct player in maintaining the sound health of our financial and economic sectors. NBFIs in Bangladesh play major role in filling gaps in financial intermediation by providing diversified investment instruments and risk pooling services. NBFIs have achieved impressive growth in recent years reflecting the importance of financial innovation and holding the promise of deepening financial intermediation through satisfying long term financing needs.

Background of NBFIs in Bangladesh

6.2 NBFIs were incorporated in Bangladesh under the then Companies Act, 1913 and were being regulated by the provisions contained in Chapter V of the Bangladesh Bank Order, 1972. Later, to remove the regulatory deficiency and also to define a wide range of activities to be covered by the NBFIs, a new statute titled the 'Financial Institution Act, 1993' was enacted in 1993, followed by the 'Financial Institution Regulation, 1994'. NBFIs have been given license and regulated under the Financial Institution Act, 1993. There are 31 NBFIs licensed under this act. As per the Financial Institution Regulation, 1994, at present, minimum paid up capital for NBFIs is Taka 1.0 billion. So far, twenty one NBFIs raised capital through issuing IPO, while three are exempted from the issuance of IPO. Other major sources of funds of NBFIs are term deposit, credit facility from banks and other NBFIs, call money as well as bond and securitisation. The NBFIs business line is narrow in comparison with banks in Bangladesh. Now a days the NBFIs are working as multi-product financial institutions.

Table 6.1 Structure of NBFIs

	2006	2007	2008	2009	2010	2011	2012*
No. of NBFIs	29	29	29	29	29	30	31
Government- owned	1	1	1	1	1	2	3
Joint-venture	8	8	8	8	8	8	10
Private	20	20	20	20	20	20	18
New branches	10	8	8	8	20	53^{R}	3
Total branches	64	72	80	88	108	161	164

*As on 30 June 2012.
Source: Department of Financial Institutions and Markets, BB.
R= Revised.

NBFIs Sector Performance

Business Growth

6.3 **Outreach:** Presently, out of 31 NBFIs, 3 are government-owned, 10 are joint venture and the rest are locally private-owned NBFIs. Meanwhile, the branch network increased to 164 as on 30 June 2012. There is no NBFI incorporated outside Bangladesh. The structure of NBFIs is shown in Table 6.1.

6.4 **Assets:** The asset base of the NBFIs increased substantially in 2011 and 2012. Aggregate industry assets increased to Taka 288.4 billion in 2011 from Taka 251.5 billion in 2010, showing a growth of 14.7 percent. The growth rate for 2012 will probably be higher than that of 2011. By the end of June 2012 total asset increased to Taka 309.0 billion (Table 6.2 and Chart 6.2).

6.5 **Investment:** NBFIs are investing in different sectors of the economy, but their investments are mostly concentrated in industrial sector. In June 2012, the different sectors in which the NBFIs invested were industry (42.6 percent), real estate (18.5 percent), margin loan (8.0 percent), trade and commerce (10.4 percent), merchant banking (1.4 percent), agriculture sector (1.3 percent) and others (17.8 percent) (Chart 6.1).

6.6 **Liabilities and Equity:** The aggregate liability of the industry in 2011 increased to Taka 235.7 billion from Taka 206.8 billion in 2010 while equity increased to Taka 52.7 billion in 2011 compared to Taka 44.7 billion in 2010 showing an overall increase of 14.0 and 17.9 percent respectively. Total liabilities and equity were Taka 252.2 billion and Taka 56.8 billion respectively at end of June 2012 (Table 6.2).

6.7 **Deposits:** Total deposits of the NBFIs in 2011 rose to Taka 112.6 billion (47.8 percent of total liabilities) from Taka 94.4 billion (45.7 percent of total liabilities) in 2010 showing an overall increase of 19.3 percent. On 30 June 2012 total deposit stood at Taka 124.2 billion (49.2 percent of total liabilities) (Table 6.2).

Performance and Rating of NBFIs

6.8 Performance of this sector has been evaluated through CAMEL rating which involves analysis and evaluation of the five crucial dimensions of NBFIs' operations. The five indicators used in the rating system are

