Chapter-5

# Banking Sector Performance, Regulation and Bank Supervision

5.1 Bangladesh Bank (BB) continued to focus on strengthening the financial system and improving functioning of the various segments. The broad parameters of the reforms undertaken during the year comprised ongoing deregulation of the operation of institutions within the BB's regulatory ambit, tightening of prudential regulation and improvement in supervisory oversight, expanding transparency and market disclosure, all with a view to improving overall efficiency and stability of the financial system. The following paragraphs highlight the recent regulatory and supervisory measures initiated by BB for banks and financial institutions and also the industry statistics of the banking sector and the performances trends.

## A. Banking Sector Performance

5.2 The banking sector of Bangladesh comprises of four categories of scheduled banks. These are state-owned commercial banks (SCBs), state-owned development finance institutions (DFIs), private commercial banks (PCBs) and foreign commercial banks (FCBs). The number of banks remained unchanged at 48 in 2007. These banks had a total number of 6717 branches as of December 2007. The number of bank branches increased from 6562 to 6717 owing to opening of new branches by the PCBs during the year. Structure of the banking sector with breakdown by type of banks is shown in Table 5.1.

Table 5.1 Banking system structure

(billion Taka)

| Bank types | 2006 | | | | | | 2007 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Number of banks | Number of branches | Total assets | % of industry assets | Deposits | % of deposits | Number of banks | Number of branches | Total assets | % of industry assets | Deposits | % of deposits |
| SCBs | 4 | 3384 | 786.7 | 32.7 | 654.1 | 35.2 | 4 | 3383 | 917.9 | 33.1 | 699.7 | 32.6 |
| DFIs | 5 | 1354 | 187.2 | 7.8 | 100.2 | 5.4 | 5 | 1359 | 201.7 | 7.3 | 115.6 | 5.4 |
| PCBs | 30 | 1776 | 1147.8 | 47.7 | 955.5 | 51.3 | 30 | 1922 | 1426.6 | 51.4 | 1150.2 | 53.5 |
| FCBs | 09 | 48 | 284.9 | 11.8 | 150.8 | 8.1 | 09 | 53 | 227.7 | 8.2 | 183.4 | 8.5 |
| **Total** | **48** | **6562** | **2406.7** | **100.0** | **1860.6** | **100.0** | **48** | **6717** | **2773.9** | **100.0** | **2148.9** | **100.0** |

5.3 In 2007, the state-owned commercial banks (SCBs) held 33.1 percent of the total industry assets as against 32.7 percent in 2006. PCBs' share rose to 51.4 percent in 2007 as against 47.7 percent in 2006. The foreign commercial banks held 8.2 percent of the industry assets in 2007, showing a declining trend by 3.6 percentage point over the previous year. The DFIs' share of assets was 7.3 percent in 2007 against 7.8 percent in 2006.

5.4 Total deposits of the banks in 2007 increased by 15.5 percent to Taka 2148.9 billion from Taka 1860.6 billion in 2006. The SCBs' (comprising largest 4 banks) share in deposits decreased from 35.2 percent in 2006 to 32.6 percent in 2007. On the other hand, PCBs' deposits in 2007 amounted to Taka 1150.2

Chart 5.1

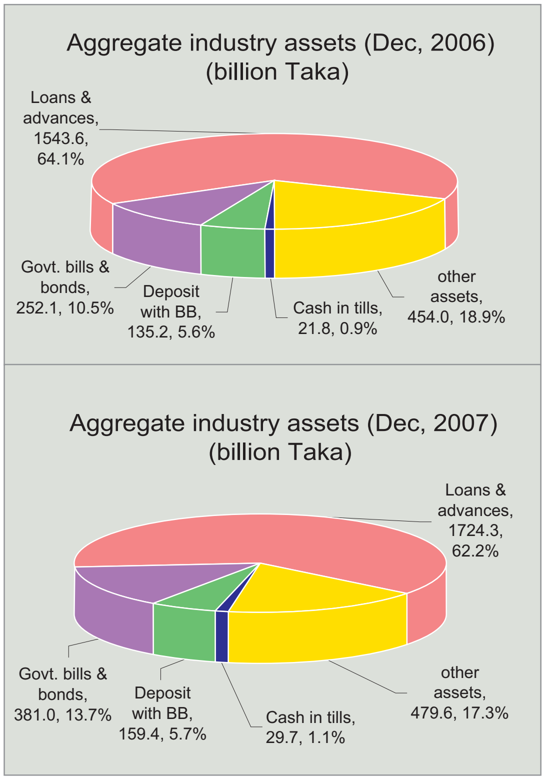
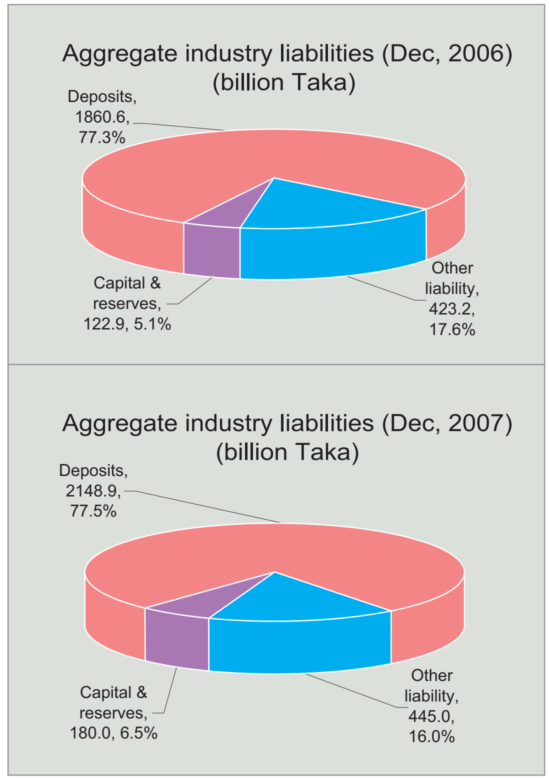



Chart 5.2




billion or 53.5 percent of the total industry deposit against Taka 955.5 billion or 51.3 percent in 2006. FCBs' deposits in 2007 rose by Taka 32.6 billion or 21.6 percent over the previous year. The DFIs' deposits in 2007 were Taka 115.6 billion against Taka 100.2 billion in 2006 showing an increase of 15.4 percent over the year.

### Aggregated Balance Sheet

5.5 **Assets:** Aggregate industry assets in 2007 registered an overall increase by 15.3 percent over 2006. During this period, SCBs' assets increased by 16.7 percent and those of the PCBs rose by 24.3 percent. Loans and advances played a major role on the uses of fund. Loans and advances amounting to Taka 1724.3 billion out of aggregate assets of Taka 2773.9 billion constituted significant portion (62.2 percent). Cash in tills were Taka 29.7 billion (1.1 percent); deposits with Bangladesh Bank were Taka 159.4 billion or 5.7 percent; other assets were Taka 479.6 billion or 17.3 percent and investment in Government bills and bonds accounted for 13.7 percent (Taka 381.0 billion) of the assets.

5.6 **Liabilities:** The aggregate liability portfolio of the banking industry in 2007 was Taka 2773.9 billion of which deposits constituted Taka 2148.9 billion or 77.5 percent and continued to be the main sources of fund of banking industry. Capital and reserves of the banks were Taka 180.0 billion or 6.5 percent of aggregate liabilities in 2007, as against Taka 122.9 billion or 5.1 percent in 2006.

### Performance and Rating of Banks

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

### Capital Adequacy

5.8 Capital adequacy focuses on the total position of bank capital and protects the depositors from the potential shocks of losses that a bank might incur. It helps absorbing major financial risks (like credit risk, market risk, foreign exchange risk, interest rate risk and risk involved in off-balance sheet operations). Banks in Bangladesh have to maintain a minimum Capital Adequacy Ratio (CAR) of not less than 10.0 percent of their risk-weighted assets (with at least 5.0 percent in core capital) or Taka 2.0 billion, whichever is higher.

5.9 Table 5.2 shows that as on 31 December 2007, the SCBs, DFIs, PCBs & FCBs maintained CAR of 7.9, -5.5, 10.6 and 22.7 percent respectively. The CAR of SCBs showed 7.9 percent in 2007 after transferring the cumulative loss for Taka 87.9 billion by creating goodwill (valuation adjustments account) at the time of corporatization of 3 SCBs. The valuation adjustment account will be amortised within 10 years. Meanwhile, the CAR of DFIs stood at -5.5 percent in 2007 after adjusting the cumulative losses of Taka 24.8 billion of BKB and RAKUB. The adjusted CAR of DFIs in 2005 and 2006 also stood at -7.5 percent and -6.7 percent considering their cumulative losses of Taka 21.9 billion and Taka 24.4 billion respectively. 5 PCBs (including 2 problem banks) also could not maintain required CAR in 2007. FCBs maintained 22.7 percent CAR in 2007 though 6 FCBs out of 9 FCBs could not maintain minimum capital for Taka 2.0 billion but they were permitted to adjust those shortfall within 30 June 2009. The CAR of the banking industry was 9.6 percent in 2007 as against 6.7 percent in 2006. The CAR of the industry showed downturn in 2005 due to the adjustment of cumulative losses by the DFIs and thereafter it has increased further positively.

