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Non-Bank Financial Institutions in Bangladesh: An Analytical Review

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Non-Bank Financial Institutions in Bangladesh: An Analytical Review

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and

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Abstract

Non-Bank Financial Institutions (NBFIs) in Bangladesh are gaining increased popularity in recent times. Though the major business of most NBFIs is leasing some are also diversifying into other lines of business like term lending, housing finance, merchant banking, equity financing and venture capital financing. The purpose of this paper is to highlight different features of NBFIs, their contribution to the overall economy and the product base of NBFIs. The paper also describes the performance of NBFIs as measured by different financial indicators, along with the effects of banks' entry into the non-bank financing area. Special emphasis has been given to identify the challenges faced by NBFIs in Bangladesh. And finally, development of NBFIs as well as their role in strengthening the financial system of Bangladesh has been discussed. It is found that despite several constraints, the industry as a whole is performing reasonably well. Given appropriate support, NBFIs will be able to play a more significant role in financial intermediation.

Key Words: Banks, Non-Bank Financial Institutions, Financial Intermediation

JEL Classification: G21, G23, G29

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1. Introduction

Non-Bank Financial Institutions (NBFIs) play a significant role in meeting the diverse financial needs of various sectors of an economy and thus contribute to the economic development of the country as well as to the deepening of the country's financial system. According to Goldsmith (1969), financial development in a country starts with the development of banking institutions. As the development process proceeds, NBFIs become prominent alongside the banking sector. Both can play significant roles in influencing and mobilizing savings for investment. Their involvement in the process generally makes them competitors as they try to cater to the same needs. However, they are also complementary to each other as each can develop its own niche, and thus may venture into an area where the other may not, which ultimately strengthens the financial mobility of both.

In relatively advanced economies there are different types of non-bank financial institutions namely insurance companies, finance companies, investment banks and those dealing with pension and mutual funds, though financial innovation is blurring the distinction between different institutions. In some countries financial institutions have adopted both banking and non-banking financial service packages to meet the changing requirements of the customers. In the Bangladesh context, NBFIs are those institutions that are licensed and controlled by the Financial Institutions Act of 1993 (FIA '93). NBFIs give loans and advances for industry, commerce, agriculture, housing and real estate, carry on underwriting or acquisition business or the investment and re-investment in shares, stocks, bonds, debentures or debenture stock or securities issued by the government or any local authority; carry on the business of hire purchase transactions including leasing of machinery or equipment, and use their capital to invest in companies.

The importance of NBFIs can be emphasized from the structure of the financial system. In the financial system of Bangladesh, commercial banks have emerged in a dominant role in mobilizing funds and using these resources for investment. Due to their structural limitations and rigidity of different regulations, banks could not expand their operations in all expected areas and were confined to a relatively limited sphere of financial services. Moreover, their efforts to meet long term financing with short term resources may result in asset-liability mismatch, which can create pressure on their financial base. They also could not broaden their operational horizon appreciably by offering new and innovative financial products. These drawbacks led to the emergence of NBFIs in Bangladesh for supporting industrialization and economic growth of the country.

The purpose of this paper is to highlight different features of NBFIs, their contribution to the overall economy and product base of NBFIs. The paper also describes the performance of NBFIs measured by different financial indicators, along with the effects of banks' entry into the non-bank financing area. Special emphasis has been given to identify the challenges faced by NBFIs in Bangladesh. Finally, development of NBFIs as well as their role in strengthening the financial system has been discussed. The analyses have been conducted on the basis of the secondary data obtained from different sources like NBFIs, Bangladesh Bank, Leasing Year Book etc.

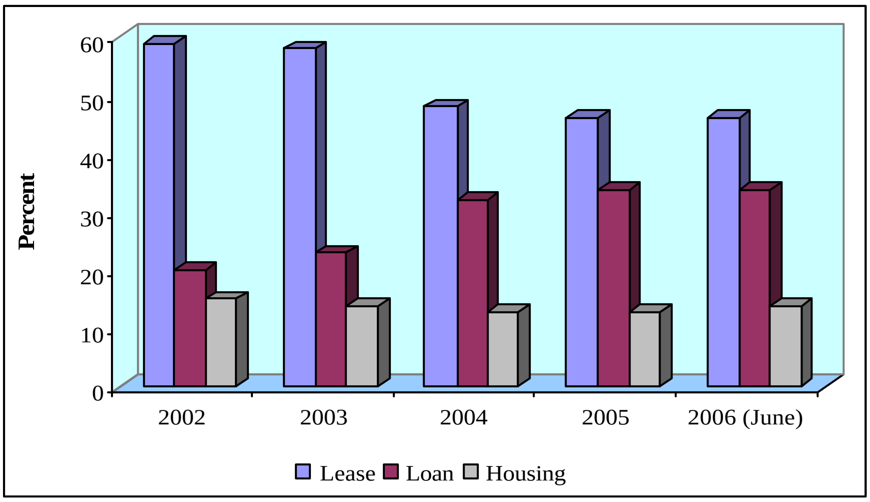
2. Emergence of Non-Bank Financial Institutions in Bangladesh

Initially, NBFIs were incorporated in Bangladesh under the Companies Act, 1913 and were regulated by the provision relating to Non-Banking Institutions as contained in Chapter V of the Bangladesh Bank Order, 1972. But this regulatory framework was not adequate and NBFIs had the scope of carrying out their business in the line of banking. Later, Bangladesh Bank promulgated an order titled 'Non Banking Financial Institutions Order, 1989' to promote better regulation and also to remove the ambiguity relating to the permissible areas of operation of NBFIs. But the order did not cover the whole range of NBFI activities. It also did not mention anything about the statutory liquidity requirement to be maintained with the central bank. To remove the regulatory deficiency and also to define a wide range of activities to be covered by NBFIs, a new act titled 'Financial Institution Act, 1993' was enacted in 1993 (Barai et al. 1999). Industrial Promotion and Development Company (IPDC) was the first private sector NBFI in Bangladesh, which started its operation in 1981. Since then the number has been increasing and in December 2006 it reached 29.[1] Of these, one is government owned, 15 are local (private) and the other 13 are established under joint venture with foreign participation.

