Performance, Regulation and Supervision of NBFIs

6.1 Non Bank Financial Institutions (NBFIs) are, in addition to banks, major financial intermediaries in the Bangladesh economy. They are playing a crucial role in the financial sector by providing additional financial services that are not always provided by the full-fledged banking industry. They have achieved impressive growth in recent years, reflecting the process of financial innovation and holding the promise of deepening financial intermediation in long- term financing needs. 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, adding differentiation to the bank-based financial market of Bangladesh. NBFIs also play a hefty 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 that reflects their important contributions.

A. NBFI Background, Outreach, and Structure in Bangladesh

A. 1. Background and Outreach

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 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 licenses and regulated under the Financial Institution Act, 1993. There are 31 NBFIs licensed under this act. The newest of the NBFIs started operation on 7 March 2012 and another new one is yet to start operation. As per the Financial Institution Regulation, 1994, at present, the minimum paid up capital for NBFIs is Taka 1.0 billion. So far 21 NBFIs have raised capital through issuing IPOs, while three are exempted from the issuance of IPOs. Other major sources of funds of NBFIs are term deposits, credit facilities from banks and other NBFIs, the call money market, as well as bonds and securitisations. The NBFIs' business line is narrow in comparison with banks in Bangladesh, but they are offering some products to a greater extent than banks. NBFIs are working as multi- product financial institutions.

Table 6.1 Structure of NBFIs

	2007	2008	2009	2010	2011	2012	2013*
No. of NBFIs	29	29	29	29	30	31	31
Government- owned	1	1	1	1	2	3	3
Joint-venture	8	8	8	8	8	10	10
Private	20	20	20	20	20	18	18
New branches	8	8	8	20	53	8	1
Total branches	72	80	88	108	161	169	170

*As on 30 June 2013.
Source: Department of Financial Institutions and Markets, BB.

6.3 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 170 as on 30 June 2013. The structure of NBFIs is shown in Table 6.1.

A. 2. Assets

6.4 The asset base increased substantially in FY13. Aggregate industry assets stood at Taka 333.9 billion in 2012 from Taka 288.4 billion in 2011, showing a higher growth of 15.8 percent compared to the previous year. At the end of June 2013, assets stood at Taka 378.5 billion.

6.5 **Investment:** NBFIs are investing in different sectors of the economy, but their investments are mostly concentrated in the industrial sector. In June 2013, NBFIs investment in different sectors are industry (43.8 percent), real estate (16.7 percent), margin loans (5.0 percent), trade and commerce (11.3 percent), merchant banking (4.0 percent), agriculture (1.5 percent) and others (17.7 percent) (Chart 6.1). As compared with December 2012, investment in industry increased by 6.2 percentage points due to a significant rise in investment in power, gas, water and sanitary services. Other investments showed little changes, except housing which decreased by 2.6 percentage points at the end of June 2013.

6.6 NBFIs are allowed to invest in the capital market to the extent indicated in the Financial Institutions Act, 1993. At end-December 2012, all NBFIs share in total investment was Taka 14.6 billion compared to Taka 19.7 billion in December 2011.

