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Services Trade in Developing Asia:
A case study of the Banking and Insurance Sector in Bangladesh

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Executive Summary

This study assesses the strengths and weaknesses of reforms in the banking and insurance industries. Banking sector performance is analysed using various indicators as well as Principle Component Analysis techniques. A comparative case study of three banks with different ownership structures is presented. The study concludes with important conclusions and policy implications for future reforms based on the findings.

Financial sector reform in Bangladesh started in 1976 with privatization of the banks to encourage private investment, and continue in the mid-1980s as part of Structural Adjustment Policies (SAP). Between 1992 and 1996, a Financial Sector Reform Programme (FSRP) was implemented. Its major aim was to improve the operations of Nationalized Commercial Banks (NCBs) through the development of new banking technologies, computerization of banking operations, upgrading of skills, changing outdated internal banking practices and corporate and credit cultures. Further reforms are underway.

Together with other reforms, financial sector liberalization has made a positive contribution to the Bangladesh economy by raising the rate of growth to above 5 percent since 2000. The sectoral distribution of GDP indicates that Bangladesh’s economy has undergone important structural transformations over the past three decades. In 2004, the industrial sector accounted for 27 per cent of GDP, while the share of agriculture dropped to 23 per cent (from 29% in 1990), and that of the services sector amounted to 50 per cent. However, changes in employment structure have been sluggish. Similarly, the gap between lending and deposit rates is high. The high non performing loan (NPL) rates of the nationalized banks indicate the necessity of a thorough assessment of the banking system. This is particularly necessary in view of increased openness of banking and growing competition at regional and global levels.

In Bangladesh, there are 49 banks (with 6318 branches) of which there are 30 private commercial banks, 10 foreign commercial banks and 9 nationalized commercial and specialized banks. The banking sector employs about 110,000 people. Total deposits and loans and advances also increased considerably between 1990 and 2005 and some financial deepening has taken place as a result of intensive reforms in the financial system. Foreign joint venture banks now hold about 9.5 percent of the total assets of commercial banks.

The lending capacity of the commercial bank increased tremendously after 1990. The sectoral lending pattern also shows a large change. While the share of agriculture sector in total lending of the commercial banks has reduced considerably, the share of trade has increased. Despite reduction in the share of manufacturing sector in the economy, working capital for the manufacturing sector has increased commensurably. The share of institutional credit going to poor people remains low.

Altogether 58 insurance companies are operating in Bangladesh with the private sector taking an increasing share in the insurance business. Performance of the general insurance industry shows a continuous growth. Despite steady expansion, still there are many barriers to both foreign and domestic investment in this sector.

The Principle Component Analysis conducted indicates that, compared to the first half of the period examined (1996-2001), the performance of the financial sector has deteriorated in the second half (2001-2005), suggesting more intensive reforms required in the banking system. The analysis also reveals that the changes in expenditure income ratio of the development financial institutions explain a significant part of the variability of the performance of the financial sector.

Return on assets (ROA) and return on equity (ROE) of the commercial banks show divergent trends. In particular, earnings as measured by ROA and ROE vary widely from one bank to another. Indicators reveal that the ROA of the NCBs has been very low and turned negative in 2004. The performance of the Development Finance Institutions (DFIs) is even worse. A higher rate of NPL is found in the government owned banks compared to domestic private and joint venture banks. Overall, however, aggregate net interest income (NII) of the banks has been positive and consistently increased during the period 1997 to 2004. A major positive impact of the reform is that the gap between deposit and lending rates has decreased over time, suggesting increasing efficiency of the banking system.

The comparative case study analysis carried out of three banks comprising nationalized, private domestic and joint venture banks revealed a big divergence in their performance. Indicators like net interest income to total assets, total deposits, total loan and advances and NPL ratios show that the performance of the nationalized bank has deteriorated sharply during the period 2001 to 2005. Such ratios for private domestic and joint venture banks, however, have increased remarkably during the same period, with the performance of the joint venture bank generally better than that of the private domestic bank.

The results from a survey of 20 banks indicated that there was no adverse employment effect in banks due to increased foreign equity participation. Likewise, survey results revealed that in most of the cases small businesses were not found to be deprived of credit facilities as a result of increased foreign equity participation. Instead, joint venture banks like Standard Chartered bank were aggressively encouraging new small entrepreneurs and business people to take advantage of credit facilities.