3. Recent Development and Activities of NBFIs

The major business of most NBFIs in Bangladesh is leasing, though some are also diversifying into other lines of business like term lending, housing finance, merchant banking, equity financing, venture capital financing etc. Lease financing, term lending and housing finance constituted 94 percent of the total financing activities of all NBFIs up to June 2006. A break-up of their financing activities reveals that the share of leasing and housing finance in the total investment portfolio of NBFIs has gradually decreased from 59 and 15 percent, respectively, in 2002 to 46 and 14 percent in June 2006. The share of term loans, on the other hand, has increased from 20 percent to 34 percent during the same period implying increased focus on the former. The evolvement of NBFI business activity is observed in Figure 1. It can also be seen from the figure that the portfolio mix of NBFIs has become quite stable from 2004.

Figure 1: Share of Lease, Loan and House Financing in Total Investment (outstanding)

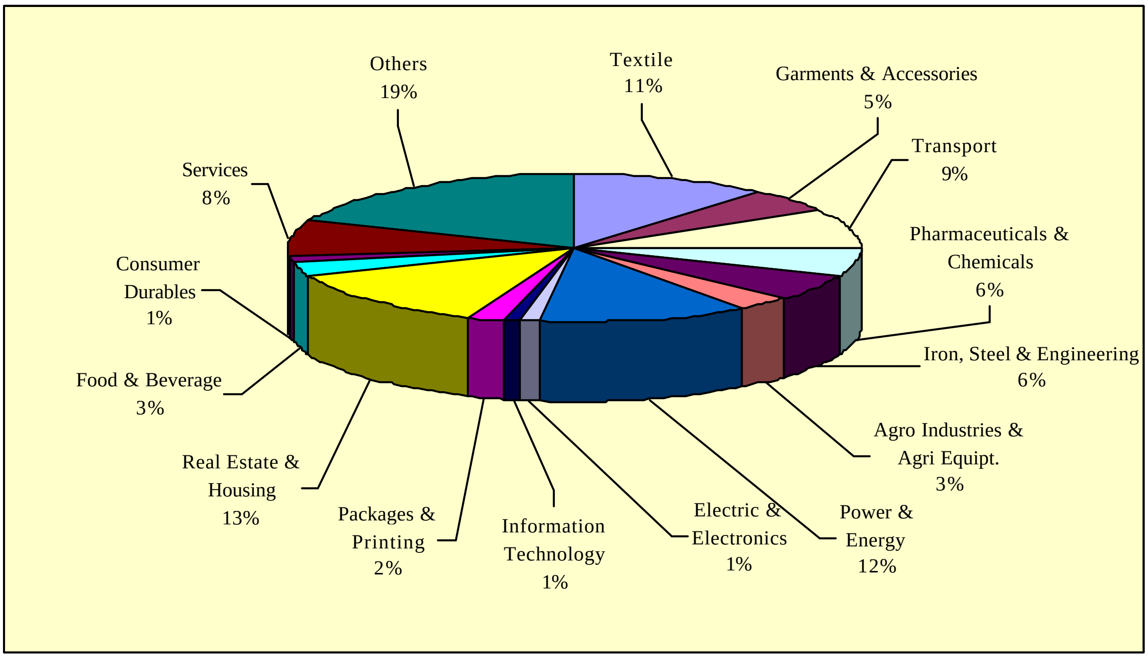


Source: Authors' calculation from data provided by Financial Institution Department, Bangladesh Bank.

[1] A list of NBFIs in Bangladesh is presented in Annexure 1.

NBFIs offer services to various sectors such as textile, chemicals, services, pharmaceuticals, transport, food and beverage, leather products, construction and engineering etc. The percentage of the sector-wise distribution of NBFIs investment in 2005 is given in Figure 2. Although an individual NBFI may have a different portfolio as per its business strategy, the aggregated data shows that NBFIs mainly focus on real estate & housing (13%), power & energy (12%), textile (11%) and transport sector (9%). Service (finance and business) is another area of importance for NBFIs. From the perspective of broad economic sectors, investment in the industrial sector (42%) dominated that in the service sector (33%) in 2005. NBFIs are also exploring other sectors namely 'pharmaceuticals & chemicals', 'iron, steel & engineering', 'garments & accessories', 'food & beverage' and 'agro industries & equipment'. The weight of these sectors is 23 percent of the total portfolio.

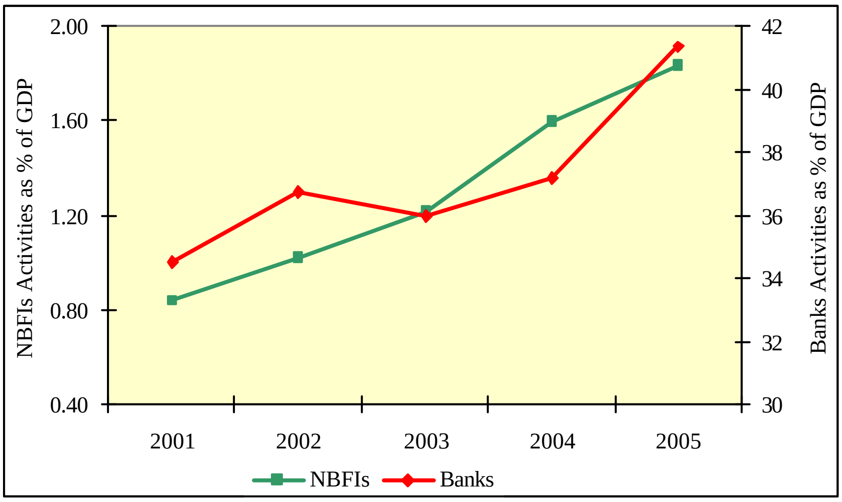
Figure 2: Sector-wise Distribution of Outstanding Investments of 2005



Source: BLFCA Year Book-2005

The contribution of NBFIs' financing activities (lease, loan, housing, investment etc.) to the overall economy persistently increased over the years as can be seen in Figure 3. In 2001, the share of NBFIs' financing to total GDP had been only 0.84 percent, which was more than doubled within 5 years and became 1.83 percent in 2005. The comparative figures for the banking sector were 34.55 and 41.32 percent in 2001 and 2005, respectively. The average yearly growth of NBFIs' contribution to GDP was about 22 percent during this period as compared to 4.7 percent of that by the banking sector. Even in the regional context, performance of NBFI sector is quite robust. As of December 2004, NBFIs contributed 5 percent of the total bank credit as against 3 percent in India, 6 percent in Pakistan and 8 percent in Sri Lanka (Chowdhury, 2005). The share is increasing over the years and reached 5.2 percent in 2005.

