Performance, Regulation and Supervision of NBFIs

7.1 Non Bank Financial Institutions (NBFIs) have emerged as an important segment of financial system in Bangladesh. NBFIs offer diversified financial services mostly long-term in nature to cater the ever changing demands of customers. NBFIs play crucial roles in providing additional financial services that cannot be always met by the banks. In addition, NBFIs are engaged in the capital market as well as in real estate sector of Bangladesh. As a watchdog, Bangladesh Bank supervises NBFIs through a risk-based supervisory system so that NBFIs can deliver financial services efficiently. NBFIs showed strong performance in terms of growth in assets and deposits during FY16.

7.2 Bangladesh Bank issues licence and supervises NBFIs under the Financial Institution Act, 1993. At present, the minimum paid up capital for NBFIs is Taka 1.0 billion as per the Financial Institution Regulation, 1994. NBFIs' business line is narrow in comparison with Banks in Bangladesh. NBFIs have been allowed to offer term deposit service for tenure of at least three months effective from 2 December 2013.

7.3 Presently, out of 33 NBFIs, three are Government-owned, 11 are joint venture and the rest 19 are locally private-owned. Meanwhile, the branch network increased to 220 as on 30 June 2016. The Structure of NBFIs is shown in Table 7.1.

A.1. Assets

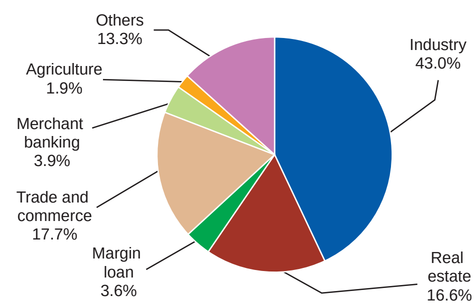
7.4 The asset of NBFIs went up substantially by 17.5 percent to 611.0 billion in 2015 from Taka 520.1 billion in 2014. At the end of June 2016, assets of NBFIs increased to Taka 672.8 billion.

Table 7.1 Structure of NBFIs

	2010	2011	2012	2013	2014	2015	2016*
No. of NBFIs	29	31	31	31	31	32	33
Government- owned	1	2	3	3	3	3	3
Joint-venture	8	8	10	10	10	10	11
Private	20	20	18	18	18	19	19
New branches	20	53	8	7	7	15	22
Total branches	108	161	169	176	183	198	220

* As on 30 June 2016.
Source: Department of Financial Institutions and Markets, BB.

Chart 7.1 Investment pattern of NBFIs as of 30 June 2016



Source: Department of Financial Institutions and Markets, BB.

A.2. Investment

7.5 NBFIs deploy funds for providing mainly term loan in different sectors of the economy with major concentration in industrial sector. Sector wise composition of NBFIs' investment at the end of June 2016 was as follows: industry 43.0 percent, real estate 16.6 percent, margin loan 3.6 percent, trade and commerce 17.7 percent, merchant banking 3.9 percent, agriculture 1.9 percent and others 13.3 percent.

7.6 NBFIs are allowed to invest in the capital market to the extent mentioned in the Financial Institutions Act, 1993. In 2015, all NBFIs' total investment in capital market was Taka 19.4 billion compared to Taka 18.4 billion in December 2014. Investment in capital market accounted for 3.2 percent of the total assets of all NBFIs. At the end of June 2016, NBFIs total investment in capital market stood at Taka 21.1 billion.

A.3. Deposits

7.7 Total deposits of the NBFIs in 2015 rose to Taka 318.1 billion (62.5 percent of total liabilities) from Taka 238.5 billion (56.2 percent of total liabilities) in 2014 showing an overall increase of 33.4 percent. At the end of June 2016, total deposit of NBFIs increased to Taka 351.4 billion.

A. 4. Other Liabilities and Equity

7.8 The aggregate liability of the industry increased to Taka 509.0 billion in 2015 from Taka 424.2 billion in 2014 while equity increased to Taka 102.0 billion compared to Taka 95.8 billion during the same period showing an overall increase of 20.0 percent and 6.5 percent respectively. At the end of June 2016, aggregate liability and equity increased to Taka 572.0 and Taka 100.8 billion respectively.

A.5. Bond and Securitisation Activity

7.9 The bond market in Bangladesh is yet to be modernised. There are few players with a limited number of instruments. NBFIs play a significant role for the development of bond market through issuing Zero Coupon Bonds and Asset-backed Securitised Bonds. By taking NOC from the Department of Financial Institutions and Markets (DFIM), Taka 2.5 billion "IDLC Infrastructure and SME Zero Coupon Bond" were issued by IDLC Finance Limited, Taka 3.0 billion non-convertible zero coupon bonds by LankaBangla Finance Limited and Taka 1.0 billion Fixed Rate Non-convertible Subordinated Bond was issued by Reliance Finance Limited as of June 2016.