Bangladesh's experience shows that ownership structure is a key to improving the performance and enhancing the efficiency of the entire banking system. Structural and institutional reforms in the state owned bank will be necessary for healthy and sustained growth in the banking system. In the whole reform process, the regulating capacity of the central bank needs enhancement.

I: Introduction

1.1 Background

After independence in 1971 Bangladesh faced a devastated economy. It was however able to quickly reconstruct. Initially, Bangladesh went through a process of nationalization. From the mid 1980s, privatization was again started along with encouragement of private investment. A large amount of loan finance was channeled through two major Development Finance Institutions i.e. Bangladesh Shilpa (industry) Bank, and Bangladesh Shilpa (industrial) Rin (loan) Sangstha (organization). These loan facilities were politically motivated. This led to large defaults. The World Bank and IMF came up with Structural Adjustment Program in which focus was put on recovery of loans, although provisions were made for non-recoverable loans. A project entitled Financial Sector Reform Programme (FSRP) was implemented in Bangladesh Bank. The major aim of FSRP at Bangladesh Bank was to improve the operations of NCBs through development of new banking technologies, computerization of banking operations, upgrading of skills, changing outdated internal banking practices and corporate and credit cultures etc. During FSRP period, 1992-96, FSRP consultants developed a number of new management and operational tools such as lending risk analysis (LRA), large loan reporting system (LLRS), new loan ledgers (NLL), performance planning system (PPS), management information system (MIS) etc. and disseminated these tools and techniques through various training programs to a large number of bank officers, especially those of NCBs.

Bank and insurance companies have played a vital role in advancing the economic and social condition of Bangladesh. They have developed a climate favourable to capital formation. Bank and insurance companies in Bangladesh now constitute the core of the country's organized financial system. They mobilize the savings of people and channel the resources towards different sector of the economy. The bankers' committee of Bangladesh Bank and Chief Controller Office of Insurance determines the planned allocation of resources among various sectors such as agriculture, real estate, leasing, industry and service sector and regions with the objective of achieving balanced regional and sectoral development.

Financial sector liberalization has made a positive contribution to the economy of Bangladesh in the form of financial deepening, reduction in the gap between deposit and lending rates over time, increased competition and quality services through foreign equity participation and expansion in the international trade, and structural changes in the economy through growing contribution to value added and employment.

Financial sector liberalization also passing has various problems. There is a persistent gap between lending and deposit rates, mainly due to the predominance of non performing assets in the banks' investment portfolios. This, to a larger extent, is undermining ongoing reform which is aimed at enhancing efficiency in the banking system. Most of the newly established banks and insurance companies are confined to urban areas with limited portfolio diversification. The collapse of small and cottage industries year after year together with potential adverse employment implications of financial sector liberalization indicate that there may be some lapses in the ongoing reforms in banking and insurance.

1.2 Definition of the Banking and Insurance Sectors

Financial services usually include banking, insurance, securities, asset management, pension funds, financial advisory, information and other services[1]. These services are commonly associated

[1] For the definition see WTO Document, TN/S/W/43.

with the supply of financial instruments[2]. Based on the nature of this study, financial services are divided into banking and non-banking services. Banking institutions provide banking and other financial services to their customers. They render services to the customers in terms of both deposits and lending by performing the role of intermediating between savers and borrowers. There are several types of banks in Bangladesh, which differ in the number of services they provide and the clientele they serve. Global banks are involved in international lending and foreign currency trading, in addition to the more typical banking services. Regional banks have numerous branches and automated teller machine (ATM) locations throughout areas that provide banking services to individuals. Banks have become more oriented toward marketing and sales. Community banks are based locally and offer more personal attention. In recent years, online banks—which provide all services entirely over the Internet—have entered the market, and some formerly Internet-only banks are opting to open branches.

Non-banking financial institutions include insurance and other fund management services. Insurance companies are the most important non-banking financial institutions. An insurance company operates as an insurer[3]. Insurance companies collect premiums and compensate those who suffer loss. Insurance is the best medium of security to both property and human life. It operates basically on three principles—the sharing of losses, the participation of a large number of clients, and the quality of risk. Insurance companies not only shift the risks but also collect small-scattered capital and invest it in various activities of a long-term nature.