Figure 3: Banks and NBFIs Activities as GDP Share



Source: Annual Report, Economic Trends and FID, Bangladesh Bank

4. Products and Services Offered by NBFIs

Non-Bank Financial Institutions play a key role in fulfilling the gap of financial services that are not generally provided by the banking sector. The competition among NBFIs is increasing over the years, which is forcing them to diversify to a wider range of products and services and to provide innovative investment solutions. NBFIs appear to offer flexible options and highly competitive products to help customers meet their operational and financial goals. The table below provides a summary of the product range offered by existing NBFIs of Bangladesh.

Table 1: Different Products and Services of NBFIs

Type of Activity	Key Features	Target Market
Lease Financing		
• Finance/ Capital Lease	Provide a long-term solution that allows customers to free up working capital	Corporate, SMEs, Individual business enterprises.
• Operational Lease	An operational lease entails the client renting an asset over a time period that is substantially less than the asset's economic life. It offers short-term flexibility, which may allow the customer to take advantage of off-balance sheet accounting treatment.	Corporate, SMEs, individual business enterprises.
• Hire Purchase	A hire purchase is an alternative to a lending transaction for the equipment purchase. It is usually employed for retail or individual financing of smaller items, such as consumer products. However, hire purchase option is also suitable for business houses depending on tax practices.	Clients that have an established credit history with the institution can manage the down payment and assume a stake in the leasing agreement.
• Leveraged Leases	Leases generally for large transactions involving three parties: a lessee, a lessor and a funding source. These leases infuse third-party non-recourse debt underwritten by the customer's ability to raise capital in the public and private capital markets for a significant portion of the cost.	Mostly corporate houses

Type of Activity	Key Features	Target Market
• Synthetic Leases	Synthetic lease structure is generally provided for property that retains value over an extended period of time such as aircraft, railroad rolling stock, manufacturing equipment and certain types of real estate.	Mostly corporate houses
• Sale/Leasebacks	Ideal for customers looking to generate liquidity from their existing equipment and reinvest the proceeds back into the business.	Corporate, SMEs, individual business enterprises
Home Loan and Real Estate Financing	House loan and real estate financing is extended for purchase of apartment and house, construction of residential house, purchase of chamber and office space for professionals, purchase of office space and display center, purchase and construction of commercial building, real estate developer for construction of apartment project. Mostly mid to long term in nature.	Individuals, Professionals, & Corporate Bodies
Short Term Loans		
• Factoring of Accounts Receivables	Financing against invoices raised by the supplier after making the delivery successfully. Major Features are Revolving Short Term Facility, Permanent Assignment of Payment, Financing against invoices, Post-delivery Financing	Small and medium size companies having regular supplies to corporate bodies
• Work Order Financing	Finance against the assignment of bill arising out of work orders on a revolving basis. The company shall take assignment of suitable work orders and / or invoices and finance the client against those.	Medium and large clients with continuous flow of work orders from customers
Corporate Finance		
• Bridge Finance	Bridge Finance is a kind of Short Term Finance extended in anticipation of immediate long term financing such as public issue, private placement, loan syndication, lease syndication, loan, lease & debenture.	Company going for an IPO or expecting to avail a long term loan or Working Capital within one year or so.
• Syndication of Large Loans	Making available a large financing for a corporate client. Arrange syndicated financing in the mode of loan, lease, equity, working capital, or any combination thereof. Particularly useful for large projects requiring large scale investment and no single financier wants to take the whole risk. Example: Greenfield project.	Financing new large project; Financing BMRE (Balancing, Modernization, Replacement and Expansion); Refinancing a large project.
• Advisory Services	Advisory services are comprehensive financial, economic and strategic advice to companies for growth, profitability, and sustainability. This includes providing wide range of services, such as corporate counseling, project counseling, capital restructuring, financial engineering, diagnosing financial problems.	All large corporate houses
• Merger and Acquisition	Help find appropriate organization for best possible synergy, conduct valuation of companies and select suitable merger and acquisition methods, negotiate and execute deal beneficial for all the parties involved.	Medium and large corporate bodies
• Securitisation	Securitisation is the issuance of financial instruments backed by assets and/or cash flows. This is one of the modern financial services, which solves specific type of financial needs of business organizations.	All corporate bodies