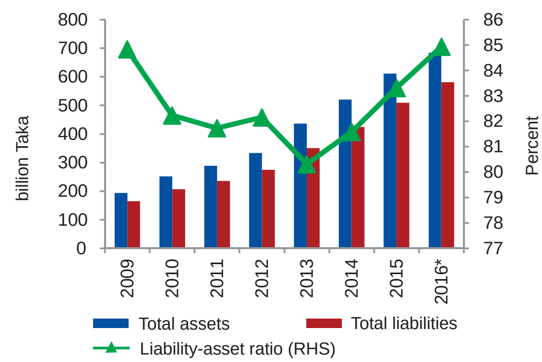
Table 7.2 Assets, liabilities and deposits of NBFIs

(billion Taka)

	2010	2011	2012	2013	2014	2015	2016*
Total assets	251.5	288.4	333.9	436.3	520.05	611.0	672.8
Total liabilities	206.8	235.7	274.3	350.4	424.24	509.0	572.0
Liabilities-assets ratio	82.2	81.7	82.2	80.3	81.5	83.3	85.0
Total deposit	94.4	112.6	145.4	198.3	238.5	318.1	351.4
Deposit as % of total liabilities	45.7	47.8	53.0	56.6	56.2	62.5	61.4

* As on 30 June 2016.
Source: Department of Financial Institutions and Markets, BB.

Chart 7.2 Assets, liabilities and their ratios of NBFIs



* As on 30 June 2016
Source: Department of Financial Institutions and Markets, BB.

B. Performance and Rating of NBFIs

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

B.1. Capital Adequacy

7.11 Capital adequacy focuses on the total position of NBFIs' capital and protects the depositors from the potential shocks of losses that an NBFI might incur. It helps absorb major financial risks related to credit, market, interest rate, etc. NBFIs in Bangladesh have been instructed under the Basel Accord to maintain Capital Adequacy Ratio (CAR) of not less than 10.0 percent with at least 5.0 percent in core capital. At the end of June 2016, out of 33 NBFIs, (one NBFI is yet to come under this operation) 2 were evaluated as "1 or Strong", 15 were "2 or Satisfactory", 14 were "3 or Fair" and 1 was "4 or Marginal" in the capital adequacy component of the CAMELS rating.

B.2. Asset Quality

7.12 The ratio of gross nonperforming loan /lease to total loan/lease is used to judge the asset quality of NBFIs. At the end of June 2016, the NPL ratio for NBFIs was 9.0 percent. In the total asset composition of all NBFIs, the concentration of loans, lease and advances was 74.2 percent. At the end of June 2016, out of 33 NBFIs, 1 was evaluated as "1 or Strong", 7 were "2 or Satisfactory", 14 were "3 or Fair", 9 were "4 or Marginal" and 1 was "5 or Unsatisfactory" in the asset quality component of the CAMELS rating matrix (the remaining one NBFI is yet to come into rating).

B.3. Management Efficiency

7.13 In financial institutions, management efficiency represents the ability of management for transforming inputs (deposits, other funds and human resources) into outputs (investments/ leases and other income generating assets). Total expenditure to total income, operating expenses to total expenses, earnings and operating expenses per employee and interest rate spread are generally used to gauge management efficiency. At the end of June 2016, out of 33 NBFIs, 4 were evaluated as "1 or Strong", 21

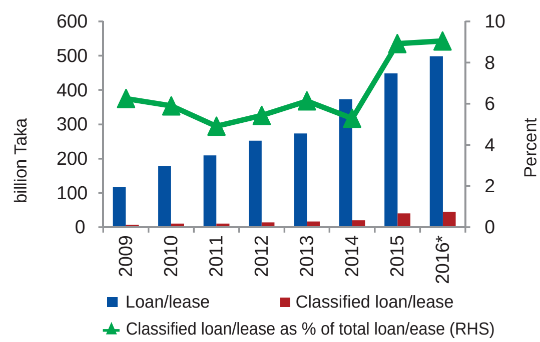
Table 7.3 Total loan/lease and classified loan/lease

(billion Taka)

	2010	2011	2012	2013	2014	2015	2016*
Loan/lease	178.1	209.7	252.1	273.6	372.8	448.5	498.6
Classified loan/lease	10.5	10.3	13.7	16.8	19.7	40.0	45.1
Classified loan/ lease as % of total	5.9	4.9	5.4	6.1	5.3	8.92	9.0

* As on 30 June 2016.
Source: Department of Financial Institutions and Markets, BB.