### Asset Quality

5.10 The asset composition of all scheduled banks shows the concentration of loans and advances (62.2 percent as of December 2007). The high concentration of loans and advances indicates vulnerability of assets to credit risk, especially since the portion of non-performing assets is significant. A huge non-performing loan portfolio has been the major predicament of banks particularly of the state-owned banks. In the total assets the share of loans and advances is followed by the investment in Government securities covering 13.7 percent.

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

(Percent)

| Bank types | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| SCBs | 4.4 | 4.3 | 4.1 | 4.3 | 4.1 | -0.4 | 1.1 | 7.9 |
| DFIs | 3.2 | 3.9 | 6.9 | 7.7 | 9.1 | -7.5* | -6.7* | -5.5* |
| PCBs | 10.9 | 9.9 | 9.7 | 10.5 | 10.3 | 9.1 | 9.8 | 10.6 |
| FCBs | 18.4 | 16.8 | 21.4 | 22.9 | 24.2 | 26.0 | 22.7 | 22.7 |
| **Total** | **6.7** | **6.7** | **7.5** | **8.4** | **8.7** | **5.6*** | **6.7*** | **9.6*** |

* Denotes the adjusted CAR after adjusting the cumulative losses of DFIs since 2005.

Chart 5.3

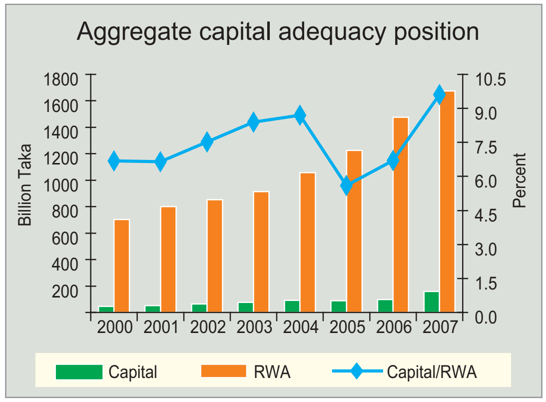



**Table 5.3 NPL ratios by type of banks**

(Percent)

| Bank types | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|
| SCBs | 45.6 | 38.6 | 37.0 | 33.7 | 29.0 | 25.3 | 21.4 | 22.9 | 29.9 |
| DFIs | 65.0 | 62.6 | 61.8 | 56.1 | 47.4 | 42.9 | 34.9 | 33.7 | 28.6 |
| PCBs | 27.1 | 22.0 | 17.0 | 16.4 | 12.4 | 8.5 | 5.6 | 5.5 | 5.0 |
| FCBs | 3.8 | 3.4 | 3.3 | 2.6 | 2.7 | 1.5 | 1.3 | 0.8 | 1.4 |
| **Total** | 41.1 | 34.9 | 31.5 | 28.0 | 22.1 | 17.6 | 13.6 | 13.2 | 13.2 |

5.11 The most important indicator intended to identify problems with asset quality in the loan portfolio is the percentage of gross and net non-performing loans (NPLs) to total advances. FCBs have the lowest and SCBs have the highest ratio of NPLs. SCBs have gross NPLs to total Loans of 29.9 percent whereas in case of PCBs, FCBs and DFIs, the ratios are 5.0, 1.4 and 28.6 percent respectively. Similarly NPLs net of provisions and interest suspense to the total loans is 12.9, 1.4 and 19.0 percent for SCBs, PCBs and DFIs respectively. FCBs are having excess provision for loan losses.

5.12 The ratio of NPL to total loans of all the banks shows an encouraging trend since its decline from the peak (41.1 percent) in 1999, although the aggregate ratio was still as high as 13.2 percent in December 2007. The reason is being very high NPL of the SCBs and the DFIs.

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

5.14 It appears from the Table 5.3(a) and Chart 5.4 (a) that the net non performing loans to total loans after adjustment of actual provision and interest suspense stands at 12.9 percent (SCBs), 19.0 percent (DFIs), 1.4 percent (PCBs) and 5.1 percent (banking sector) in 2007. SCBs' and DFIs' non-performing portfolio were still high after

Chart 5.4

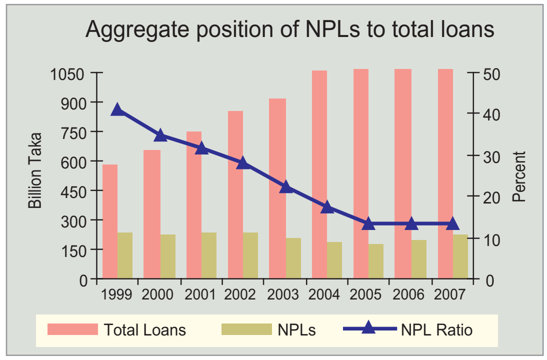



Table 5.3(a): Ratio of net NPL to total loans by type of banks

(Percent)

| Bank types | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|
| SCBs | 41.3 | 34.1 | 32.8 | 30.1 | 28.3 | 17.6 | 13.2 | 14.5 | 12.9 |
| DFIs | 58.5 | 54.6 | 54.5 | 48.0 | 38.3 | 23.0 | 22.6 | 23.6 | 19.0 |
| PCBs | 21.2 | 15.5 | 10.5 | 10.5 | 8.3 | 3.4 | 1.8 | 1.8 | 1.4 |
| FCBs | 0.9 | -0.1 | -0.3 | -0.4 | 0.1 | -1.5 | -2.2 | -2.6 | -1.9 |
| **Total** | 35.6 | 28.8 | 25.6 | 22.6 | 18.8 | 9.8 | 7.2 | 7.1 | 5.1 |

Chart 5.4 (a)

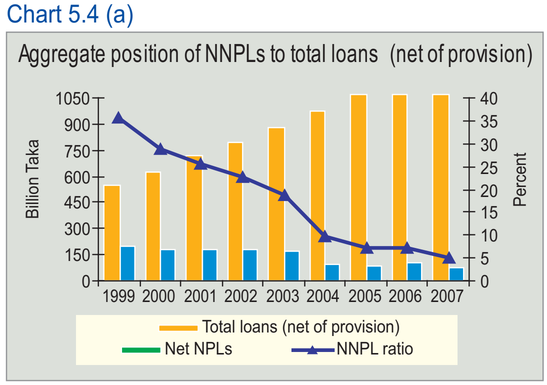
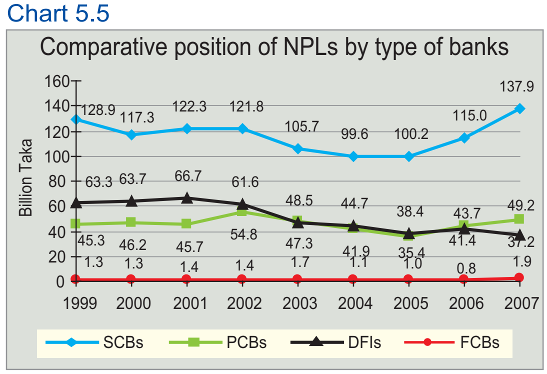



Chart 5.5



adjustment of actual provision and interest suspense, whereas FCBs have excess provision on their classified loans.

5.15 Chart 5.5 graphically displays the amounts in NPLs of the 4 types of banks since 1999 through 2007. Amount of NPLs of the SCBs decreased from Taka 128.9 billion in 1999 to Taka 115.0 billion in 2006 but again increased to Taka 137.9 billion. The PCBs also recorded a total increase of Taka 3.9 billion in their NPL accounts, which stood at Taka 49.2 billion in 2007 as against Taka 45.3 billion in 1999. The amount of NPLs of the DFIs decreased to Taka 37.2 billion in 2007 from Taka 63.3 billion in 1999. The decline in NPL ratios in the recent years can be attributed partly to some progress in recovery of long outstanding loans and partly to write-off of loans classified as 'bad' or 'loss'.

### Loan Loss Provisioning of the Banks

5.16 The Table 5.4 shows the aggregate amounts of NPLs of all banks, amounts of provision required to be maintained and the amounts actually provided by the banks from 1999 to 2007.