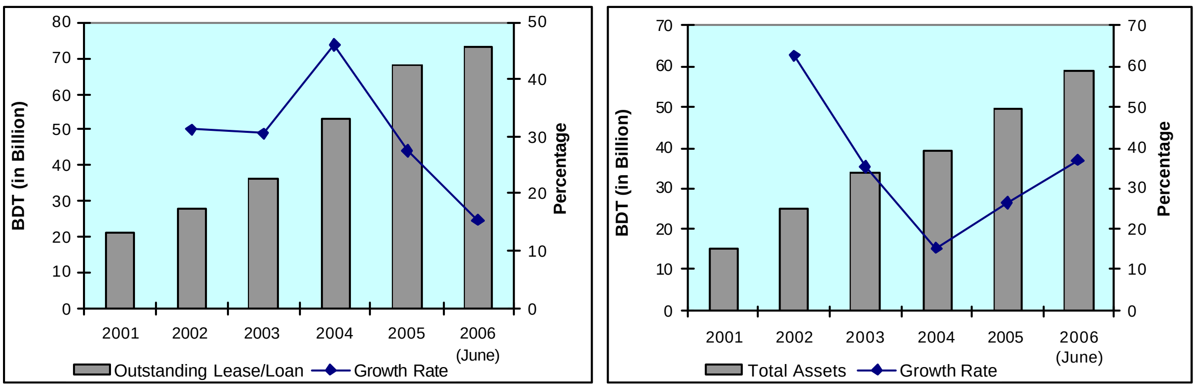
Type of Activity	Key Features	Target Market
Merchant Banking		
• Issue Management	The Issue Management group is capable of devising innovative solution for raising capital – debt e.g. placement of bonds and debentures, and raising equity through private and public placement – from the market suiting the unique needs and constraints of the corporate clients.	All corporate bodies
• Underwriting	Underwriting refers to the guarantee by the underwriters that in the event of under-subscription, the underwriter will take up the under-subscribed amount on pro-rata basis upon payment of price of that option	All corporate bodies
• Portfolio Management	Merchant banks allow small investors to open investor account with merchant banks and provide support for the purchase and sales of shares. Clients shall have absolute discretionary power to make investment decisions.	Individuals, Professionals, & Corporate Bodies
• Corporate Advising	Through corporate advising, the merchant bank helps the issuer analyse its financing needs and suggest various ways to raise needed funds.	All corporate bodies
Securities Services		
• Brokerage Services	Provide services for Trade Execution (Dhaka and Chittagong Stock Exchanges), Pre-IPO private placement, Asset allocation advice, Opportunities for trading in different financial instruments.	All corporate bodies
• CDBL Services as full service Depository Participant (DP)	Apart from the brokerage services, securities services also provide the services like BO (Beneficial Owner) accounts opening and maintenance, Dematerialization, Re-materialization, Transfers and multiple accounts movement, Lending and borrowing etc.	Individuals, Professionals, & Corporate Bodies

Source: Compiled from Khan (2005)

5. Performance Analysis

The growth of NBFIs in terms of assets and liabilities and diversification of business has significantly increased from the time of inception. Figure 4 illustrates NBFIs total outstanding financing, total asset and its growth. Total outstanding financing of NBFIs at the end of June 2006 stood at BDT 7.3 billion, which reflects a 15.50 percent growth (on an annualized basis) over December 2005. Annual

Figure 4: Total Lease & Loan Disbursement, Total Asset of NBFIs and Their Growth



Source: Authors' calculation from data provided by Financial Institution Department, Bangladesh Bank.

average growth from 2002 to 2005 was 33.89 percent. Total asset of the industry reached BDT 59 billion in June 2006 which reflects a growth of 18.47 percent over December 2005. If considered on an annualized basis, this growth is consistent with the annual average growth of 34.91 percent over the last four years. Therefore, it appears that the growth of the industry has been impressive and in a market with considerable competitive pressures from banks and other financial institutions, NBFIs have exhibited significant resilience.

Table 2 shows performance ratios of NBFIs. Current ratio, debt-equity ratio, productivity ratio and return on equity (ROE) of the industry are considered as measures of liquidity, risk coverage, operational efficiency and profitability, respectively. [2]

Table 2: Performance Ratios of NBFIs

Year	Current Ratio	Debt-Equity Ratio	Productivity Ratio	Return on Equity
2002	1.98	1.61	1.34	6.57
2003	1.91	2.20	1.36	10.57
2004	1.81	2.42	1.36	16.37
2005	2.83	2.56	1.30	14.15
2006 (Jan – Jun)	2.66	2.94	-	6.34

Source: Authors' calculation from data provided by the Financial Institution Department, BB

The current ratio of the industry was less than 2 up to 2004 and increased to 2.83 in 2005. During the first six months of 2006 it stood at 2.66. The ratio had values of. The volatility (measured by standard deviation) reduced to 3.72 in 2006 from 6.23 in 2005. This indicates that the industry as a whole is well capable of meeting the current portion of their total liabilities with their current assets. However, the current ratio of individual firms varied from 0.47 to 16.58. Three firms still have current ratios which are less than one and therefore need to concentrate more on their liquidity management.

Risk coverage, measured by debt-equity ratio, is one of the major indicators in measuring the financial stability of NBFIs. The debt-equity ratio of NBFIs gradually increased from 1.61 in 2002 to 2.94 in June 2006. Though the standard deviation was 2.79, debt-equity ratio of individual firms varied from 0.19 to 12.49. This shows that NBFIs are gaining more confidence and steadily generating a greater amount of debt. However the percentage of classified loan of NBFIs has also increased in 2006. Hence NBFIs should monitor the quality of their assets carefully and be more cautious while creating new debt. The productivity ratio of NBFIs hovered around 1.3 from 2002 to 2005 indicating that NBFIs are operating quite efficiently.

Figure 5 compares ROEs of NBFIs and PCBs. Both the curves follow a similar pattern from 2003 with ROEs of NBFIs lying a little lower than their competitors'. This is likely to be due to the higher

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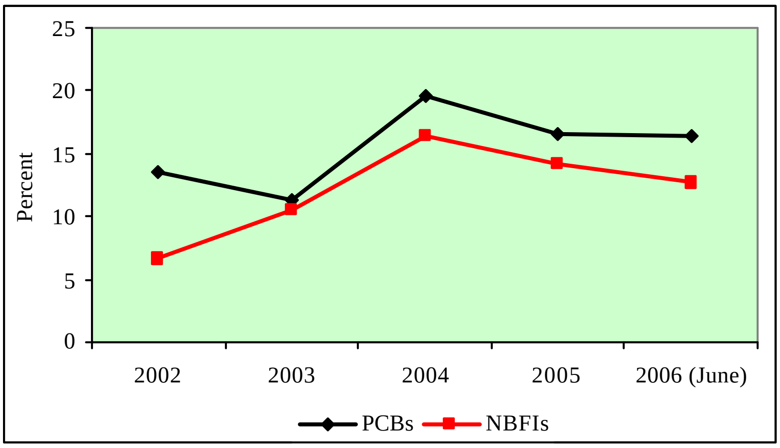
[2] Industry wise ratios are calculated taking weighted averages of the ratios of individual firms in the industry. In calculating the industry average one NBFI company was not considered as it has a very limited debt (close to zero) and therefore the ratios for this firm is far away from the industry average and can be treated as an outlier.
Current Ratio = Current Assets/Current Liabilities. The weight is calculated using current asset.
Debt-Equity Ratio = Total Debt/Shareholder's Equity. The weight is calculated using shareholder's equity.
Productivity Ratio = Operational Revenue/Operational Expense
Return on Equity = Net profit after taxes/Shareholder's Equity. The weight is calculated using shareholder's equity.

cost of funds incurred by NBFIs. Weighted average ROEs of NBFIs stood at 12.68 (on an annualized basis) vis-à-vis 16.48 in case of the PCBs during the first six months of 2006. ROEs of NBFIs varied widely from 3.51 to 32.49 percent although volatility was much lower compared to the previous year. In 2006, six firms had ROEs less than 10 percent and ten firms had ROEs which were greater than 20 percent. Therefore in terms of profitability NBFIs have performed well vis-à-vis PCBs' and stood up to the challenges in a small market having a large number of competitors.