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



* As on 30 June 2016.
Source: Department of Financial Institutions and Markets, BB.

were "2 or Satisfactory", 4 were "3 or Fair", 2 were "4 or Marginal" and 1 was "5 or unsatisfactory" in the Management Capacity component of the CAMELS rating (the remaining one NBFI is yet to come into rating).

B.4. Earnings and Profitability

7.14 Earnings and profitability of an NBFI reflects its efficiency in managing resources and its long term sustainability. Among various measures of earnings and profitability, the best and widely used indicator is the return on assets (ROA) which is supplemented by return on equity (ROE). ROA and ROE of all the NBFIs in June 2016 were 0.8 and 5.6 percent respectively. At the end of June 2016, out of 33 NBFIs, 3 were evaluated as "1 or Strong", 16 were "2 or Satisfactory", 11 were "3 or Fair" and 2 were "4 or Marginal" in the earnings and profitability component of the CAMELS rating (the remaining one NBFI is yet to come into rating).

B.5. Liquidity

7.15 NBFIs are allowed to mobilise term deposit only. At present, term liabilities are subject to a statutory liquidity requirement (SLR) of 5.0 percent inclusive of average 2.5 percent (at least 2.0 percent in each day) cash reserve ratio (CRR) on a bi-weekly basis. The SLR for the NBFIs operating without taking term deposit is 2.5 percent. The Infrastructure Development Company Limited (IDCOL) established by the Government of Bangladesh is exempted from maintaining the SLR. At the end of June 2016, out of 33 NBFIs, 19 were evaluated as "2 or Satisfactory", 10 were "3 or Fair", 2 were "4 or Marginal" and 1 was "5 or Unsatisfactory" in the liquidity position component of the CAMELS rating (the remaining one NBFI is yet to come into rating).

B.6. Sensitivity to Market Risk

7.16 The sensitivity to market risk reflects the degree to which changes in interest rates or equity prices can adversely affect an NBFI's asset-liability position, earnings and capital. When evaluating this sensitivity component, consideration should be given to management's ability to identify, measure, and control market risk via the implementation of effective Core Risk Management System. Vulnerability of the NBFI in a stressed situation from either an interest rate or equity price shock (or both) should be taken under consideration to evaluate sensitivity. For many NBFIs, the primary source of market risk arises from non-trading positions and their sensitivity to changes in interest rates. At the end of June 2016, out of 33 NBFIs, 3 were evaluated as "1 or Strong", 9 were "2 or Satisfactory", 15 were "3 or Fair", 4 were "4 or Marginal" and 1 was "5 or Unsatisfactory" in the sensitivity to market risk component of the CAMELS rating matrix (the remaining one NBFI is yet to come into rating).

Table 7.4 Profitability of NBFIs

(percent)

	2009	2010	2011	2012	2013	2014	2015	2016*
Return on equity (ROE)	20.9	24.4	11.7	10.4	7.5	9.9	9.9	5.6
Return on asset (ROA)	3.2	4.3	2.1	1.9	1.5	1.8	1.8	0.8

* As on 30 June 2016 (Annualised)
Source: Department of Financial Institutions and Markets, BB.

B.7. Composite CAMELS Rating

7.17 At the end of June 2016, according to the composite CAMELS rating out of 33 NBFIs, 1 was "1 or Strong", 15 were "2 or Satisfactory", 13 were "3 or Fair" and 3 were "4 or Marginal" (the remaining one NBFI is yet to come into rating).

C. Legal Reform and Prudential Regulations

7.18 As part of the ongoing efforts to strengthen the NBFIs through the adoption of policies aimed at both improving the financial strength of NBFIs as well as bringing about greater transparency in their operations, some legal and regulatory policy measures have been continued in FY16.

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

7.19 Basel-II has been implemented in the NBFIs since 1 January 2012. Prudential guidelines on capital adequacy and market discipline (CAMD) has been issued to promote international best practices and to make the capital of NBFIs more risk-based as well as more shock resilient. NBFIs have to follow the guidelines as statutory compliance. In this regard, a high-level Steering Committee (SC) headed by a Deputy

Governor of BB comprising NBFIs' Chief Executive Officers has been formed for working on policy decisions. Furthermore, a Working Group (WG) headed by an Executive Director of BB has been assisting the SC in decision-making. Basel Implementation Cell (BIC) under DFIM has been formed to assist and carry out the instructions of SC and WG on Basel accord implementation.

C.2. Corporate Governance in NBFIs

7.20 BB has taken some policy measures in order to put in place good corporate governance in NBFIs. BB has specified clearly the authority, responsibility and functions of the Board of Directors, Executive Committees, Audit Committees, Management and Chief Executive Officer of NBFIs. The number of directors in the Board is ranging from 9 to 11. The Board sets and approves the vision/mission, annual strategic planning, key performance indicators, core risk management guidelines, etc. Chief Executive Officer is responsible to conduct day to day functions and materialisation of the strategic business plan.