5.17 Table 5.4 and Chart 5.6 depict that in aggregate, the banks have been continuously failing to maintain the required level of provisions against their NPLs. During the years from 1999 through 2007, the banks could maintain 60.5 percent of the required provision in 2001, which increased thereafter to 76.3 percent in 2007. The main reasons for the continuous shortfall in provision adequacy is the inability of the SCBs and some of the PCBs including those in problem bank category to make sufficient provisions due to inadequate profits and also transferred provision for write-offs. Notably the FCBs are much better in that they have been able to make adequate provisions in the recent years. A comparative position as of end 2006 and 2007 is shown in Table 5.5.

5.18 Out of 30 PCBs, 27 could make adequate provisions, while other 3 failed to maintain adequate provision due to their poor assets portfolio and earning level.

**Table 5.4 Required provision and provision maintained - all banks**

(billion Taka)

| All banks | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|
| Amount of NPLs | 238.8 | 228.5 | 236.0 | 238.6 | 203.2 | 187.3 | 175.1 | 200.1 | 226.2 |
| Required provision | 100.2 | 98.4 | 101.6 | 106.8 | 92.5 | 87.8 | 88.3 | 106.1 | 127.2 |
| Provision maintained | 51.5 | 58.1 | 61.4 | 59.6 | 37.3 | 35.9 | 42.6 | 52.9 | 97.1 |
| Excess(+)/ shortfall(-) | -48.7 | -40.3 | -40.2 | -47.2 | -55.2 | -51.9 | -45.7 | -53.2 | -30.1 |
| Provision maintenance ratio (%) | 51.4 | 59.1 | 60.5 | 55.8 | 40.3 | 40.9 | 48.2 | 49.9 | 76.3 |

Chart 5.6

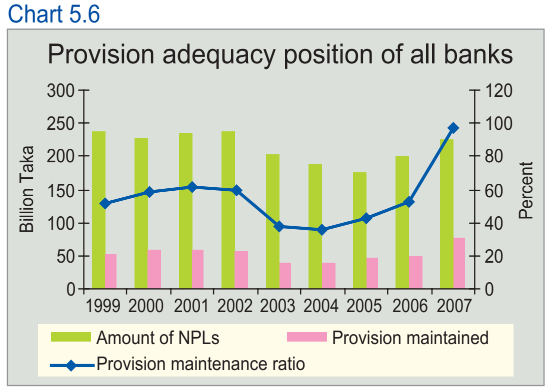



**Table 5.5 Comparative position of provision adequacy**

(billion Taka)

| Year | Items | SCBs | DFIs | PCBs | FCBs |
|---|---|---|---|---|---|
| 2006 | Required provision | 61.6 | 14.8 | 27.5 | 2.2 |
| | Provision maintained | 18.2 | 9.1 | 22.6 | 3.1 |
| | Provision maintenance ratio% | 29.5 | 61.5 | 82.2 | 140.9 |
| 2007 | Required provision | 71.4 | 17.3 | 34.9 | 3.5 |
| | Provision maintained | 56.5 | 8.7 | 28.2 | 3.8 |
| | Provision maintenance ratio% | 79.1 | 50.3 | 80.8 | 108.6 |

**Table 5.6 Weighted average deposit and lending rates (30/06/2001 - 31/12/2007)**

(Percent)

| Date | Weighted average | | Spread |
|---|---|---|---|
| | Deposit rate | Lending rate | |
| 30/06/01 | 7.03 | 13.75 | 6.72 |
| 31/12/01 | 6.75 | 13.42 | 6.67 |
| 30/06/02 | 6.74 | 13.16 | 6.42 |
| 31/12/02 | 6.49 | 13.09 | 6.60 |
| 30/06/03 | 6.30 | 12.78 | 6.48 |
| 31/12/03 | 6.25 | 12.36 | 6.11 |
| 30/06/04 | 5.65 | 11.01 | 5.36 |
| 31/12/04 | 5.56 | 10.83 | 5.27 |
| 30/06/05 | 5.62 | 10.91 | 5.31 |
| 31/12/05 | 5.90 | 11.25 | 5.35 |
| 30/06/06 | 6.68 | 12.06 | 5.38 |
| 31/12/06 | 6.99 | 12.60 | 5.61 |
| 30/06/07 | 6.85 | 12.77 | 5.92 |
| 31/12/07 | 6.77 | 12.75 | 5.98 |

**Weighted Average Deposit and Lending Rates**

5.19 The weighted average deposit rate, decreased from 6.85 to 6.77 percent and weighted average lending rate of banks decreased from 12.77 to 12.75 percent during the first half of FY08. The spread between lending and deposit rate is the measure of intermediation cost of banks, which has increased over time. It was 5.92 percent at the end of FY07, which increased to 5.98 percent in the first half of FY08. Weighted average deposit and lending rates along with the spread during 30/06/2001 to 31/12/2007 have been shown in Table 5.6 and Chart 5.7.

**Writing-off Bad Debts**

5.20 To impede unnecessarily and artificially inflated size of balance sheet, uniform guidelines of write-off has been introduced in 2003. According to the policy, banks may, at any time, write-off loans classified as bad/loss. Those loans, which have been classified as bad/loss for last 5 years and above and loans for which 100 percent provisions have been kept, should be written-off without delay. The total amount of bad debts written-off from June 2004 to June 2008 in different bank categories is given in Table 5.7. It is revealed from the Table 5.7 that banks have been able to write off an amount of Taka 10.2 billion during 1 July 2007 to 30 June 2008.

**Management Soundness**

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

Chart 5.7

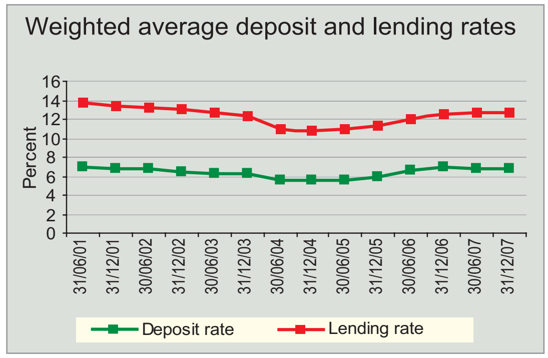



Table 5.7 Writing off bad debts in different bank categories (30/06/2004 - 31/03/2008)

(billion Taka)

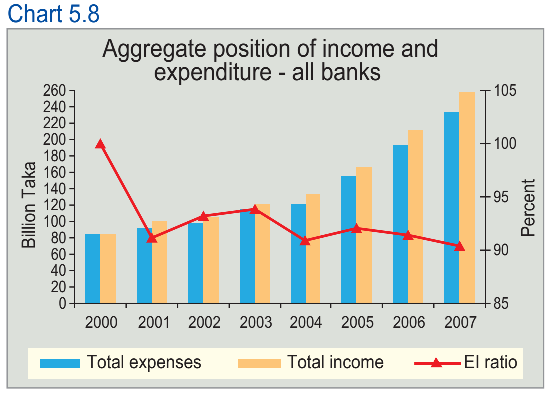
| Bank types | 30/06/2004 | 30/06/2005 | 30/06/2006 | 30/06/2007 | 30/06/2008 |
|---|---|---|---|---|---|
| SCBs | 26.3 | 29.7 | 35.7 | 42.8 | 48.4 |
| DFIs | 17.4 | 27.6 | 28.6 | 30.4 | 31.0 |
| PCBs | 21.2 | 32.9 | 40.7 | 45.5 | 49.4 |
| FCBs | 0.9 | 1.1 | 1.5 | 1.6 | 1.7 |
| **Total** | **65.8** | **91.3** | **106.5** | **120.3** | **130.5** |

Table 5.8 Expenditure-income ratio by type of banks

(Percent)

| Bank types | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| SCBs | 99.4 | 99.0 | 98.5 | 98.8 | 102.3 | 101.9 | 100.0 | 100.0 |
| DFIs | 175.3 | 89.1 | 95.9 | 101.1 | 104.0 | 103.9 | 103.5 | 107.7 |
| PCBs | 90.8 | 88.1 | 91.9 | 93.1 | 87.1 | 89.3 | 90.2 | 88.8 |
| FCBs | 77.7 | 75.7 | 78.3 | 80.3 | 76.3 | 70.8 | 71.1 | 72.9 |
| **Total** | **99.9** | **91.2** | **93.3** | **93.9** | **90.9** | **92.1** | **91.4** | **90.4** |

Chart 5.8



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

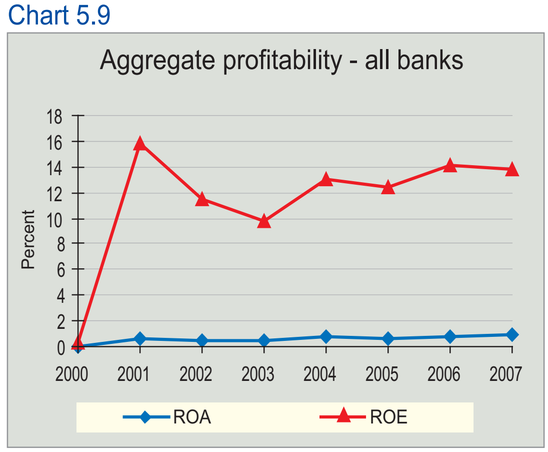
5.22 It transpires from Table 5.8 and Chart 5.8 that expenditure-income (EI) ratio of the DFIs was very high at 175.3 percent in 2000. This was mainly because the DFIs made loan loss provisions by debiting 'loss' in their books. The position however improved after 2000 and the ratio came down to 89.1 percent and 95.9 percent in 2001 and 2002 respectively but again rose to 101.1 percent in 2003 and later on 107.7 in 2007 due to operating loss incurred by BKB & RAKUB. The EI ratio of the SCBs exceeded 100.0 percent in 2004; the ratio stood at 100.0 percent in 2007. Very high EI ratio of SCBs was mainly attributable to high administrative and overhead expenses; suspension of income against NPLs. EI ratio of PCBs is substantially high due to deduction of provision for loans, other assets and corporate tax from current income.