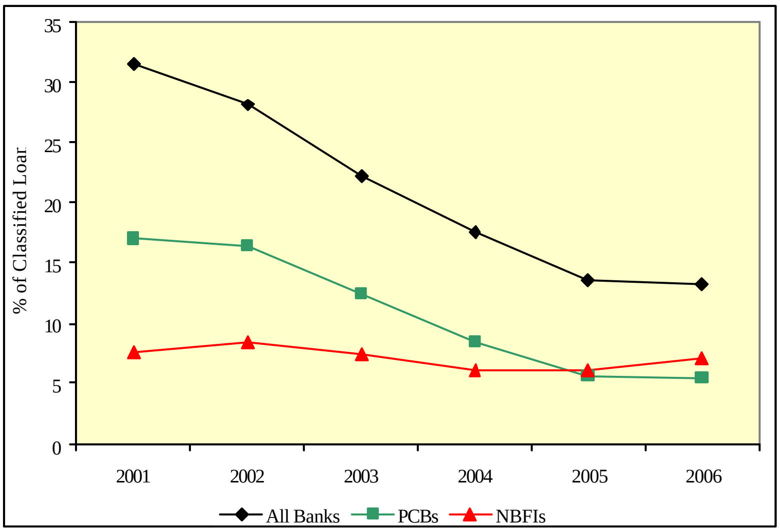
Figure 5: ROEs of NBFIs and PCBs[3]



Source: Authors' calculation from data provided by the FID, BB and Bangladesh Bank Quarterly

The share of classified lease/loan of NBFIs came down from 8.42 percent in 2002 to 6.06 percent in December 2005 but again increased to 7.18 percent in June 2006. Figure 6 shows that classified loans of their major competitors, namely PCBs, also have a similar trend. Classified loans of PCBs had declined from 16.38 percent in 2002 to 5.62 percent in 2005 and 5.98 percent in 2006. It may be noted that though NBFIs form a much newer market segment than PCBs, they have been able to maintain the share of classified loans within a range that is well below that in the banking sector, although the scenario for PCBs has improved significantly in recent years.

Figure 6: Gross NPL to Total Financing of Banks and NBFIs



Source: Annual Report and Financial Institution Department, BB
Note: The figure for NBFIs is upto June 2006

[3] All 2006 figures are on an annualized basis.

6. Banks' Entry in Non-Bank Financial Activity

The activities of NBFIs witnessed an impressive growth during the last five years. As per Section 7 of the Banking Companies Act 1991, commercial banks also started different activities offered by NBFIs, specially leasing. The entry of banks in this sector is expected to brace the growth momentum and will fill the gap in acquiring the institutional finance and serve the needs of the industrial sector in the acquisition of capital assets.

Commercial banks worldwide are directly or indirectly involved in activities such as leasing, hire purchase, term lending, house financing and capital market operation. In developed countries commercial banks are also actively involved in different activities other than banking. In Turkey, banks are empowered to arrange lease finance by virtue of special laws relating to this particular activity. Following the deregulation of the local banking system as well as diversification of business, a number of banks in Taiwan established their own independent leasing companies (Chen 2001). In India, commercial banks are permitted to transact leasing business through subsidiaries. In Bangladesh, commercial banks started their leasing operation effectively in 1995 (Banarjee and Mamun, 2003). At present, almost all major private commercial banks are involved in non-bank financial operations.

Operation by banks in what have been traditional non-banking areas is often questioned by NBFIs although both can act as complementary to each other rather than being competitors. Bangladesh Lease and Finance Companies Association (BLFCA) alleged that commercial banks of the country are engaged in non-bank finance activities within the existing banking rules, which is posing difficulties for non-bank financial institutions.[4] This is because by having access to cheaper rate funds, banks have a comparative advantage over NBFIs that does not ensure proper competition for both. Again, it is argued that if banks continue in the leasing business then the default culture of the banking system may also infect the leasing industry (Choudhury, 2001), though Figure 6 suggests that this has not been the case.

