Performance, Regulation and Supervision of NBFIs

7.1 Non Bank Financial Institutions (NBFIs) are playing crucial role in the financial sector by providing additional financial services that can not be always provided by the banks. The financial institutions, with more multifaceted products and services, have taken their place in the competitive financial market to satisfy the changing demands of customers. NBFIs also play an important role in the capital market as well as in real estate sector of Bangladesh. Like the banks, most of the NBFIs have separate subsidiaries to operate merchant banking activities. NBFIs are supervised by Bangladesh Bank in a risk-based supervisory system.

7.2 NBFIs have been given license and regulated under the Financial Institution Act, 1993. At present, the minimum paid up capital for NBFIs is Taka 1.0 billion as per the Financial Institution Regulation, 1994. NBFIs' business line is narrow in comparison with Banks in Bangladesh. NBFIs are allowed to take term deposit for three months from 2 December 2013 (DFIM circular no. 09/2013).

7.3 Presently, out of 31 NBFIs, 3 are Government-owned, 10 are joint venture and the rest 18 are locally private-owned. Meanwhile, the branch network increased to 183 as on 30 June 2014. The Structure of NBFIs is shown in Table 7.1.

Table 7.1 Structure of NBFIs

	2008	2009	2010	2011	2012	2013	2014*
No. of NBFIs	29	29	29	31	31	31	31
Government- owned	1	1	1	2	3	3	3
Joint-venture	8	8	8	8	10	10	10
Private	20	20	20	20	18	18	18
New branches	8	20	20	53	8	7	7
Total branches	80	88	108	161	169	176	183

*As on 30 June 2014.
Source: Department of Financial Institutions and Markets, BB.

A. 1. Assets

7.4 The asset of NBFIs have increased substantially in FY14, by 30.7 percent to Taka 436.3 billion in 2013 from Taka 333.9 billion in 2012. At the end of June 2014, total assets stood at Taka 500.6 billion.

7.5 **Investment:** NBFIs are investing in different sectors of the economy, but their Investments are mostly concentrated in industrial sector. The sectoral composition of NBFIs' investment by end of June 2014 is as follows: industry (43.0 percent), real estate (16.9 percent), margin loan (4.4 percent), trade and commerce (15.4 percent), merchant banking (4.5 percent), agriculture (1.4 percent) and others (14.4 percent) (Chart 7.1). As compared with December 2013, no significant change occurred among the sectors except trade & commerce and others. Investment in trade & commerce and others sectors showed a little change of 4.1 percent and 3.2 percent respectively.

7.6 NBFIs are allowed to invest in the capital market to the extent indicated in the Financial Act, 1993. At the end of December 2013, all NBFIs' total investment in capital market was Taka 10.7 billion compared to Taka 14.6 billion in December 2012. Investment in capital market accounts for 2.5 percent of the total assets of all NBFIs.

A. 2. Deposits

7.7 Total deposits of the NBFIs in 2013 rose to Taka 198.3 billion (56.6 percent of total liabilities) from Taka 145.4 billion (53.0 percent of total liabilities) in 2012 showing an overall increase of 36.4 percent. Total deposits further increased to Taka 233.2 billion at the end of June 20014 (Table 7.2).

A. 3. Other Liabilities and Equity

7.8 The aggregate liability of the industry in 2013 increased to Taka 350.4 billion from Taka 274.3 billion in 2012 while equity increased to Taka 85.9 billion compared with Taka 59.6 billion over the same period showing an overall increases by 27.7 percent and 44.1 percent respectively. In June 2014, total liabilities stood at Taka 406.9 billion and equity reached at Taka 93.7 billion.

A. 4. Bond and Securitisation Activity

7.9 The bond market in Bangladesh is yet to be further modernised. There are few players with a limited number of instruments. NBFIs play a significant role for the development of bond market through Issuing Zero Coupon Bonds and Asset-backed Securitised Bonds. By taking a no-objection certificate (NOC) from the Department of Financial Institutions and Markets (DFIM), Taka 1.5 billion non-convertible Zero Coupon Bonds have been issued by a financial institution (IDLC Finance Limited) as of June 2014.