1.3 Review of the Literature

In last few years some research has been done in the areas of banking and finance in Bangladesh. Beck and Rahman (2006) examined three indicators of financial development (Domestic credit to private sector as percent of GDP, Total Deposits as percent of GDP, Broad Money as percent of GDP) and found widening and deepening of the financial system in Bangladesh. Similarly, their study shows a close relationship between financial development and investment and per capita income. Likewise, a study examining the impact of financial reform on private saving finds a positive association between the two (Choudhury et al 2000). Choudhury and Raihan (1999) find that the effects of WTO on the financial system of Bangladesh have been mainly positive. A study examining the effect of foreign direct investment in the banking and insurance finds that even though domestic banks have lost market share, the quality of banking services has improved in Bangladesh (Raihan and Morium 2000). Substantial growth in information technology has expanded electronic banking in Bangladesh (Raihan 1998). Access to credit by SMEs has grown in recent time (Saha et al 2000). A study investigating the implications of global financial crises for the banking Sector in Bangladesh finds that the sector has not been adversely affected (Choudhury and Raihan 1999). Despite all these studies, no comprehensive studies examining the broader impact of financial sector reform in general and banking and insurance sector reform are available.

1.4 Research Questions and Scope of This Study

1.4.1 Research Questions

The most important research questions addressed by the study are as follows:

[2] See www.fin.gc.ca/hst/hstglo-e.html
[3] See www.alwarrantysolution.com/glossary.htm

1. How have banking and insurance sector-related trade liberalization policies been pursued in Bangladesh? Are these and other reforms accompanied by strengthening of rules, regulations and the regulatory system?
2. Has banking and insurance sector liberalization enhanced competition and efficiency ?
3. Is there any adverse employment effect of increased foreign equity participation? Has it adversely affecting a process of gender mainstreaming?
4. What lessons could countries like Bangladesh learn from the ongoing trade liberalization and reform of banking and insurance in order to be useful for local policy reforms as well as for further trade liberalization negotiations?

1.4.2 Scope of the Study

The scope of the study is as follows:

– Briefly assess the liberalization policies pursued in the banking and insurance sector since the 1990s,

– Examine the strengths and weaknesses of banking and insurance sector liberalization in the light of their contribution to raising efficiency and competitiveness,

– Make a comparative assessment on the role of joint venture, private and government owned banks and insurance companies promoting business and enhancing access to credit with special focus on gender dimension, and

– Explore the possibility of enhancing the role of banking and insurance services in the Bangladesh economy and set out the strategies appropriate to preferential trade agreements for LDC's like Bangladesh.

1.5 Methodology and Data

Both in country specific and cross-country studies various approaches and methods have been used to examine the impact of liberalization in services trade, including financial services. The trade models that are used in impact analysis generally assume that resources are fully employed. For assessing the impact of financial liberalization composite index are constructed and used in the cross-country regression analysis. To represent the degree of liberalization in financial services, a competition index is introduced. In terms of methodology and approaches, most of the studies have given main emphasis to competition and efficiency issues including issues associated with the regulatory system. Some studies also emphasize the necessity of examining the factor impact in terms of employment and access to credit facilities. Taking all these into account, we follow a three pronged approach.

Firstly, the report examines various policy measures pursued in the banking and insurance sector. In the course of analysis, various indices like financial deepening, the spread between lending and deposit rates, rate of return, access to financial services and extent of prudential regulations have been examined.

This has been followed by construction of a financial sector performance index. For this, Principal Component Analysis been used. Such an analysis enables us to find the factor which explains the highest variability of performance of the financial sector. This composite index also shows variations in the performance of the sector.

Finally, case studies of government, private domestic and joint venture banks have been undertaken. Net interest margins, non-interest income, overhead cost, non-performing loans, and credit to the private sector etc have been specially looked into. The employment pattern in the banks has also been examined to analyse the role of liberalization in enhancing gender mainstreaming.

Thus, for the study both secondary and primary data sources have been used. Earlier studies and their findings including their data sources have also been used for the comparative purposes.