7. Challenging Issues for NBFIs

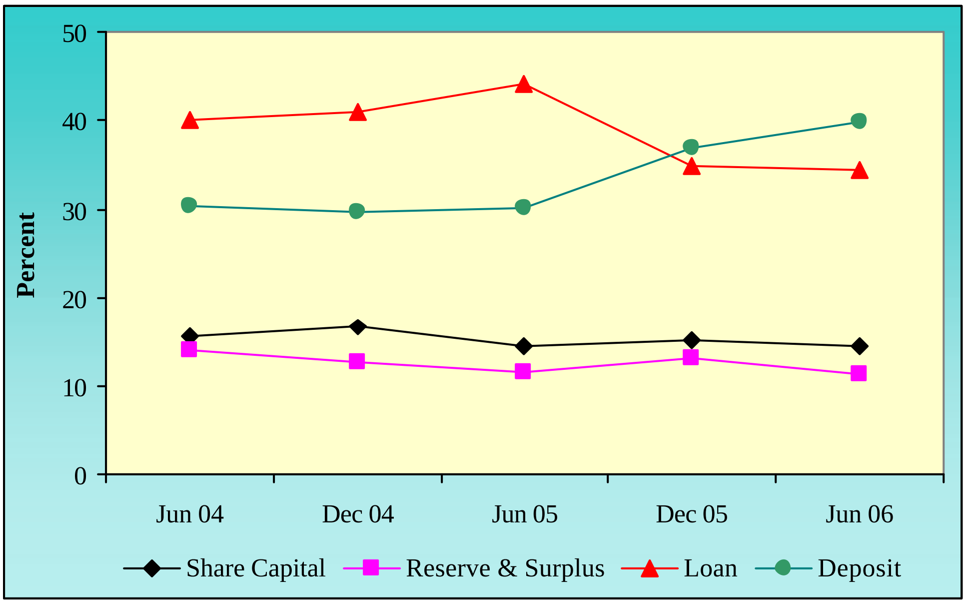
(a) Sources of Funds

NBFIs collect funds from a wide range of sources including financial instruments, loans from banks, financial institutions, insurance companies and international agencies as well as deposits from institutions and the public. Line of credit from banks constitutes the major portion of total funds for NBFIs. Deposit from public is another important source of fund for NBFIs, which has been increasing over the years. NBFIs are allowed to take deposits directly from the public as well as institutions. According to the central bank regulation, NBFIs has the restriction to collect public deposits for less than one year, which creates uneven competition with banks as banks are also exploring the business opportunities created by NBFIs with their lower cost of fund. Although recent reduction of the minimum tenure of the term deposit from one year to six months for institutional investor has had a positive impact on their deposit mobilization capacity. NBFIs can develop attractive term deposit products of different maturities to have access to public deposits as these are one significant source of their funds.

[4] See BLFCA Year Book, 2004

Although share capital is another prospective source of fund for NBFIs, many companies have not utilized this opportunity fully. As all NBFIs are incorporated as public limited companies, it could be a better alternative for them to raise fund through initial public offerings in order to finance the expanding horizon of activities. Figure 7 shows the composition of the sources of fund for NBFIs. It is evident that loan from bank and deposit base are the key sources for NBFIs' fund and account for nearly 75 percent of the total. It can also be seen that the dominance of bank loan in the total fund is decreasing while the importance deposit base is gaining momentum.

Figure 7: Composition of the Sources of Fund for NBFIs



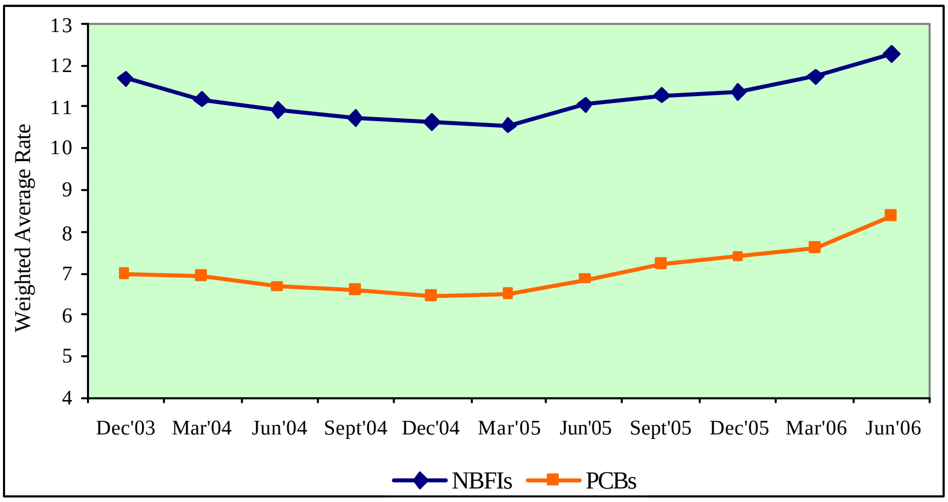
Source: Financial Institution Department (FID), BB

According to a directive of the central bank issued in April '05 (FID Circular No. 3, April 30, 2005), financial institutions have to raise capital and reserve of at least BDT 250 million, a portion of which must be collected through the issuance of IPO. This arrangement will make their operations more transparent, bring accountability to the shareholders and reduce dependence on credit lines. Though all NBFIs were required to raise their minimum capital requirement thorough IPOs by September 2006 (extended from June 2006), eight (8) companies are yet to float their shares in the market. Four of these have already submitted necessary documents to Securities and Exchange Commission (SEC) for review while four others are still in the process of doing so. Total paid-up capital of all NBFIs was BDT 8.45 billion by the end of June 2006.

(b) Cost of Fund

The structure of cost of fund for NBFIs does not follow any unique trend. Banerjee and Mamun (2003) showed that weighted average cost of fund for the leasing companies is always positioned much higher than that of banks. According to their study, cost of funds for leasing companies varied between 8.4 to 15.3 percent while that of banks was between 8.5 to 9.5 percent. Choudhury (2001) mentioned that about 15 percent of the deposit of the banking sector was reported to be demand deposits, which are interest free while 35 percent constituted low cost saving deposits having an average of 4 to 5 percent interest rate and the rest were fixed deposits bearing an average of 9 percent interest rate. Thus the weighted average cost of fund for banks would be at best 7 to 8 percent, which is almost half of that of NBFIs.

Figure 8: Weighted Average Cost of Fund for NBFIs and PCBs



Source: Authors' calculation based on the data from FID and SBS, Bangladesh Bank

Figure 8 shows the weighted average cost of fund for private commercial banks (PCBs) and NBFIs.[5] As stated earlier, the principal sources of fund for NBFIs are loan from banks and deposits from institutions and individuals. But NBFIs face comparative disadvantage in collecting funds compared to the banks because NBFIs cannot collect short term (less than one year) deposits from individuals due to the central bank's restriction, and again deposits in NBFIs are perceived to be less safe to the public. As a result NBFIs have to offer higher rates on deposits, which are sometimes as expensive as bank borrowing. Again, excessive dependence on bank loan and deposit has had an adverse impact on the overall industry. Due to the liquidity crisis, when interest rate goes up, the average rate of interest on bank credit lines and deposit rate also increases, which causes significant rise in the cost of fund for NBFIs. The high cost of fund for NBFIs compels them to operate on a relatively low profit margin.