Chart 7.1 Investment pattern of NBFIs as of 30 June 2014

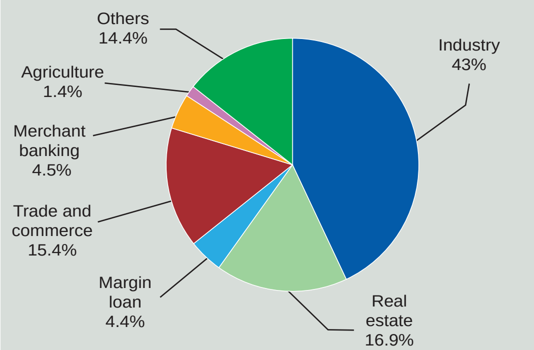


Chart 7.2 Assets, liabilities and their ratios of NBFIs

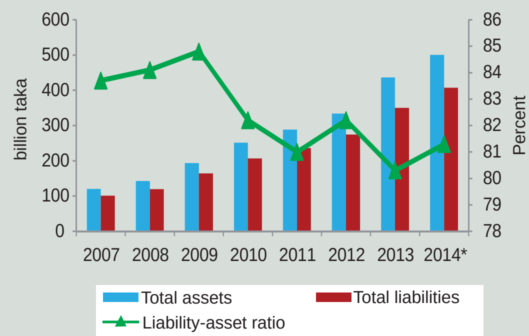


Table 7.2 Assets, liabilities and deposits of NBFIs

(billion Taka)

	2008	2009	2010	2011	2012	2013	2014*
Total assets	142.4	193.8	251.5	288.4	333.9	436.3	500.6
Total liabilities	119.8	164.4	206.8	235.7	274.3	350.4	406.9
Liabilities-assets ratio	84.1	84.8	82.2	81.0	82.2	80.3	81.3
Total deposit	38.3	80.8	94.4	112.6	145.4	198.3	233.2
Deposit as % of total liabilities	32.0	49.2	45.7	47.8	53.0	56.6	57.3

*As on 30 June 2014.
Source: Department of Financial Institutions and Markets, BB.

B. Performance and Rating of NBFIs

7.10 Like banks, the performance of NBFIs is also evaluated through the CAMELS rating which involves analysis and evaluation of the six crucial dimensions of NBFIs operations. The six indicators used in the rating system are (i) capital adequacy, (ii) asset quality, (iii) management efficiency, (iv) earnings (v) liquidity and (vi) sensitivity to market risk.

B. 1. Capital Adequacy

7.11 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.). NBFIs in Bangladesh have been instructed under the Basel Accord to maintain Capital Adequacy Ratio (CAR) of not less than 10.0 percent with at least 5.0 percent in core capital. At the end of June 2014, out of 30 NBFIs (excluding the newest one), 28 financial institutions are maintaining CAR at the desired level. At the end of December 2013, out of 30 NBFIs (the remaining 1 company is yet to come under this rating), 1 is "1 or Strong", 17 are "2 or Satisfactory", 10 are "3 or Fair" and the remaining 2 are "4 or Marginal" in the capital adequacy component of the CAMELS rating matrix.

B. 2. Asset Quality

7.12 The most important indicator intended to identify problems with asset quality in the loan portfolio is the ratio of gross non-performing loan/lease to total loan/lease. At the end of June 2014, the ratio for NBFIs is 5.4 percent and it was highest (7.1 percent) in 2007. In the total asset composition of all NBFIs, the concentration of loans, lease and advances is 72.2 percent. At the end of December 2013, out of 30 NBFIs (the remaining 1 company is yet to come under this rating), 4 are "2 or Satisfactory", 18 are "3 or Fair" and the remaining 8 are "4 or Marginal" in the asset quality component of the CAMELS rating matrix.

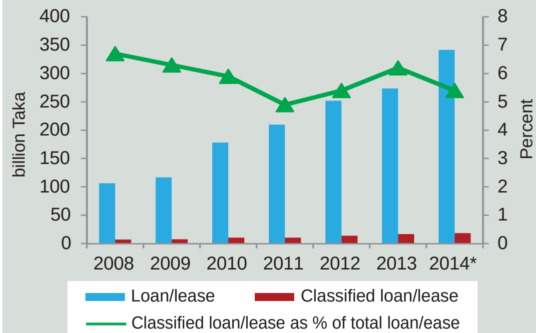
Table 7.3 Total loan/lease and classified loan/lease

(billion Taka)

	2008	2009	2010	2011	2012	2013	2014*
Loan/lease	106.4	116.7	178.1	209.7	252.1	273.6	341.7
Classified loan/lease	7.1	7.3	10.5	10.3	13.7	16.8	18.5
Classified loan/llease as % of total loan/lease	6.7	6.3	5.9	4.9	5.4	6.2	5.4

*As on 3o June, 2014
Source: Department of Financial Institutions and Markets, BB.