1.6 Structure of the Report

Chapter II briefly reviews the performance of the economy in the pre- and post liberalization period. This is followed by a critical review on the policy reforms carried out in the banking and insurance sectors. Bangladesh’s commitments under multilateral and regional trade agreements as well as autonomous policy are reviewed in Chapter IV. Chapter V is devoted to examining performance of the banking and insurance sector. Chapter VI presents case studies of different types of banks and survey findings. Finally, Chapter VII provides major conclusions and policy implications.

II: *A Brief Review of the Bangladeshi Economy and Its Performance*

A comparison of GDP growth rates in constant prices between the 1980s and the 1990s indicates that there has been an improvement in the growth performance over the years. Compared with growth rate of 3.6 percent in the 1980s, the average growth rate reached 4.8 percent in the 1990s. Subsequently, the growth rate accelerated further with average growth rate of 5.3 percent during the period 2001 to 2005 (Table 2.1). Economic reforms and liberalization played an important role in such a rise. Despite this, there are number of emerging structural and institutional constraints affecting sustained growth and economic diversification. During the financial year 2005-06, Bangladesh economy was confronted with serious problems emanating from devastating flood, inflation of oil prices and termination of the Multi Fiber Arrangement. To cope with these challenges, a series of new policy measures was introduced.

Table 2.1
Sectoral Growth Rate (per cent)

Sector	FY91-FY00 (Average)	FY01-FY05 (Average)	FY03-FY04	FY04-FY05
Agriculture	**3.2**	**2.1**	**4.1**	**0.3**
a) Agriculture and forestry	2.1	2.4	4.4	-0.7
b) Fishing	8.2	1.4	3.1	4.0
Industry	**7.0**	**7.5**	**7.6**	**8.6**
a) Mining and quarrying	6.0	7.5	7.7	8.4
b) Manufacturing	6.9	6.9	7.1	8.4
c) Power, gas and water-supply	5.5	8.2	9.1	9.1
d) Construction	7.5	8.5	8.3	8.7
Services	**4.5**	**5.7**	**5.7**	**6.6**
a) Wholesale and retail trade	5.7	6.5	6.6	6.9
b) Hotel and restaurant	5.5	7.1	7.1	7.3
c) Transport, storage and	4.6	7.1	6.2	8.1
communication	4.8	7.0	7.0	9.0
d) Financial sector	3.5	3.5	3.6	3.6
e) Real-estate, renting and other				
business activities	6.8	7.1	7.1	11.2
f) Public administration and	6.1	7.7	7.7	8.4
defense	4.0	5.8	6.2	6.9
g) Education				
h) Health and social works				
GDP (Constant prices)	**4.8**	**5.3**	**6.3**	**5.4**

Source: Bangladesh Bureau of Statistics 2006

After examination of the sectoral growth pattern, it is found that the growth rate in both industry and services has been consistently strong. The growth rate in these sectors was 7 and 4.5 percent during the period 1991 to 2000 respectively. The growth rate of these sectors rose to 8.6 and 6.6 percent respectively in 2005. By contrast, a fluctuating growth trend is found in the agricultural sector. During the period 1991 to 2000, the average growth rate was 3.2 percent. There was some pick up in the growth rate in the following years leading to 4.1 percent growth rate in 2004. But there was sharp fall in the growth rate during the year 2005 at 0.3 percent.

Table 2.2
Industry Shares in GDP (per cent)

	1971	1990	2004
Agriculture	50	29	23
Industry	10	20	27
Service	40	51	50
Total	100	100	100

Source: Bangladesh Bureau of Statistics 2006

The sectoral distribution of GDP indicates that Bangladesh's economy has undergone important structural transformations over the past three decades. At independence in 1971, agriculture was the dominant sector, accounting for over half of total GDP. The industrial sector was small, contributing less than 10 per cent of GDP, while services, including transportation and power, accounted for the rest. However, following remarkable growth in the ready-made garments sector, its share began to change. By 1990, the contribution of industry to GDP had almost doubled to over 20 per cent. The share of agriculture fell to 29 percent that year, while that of services rose to 51 percent. To the extent that the growth of the ready-made garments sector was driven by international market conditions in textiles and clothing, the structural changes in the economy were influenced by external factors. In 2004, the industrial sector accounted for 27 per cent of GDP, while the share of agriculture dropped to 23 per cent, and that of the services sector remained stable to 50 per cent (Table 2.2).