(c) Asset-Liability Mismatch

Asset-liability mismatch is another cause of concern for NBFIs. Demand for funds to meet the increasing lending requirements has increased many times. But the availability of funds has become inadequate as NBFIs are mostly dependent on loan from commercial banks. International Finance Corporation (1996) observed that leasing companies are in a great dilemma while managing the mismatch between their asset and liability. According to IFC, the average weighted life of the company's business portfolio should be less than the average weighted life of its deposits and borrowing in its operating guidelines for a leasing company. Only one company in Bangladesh was successful in maintaining the above guideline (Banerjee and Mamun (2003)). Therefore, NBFIs have to explore alternative ways for raising funds. Information about the asset-liability mismatch scenario of selected NBFIs is shown in table 3.

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[5] The weighted average deposit interest rate is considered as a proxy for the cost of fund of PCBs. The cost of fund for NBFIs is calculated by considering weights of the different component of NBFIs' fund along with their respective costs.

Table 3: Average weighted life of Assets and Liabilities

Name of the NBFIs	Average weighted life of Deposit and Borrowing (Years)	Average weighted life of the Business Portfolio (Years)
IDLC	2.94	2.84
ULC	3.64	4
PLC	1.92	2.5
BLIL	1.25	1.5
PFIL	3	3
BIFCL	3	3
BFICL	N/A	3

Source: Banerjee and Mamun (2003)

(d) Investment in High Risk Portfolio

It is already mentioned that cost of funds for NBFIs are higher than that of banks. In order to sustain the high cost of borrowing, NBFIs may be inclined to invest in the high return segments, which can expose them to commensurately higher risks. Moreover, fierce competition among competitors may also force many NBFIs to reduce the margin at the expense of quality of the asset portfolio. This strategy may eventually create the possibility of an increase in the non-performing accounts. Unless adequate risk management capabilities are developed, the growth prospects of NBFIs would not only be hindered but it might also be misapprehended (Sarker, 2004).

(e) Product Diversification

NBFIs emerged primarily to fill in the gaps in the supply of financial services which were not generally provided by the banking sector, and also to complement the banking sector in meeting the financing requirements of the evolving economy. With regard to deployment of funds, the total outstanding lease, loan and investment by NBFIs stood over BDT 34 billion, BDT 26 billion and BDT 3 billion respectively by the end of September, 2006. NBFIs are permitted to undertake a wide array of activities and should therefore not confine themselves to a limited number of products only. Leasing, no doubt, presents a good alternative form of term financing. Even in leasing, investments were not always made in the real sector and non-conventional manufacturing sector. Almost all the leasing companies concentrated on equipment leases to BMRE (Balancing, Modernization, Replacement and Expansion) units only. New industrial units were hardly brought under the purview of leasing facilities. This implies that the new customer base has not been created and the growth of industrial entrepreneurship could not be facilitated through NBFI financing packages. Diversifying the product range is a strategic challenge for NBFIs in order to become competitive in the rapidly growing market.

(f) Competition with Banks

With the advent of new NBFIs, the market share is being spread over the competing firms and the demand facing each firm is becoming more elastic. Active participation of commercial banks in the non-bank financing activities has further increased the level of competition in the industry. Leasing was considered as a non-bank financing activity until recently. But a large number of banks has also shown their interest in the leasing business and has already penetrated the market. For banks, public deposit is one major source of funds which they can collect with relatively lower cost. Thus the business environment for NBFIs has become more challenging as they have to face uneven competition with banks in terms of collecting funds.

(g) Lack of Human Resource

Skilled and trained human resource is considered as an important component for the development of any institution. Due to the recent growth of NBFIs, availability of experienced manpower is a challenge for this industry. The supply shortage of efficient resource personnel has been leading to a significant increase in the compensation package, which is also a cause of concern for NBFIs. The industry experts believe that although there exist enormous growth opportunity the market is still quite small and scope of work for skilled personnel is very limited compared to that of banks. This makes the competent personnel to switch from NBFIs to other institutions after a certain period implying low retention rate of skilled human resource.

(h) Weak Legal System

Although the default culture has not yet infected NBFIs to any major extent, they face difficulties in recovering the leased assets in case of a default. Moreover delays in court procedures create another cause of concern. The situation cannot be improved only by making the legal system stronger through enactment of new laws rather ensuring proper implementation existing ones is more of concern.

(i) Lack of a Secondary Market

Even in cases when the defaulted asset is recovered, the disposal of the same becomes difficult because of lack of an established secondary market. For the promotion of a secondary market, NBFIs may consider initiating the concept of operating lease instead of the prevalent mode of finance lease in case of these recovered assets to create a demand for second hand or used machinery and equipment.

8. Suggested Alternatives

(a) Exploring Alternative Sources of Funds

The finance and leasing companies across the world are using different sources for collecting funds. NBFIs in Bangladesh may also explore the possibilities of gaining access to new sources of funds like issuance of commercial paper and discounting or sale of lease receivables. However, in releasing such new products, some regulatory changes have to be made. Another innovative and promising source of funds may be the securitisation of assets.[6] In this connection, IPDC launched first asset backed securities in 2004 as an alternative source of funding. This new instrument emerged as an important tool and added a new dimension in the financial market. The core attraction of this scheme was the

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[6] Securitisation is the process whereby the ownership of a large number of receivables (Leases/Loans) are transferred to a securitisation company to form a pool of such receivables and a trustee to manage the issue of bonds against the receivables. The bonds will be purchased by investors and traded in the secondary market but initially banks, insurance companies and other financial institutions may purchase the instruments. Ultimately the lessee/borrower will pay their dues to the Securitisation Company which will in turn make payment to the investors (Barai et. al., 1999)

tax benefit made available to investors at the rate of 10 percent at the time of credit of such interest or at the time of payment thereof, whichever is earlier, and this deduction was deemed to be final discharge of tax liability (Chowdhury, 2005). But changes in taxation policy in 2005 by the government have made the future of this instrument less attractive for the concerned financial institutions.