C.3. Asset Classification and Provisioning

7.21 NBFIs are required to maintain provision for expected losses on loans, advances, leases, investments considering aging analysis. Aging analysis of overdue loans/leases classifies them to standards, special mention accounts, sub-standards, doubtful and bad/losses, requiring the NBFIs to keep provision by 1 percent, 5 percent, 20 percent, 50 percent and 100 percent respectively. To boost up SME investment a special allowance of general provision of 0.25 percent provided instead of 1 percent in standard SME loans. At the end of June 2016, the total outstanding loan/lease was Taka 498.6 billion of which NPL was Taka 45.1 billion (9.0 percent).

C.4. Loan Rescheduling Policy

7.22 For the purpose of rescheduling of loans/leases NBFIs must have to receive down payments from clients. NBFIs take minimum of 15 percent, 30 percent, 50 percent of overdue amount or 10 percent, 20 percent, 30 percent of outstanding amount, whichever is lower, as down payment in cash for first time, second time and third time rescheduling respectively.

C.5. Core Risk Management

7.23 Guidelines on five core risk areas, namely, credit risk management, internal control and compliance, asset-liability management, prevention of money laundering and terrorist financing and information and communication technology (ICT) security have been issued for NBFIs. Besides the above with a view to address and manage all the risks in more prudent and organised way the 'Integrated Risk Management Guidelines for Financial Institutions' have also been issued to adopt improved policies and procedures in line with international best practices for their risk management framework. For this purpose, the Guidelines encompass all the probable risks that include credit risk, market risk, liquidity risk, operational risk, compliance risk, strategic risk, reputation risk, environmental risk, and money laundering risk.

C.6. Stress Testing

7.24 NBFIs have been conducting stress testing on a quarterly basis since 2010. A new financial position indicator, insolvency ratio (IR), artificial intelligence to auto-generate recommended action plan, rating scale of 1 to 5, zonal positioning (Green, Yellow and Red) through weighted average resilience-weighted insolvency ratio (WAR-WIR) matrix have been included in the revised guideline for NBFIs. As per the new guideline, NBFIs carry out stress testing on a quarterly basis. As of June 2016, out of 33 NBFIs 5 were in Green Zone, 13 were in Yellow Zone and the rest 15 were in the Red Zone.

D. Consumer Protection Regulations

D.1. Schedule of Charges

7.25 BB has rationalised the charges of some services to ensure the interest of depositors/ investors/customers and advised all NBFIs to display the complete schedule of charges in suitable places in their branches and head offices to make it visible to the current and potential customers. They are also instructed to post the same information in their websites. BB monitors this issue and NBFIs are required to submit semi- annual statements in this regard. No charge/commission like commitment fee, supervision fee and cheque dishonour fee can be charged.

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

7.26 Along with the banks, the financial institutions with their customised products and services have emerged as the competitive financial intermediaries to meet the growing and changing demands of customers. The 'Guidelines on Products and Services of Financial Institutions in Bangladesh" has outlined the different characteristics of existing and new products. These guidelines protect clients' interest as well as provide greater flexibility to financial institutions to cope up with changing environment. This also helps promoting sound risk management system and brings discipline in launching new products and services.

E. Cost of Funds Index for NBFIs

7.27 NBFIs are regularly submitting their monthly statements of base rate and cost of funds to BB as per guideline published in 2013. On the basis of these statements, BB prepares an aggregate cost of funds index, uploads that in the BB website and updates it in its website on a monthly basis. It can be mentioned that base rate is the minimum interest rate below which it is not viable for an NBFI to lend in the market. As there was no specific guideline before December 2013, the NBFIs calculated the interest rate in different ways from their own perspective. Some NBFIs provided loan using floating interest rate. In that case, they imposed the rate based on the deviation among their own cost of funds. As a result, their efficiency or inefficiency to manage the liquidity directly affected the clients. The cost of funds index is used as an acceptable reference rate. The base rate system facilitates the interest rate determining process and ensures more transparency and accountability in the NBFIs. Base Rate System is used in different countries including India, Nepal and Bhutan. In Bangladesh, the base rate system with cost of funds index has been initiated for the first time.

F. Guidelines on Commercial Paper for Financial Institutions

7.28 In order to set some regulations regarding commercial paper the 'Guidelines on Commercial Paper for Financial Institutions' has been introduced. Financial Institutions are allowed to be involved in commercial paper as investor, issuer, guarantor, and Issuing and Paying Agent by complying the terms and conditions as mentioned in the guidelines.