Despite these changes in the sectoral composition of GDP, agriculture continued to account for the bulk of employment. In 2002/03, it contributed about 52 percent in total employment against about 49 percent in 1995/96. But there was slight decrease in the contribution of manufacturing sector employment during these periods, from 10.06 per cent in 1995/96 to 9.94 per cent in 2002/03. Similarly, a marginal decrease in the services sector employment is observed during this period. Thus, both sectoral growth rate and employment pattern shows virtually no structural changes in the economy highlighting the need to identify the underlying reasons.

Table 2.3
Share of Employed Labor Force by Industry (per cent)

Industrial Group/Year	***1995-96***	***1999-00***	***2002-03***
Total	***100.0***	***100.0***	***100.0***
Agriculture.	48.85	50.77	51.69
Manufacturing	10.06	10.00	9.94
Services	**41.09**	**39.23**	**38.37**
Power, gas and water	0.29	0.26	0.23
Construction	2.87	2.82	3.39
Trade, hotel and restaurant	17.24	15.64	15.34
Transport, maintenance and communication	6.32	6.41	6.77
Finance and business services	0.57	1.03	0.68
Comm.& Personal services	13.80	13.07	5.64
Public Administration and Defense	-	-	6.32

Source: Bangladesh Bureau of Statistics

III: Financial Structure and Policy Reforms in the Banking and Insurance Sector

3.1 Structure of the Financial System

Banks and other financial institutions (OFIs) have been playing key role in boosting economic activities in the Bangladesh economy. Today, there are 49 banks with 6318 branches. With increased privatization, there was a spurt in the growth of private banks. There are now 30 private commercial banks and 4 nationalized commercial banks, many of which are being privatized. There are now 10 joint venture commercial banks. In addition, there are 5 specialized banks. One national co-operative bank, one Ansar-VDP Bank, one Karmasangsthan Bank and one Grameen Bank and some non-scheduled banks are also in operation. Under branch rationalization programmes, 91 new branches were established and 9 existing branches were closed up in June 2005. There are also thirty registered merchant banks (investment banks) under the regulation of SEC (Securities and Exchange Commission). These banks invest in stocks on behalf of customers. Fund management companies have also come into existence to provide brokerage services.

Table 3.1
Structure of the Banking Sector in Bangladesh

Type of banks	No. Of banks	No. Of branches
NCB’s	4	3388
SBs	5	1334
PCB’s	30	1557
FCB’s	10	39
Total	49	6318

Source: Statistical department, Bangladesh Bank

Nationalized commercial banks are expanding their branches in rural areas. The following table shows that urban branches dominate the banking sector. Of total 6318 branches, 74.18 percent of private commercial banks are mainly located in the urban areas, while specialized banks such as Agricultural Development banks are mainly located in the rural areas (88.68 percent).

Table 3.2
Development of Bank Branches

Type of banks	No. Of banks	No. of branches			As percent of total branches		
		Urban	Rural	Total	Urban	Rural	Total
NCB’s	4	1241	2147	3388	36.69	63.37	100
SBs	5	151	1183	1334	11.32	88.68	100
PCB’s	30	1155	402	1557	74.18	25.82	100
FCB’s	9	39	0	39	100.00	0.00	100

Source: Statistical department, Bangladesh Bank

There are around 58 listed insurance companies in Bangladesh. In addition, some other unlisted insurance companies are doing business all over the country. The total number of insurance company branches is around 7500. Most of the insurance companies have their branches in rural areas.

Assets

Out of the total assets of the financial institutions, the share of the commercial banks is more than 90 percent. In 2005, the nationalized commercial banks (NCBs) held 40.14 percent of total industry assets against 39.6 percent in 2004. Evidently, NCBs domination in this area is showing an increasing trend, while PCBs' share has declined to 42.63 percent in 2005 against 43.5 percent in 2004. The foreign commercial banks held 9.46 percent of the industry assets in 2005 against 7.2 percent in 2004. There has been a decline in the operation of the DFIs with their shares of assets of only 7.73 percent in 2005, against 9.7 percent in 2004 (Table 3.3).