Table 5.9: Profitability ratios by type of banks

(Percent)

| Bank types | Return on assets (ROA) | | | | | | | | Return on equity (ROE) | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| SCBs | 0.1 | 0.1 | 0.1 | 0.1 | -0.1 | -0.1 | 0.0 | 0.0 | 1.7 | 2.4 | 4.2 | 3.0 | -5.3 | -6.9 | 0.0 | 0.0 |
| DFIs | -3.7 | 0.7 | 0.3 | 0.0 | -0.2 | -0.1 | -0.2 | -0.3 | -68.0 | 12.3 | 5.8 | -0.6 | -2.1 | -2.0 | -2.0 | -3.4 |
| PCBs | 0.8 | 1.1 | 0.8 | 0.7 | 1.2 | 1.1 | 1.1 | 1.3 | 17.0 | 20.9 | 13.6 | 11.4 | 19.5 | 18.1 | 15.2 | 16.7 |
| FCBs | 2.7 | 2.8 | 2.4 | 2.6 | 3.2 | 3.1 | 2.2 | 3.1 | 27.3 | 32.4 | 21.5 | 20.4 | 22.5 | 18.4 | 21.5 | 20.4 |
| **Total** | **0.0** | **0.7** | **0.5** | **0.5** | **0.7** | **0.6** | **0.8** | **0.9** | **0.3** | **15.9** | **11.6** | **9.8** | **13.0** | **12.4** | 14.1 | **13.8** |

Chart 5.9




## Earnings and Profitability

5.23 Strong earnings and profitability profile of a bank reflect its ability to support present and future operations. More specifically, this determines the capacity to absorb losses by building an adequate capital base, finance its expansion and pay adequate dividends to its shareholders. Although there are various measures of 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).

5.24 Earnings as measured by return on assets (ROA) and return on equity (ROE) vary largely within the industry. Table 5.9 shows ROA and ROE by types of banks and Chart 5.9 shows the aggregate position of these two indicators for all banks. Analysis of these indicators reveals that the ROA of the SCBs have been almost zero percent considering huge provision shortfall and that of the DFIs even worse. PCBs had an inconsistent trend but satisfactory and FCBs' return on assets ratio has been consistently strong during last 8 years.

5.25 SCBs return on equity ratio was 3.0 percent in 2003 but have been shown almost zero percent in 2007 considering provision shortfall. In case of DFIs, the ROE position remained worse (-3.4 percent) in 2007. The ROE of PCBs and FCBs were satisfactory in 2007. BKB, RAKUB and Bangladesh Commerce Bank Ltd. incurred loss only due to their huge operating expenses.

## Net Interest Income (NII)

5.26 Aggregate net interest income (NII) of the industry has been positive and consistently increased from Taka 8.4 billion in 2000 to Taka 54.8 billion in 2007. However, the NII of the SCBs sharply declined to a negative amount of Taka 1.2 billion in 2000. The trend continued and the SCBs' NII was -1.8 billion (2001), -1.5 billion (2002), -0.3 billion (2003), -1.1 billion (2004) but in 2005 their positive NII was Taka 7.7 billion and it was Taka 7.4 billion in 2007. The DFIs had a consistent positive trend since 2000 and it was Taka 1.4 billion in 2007.

5.27 Since 2005, SCBs have been able to increase their net interest income (NII) by reducing their cost of fund. The NII of the PCBs and FCBs has been very high over the period from 2000 through 2007. Overall industry NII shows a consistently upward trend. The trend of NII indicates that the PCBs and the FCBs are charging interests at very high rates on their lending as compared to the interest they are paying to the depositors.

Table 5.10 Net interest income by type of banks

(billion Taka)

| Bank types | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| SCBs | -1.2 | -1.8 | -1.5 | -0.3 | -1.1 | 7.7 | 9.0 | 7.4 |
| DFIs | 1.0 | 2.7 | 1.4 | 1.3 | 1.8 | 1.0 | 1.7 | 1.4 |
| PCBs | 6.1 | 9.2 | 10.2 | 12.0 | 13.7 | 21.0 | 25.4 | 36.1 |
| FCBs | 2.5 | 3.3 | 3.4 | 3.6 | 4.2 | 5.6 | 8.2 | 9.9 |
| **Total** | **8.4** | **13.4** | **13.5** | **16.6** | **18.3** | **35.3** | **44.3** | **54.8** |

Chart 5.10

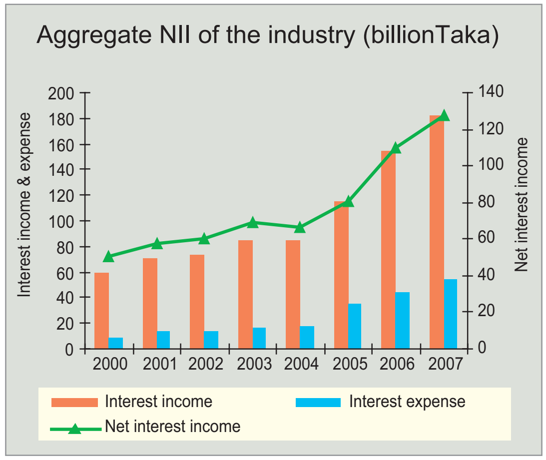



Table 5.11 Liquidity ratio by type of banks

(Percent)

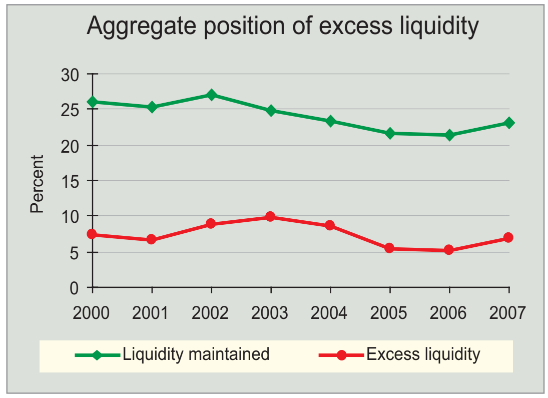
| Bank types | Liquid assets | | | | | | | | Excess liquidity | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| SCBs | 26.5 | 25.7 | 27.3 | 24.4 | 22.8 | 20.0 | 20.1 | 24.9 | 6.5 | 5.7 | 7.3 | 8.4 | 6.8 | 2.0 | 2.1 | 6.9 |
| DFIs | 16.2 | 15.3 | 13.7 | 12.0 | 11.2 | 11.2 | 11.9 | 14.2 | 9.9 | 8.9 | 6.9 | 5.8 | 4.7 | 6.2 | 3.8 | 5.6 |
| PCBs | 24.8 | 24.2 | 26.3 | 24.4 | 23.1 | 21.0 | 21.4 | 22.2 | 6.8 | 6.2 | 8.5 | 9.8 | 8.8 | 5.1 | 5.6 | 6.4 |
| FCBs | 34.7 | 34.1 | 41.6 | 37.8 | 37.8 | 41.5 | 34.4 | 29.2 | 14.8 | 14.3 | 21.8 | 21.9 | 21.9 | 23.6 | 16.4 | 11.2 |
| **Total** | 26.1 | 25.3 | 27.2 | 24.7 | 23.4 | 21.7 | 21.5 | 23.2 | 7.5 | 6.7 | 8.7 | 9.9 | 8.7 | 5.3 | 5.1 | 6.9 |

## Liquidity

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

5.29 Table 5.11 and Chart 5.11 show that the FCBs are having the highest liquidity ratios followed by the SCBs. This situation of constant surplus of liquidity warrants creation of effective demand for credit at lower costs.