Chart 6.1

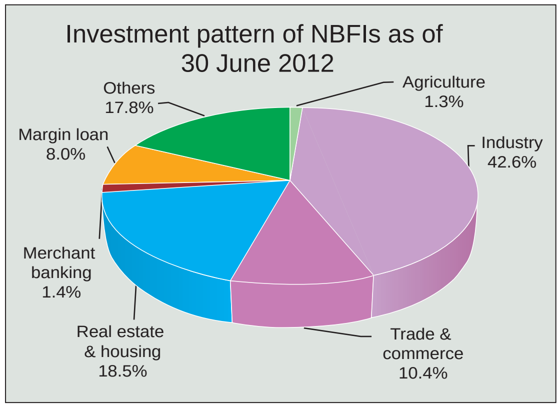


Chart 6.2

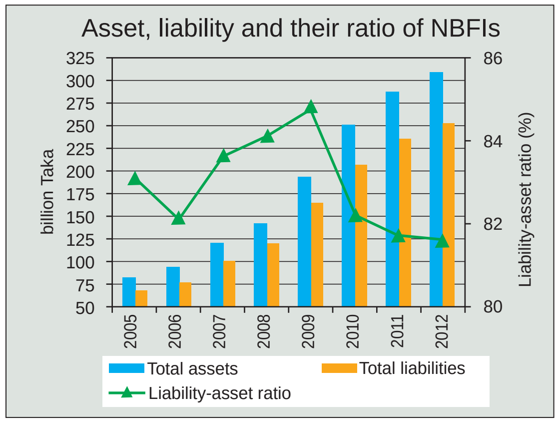


Table 6.2 Assets, liabilities and deposits of NBFIs

(billion Taka)

	2006	2007	2008	2009	2010	2011	2012*
Total assets	94.7	120.6	142.4	193.8	251.5	288.4	309.0
Total liabilities	77.8	100.9	119.8	164.4	206.8	235.7	252.2
Liability-asset ratio	82.2	83.7	84.1	84.8	82.2	81.0	81.6
Total deposit	20.8	26.8	38.3	80.8	94.4	112.6	124.2
Deposit as % of total liabilities	26.7	26.6	32.0	49.1	45.6	47.8	49.2

*As on 30 June 2012.
Source: Department of Financial Institution and Markets, BB.

(i) capital adequacy, (ii) asset quality, (iii) management efficiency, (iv) earnings and (v) liquidity.

Capital Adequacy

6.9 Capital adequacy focuses on the total position of NBFIs' capital and protects the depositors from the potential shocks of losses that a NBFI might incur. It helps absorb major financial risks (credit risk, market risk, interest rate risk, etc.). In 2011 the NBFIs in Bangladesh were instructed under the Basel Accord to maintain a minimum of 10.0 percent Capital Adequacy Ratio (CAR) with at least 5.0 percent in core capital. At the end of December 2011 out of the 29 NBFIs, 18 were rated "1" or Strong, 2 were rated "2" or Satisfactory, 6 were rated "3" or Fair and the rest were "5" or Unsatisfactory in capital adequacy rating in CAMEL rating matrix.

Asset Quality

6.10 The most important indicator intended to identify problems with asset quality in the loan portfolio is the ratio of gross non-performing loans/lease to total loans/lease. At the end of December 2011, this ratio for NBFI was 4.9 percent which was lower than those of the last five years due mainly to proper monitoring.

In the total asset composition of all NBFIs, the concentration of loans, lease and advances was 74.6 percent at the end of December 2011. Out of the 29 NBFIs, 6 were "1" or Strong, 9 were "2" or Satisfactory, 13 were "3" or Fair and the rest was "4" or Marginal in asset quality rating in CAMEL rating matrix.

Management Efficiency

6.11 Sound management is the most important prerequisite for the strength and growth of any NBFI. 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 gauge management efficiency. At the end of December 2011, out of the 29 NBFIs, 2 were "1" or Strong, 15 were "2" or Satisfactory and 11 were "3" or Fair and the rest was "4" or Marginal in Management Capacity rating in CAMEL rating matrix.

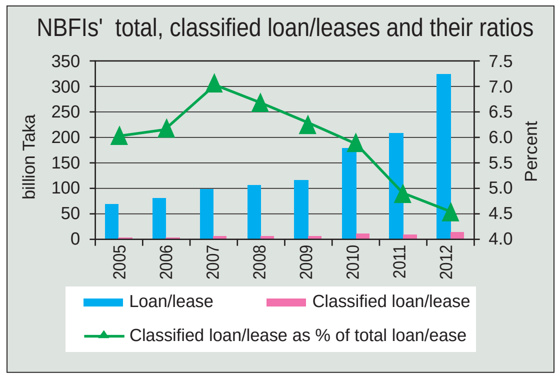
Table 6.3 Total loan/lease and classified loan/leases

(billion Taka)

	2006	2007	2008	2009	2010	2011	2012*
Loan/lease	82.6	99.1	106.4	116.7	178.1	209.7	322.4
Classified loan/lease	5.1	7.0	7.1	7.3	10.5	10.3	14.6
Classified loan/lease as % of total loan/ease	6.2	7.1	6.7	6.3	5.9	4.9	4.5

*As on 30 June 2012.
Source: Department of Financial Institution and Markets, BB.