Table 3.3
Market Shares of Financial Institutions (per cent)

Type of banks	Total asset	Total deposit
NCB's	40.14	39.78
SBs	7.73	7.22
PCB's	42.67	47.18
FCB's	9.46	5.82
Total	100	100

Source: Statistical department, Bangladesh Bank

Graph 3.1 shows that aggregated banking assets in 2004 registered an overall increase by 14.0 percent over 2003. During this period, NCBs' assets increased by 8.2 percent and those of the PCBs by 21.2 percent. Loans and advances played a major role in the use of funds. Loans and advances reached Taka 1047.1 billion out of the aggregate assets of Taka 1725.5 billion. Cash in tills were Taka 15.5 billion (below 1.0 percent), deposits with Bangladesh bank were Taka 86.3 billion (or 5.0 percent). Other assets were Taka 385.7 billion or 22.4 percent and investment in government bills and bonds accounted for Taka 190.9 billion or 11.1 percent of the assets.

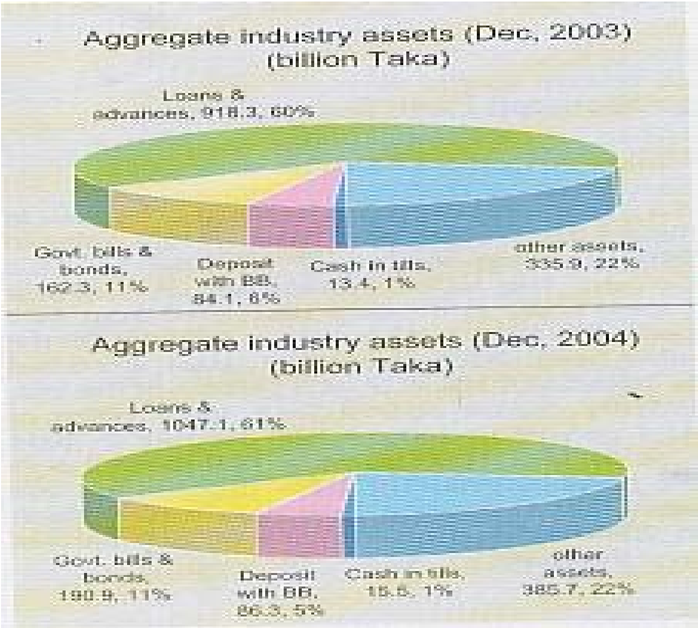
Growth of PCBs has been excellent. Of the total assets in the banking sector, about 43 percent belongs to the private commercial banks followed by nationalized commercial banks (about 40 percent). Ranking of these two types of banks remain the same with regard to deposits (about 47 percent and 40 percent).

Deposit and rate of deposit

Total deposits of the banks in 2005 rose to Taka 1551.5 billion from Taka 1326.1 billion in 2004 showing an overall increase by 17.0 percent. The NCBs' share in deposits decreased from 42.8 percent in 2004 to 39.78 percent in 2005. On the other hand, PCBs's deposits in 2005 amounted to Taka 732.0 billion or 47.18 percent of the total industry deposits against Taka 588.0 billion or 43.5 percent in 2004. FCBs' deposits in 2005 fell by Taka 5.2 billion or 1.38 percent over the previous year. The DFIs' deposits in 2005 were Taka 112.0 billion against Taka 75.1 billion in 2004.