Chart 5.11




## CAMELS Rating

5.30 Performance indicators of the banking industry depict a trend similar to that of the state-owned banks, which is understandable due to their predominant market share. Ratings done on the basis of the various indicators discussed hereinbefore indicate that financial performance of the PCBs and FCBs in general has been better than that of the industry average. Under the Financial Sector Reform Programme, the Bangladesh Bank strengthened the supervision and monitoring of the scheduled banks since 1990. Reporting formats required for CAMELS rating of scheduled banks have been revised incorporating additional necessary data to ensure depth of information. Other segments of the formats are under process of departmental reviewing and rechecking with a view to rationalize overall reporting formats that would be required for more detailed banking analysis. Any bank rated 4 or 5 i.e., 'Marginal' or 'Unsatisfactory' under composite CAMELS rating is generally identified as Problem Bank. Activities of the problem banks are closely monitored by the Central Bank. Bangladesh Bank issues directives from time to time to the problem banks to bring them in good shape. One of the private commercial banks rated CAMELS 5 are still in the problem bank list out of seven put in this category in the mid nineties. Up to 2005, six such banks were taken off from the problem bank list phase by phase because of their improved performance. Only that bank mentioned above was not able to lift its name from the list of problem bank. That bank was categorised as a problem bank mainly due to shortfall of capital, liquidity crisis and large amount of adversely classified loans which had adversely affected the interest of the depositors and therefore Bangladesh Bank dissolved the board of directors and removed the chief executive officer of the bank in June 2006 and appointed an administrator to the bank to restore confidence of the depositors and run the bank properly. Simultaneously legal action has already been initiated against the corrupt personnel. The Government in January 2007 imposed a moratorium (suspension) for six months on all activities of the bank except some kinds of transactions, including limited level of deposit withdrawal. Later on, Bangladesh Bank extended the moratorium for twice. The moratorium was imposed for the reconstruction of the bank following an acute financial crisis and fragility including rampant corruption by a section of directors as well as part of management. However, Bangladesh Bank lifted moratorium, which came into effect on 5 May 2008. In the meantime, under a reconstruction scheme a foreign financial group purchased 50.1 percent shares of that bank and took over the management of the bank. The bank already changed its name and started its activities in a new name.

Later on another three banks were included in the problem bank list for their unsoundness and unhealthy financial position. Out of three banks two already get rid of the list of problem banks due to their overall good performance. Now there are two problem banks and it is expected that in the near future under the proper monitoring and guidance of Bangladesh Bank both the existing problem banks will come out from the list of problem banks.

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

5.31 BB introduced Early Warning System (EWS) of supervision from March 2005 to address the difficulties faced by the banks in any of the areas of CAMELS. Any bank found to have faced difficulty in any areas of operation, is brought under Early Warning category and monitored very closely to help improve its performance. Presently 8 banks are monitored under EW system. Interface of dialogues with the management of scheduled banks have been organized in more structured way to address various compliance issues those seem to be as early signal to delinquent key performance areas in banking operation.

5.32 In addition to Rupali Bank Ltd. now, Sonali Bank Ltd., Janata Bank Ltd. and Agrani Bank Ltd. are three other scheduled banks which are incorporated under the Companies' Act, 1994. Bangladesh Bank is also monitoring the SCBs i.e. Sonali Bank Ltd., Janata Bank Ltd., Agrani Bank Ltd. and Rupali Bank Ltd. through its off-site supervision tools. Government of Bangladesh (GoB), the owner of those banks also adequately monitors them. At present, the SCBs are experiencing huge capital and provision shortfall, having large amount of classified loans, low earnings and less efficient management. Various restrictive measures have been taken by the Bangladesh Bank on the activities of the SCBs to put them on right track of business operation and growth. All the 4 SCBs have been made to sign Memorandum of Understandings (MoUs) with the Bangladesh Bank to improve their performance. Approvals of Large loans by the banks are also monitored by the Bangladesh Bank on monthly basis to detect the irregularities.

5.33 As of end 2007, CAMELS rating of 6 banks was 1 or Strong; 29 banks were rated 2 or Satisfactory; rating of 5 banks was 3 or Fair; 6 (including 4 SCBs) were rated 4 or Marginal and 1 bank got 5 or Unsatisfactory rating.

**Islamic Banking**

5.34 Alongside the conventional interest bearing banking system, Bangladesh entered into an Islamic banking system (profit-loss sharing) in 1983. At present, out of 48 banks in Bangladesh, 6 private commercial banks are operating as full-fledged Islamic banks and 21 branches of 10 conventional banks are involved in Islamic banking. The Islamic banking industry continued to show strong growth since its inception in 1983 to June 2008 in tandem with the growth in the economy, as reflected by the increased market share of the Islamic banking industry in terms of assets, financing and deposits of the total banking system. The entire picture is given at Table 5.12. Total deposits of the Islamic banks and Islamic banking branches of the conventional banks stood at Taka 347.3 billion at end June 2008. This was 24.4 percent of the deposits of all private commercial banks and 16.1 percent of the deposits of the total banking system at the end of June 2008. Total investment of the Islamic banks and the Islamic banking branches of the conventional banks stood at Taka 349.1 billion at end June 2008. This was 26.8 percent of all private banks and 19.3 percent of the total banking system of the country.

**Deposit Insurance Scheme**

5.35 Deposit insurance system was introduced in Bangladesh in August 1984 to act as a safety net. It aims at minimizing or eliminating the risk of loss of depositors fund with banks. Deposit insurance in Bangladesh is now being governed by the Bank Deposit Insurance Act 2000. A Deposit Insurance Trust Fund (DITF) has also been created for providing limited protection

Table 5.12 : Comparative position of the islamic banking sector (as at end June 2008)

(billion Taka)

| Particulars | Islamic Banks | Islamic Banking Branches | Islamic Banking Sector | Private Commercial Banks[1] | All Banks[2] |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4=2+3 | 5 | 6 |
| 1. Number of Banks | 6 | 10 | 16 | 30 | 48 |
| 2. Number of Branches | 358 | 21 | 379 | 2004 (18.9) | 6747 (5.6) |
| 3. Number of Employees | 13186 | 400 | 13586 | 38426* (27.73) | 99287* (10.73) |
| 4. Deposits | 318.7 | 28.6 | 347.3 | 1424.3 (24.4) | 2160.0 (16.1) |
| 5. Investments (credits) | 327.7 | 21.4 | 349.1 | 1304.8 (26.8) | 1812.2 (19.3) |
| 6. Investment deposit ratio | 1.03 | 0.75 | 1.01 | 0.92 | 0.84 |
| 7. Liquidity: excess (+) shortfall (-) | 0.13 | @ | 0.13 | 78.8 (0.2) | 129.9 (0.1) |

Notes: 1/ Figures in the parentheses indicate share of percentage of the Islamic banking sector to the all private banks.

2/ Figures in the parentheses indicate share of percentage of the Islamic banking sector to all banks.

* Figures as at end June 2006.

@ Conventional banks which have Islami banking branches do not maintain SLR individually. The Head Offices of the respective banks combindly maintain SLR and liquidity position.

Sources: Research Department, Statistics Department and Department of Off-site Supervision, Bangladesh Bank, and Central Accounts Departments of all Islamic banks and conventional banks having the Islamic banking branches.

(not exceeding Taka 1.0 lac) to small depositor in case of winding up of any bank. The Board of Directors of the Bangladesh Bank is the Trustee Board for DITF. The DITF is now being administered and managed under the guidance of the Trustee Board. Bangladesh Bank is now a member of International Association of Deposit Insurers (IADI). As at end June 2008, the total assets of the DITF stood at Taka 7.30 billion of which Taka 7.29 billion were invested in the Government securities. Revised risk based premium rate was introduced from January 2007. As per new schedule, the banks under problem bank category will have to pay 0.09 percent whereas other banks will pay 0.07 percent as premium on their deposits. To inform the public and for stabilizing the payment system in the banking sector, the information regarding deposit insurance scheme, its nature, operating procedures, level of coverage, premium rates etc. and last audited balance sheet (as on 30-06-2007) has been disclosed in Bangladesh Bank website.

## B. Legal Reforms and Prudential Regulations

As part of the ongoing efforts to strengthen the banking system through the adoption of policies aimed at both improving the financial strength of banks as well as bringing about greater transparency in their operations, several policy measures were initiated during FY08.

### Capital Adequacy of the Banks

5.36 With a view to strengthening the capital base of banks and making them prepared for the implementation of Basel-II Accord, banks are required to maintain Capital to Risk-Weighted Assets ratio 10 percent at the minimum with core capital not less than 5 percent effective from 31 December 2007. However, minimum capital requirements (paid up capital and statutory reserve) for all banks will be Taka 2.0 billion as per Bank Company (Amendment) Act, 2007. Banks having capital shortfall will have to meet at least 50 percent of the shortfall by June 2008 and the rest by June 2009.