Chart 6.3



Earnings and Profitability

6.12 Earnings and profitability of an NBFI reflects its efficiency in managing resources and its long term sustainability. These indicators determine the capacity to absorb probable losses by building an adequate capital base; finance its expansion and pay adequate dividends to its shareholders. Among various measures of earnings and profitability, the best and widely used indicator is return on assets (ROA), which is supplemented by return on equity (ROE) and net interest margin (NIM). ROA, ROE and NIM of all the NBFIs in December 2011 were 2.1, 11.7 and 3.4 percent respectively (Table 6.4). In December 2011, the weighted average deposit and lending rates of the NBFIs were 12.54 and 13.38 percent respectively. As of December 2011, out of the 29 NBFIs, 4 were

"1" or Strong, 16 were "2" or Satisfactory and 7 were "3" or Fair and 2 were "4" or Marginal in earning ability rating in CAMEL rating matrix.

Liquidity

6.13 The NBFIs are allowed to mobilise term deposit only. At present term liabilities are subject to a Statutory Liquidity Requirement (SLR) of 5.0 percent inclusive of average 2.5 percent (at least 2.0 percent in each day) cash reserve ratio (CRR) on bi-weekly basis. The SLR for the NBFIs operating without taking term deposit is 2.5 percent. The Infrastructure Development Company Limited (IDCOL) established by the Government of Bangladesh is exempted from maintaining the SLR. At end December 2011, out of the 29 NBFIs, 4 were "1" or Strong, 7 were "2" or Satisfactory and 16 were "3" or Fair and 2 were "4" or Marginal in liquidity position rating in CAMEL rating matrix.

Composite CAMEL Rating

6.14 As of December 2011, out of the 29 NBFIs, the composite CAMEL rating (C=capital adequacy, A=asset quality, M=management capacity, E=earning ability and L=liquidity position) of 2 NBFIs were "1" or Strong, 16 were "2" or Satisfactory, 10 were "3" or Fair and the rest was "4" or Marginal. On the other hand, in December 2010, out of the 29 NBFIs, the composite CAMEL rating of 14 NBFIs were "2" or Satisfactory and the rest of the 15 NBFIs' rating were "3" or Fair. The CAMEL rating of the entire industry improved compared to the previous year.

Investment in Shares by NBFIs

6.15 The NBFIs are allowed to invest in the capital market to the extent as indicated in the Financial Institutions Act, 1993. At the end of December 2011, all NBFIs' share in total investment was Taka 19.7 billion (of which investment in listed companies' share were 8.1 billion) compared to Taka 16.9 billion in December 2010. Investment in share comprises 4.3 percent of total asset of all NBFIs.

Table 6.4 Profitability of NBFIs

	2006	2007	2008	2009	2010	2011	2012*
Return on equity (ROE)	12.4	13.8	12.9	20.9	24.4	11.70	8.9
Return on asset (ROA)	2.2	2.3	2.1	3.2	4.3	2.14	1.64

*As on 30 June 2012.
Source: Department of Financial Institutions and Markets, BB.

Bond and Securitisation

6.16 The bond market in Bangladesh is at it's earlier stage. There are very few players operating in this market with limited number of instruments. NBFIs play a significant role for the development of bond market through issuing Zero Coupon Bond and Asset-backed Securitised Bond. By taking NOC from the Department of Financial Institutions and Markets (DFIM), they have issued Taka 8.5 billion worth of Zero Coupon Bond and Taka 1.7 billion worth of Asset-backed Securitised Bond as of December 2011.

Legal Reform and Prudential Regulations

6.17 As part of the ongoing efforts to improve the financial strength of the NBFIs and to bring about greater transparency in their operations, several policy and regulatory measures were initiated in FY11.

Corporate Governance in NBFIs

6.18 Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a company is directed, administered or controlled. Authority, responsibility and functions of the Board of Directors, Committees, Management and Chief Executive Officer of the NBFIs are clearly stated in different circulars issued by the BB. The duties and responsibilities of the Audit Committee on Internal Control, Financial

Report, Internal Audit, External Audit, Compliance of Existing rules and regulations; Organogram of Audit Committee, eligibility of a member and procedures/rules for arranging meetings have been mentioned in the DFIM Circular (No-13, dated 26 October 2011). The number of Directors in the Board should be between 9 -11. The Board sets and approves the Vision/Mission, Annual Strategic Planning, Key Performance Indicators, Core Risk Management Guidelines etc. The Chief Executive Officer is responsible for conducting day to day functions and materialisation of the Strategic Business Plan.