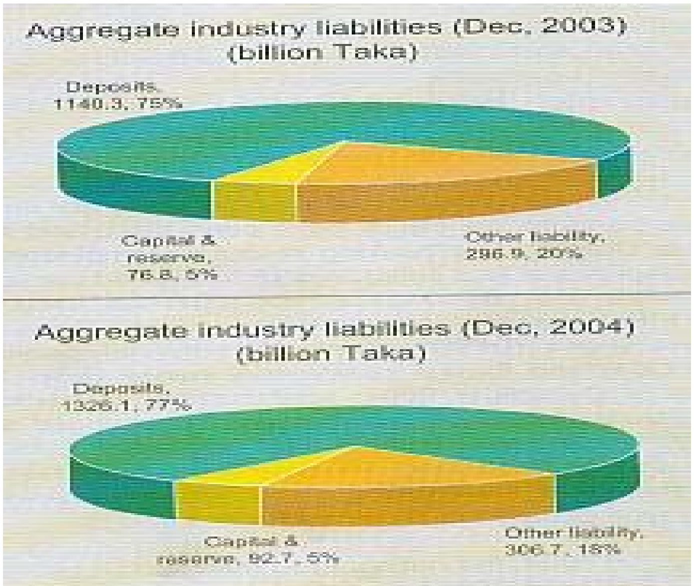
Liability

The aggregated liability portfolio of the banking industry in 2004 was Taka 1725.5 billion of which deposits constituted Taka 1326.1 billion or 76.9 percent and continued to be the main sources of fund of banking industry. Capital and reserves of the banks were Taka 92.7 billion or 5.4 percent of aggregated liabilities in 2004, against Taka 76.8 billion or 5.1 percent in 2003. (Graph 3.2)



Source: Bangladesh Bank

Graph 3.1



Source: Bangladesh Bank

Graph 3.2

3.2 Policy Reforms in Banking and Insurance

Over the last three decades, Bangladesh's economic and policy orientation has evolved considerably, from a highly interventionist regime with widespread control on trade, the exchange rate and investment, to a substantially liberalized economic regime. The situation with regard to the external sector was particularly difficult. Faced with very low foreign exchange reserves, a shallow export base and rising import prices, the government resorted to severe import controls, ranging from extensive use of non-tariff barriers (NTBs) to high and even prohibitive import duties. These protectionist measures were not dictated by a deliberate industrialization strategy aimed at influencing inter sectoral or inter-industry resource allocation. Instead, these policies reflected desperate attempts to rein in a worsening balance-of-payments situation.

The principal underlying causes of external sector difficulties were a combination of a large and growing domestic deficit and an expansionary monetary policy, leading to an overvaluation of the real exchange rate. The policy-makers responded by treating the symptoms rather than addressing the root causes. It was perhaps difficult for the immediate post-independence government, which proclaimed socialism as a fundamental state policy, to abruptly change course. A case in point relates to public sector enterprises, which occupied a dominant position in the manufacturing and services sectors of the economy. Most of them had come under public ownership as part of the government's declared socialist economic programme. Thus, with the State-owned bank's share of 34 per cent in total fixed assets in 1970, its share rose to 92 per cent in 1972 as the result of nationalization. Collectively, these enterprises became a major drain on the budget, yet the policy orientation of the regime, coupled with the vested interests created by nationalization, prevented policy-makers from undertaking any serious reforms to improve efficiency or privatize.

Initial Phases of Reforms

The beginnings of policy reform and liberalization can be traced to deregulation measures starting in 1976 under a new government, which increasingly distanced itself from the earlier socialist approach. However, initial reform efforts had neither a clear direction, nor a broad time frame for implementation. This phase of muddling through lasted for about a decade. Four notable features of policy during this period of greater market orientation were: reduction of restrictions on investment; gathering momentum of denationalization of public sector enterprises; limited reduction of tariffs and NTBs; and incentive packages for the emerging ready-made garments sector. During the latter half of the 1980s, a more coherent picture of reforms began to emerge under structural adjustment policies (SAPs). In the area of tariff reforms, SAPs emphasized rationalization of the import regime, simplification and reduction of effective protection, elimination of negative and restricted lists of industrial imports, and facilitation of imports of raw materials and intermediate and capital goods, including the imports needed for direct and indirect exporters. However, political commitment to policy reforms remained problematic due to the Government's continued preoccupation with the need to gain political legitimacy, which greatly restricted its ability to implement actions deemed unpopular. There were also genuine concerns over the policy prescriptions of the donors, particularly with regard to the design and implementation of the SAPs and their distributive implications.

Recent Phases of Policy Reforms

Since 2000, banking and insurance have made revolutionary changes in the financial sector of Bangladesh. According to Banking Company Act 1991, many policies have been adopted to regulate and monitor the banking sector of Bangladesh. Bangladesh Bank is the key institution to adopt policy making in Bangladesh. Ithas implemented wide ranging policies including human resource, bank rate, CRR, SLR, monetary, fiscal and money laundering policies. The Ministry of Commerce implemented premium, discount and annuity policies to regulate the insurance.