Chart 7.3 NBFIs total, classified loan/lease and their ratios



* As on 30 June 2014

B. 3. Management Efficiency

7.13 Sound management is the most important prerequisite for the 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 2013, out of 30 NBFIs (the remaining 1 company is yet to come under this rating), 1 is "1 or Strong", 15 are "2 or Satisfactory", 10 are "3 or Fair" and the remaining 4 are "4 or Marginal" in the Management Capacity component of the CAMELS rating matrix.

B. 4. Earnings and Profitability

7.14 Earnings and profitability of an NBFI reflects its efficiency in managing resources and its long term sustainability. Among various measures of earnings and profitability, the best and widely used indicator is the return on assets (ROA) which is supplemented by return on equity (ROE). ROA and ROE of all the NBFIs in December 2013 were 1.5 and 7.5 respectively. As of December 2013, out of 30 NBFIs (the remaining 1 company is yet to come under this rating), 2 are "1 or Strong", 11 are "2 or Satisfactory", 16 are "3 or Fair" and the remaining 1 is "4 or Marginal" in the earnings and profitability component of the CAMELS rating matrix.

Liquidity

7.15 NBFIs are allowed to mobilise term deposit only. At present, term liabilities are subject to a statutory liquidity requirement (SLR) of 5 percent inclusive of average 2.5 percent (at least 2 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 the end of December 2013, out of 30 NBFIs (the remaining 1 company is yet to come under this rating), 16 are "2 or Satisfactory", 12 are "3 or Fair" and 2 is "4 or Marginal" in the liquidity position component of the CAMELS rating matrix.

B. 5. Sensitivity to Market Risk

7.16 The sensitivity to market risk reflects the degree to which changes in interest rates or equity prices can adversely affect an NBFI's asset-liability position, earnings and capital. When evaluating this sensitivity component, consideration should be given to management's ability to identify, measure, and control market risk via the implementation of effective Core Risk Management System. Vulnerability of the NBFI in a stressed situation from either an interest rate or equity price shock (or both) should be taken under consideration to evaluate sensitivity. For many NBFIs, the primary source of market risk arises from non-trading positions and their sensitivity to changes in interest rates. At the end of December 2013, out of 30 NBFIs (the remaining 1 company is yet to come under this rating), 9 are "2 or Satisfactory" and 14 are "3 or Fair", 6 are "4 or Marginal" and the remaining 1 is "5 or Unsatisfactory" in the sensitivity to market risk component of the CAMELS rating matrix.

Table 7.4 Profitability of NBFIs

(percent)

	2007	2008	2009	2010	2011	2012	2013	2014*
Return on equity (ROE)	13.8	12.9	20.9	24.4	11.7	10.4	7.5	7.6
Return on asset (ROA)	2.3	2.1	3.2	4.3	2.1	1.9	1.5	1.4

* As on 30 June 2014.
Source : Department of Financial Institutions and Markets, BB.

B. 6. Composite CAMELS Rating

7.17 As of June 2014, out of 31 NBFIs, the composite CAMELS rating (C=capital adequacy, A=asset quality, M=management capacity, E=earning ability, L=liquidity position and S=Sensitivity to Market) of 16 are "2 or Satisfactory", 13 are "3 or Fair", 1 is "4 or Marginal" and the newly one NBFIs is unrated. On the other hand, in June 2013, out of 30 NBFIs the composite CAMEL rating of 13 was "2 or Satisfactory", 14 was "3 or Fair", and the remaining 3 was "4 or Marginal".

C. Legal Reform and Prudential Regulations

7.18 As part of the ongoing efforts to strengthen the NBFIs through the adoption of policies aimed at both improving the financial strength of NBFIs as well as bringing about greater transparency in their operations, some legal and regulatory policy measures have been continued in FY14.

C. 1. Capital Adequacy and Progress of BASEL Accord Implementation in NBFIs

7.19 Basel-II has been implemented in the NBFIs from 1 January 2012. Prudential Guidelines on Capital Adequacy and Market Discipline (CAMD) has been issued to promote international best practices and to make the capital of NBFIs more risk-based as well as more shock resilient. NBFIs have to follow the guidelines as statutory compliance. In this regard, a high-level Steering Committee (SC) headed by a Deputy Governor of BB comprising NBFIs' Chief Executive Officers was formed for working on policy decisions. Furthermore, a Working Group (WG) headed by an Executive Director of BB has been assisting the SC in decision-making. Basel Implementation Cell (BIC) under DFIM has been formed to assist and carry out the instructions of SC and WG on Basel Accord implementation.