Asset Classification and Provisioning

6.19 The NBFIs are required to maintain provision on probable loss of loan, advance, lease, investments on an aging analysis. Aging analysis of overdue loan/lease classes them as Standards, Special Mention Accounts, Sub-standards, Doubtful and Bad/Losses. The provision requirements are set at 1, 5, 20, 50 and 100 percent for the above classes respectively. At the end of December 2011, the industry as a whole was able to maintain adequate provision except for one. As on December 2011 total outstanding loan/lease was Taka 209.7 billion of which NPL was Taka 10.3 billion (i.e. 4.9 percent). The share of NPL in total outstanding loan/lease declined from 5.9 percent in December 2010 to 4.9 percent in December 2011, i.e. the condition of the industry improved over the year.

Loan Rescheduling Policy

6.20 Rescheduling of loan/lease is under the policy of receipt of down payment. The required down payments for the 1st, 2nd and 3rd rescheduling are 15, 30 and 50 percent of overdue or 10, 20 and 30 percent of outstanding, whichever is lower.

Schedule of Charges

6.21 BB has rationalised the charges of some services to ensure the interest of depositors/investors/customers and advised all NBFIs to display the complete schedule of charges in suitable visible places in their branches and head offices and upload the same in their respective websites for the convenience of the customers. BB monitors this issue and the NBFIs are required to submit semi-annual statement in this regard. No charge/commission like commitment fee, supervision fee and cheque dishonour fee will be charged.

Corporate Social Responsibility (CSR)

6.22 For the purpose of monitoring CSR adoption and CSR performance, NBFIs are advised to submit statement on CSR focusing on gender equality on a half yearly basis.

Core Risk Management

6.23 Guidelines on four core risk areas, namely, Credit Risk Management, Internal Control and Compliance, Asset Liability Management and Information and Communication Technology Management for the NBFIs have been issued. The NBFIs have also developed their customised guidelines on these risk areas keeping the stated guidelines as minimum requirements.

Environmental Risk Management (ERM)

6.24 The concept of Environmental Governance is now a very important phenomenon. Bangladesh Bank issued a guideline on ERM to streamline solutions for managing the environmental risks in the financial sector for all sorts of financing.

Progress of BASEL Accord Implementation in NBFIs

6.25 Basel-II has been implemented in the NBFIs from 1 January 2012. BB has issued a guideline namely Prudential Guidelines on Capital Adequacy and Market Discipline (CAMD) to cope up with the international best practices and to make the capital of NBFIs more risks based as well as more shock resilient. The instructions regarding Minimum Capital Requirement, Supervisory Review Process and Disclosure Requirement as stated in the CAMD guidelines have to be followed by all the NBFIs as statutory compliance. As a part of the consultative approach in this regard, a high-level Steering Committee (SC) headed by a Deputy Governor of BB was formed comprising the NBFIs' Chief Executive Officers for working on the policy decisions. Furthermore, there is a Working Group (WG) headed by an Executive Director of BB to assist the SC in decision-making. A Basel Implementation Cell (BIC) under the DFIM has been formed to assist and carry out the instructions of SC and WG on Basel Accord implementation.

Stress Testing

6.26 In order to further strengthen the country's financial system, the NBFIs are undergoing the purview of Stress Testing from 2010. They are conducting the exercise on a half-yearly basis. BB monitors the resilience of the NBFIs under different levels of the defined exceptional but plausible shocks. After thorough analysis of the situational requirements and future perspectives BB has revised the guidelines for the NBFIs. A new financial position indicator, Insolvency Ratio (IR), Artificial Intelligence to auto-generate Recommended Action Plan, Rating Scale of 1 to 5, Zonal Positioning (Green, Yellow & Red) through Weighted Average Resilience-Weighted Insolvency Ratio (WAR-WIR) Matrix has been introduced in the revised guideline for the NBFIs. As per the new guideline, the NBFIs carry out stress testing on quarterly basis i.e. on 31 March, 30 June, 30 September and 31 December.

On-site Supervision of NBFIs

6.27 BB is entrusted with the responsibility to regulate and supervise the NBFIs operating in the country. The Department of Banking Inspection-2 (DBI-2) of BB conducts the comprehensive and special inspection on NBFIs. The DBI-2 conducted a total number of 64 comprehensive inspections on NBFIs during FY12 including 26 head offices and 38 branches. Under the special inspection programme, a total number of 10 inspections were carried out during FY12.