Chart 6.1

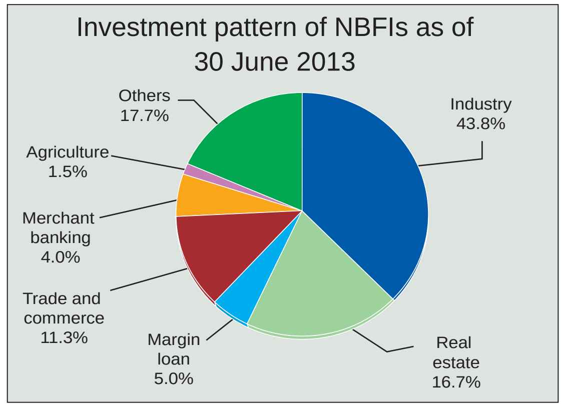


Chart 6.2

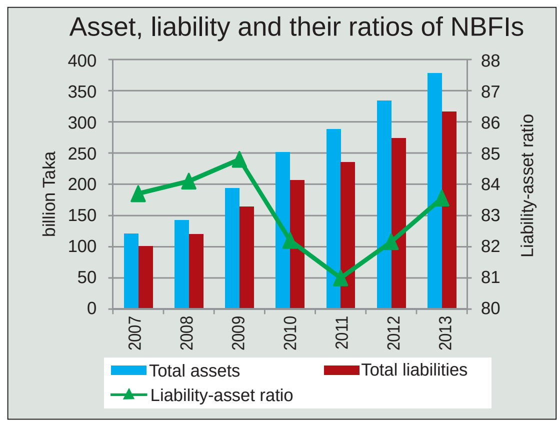


Table 6.2 Assets, liabilities and deposits of NBFIs

(billion Taka)

	2007	2008	2009	2010	2011	2012	2013*
Total assets	120.6	142.4	193.8	251.5	288.4	333.9	378.5
Total liabilities	100.9	119.8	164.4	206.8	235.7	274.3	316.3
Liabilities-assets ratio	83.7	84.1	84.8	82.2	81.0	82.2	83.6
Total deposit	26.8	38.3	80.8	94.4	112.6	145.4	174.0
Deposit as % of Total liabilities	26.6	32.0	49.2	45.7	47.8	53.0	55.0

*As on 30 June 2013.
Source: Department of Financial Institutions and Markets, BB.

Investment in shares comprises 4.4 percent of the total assets of all NBFIs.

A. 3. Deposits

6.7 Total deposits of the NBFIs in 2012 rose to Taka 145.4 billion (53.0 percent of total liabilities) from Taka 112.6 billion (47.8

percent of total liabilities) in 2011, an overall increase of 29.1 percent. Total deposits further increased to Taka 174.0 billion at the end of June 2013 (Table 6.2).

A. 4. Other Liabilities and Equity

6.8 The aggregate liabilities of the industry in 2012 increased to Taka 274.3 billion from Taka 235.7 billion in 2011, while equity increased to Taka 59.6 billion in 2012 compared with Taka 52.7 billion in 2011, showing overall increases of 16.4 percent and 13.1 percent respectively. In June 2013, total liabilities stood at Taka 316.3 billion and equity reached at Taka 62.2 billion.

A. 5. Bond and Securitisation Activity

6.9 The bond market in Bangladesh is at its early stages. There are few players with a limited number of instruments. NBFIs play a significant role in the development of the 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 8.5 billion and Taka 1.7 billion Zero Coupon Bonds and Asset-backed Securitised Bonds have been issued respectively by all the NBFIs as of December 2012. In addition, a NOC has been given to a financial institution to issue Taka 1.5 billion in non-convertible zero coupon bonds which have not yet been issued.

B. Performance and Rating of NBFIs

6.10 As with the banks, the performance of this sector is 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.

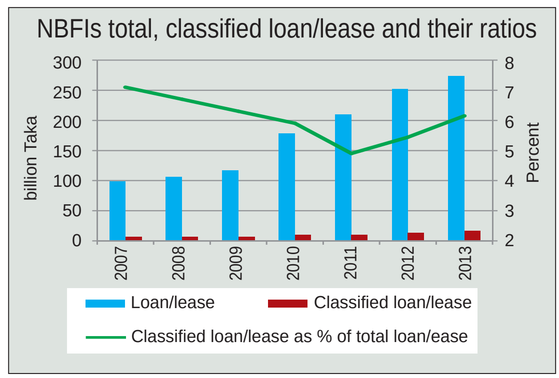
Table 6.3 Total loan/ lease and classified loan/ lease

(billion Taka)

	2007	2008	2009	2010	2011	2012	2013*
Loan/lease	99.1	106.4	116.7	178.1	209.7	252.1	273.6
Classified loan/lease	7.0	7.1	7.3	10.5	10.3	13.7	16.8
Classified loan/lease as % of total loan/lease	7.1	6.7	6.3	5.9	4.9	5.4	6.2

* As on 30 June 2013.
Source: Department of Financial Institutions and Markets, BB.