Box 5.1

**Service Charges by the Banks to the Customers**

With a view to establishing a market oriented financial system under Financial Sector Reform Programme (FSRP) activated in 1990, Administered credit system has been abolished and banks have been given full freedom for portfolio selection. At present, banks are free to fix their rate of charges and commissions against the services provided to their customers with some exceptions. Bangladesh Bank recently has advised all banks to rationalize charges/fees/commissions collected against the services rendered by the banks. Banks have also been advised to upload their schedule of charges in their respective website and display the same at their bank branches and head office.

Revaluation reserves of held to maturity (HTM) securities (up to 50 percent of the revaluation reserves) has been added to the components of supplementary capital. Besides, 'Hedging the price risk of commodity transactions' has been included in short term self liquidating trade related contingencies.

**Interest Rate Policy**

5.37 Banks are now free to charge/fix their deposit and lending rate other than export credit. At present, loans at reduced rates (7 percent) are provided for all sorts of export credit since January 2004. Moreover, with a view to controlling the price hike and ensuring adequate supply of essential commodities, the rate of interest on loan for import financing of rice, wheat, sugar, edible oil (crude and refined), chickpeas, beans, lentils, onions, spices , dates and powder milk has been temporarily fixed to a maximum of 12 percent.

At present, banks can differentiate interest rate up to 3 percent considering comparative risk elements involved among borrowers in same lending category. With progressive deregulation of interest rates, banks have been advised to announce the mid-rate of the limit (if any) for different sectors and the banks may change interest 1.5 percent more or less than the announced mid-rate on the basis of the comparative credit risk.

**Maintaining Adequate Security of Lockers**

5.38 Bangladesh Bank has issued detail guidelines on maintaining adequate security of lockers. Accordingly, banks are now to observe the minimum safety and security measures at branches/places where safe deposit lockers facilities are offered to general public so that the security procedures are well documented and the concerned staff/officers are well trained about the procedures. Banks are also to carry out proper due diligence process on the security agencies, as well as guards posted at their branches. Besides, corporate group insurance as per categories and sizes of lockers are to be maintained by the banks so that in case of any loss arising due to breakage/damage to the lockers could be paid to the locker holders.

**SCBs Reforms Programme**

5.39 Bangladesh Bank has issued licenses under article 31(1) and 31(2) of Banking Companies Act 1991 in favour of Agrani Bank Limited, Janata Bank Limited and Sonali Bank Limited on 30 May, 31 May and 5 June 2007 respectively to operate banking business. In order to complete the process of corporatization, a Vendor's Agreement was signed with the newly licensed banks as per clause (i) of Article 27A of Bangladesh Banks (Nationalization) Order, 1972, to transfer/vest the entire assets, liabilities and capital of the SCBs to the new banks.

The names of "Sonali Bank Limited ", "Janata Bank Limited" & "Agrani Bank Limited" have been included and the names of "Sonali Bank", "Janata Bank" & "Agrani Bank" have been excluded from the list of scheduled banks with effect from 15 November 2007. The Government, though retaining Government ownership for now, will not interfere in these banks' day to day activities and instead they will be more accountable to the central bank. This change may facilitate in reducing impaired assets in the SCBs and thus positively contribute to the soundness and stability of the banking sector. After corporatization of the SCBs, all the commercial banks are expected to have a level playing field with uniform regulatory framework. With the corporatisation, the Board of Directors (BoDs) will have the responsibility to ensure that the bank is operated on a prudent and commercial basis and the MDs/CEOs who will be appointed by the BoDs with prior approval of BB along with the Board must adhere to all prudential requirements.

### Maintaining General Provision against Off-balance Sheet Item

5.40 Banks were advised to maintain general provision against Off-balance sheet exposures in the following manner:

1. 0.5 percent provision effective from 31 December 2007 and
2. 1.0 percent provision effective from 31 December 2008.

### SME Service Centres

5.41 Bangladesh Bank has taken a decision in principle to accord permission for opening SME Service Centres. These Service Centres will be allowed to perform the following functions:

1. The SME Service Centres will render banking services only for receiving application, disbursement, monitoring and recovery of loan to SME sector.
2. The SME Service Centres will be allowed to receive foreign remittances and deliver/hand over the same in domestic currency to the payees concerned.
3. The SME Service Centres will be allowed to open a separate desk in order to prioritize the women entrepreneurs involved in the promotion of Small and Medium Enterprise (SME) sector.

### Reconstruction of The Oriental Bank Limited

5.42 The Oriental Bank Limited has been reconstructed under "The Oriental Bank Limited (Reconstruction) Scheme, 2007 and renamed as ICB Islamic Bank Limited. The Oriental Bank Limited had been suffering from a huge shortfall of capital and provision, large amount of adversely classified loans, inefficient management and acute liquidity crisis which had adversely affected the interest of the depositors and therefore Bangladesh Bank superseded the Board of Directors and removed the Chief Executive Officer of the Oriental Bank Limited on 19 June 2006 and appointed a high official of the Bangladesh Bank to execute the power and responsibility of the Board of Directors and the Chief Executive Officer of the bank. For the interest of public and depositors, ensuring proper management and maintaining public confidence on the banking system, the Government of the People's Republic of Bangladesh has made an order of moratorium under Section 77(2) of the Banking Companies Act, 1991 with effect from 25 January 2007 only for reconstruction of the bank.

Bangladesh Bank formulated the scheme "The Oriental Bank Limited (Reconstruction) Scheme, 2007" under Section 77(4) of the Banking Companies Act, 1991. As per provision of the Scheme, authorized and paid up capital of the Bank has been increased to Taka 1000 crore and Taka 700 crore respectively. Newly issued 35,06,743 number ordinary shares amounting to BDT 35,06,743,888 were sold through International Open Tender to ICB Financial Groups Holdings A.G. incorporated in Switzerland. Shares are being issued in favour of the depositors as per provision of the Scheme. The Board of Directors has been reformed and the new Managing Director has taken over the bank. Thus the problem bank has been reconstructed and the depositors of the bank are safer than before.

### Progress of Basel II Implementation in Bangladesh

5.43 To make the banks in Bangladesh more shock absorbent as well as to cope with international best practices for risk management and, a sound and robust banking industry, Bangladesh Bank (BB), being regulatory & supervisory authority, is moving to implement

Basel II from early of 2009. In this regard BB is pursuing consultative approach to implement Basel II in Bangladesh. Thus a National Steering Committee, a Coordination Committee and Basel II Implementation Cell are carrying out the required activities. In the mean time an Action-plan/ Roadmap has been published via BRPD circular no. 14/2007 on 30 December 2007. Before drawing the Roadmap on Basel II implementation BB has done two studies as follows:

a) Self audit on BCPs ( Basel Core Principles) for effective banking supervision:
   - Shows favourable situation for implementing Basel II;
   - BB has its operational independence;
   - BB has issued guidelines on core risk management;
   - Banks are practicing KYC methods;
   - Practicing CRG for credit risk assessment;
   - CAMELS & EWS are two vital instruments are in place for bank supervision;
   - BB has standard methodology of bank supervision.

b) QIS (Quantitative Impact Study) in order to assess readiness of banks which shows:
   - Banks are aware with the core risks related with their activities;
   - They can identify, measure and mitigate the risks;
   - Require capacity building;
   - Require a straightforward guideline;
   - Require parallel run.

Under standardized approach, Basel II implementation requires the recognition of External Credit Assessment Institutions (ECAIs). For this, a guideline on the same has been prepared. Two credit rating agencies are operating in Bangladesh. They are registered with Securities and Exchange Commission and required to be recognized by BB for Basel II purpose. Recognition process of the rating agencies is under process. Preparation of the guideline on revised risk based capital regulation in line with Basel II is in progress .

**Corporate Governance in Banks**

5.44 Liquidity and solvency problems caused by poor governance in banks can have harmful systematic consequences in the broader economy reliant on banks for credit and payment services. High priority is therefore accorded to ensure corporate governance in banks, putting in place checks and balances comprising a mix of legal, regulatory and institutional provisions specifying the roles and accountabilities of the board, the executive management, external and internal audit, disclosure and transparency prescriptions.

Corporate governance is a sine-qua-non for a sound financial system in private commercial banks. Good corporate governance can contribute substantially to a shared working environment between banks and its supervisors. It supports not only a well-managed banking system but also necessary to protect depositors' interest. BB has taken several measures in recent times to put in place good corporate governance in banks. These include-regulation limiting the tenure of directors not more than six years at a stretch; reduction in the size of bank boards to a maximum of thirteen directors; appointment of two independent directors by BB; fit and proper test for appointment of board members and chief executive officers of PCBs; constitution of audit committee of board and enhanced disclosure requirements etc. In continuation of the above reforms, the roles and functions of the Board and Management were redefined and clarified with a view to specifying the powers of the management and restricting the intervention of directors in day to day management of the bank (Box 5.2).