C. 2. Corporate Governance in NBFIs

7.20 BB has taken some policy measures in order to put in place good corporate governance in NBFIs. Authority, responsibility and functions of the Board of Directors, Committees, Management, and Chief Executive Officer of NBFIs are clearly specified by BB. In addition, duties, responsibilities and organogram of the Audit committee, arrangement of the meeting have been defined in DFIM Circular (No-13, dated 26 October 2011). Number of Directors in the Board is 9 to 11. Board sets and approves the vision/mission, annual strategic planning, key performance indicators, core risk management guidelines etc. Chief Executive Officer is responsible to conduct day to day functions and materialisation of the strategic business plan.

C. 3. Asset Classification and Provisioning

7.21 NBFIs are required to maintain provision for expected losses on loans, advances, leases, investments on an aging analysis. Aging analysis of overdue loan/lease classifies them to Standards, Special Mention Accounts, Sub-standards, Doubtful and Bad/Losses, requiring the NBFIs to keep 1, 5, 20, 50 and 100 percent provision respectively. At the end of June 2014, the industry as a whole was able to maintain adequate provision except two institutions. As of June, 2014 the total outstanding of loan/lease was Taka 341.7 billion against which NPL was Taka 18.5 billion : (5.4 percent) which was 5.6 percent in December 2013.

C. 4. Loan Rescheduling Policy

7.22 Rescheduling of loan/lease is allowed under the policy of receipt of down payment. Minimum receipt of a down payment for reschedule is the lower of 15, 30 and 50 percent of overdue or 10, 20, 30 percent of outstanding for 1st, 2nd and thereafter instances of restructuring respectively.

C. 5. Core Risk Management

7.23 Guidelines on five core risk areas, namely, Credit Risk Management, Internal Control and Compliance, Asset-Liability Management, Anti-Money Laundering Risk management and Information and Communication Technology Management on NBFIs have been issued. NBFIs have developed their customised guidelines monitor and minimise these risks in the light of the guideline provided by Bangladesh Bank.

C. 6. Stress Testing

7.24 NBFIs have been conducting stress testing on quarterly basis from 2010. 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 have been included in the revised guideline for NBFIs. As per the new guideline, NBFIs carry out stress testing on quarterly basis i.e. on 31 March, 30 June, 30 September and 31 December. As of December 2013, out of 30 NBFIs 3 are in Green Zone, 19 are in Yellow Zone and the remaining 8 are in the Red Zone. Based on June 2014 among the 30 NBFIs 3 are in Green Zone, 16 are in Yellow Zone and the other 11 are in the Red Zone.

D. Consumer Protection Regulations

D. 1. Schedule of Charges

7.25 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 places in their branches and head offices so that the current and potential clients can easily see them. They are also instructed to post the same information. BB monitors this issue and NBFIs are required to submit semi-annual statements in this regard. No charge/ commission like commitment fee, supervision fee and cheque dishonour fees can be charged.

D. 2. Guidelines on Products and Services of Financial Institutions in Bangladesh

7.26 The financial institutions along with the banks, with their customised products and services have emerged as the competitive financial intermediaries to meet the growing and changing demands of customers.

The "Guidelines on Products and Services of Financial Institutions in Bangladesh" has outline the different characteristics of existing and new products. These guidelines ensures clients' interest as well as provides greater flexibility to financial institutions to cope up with changing environment. This also helps promotion of sound risk management system and bring discipline in launching new products and services.

E. Cost of Funds Index for NBFIs

7.27 NBFIs regularly submitting their monthly statements of base rate and cost of funds to BB as per guideline of Base Rate System for NBFIs published in 2013. On the basis of these statements, BB prepares an aggregate Cost of Funds Index, uploads that in the website of BB and updates the index monthly.

It can be mentioned that base rate is the minimum interest rate at which loan/lease facility can be provided. As there is no specific guideline, the NBFIs determine the interest rate in different ways from their own perspective. Some NBFIs provide loan using floating interest rate. In that case, they impose the rate based on the deviation among their own cost of funds. As a result, their skill and efficiency to manage the liquidity directly affect the clients. Since there is no standard for a reference rate which can be used to determine the floating interest rate for the NBFIs, the Cost of Funds Index is used as an acceptable reference. Base Rate System will facilitate the interest rate determining process and ensure more transparency of accounting and accountability in the NBFIs.

Base Rate System is used in different countries including India, Nepal & Bhutan. In Bangladesh, for the first time, Base Rate System for the NBFIs has been initiated to introduce Cost of Funds Index in this region.