Chart 6.3



B. 1. Capital Adequacy

6.11 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 a 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 2013, out of 30 NBFIs, 27 financial institutions are maintaining CAR at the desired level. At the end of December 2012, out of 29 NBFIs (the remaining 2 companies had been yet to come under this rating), 1 is "1 or Strong", 14 are "2 or Satisfactory", 12 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

6.12 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 December 2012, the ratio for NBFI is 5.4 percent and, in recent years, it was highest (7.1 percent) in 2007. In the total asset composition of all NBFIs, the concentration of loans, lease and advances is 75.4 percent. At the end of December 2012, out of 29 NBFIs (the remaining 2 companies are yet to come under this rating), 7 are "2 or Satisfactory", 14 are "3 or Fair" and the remaining 8 are "4 or Marginal" in the asset quality component of the CAMELS rating matrix.

B. 3. Management Efficiency

6.13 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 2012, out of 29 NBFIs (the remaining 2 companies are yet to come under this rating), 14 are "2 or Satisfactory", 11 are "3 or Fair" and the remaining 4 are "4 or Marginal" in Management Capacity component of the CAMELS rating matrix.

Table 6.4 Profitability of NBFIs

	2007	2008	2009	2010	2011	2012	2013*
Return on equity (ROE)	13.8	12.9	20.9	24.4	11.7	10.4	8.1
Return on asset (ROA)	2.3	2.1	3.2	4.3	2.1	1.9	1.5

* As on 30 June 2013.
Source : Department of Financial Institutions and Markets, BB.

B. 4. Earnings and Profitability

6.14 Earnings and profitability of a NBFI reflect 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). ROA and ROE of all the NBFIs in December 2012 were 1.9 and 10.4 percent respectively (Table 6.4). As of December 2012, out of 29 NBFIs, 2 are "1 or Strong", 11 are "2 or Satisfactory" 13 are "3 or Fair" and 3 are "4 or Marginal" in the earnings and profitability component of the CAMELS rating matrix.

Liquidity

6.15 NBFIs are allowed to mobilise term deposits only. At present term liabilities are subject to a Statutory Liquidity Requirement (SLR) of 5 percent inclusive of an 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 deposist 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 2012, out of 29 NBFIs (the remaining 2 companies are yet to come under this rating), 10 are "2 or Satisfactory" 18 are "3 or Fair" and 1 is "4 or Marginal" in the liquidity position component of the CAMELS rating matrix.

B. 5. Sensitivity to Market Risk

6.16 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 systems. Vulnerability of the NBFI in a stressed situation to 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 2012, out of 29 NBFIs (the remaining 2 companies are yet to come under this rating), 7 are "2 or Satisfactory", 15 are "3 or Fair" and the remaining 7 are "4 or Marginal" in the Sensitivity to Market Risk component of the CAMELS rating matrix.

B. 6. Composite CAMELS Rating

6.17 As of June 2013 out of 29 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 Risk) of 13 are "2 or Satisfactory", 14 are "3 or Fair" and the remaining 3 are "4 or Marginal". On the other hand, in December 2011, out of 29 NBFIs the composite CAMEL rating of 2 NBFIs was "1 or Strong", 16 were rated "2 or Satisfactory" 10 were scored "3 or Fair", and the remaining one was "4 or Marginal".

C. Legal Framework and Prudential Regulations

6.18 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, several policy and regulatory measures were initiated in FY13.