**Corporate Social Responsibility (CSR)**

5.45 Corporate social responsibility (CSR) is mainly about the awareness of and actions in support of environmentally sustainable societal development. Yet to be mainstreamed into

Box 5.2

## Corporate Governance in Banks and Financial Institutions

Corporate Governance is the system of internal controls and procedures used to define and protect the rights and responsibilities of various stakeholders. In recent year, with the increase of failure of large corporations due to poor corporate governance the issue comes to front and many organizations pronounce the guidelines those are intended to protect the rights of various stakeholders and reduce the conflict of interests among them. Banks and Financial Institutions (FIs) are "special" as they do not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but also leverage such funds through credit creation. The depositors, particularly retail depositors, cannot effectively protect themselves as they do not have adequate information, nor are they in a position to coordinate with each other. It is believed that there could be a contagion effect resulting from the instability of one bank, which would affect a class of banks or even the entire financial system and the economy. As one bank becomes unstable, there may be a heightened perception of risk among depositors for the entire class of such banks, resulting in a run on the deposits and putting the entire financial system in jeopardy. The crisis of an individual bank may cause to create problem for entire financial system as well as the monetary management of the country. So, there should have clear and defined duties and responsibilities for the Management and the Board that act as the fiduciary for shareholders and the depositors. In view of the above, Bangladesh Bank is deploying continuous effort by inserting appropriate provisions in the Banking Companies Act, 1991 and Financial Institutions Act, 1993, supplemented by prudential regulations/guidelines in line with international best practices. The existing legal framework and significant current practices in particular cover the following aspects:

**The Board of Directors**

**Composition, Terms, Qualification etc.:** The maximum number of the Directors of the Board of banks and Financial Institutions (FIs) would be 13 and 11 respectively. Tenure of a Director of a bank would be 3 years extendable to another one term i.e. a Director can continue his/her office for six years at a stretch. A recess of one term is required after completion of six years as a Director. For FIs the tenure of a Director is 3 years and is renewable. Not more than 10 percent of the shares of a bank will be held by the members of a family. Not more than two member of a family will become Director of a bank in case of holding of more than 5 percent share of the Bank by that family and one member in case of holding of up to 5 percent share. Maximum voting right of any shareholder is restricted to 5 percent of total voting rights of all shareholders of the bank. On the other hand, maximum limit of holding shares of an FI by a single person/family/institution is 20 percent for domestic shareholders and 25 percent for joint venture. To be appointed a Director of a Bank or FI one requires to pass the 'fit and proper test' criteria: s/he has to hold qualifying amount of shares and not to be a minor or undercharged insolvent or mentally unsound with no record of criminal conviction or adverse judicial comment in any civil or criminal proceeding, no record of penalization by any authority for regulatory breach and, no loan default. In addition, the Director of a Bank requires having at least ten years of business or professional experience. No employee/executive, except CEO, would be appointed as the Director of any Bank/FI.

**Appointment of Directors from Depositors:**

For ensuring good governance in Banks, Banks are required to appoint 2 Directors from the depositors who will be in addition to 13 (thirteen) directors mentioned in the sub-clause 15(6) of Banking Companies Act, 1991. "Fit and proper test" criteria stated above, are applicable for appointing Directors from depositors. In addition, such Director should be a depositor of the bank company must at least have a bachelor degree from any recognized university, shall not be a director, officer/staff or advisor of any bank company, financial institution, insurance company or stock exchange, he, including his family members shall not hold more than 1% shares of the paid up capital of the bank, shall not be a salaried staff of the bank, shall not be involved with any political party, shall not be a loan/tax/bill defaulter.

Removal of Directors and Vacation of Office: A Bank/FI by extra ordinary resolution can remove any Director. Failure to attend in the three consecutive Board meetings without approval of leave of absence, become default of loan of any bank or FI and failure to repay the entire defaulted loan within two months of receiving the notice, submission of false declaration at the time of appointment and loss of qualification will cause to vacate the office of a Director.

**Responsibilities and Authorities of the Board of Directors**

**(a) Work-planning and Strategic Management:** The Board shall determine the objectives and goals and to this

Box 5.2

## Corporate Governance in Banks and Financial Institutions

*(Contd.)*

end shall chalk out strategies and work-plans on annual basis. The Board shall have its analytical review incorporated in the Annual Report as regard the success/failure in achieving the business and other targets as set out in its annual work-plan and shall apprise the shareholders of its opinions/recommendations on future plans and strategies. It shall set the Key Performance Indicators (KPIs) for the CEO and other senior executives and have it evaluated at times.

**(b) Lending and Risk Management:** The policies, strategies, procedures etc. in respect of appraisal of loan/investment proposal, sanctioning, disbursement, recovery, rescheduling and writing-off thereof shall be made with the Board's approval under the purview of the existing laws, rules and regulations. The Board shall specifically distribute the power of sanction of loan/investment and such distribution should desirably be made among the CEO and his subordinate executives as much as possible. No Director, however, shall interfere, directly or indirectly, into the process of loan approval. The Board shall frame policies for risk management and get them complied with and shall monitor the compliance thereof quarterly.

**(c) Internal Control Management:** The Board shall be vigilant on the internal control system of the bank and Financial Institutions in order to attain and maintain satisfactory qualitative standard of its loan/investment portfolio. It shall review the reports submitted by its audit committee regarding compliance of recommendations made in internal and external audit reports and the Bangladesh Bank inspection reports.

**(d) Human Resources Management and Development:** Policies relating to recruitment, promotion, transfer, disciplinary and punitive measures, human resources development etc. and service rules shall be framed and approved by the Board. The Chairman or the Directors shall in no way involve themselves or interfere into or influence over any administrative affairs including recruitment, promotion, transfer and disciplinary measures as executed under the set service rules. No member of the Board of Directors shall be included in the selection committees for recruitment and promotion to different levels. Recruitment and promotion to the immediate two tiers below the CEO shall, however, rest upon the Board. Such recruitment and promotion shall have to be carried out complying with the service rules i.e., policies for recruitment and promotion.

**(e) Financial Management:** The annual budget and the statutory financial statements shall finally be prepared with the approval of the Board. It shall quarterly review/monitor the positions in respect of bank's income, expenditure, liquidity, non-performing asset, capital base and adequacy, maintenance of loan loss provision and steps taken for recovery of defaulted loans including legal measures. The Board shall frame the policies and procedures for bank's purchase and procurement activities and shall accordingly approve the distribution of power for making such expenditures. The maximum possible delegation of such power shall rest on the CEO and his subordinates. Decisions on matters relating to infrastructure development and purchase of land, building, vehicles etc. for the purpose of bank's business shall, however, be adopted with the approval of the Board.

**(f) Formation of Supporting Committees:** For decision on urgent matters an Executive Committee, whatever name called, may be formed with the Directors. There shall be no committee or sub-committee of the Board other than the Executive Committee and the audit committee. No Alternate Director shall be included in these committees.

**(g) Appointment of CEO:** The Board shall appoint a competent CEO, whatever name called, for the Bank/FI with the approval of the Bangladesh Bank. The CEO for banking companies should be appointed for tenure of at least 3 years.

**Responsibilities of the Chairman of the Board of Directors:** As the Chairman of the Board of Directors (or Chairman of any Committee formed by the Board or any Director) does not personally possess the jurisdiction to apply policymaking or executive authority, he shall not participate in or interfere into the administrative or operational and routine affairs of the bank. The Chairman may conduct on-site inspection of any bank-branch or financing activities under the purview of the oversight responsibilities of the Board. He may call for any information relating to bank's operation or ask for investigation into any such affairs; he may submit such information or investigation report to the meeting of the Board or the Executive Committee and if deemed necessary, with the approval of the Board, s/he shall effect necessary action thereon in accordance with the set rules through the CEO. However, any complaint against the CEO shall have to be apprised to Bangladesh Bank through the Board along with the statement of the CEO.

Box 5.2

## Corporate Governance in Banks and Financial Institutions

*(Contd.)*

**Role of the Audit Committee:** The Audit Committee of Board of Directors will assist the Board in fulfilling its oversight responsibilities including implementation of the objectives, strategies and overall business plans set by the Board for effective functioning of the bank. The Committee will review the financial reporting process, the system of internal control and management of financial risks, the audit process, and the bank's process for monitoring compliance with laws and regulations and its own code of business conduct.

**The Chief Executive Officer (CEO)**

**Appointment :** To be appointed as chief executive of a banking company, an individual must possess at least 15 years of banking experience with at least 2 years in the level next below the chief executive and must meet the other stipulations mentioned above for Directors, except qualifying shares. The minimum experience of the CEO in the case of FI is 12 years and experience of 2 years in the post of next below the CEO is not required. Maximum age limit of CEO of Banks is 65 years.

**Responsibilities:** The CEO of the bank shall discharge the responsibilities and hold the authorities as follows:

(a) In terms of the financial, business and administrative authorities vested upon him by the Board, the CEO shall discharge his own responsibilities. S/he shall remain accountable for achievement of financial and other business targets by means of business plan, efficient implementation thereof and prudent administrative and financial management.