(b) Competition and Product Diversification

NBFIs in Bangladesh are operating in a highly competitive environment. The competition for NBFIs is even more challenging as they have to compete with banks. Given the changes in the business environment, the need for product diversification is very important. At present, lease financing constitutes 55 percent of the total long term assets of NBFIs. The remaining part concentrates mainly on term financing and housing finance. Some of NBFIs are primarily engaged in leasing, some are also diversifying into other lines of business like merchant banking, equity financing etc. Currently, 22 NBFIs (out of 29) specialize in lease financing. NBFIs are permitted to undertake a wide array of activities and therefore should not confine themselves to one or two types of product only. Leasing, no doubt, presents a good alternative form of term financing but NBFIs should also venture into diversified use of their funds such as merchant banking, venture capital financing, factoring, etc. for a healthy growth of the capital market.

(c) Enhancing Capital Market Activities

NBFIs around the world carry out a significant role in the development of the capital market. Strong institutional support is necessary for a vibrant capital market which is the core of economic development in any market based economic system. NBFIs through their merchant banking wing can act in this regard. A total of 30 companies are now listed as merchant banks in Bangladesh, of which 23 are full-fledged, 6 are issue managers, and only one is a portfolio manager. Only nine NBFIs have registered with SEC for performing merchant banking activities. But their activities in the capital market are rather limited (*Financial Sector Review*, Bangladesh Bank, 2006). Active participation of merchant banks is essential to accelerate the capital market activities which can expedite the economic growth of the country. The success of merchant banking operations is largely linked to the development of the security market. So NBFIs should concentrate more on their opportunities in the capital market.

(d) Issues of Taxation

The financing mode of lending and leasing are totally different from one another. The concept and procedure particularly the accounting and taxation system are also quite different. So it is advisable not to mix up the two different operations, otherwise it might distort the basic financial norms. As the tax treatment is totally different in leasing business, mixing up of lending and leasing in the same business portfolio might create the possibility of tax evasion (Sarker, 2004).

(e) Market Segmentation

It has been discussed earlier that though banks and NBFIs compete with each other they can also perform complementary functions. As suggested by Jamal (2004) and Sarker (2004), to function as complementary institutions both banks and NBFIs should follow some ethical and technical norms.

Banks wishing to enter in the leasing business, which is essentially a core operation of NBFIs, should do so through opening subsidiaries so that a level playing field for NBFIs can be maintained. This is needed as banks have access to lower cost funds compared to NBFIs, which puts the former in an advantageous position. Alternatively, banks can go for joint financing under syndication arrangements with leasing companies on any project proposal. Again, banks can concentrate on working capital finance and foreign exchange operations, which matches more with their asset-liability management. Long term investment like financing capital machineries can be done by NBFIs and in the event when banks want to engage in such activities they can place their funds with an NBFI to extend lease facility for those machineries. Jamal (2004) mentioned that this is important for two reasons: "first, in case of lease facility, the machineries will remain under the ownership of leasing companies, who will have absolute authority and control on their assets. Second, machineries will be imported in the name of a leasing company and letter of credit will be opened against its name. So, over invoicing or under invoicing may be averted and thereby more transparency will be ensured and tax evasion may be plugged".

9. Conclusion

Banks and Non-Bank Financial Institutions are both key elements of a sound and stable financial system. Banks usually dominate the financial system in most countries because businesses, households and the public sector all rely on the banking system for a wide range of financial products to meet their financial needs. However, by providing additional and alternative financial services, NBFIs have already gained considerable popularity both in developed and developing countries. In one hand these institutions help to facilitate long-term investment and financing, which is often a challenge to the banking sector and on the other, the growth of NBFIs widens the range of products available for individuals and institutions with resources to invest. Through their operation NBFIs can mobilize long-term funds necessary for the development of equity and corporate debt markets, leasing, factoring and venture capital. Another important role which NBFI's play in an economy is to act as a buffer, especially in the moments of economic distress. An efficient NBFI sector also acts as a systemic risk mitigator and contributes to the overall goal of financial stability in the economy.

NBFIs of Bangladesh have already passed more than two and a half decades of operation. Despite several constraints, the industry has performed notably well and their role in the economy should be duly recognized. It is important to view NBFIs as a catalyst for economic growth and to provide necessary support for their development. A long term approach by all concerned for the development of NBFIs is necessary. Given appropriate support, NBFIs will be able to play a more significant role in the economic development of the country.

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Annex 1: The listing of NBFIs (as of December 2006)

	Name of Non-Bank Financial Institution	Year of Commencement
1	Industrial Promotion and Development Company of Bangladesh Ltd (IPDC)	1981
2	Saudi-Bangladesh Industrial and Agricultural Investment Company Ltd (SABINCO)	1984
3	Industrial Development leasing Company of Bangladesh Ltd (IDLC)	1985
4	The UAE Bangladesh Investment Company Ltd	1989
5	United Leasing Company Ltd (ULCL)	1989
6	Phoenix Leasing Company Ltd	1995
7	Uttara Finance and Investment Ltd	1995
8	International Leasing and Financial Services Ltd (ILFSL)	1996
9	GSP Finance Company (Bangladesh) Ltd.	1996
10	Prime Finance and Investment Ltd.	1996
11	Oman Bangladesh Leasing and Investment Company Ltd	1996
12	Bay Leasing and Investment Ltd	1996
13	Peoples Leasing and Financial Services Ltd.	1996
14	First Lease International Ltd	1996
15	Delta BRAC Housing Finance Corporation Ltd (DBH)	1996
16	LankaBangla Finance Ltd.	1997
17	Infrastructure Development Company Ltd (IDCOL)	1997
18	Bangladesh Industrial Finance Company Ltd (BIFC)	1998
19	Union Capital Ltd (UCL)	1998
20	National Housing Finance and Investments Ltd	1998
21	Midas Financing Ltd (MFL)	2000
22	Bangladesh Finance and Industrial Company Ltd (BFIC)	2000
23	Industrial and Infrastructure Development Finance Company Ltd (IIDFCL)	2001
24	Islamic Finance and Investment Ltd (IFIL)	2001
25	Fidelity Assets and Securities Company Ltd	2001
26	Fareast Finance and Investment Ltd	2001
27	Premier Leasing International Ltd	2002
28	Self Employment Finance Ltd	2002
29	Ahsania-Malaysia Hajj Investment and Finance Company Limited	2006