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

6.19 Basel-II has been implemented in the NBFIs from 1 January 2012. BB has issued a guideline, Prudential Guidelines on Capital Adequacy and Market Discipline (CAMD), to promote international best practices and to make the capital of NBFIs more risk-based as well as more shock-resilient. The instructions regarding minimum capital requirements, 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 has been formed, comprising NBFIs' chief executive officers, for working on 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 DFIM has been formed to assist and carry out the instructions of SC and WG on the Basel accord implementation.

C. 2. Corporate Governance in NBFIs

6.20 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 NBFIs are clearly stated in different circulars issued from time to time by BB. In addition, duties and responsibilities of the Audit Committee on internal control, financial reporting, internal audit, external audit, compliance of existing rules and regulations, an organogram of the audit committee, eligibility of a member, and arrangements of meetings have been mentioned in the DFIM Circular (No-13, dated 26 October 2011). The allowed number of Directors in the Board is 9 to 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.

C. 3. Asset Classification and Provisioning

6.21 NBFIs are required to maintain provisions for expected losses on loans, advances, leases, and investments on an aging analysis. The aging analysis of overdue loans/leases classifies them to Standard, Special Mention Account, Sub-standard, Doubtful and Bad/Loss, requiring the NBFI to keep a 1, 5, 20, 50 and 100 percent provision respectively. At end of December 2012, the industry as a whole was able to maintain adequate provisions, except one institution. As of December 2012, the total outstanding of loans/leases was Taka 252.1 billion, of which NPL was Taka 13.7 billion (5.4 percent), which was up from 4.9 percent in December 2011.

C. 4. Loan Rescheduling Policy

6.22 Rescheduling of loans/leases is allowed only under the policy of receipt of a down payment. The minimum down payment for rescheduling 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

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 NBFIs have been issued. NBFIs have developed customised guidelines on these risk areas, keeping the stated guidelines as minimum requirements.

C. 6. Stress Testing

6.24 In order to further strengthen the country's financial system, NBFIs are undergoing the purview of Stress Testing from 2010 and thereafter conducting the exercise on a half-yearly basis. BB monitors the resilience of the NBFIs under different levels of defined exceptional but plausible shocks. After a thorough analysis of the situational requirements and future perspectives, BB has revised the guidelines for the NBFIs. A new financial position indicator, the Insolvency Ratio (IR), artificial intelligence to auto-generate a recommended action plan, a rating scale of 1 to 5, and zonal positioning (Green, Yellow & Red) determined by a Weighted Average Resilience-Weighted Insolvency Ratio (WAR-WIR) matrix have been introduced in the revised guideline for NBFIs.

D. Consumer Protection Regulations

D. 1. Schedule of Charges

6.25 BB has rationalised the charges of some services to protect 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 NBFIs are required to submit semi-annual statements in this regard. No charge/commission like commitment fees, supervision fees, and cheque dishonour fees are to be charged.

D. 2. Guidelines on Products and Services of NBFIs in Bangladesh

6.26 In order to deal with complex products it is necessary to review and design the regulatory framework for managing products and services offered by the NBFIs. Keeping this in mind, different aspects of both existing and new products and services are equipped in the new guidelines "Guidelines on Products and Services of NBFIs in Bangladesh". These guidelines will be able to protect clients' interests, about which Bangladesh Bank is constantly concerned. At the same time, these guidelines will provide greater flexibility to NBFIs to cope with changing circumstances. This will also help promote sound risk management system associated with products and services and bring discipline in launching new products and services.

E. Regulations for Socially-Responsible Financing

E. 1. Corporate Social Responsibility (CSR)

6.27 For the purpose of monitoring CSR adoption and CSR performance, NBFIs are advised to submit a statement on CSR, with special emphasis on gender equality performance, on a half-yearly basis.

E. 2. Environmental Risk Management (ERM)

6.28 The concept of Environmental Governance is now a very important phenomenon. BB has issued a Guideline on ERM to streamline solutions for managing the environmental risks in the financial sector. ERM is an important consideration for all sorts of financing.