(b) The CEO shall ensure compliance of the Banking Companies Act, 1991 or Financial Institutions Act, 1993 as the case may be and/or other relevant laws and regulations in discharge of routine functions of the bank.

(c) The recruitment and promotion of all staff of the bank/FI except those in the two tiers below him shall rest on the CEO. S/he shall act in such cases in accordance with the approved service rules on the basis of the human resources policy and sanctioned strength of employees as approved by the Board. The authority relating to transfer of and disciplinary measures against the staff, shall rest on him, which S/he shall apply in accordance with the approved service rules. Besides, under the purview of the human resources policy as approved by the Board, he shall nominate officers for training etc.

**Disclosure Requirements**

Banks/FIs are required to prepare their financial statements comprising of balance sheet, profit and loss account, cash flow statement, statement of changes in equity, liquidity statement and other explanatory notes in accordance with International Accounting Standard (IAS). Copies of financial statements should be preserved in each of the bank branches, so that the customers of the bank may readily use those on request. Besides, balance sheet should be affixed in a visible place of each bank branch. The financial statements should be published in widely circulated one Bangla and one English daily newspaper within one week of submission of the statements to Bangladesh Bank so that the stakeholders of the bank including its depositors, shareholders and regulatory bodies can get information about the bank easily. These should also be disclosed in the bank's website.

**Other Issues**

Lending to the Director of own bank/FI is restricted up to 50 percent of the paid-up capital of such Director. Banks are not allowed to appoint Consultants for routine works that can be performed by the regular staff. The Consultants should have specific terms of references (ToR). No past Chairman, Director, Adviser, Chief Executive would be appointed as the Consultant of the same bank. No Consultant or Advisor shall participate in decision making process or exercise power regarding the financial, administrative or operational and routine affairs of the bank. With the view to save the interest of the Depositors, Banks are to appoint two Directors from the depositors who will be in addition to 13 Directors from the shareholders. Issuance of comprehensive guideline on maintenance of risk based capital in accordance with the Basel II is under process which would strengthen long term sustainability of banks.

corporate practice with a firmed up definition, CSR actions aim at mitigating the diverse environmental impacts of the activities of the business, and at reducing inequalities and alleviating deprivation and poverty in the communities across the country. In the wide range of possible CSR actions each business is expected to focus on areas of their core strength, working separately or in network with others. Well chosen, well executed CSR actions can enhance the longer run competitive position of a business; bringing in environmentally sounder practices, increased employee loyalty and commitment, actual and potential increase in customer base.

CSR activities are yet to be mainstreamed into corporate practice in Bangladesh in the banking sector or elsewhere. A few foreign banks and multinational corporates are undertaking CSR actions in Bangladesh, in line with the practices in their home countries. Many local banks and other businesses are already spending money philanthropically out of their profits in improving welfare of the poorer sections of the society; their actions should to be easy to be formalized into CSR initiatives, with appropriate sensitization and encouragement. Well chosen CSR actions by banks may serve to feel prevailing market gaps and market failures, such as scant availability of business loans for SMEs and crop loans for small farmers. To this end, Bangladesh Bank has issued guidelines for mainstreaming CSR in the financial sector in Bangladesh, encouraging bank and financial institutions to embrace CSR voluntarily in their management strategies, objective and practices.

**Activities of Credit Information Bureau (CIB)**

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

5.47 The workload of the Bureau kept on increasing unabated in terms of number of requests, number of borrowers and owners, number of reporting banks/financial institutions. CIB database consists of detailed information in respect of individual borrowers, owners and guarantors; the total number of which was 1,655,591(June 2008) recording an increase of 25.56 percent over the previous period (1,318,594 as of end June 2007). The number of CIB reports supplied during FY08 stood at 764,508 as compared to 565,957 in the FY07 showing an annual increase by 35.08 percent. As per existing service standard the credit reports are supplied within 5 working days of receiving the request, the volume of which was around 3100 per day during FY08.

5.48 The achievement of Credit Information Bureau in fulfilling its objectives of bringing down the extent of default loan has been found quite remarkable. As per reporting of scheduled banks/financial institutions, the classified loan decreased during FY08. The classified loan decreased to 11.93 percent at end June 2008 compared to 12.35 percent in the preceding year. The percentage of such classified loan was 34.9 in December 2000. It may be mentioned that with effect from June 2004 quarter the amount of "written-off" loan was excluded from both classified and outstanding loans, and after exclusion the percentage of classified loan stood at 11.93 as on 30 June 2008.

5.49 In order to ensure prompt collection of credit data from the sources as well as instantaneous delivery of credit report to the users by applying latest computer technology, the CIB started diagnostic analysis of the customer and the central bank with effect from 13 July 2007 under DFID financial assistance programme aimed at implementing on-line services between the Bureau and the lending institutions. The project of implementing on-line connectivity between CIB and the Head Offices of the banks and financial institutions is expected to be completed by the year end June 2009.

### C. Supervision of Banks

With a view to promoting and maintaining soundness, solvency and systemic stability of the financial sector as well as protection of depositors' interest, BB carries out two types of supervision namely, off-site supervision and on-site supervision. Department of Off-site Supervision (DOS) is responsible to conduct off-site supervision of banks. The operations of DOS have been discussed in the chapter above. The details of on-site supervision is given below :

### On-site Inspection of Banks

5.50 Bangladesh Bank, being the Central Bank of the country, is entrusted with the responsibility to regulate and supervise the banks and financial institutions operating in the country. Inspection of banking companies is assigned on Bangladesh Bank under article 7A(f) of the Bangladesh Bank Order 1972 and section 44 of the Banking Companies Act 1991. As part of Bank's statutory function, three departments of the Bangladesh Bank namely Department of Banking Inspection-1, Department of Banking Inspection-2 and Foreign Exchange and Vigilance Department are conducting the inspection activities. These three departments conduct on-site inspection on State-owned Commercial Banks (SCBs), Specialized Banks, Private Commercial Banks (including banks under Islamic shariah), Foreign Banks and other institutions including Investment Corporation of Bangladesh (ICB) and Money Changers. Basically, two types of inspections are conducted namely (i) comprehensive inspection and (ii) special inspection.

The broad objectives of on-site inspection are as follows:

- To ensure safety, stability and discipline in banking sector;
- To ensure compliance of banking laws, rules and regulations;
- To evaluate quality and performance of bank management and Board of Directors;
- To identify weaknesses which are to be addressed to strengthen the banks;
- To evaluate financial soundness and operational efficiency of the banks.

In comprehensive inspection, overall performance/conditions of the banks such as capital adequacy, asset quality, liquidity, earnings, management competence etc. are evaluated. Based on their performance banks are rated between 1-5 grades in ascending order. Inspection is done according to the Annual Inspection Programme (AIP) chalked out by the departments well ahead of the beginning of each calendar year. These departments also monitor implementation of the suggestions/ recommendations made in the inspection reports. Special inspections are conducted on the banks on specific/particular issue(s) as well as to investigate complaints received from the depositors, general public or institutions. Moreover to oversee risk management practice of the banks/ implementation of core risk management guidelines by the banks, systems inspection were also conducted.

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

5.52 DBI-1 and 2 conducted a total number of 2120 inspections throughout banking sectors under comprehensive inspection programme during FY08 including 43 head offices, 542 big branches and 1535 small branches. Under the special inspection Programme, a total number of 673 inspections were carried out by DBI-1 and DBI-2 regarding risk-based audits and others during FY08.

**Financial Institutions (FIs)**

5.53 FIs represent one of the most important segments of financial system and play very important role in mobilizing and channeling resources in Bangladesh. The financial institutions comprises investment and finance companies, leasing companies etc. The financial institutions numbering 29 as of December 2007 (starting from IPDC in 1981) are regulated by the Financial Institutions Act, 1993 and the regulations made thereunder. In view of their increased role in financing industry, trade and commerce, transport, information technology, housing etc. the minimum capital requirement of the FIs was raised to Taka 0.25 billion vide FID circular 2, dated 29 June 2003, Most of the FIs (except two) have raised their required capital. 18 FIs have issued IPO, three of them are given waiver from issuing IPO and rest of them have been asked to issue IPO (initial public offering) and raise their capital as required level. FIs are allowed to participate in the call money market upto 15 percent of their total net assets. Total investment of FIs in different sectors upto June 2008 were Taka 96.8 billion. Investment in capital market was Taka 6.2 billion. Since December 2000, classification of loan/lease and provisioning thereagainst has been introduced for the financial institutions like the banking companies. As on 30 June 2008, total classified loan/lease stood at Taka 7.9 billion or 8.2 percent of total loan/lease. After netting of interest suspense and provision, the net classified loan/lease would be 1.6 percent.