Policy on Loan Classification and Provisioning

In order to strengthen credit-discipline and to bring classifications gradually into line with international standards it has been decided that, with effect from March 3, 2005, a continuous credit, demand loan or term loan which remains overdue for a period of 90 days or more, will be put into the " Special Mention Account", and interest accrued on such loan will be credited to Interest Suspense Account instead of crediting it to Income Account. Loans in the "Special Mention

Account" will not be treated as defaulted for the purpose of section 27ka (3) of the Banking Company Act, 1991 and the status of loan (Special Loan) need not to be reported to the Credit Information Bureau (CIB) of Bangladesh Bank. This will help the banks to look at accounts with potential problems in a focused manner.

Prudential Guidelines for Consumer Financing and Small Enterprise Financing

Since credit disbursement in the consumer financing sector has been significantly increased and credit flow in the small enterprise financing sector has also been encouraged in trecent time, two separate guidelines have been issued to the banks for their better management of credit disbursed in these two sectors. However, Bangladesh Bank's (BB) inspection team, while conducting their regular inspection in the scheduled banks, will monitor implementation of these guidelines.

Single Borrower Exposure Limit

In order to enable the banks to improve their credit risk management BB has decided to reduce the single borrower exposure limit from 50 percent to 35 percent. The total outstanding financing facilities by a bank to any single person or enterprise shall not at any point of time exceed 35 percent of a bank's total capital subject to the condition that the maximum fund based credit facilities do not exceed 15 percent of its total capital. In the case of export sector, single borrower exposure limit remains unchanged at 50 percent of a bank's total capital but funded facilities has been fixed at 15 percent of its total capital.

Customer Complaint Cell

Banks have been advised to set up "Complaint Cell" to deal with all sorts of complaint, either received directly by them or referred through different agencies/institutions, including BB. BB has also set up a "Complaint Cell" headed by a Deputy General Manager (DGM) in its Department of Banking Inspection (DBI) This Cell will check the performance, effectiveness and functioning of the Complaint Cells of the banks, and monitor the status of customer complaints. A new Webpage regarding complaints has been opened on the Website of Bangladesh Bank.

Cash Reserve Requirement (CRR)

The Cash Reserve Requirement (CRR) of the scheduled banks with the Bangladesh Bank was fixed at 4 percent of their total demand and time liabilities (excluding inter-bank items) on July 2004. In pursuance of the objectives of monetary policy, CRR has been increased to 4.5 percent from 4 percent of their total demand and time liabilities effective from March 1, 2005. However, banks are allowed to maintain CRR at 4.5 percent daily on bi-weekly average basis, subject to the condition that CRR, so maintained, should not be less than 3.5 percent on any day.

Statutory Liquidity Requirement (SLR)

The Statutory Liquidity Requirement (SLR) for the scheduled banks, excepting banks operating under the Islamic Shariah and the specialized banks, has been re-fixed at 16 percent from 20 percent on November 08, 2003 and remained unchanged thereafter. The SLR for the Islamic banks remained unchanged at 10.0 percent. The specialized banks continued to remain exempt from the SLR.

Interest Rate Policy

Since 25 April 1994, interest rate band for export credit had been fixed between 8.0 and 10.0 percent. From November 10, 2001, interest rate had been fixed at 7 percent for export credit of readymade garments, frozen foods and agro-based industrial products. However, from 23 February 2003, the same rate had been applied for export credit of leather made goods and shoes. From 02 November 2003, the lending rate for export financing of potato had been fixed at 8 percent. The interest rate for all sorts of export credit has been fixed at 7 percent since January 10, 2004. 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 charge interest 1.5 percent more or less than the announced mid-rate on the basis of the comparative credit risk. Bangladesh Bank is keenly monitoring the movements of interest rates.

Table 3.1 summarizes some policies adopted by Bangladesh Bank.

Table 3.1
Policy Measures by Bangladesh Bank

Measure	Objectives	Criteria	Reasons for failure to reach target
Interest Rate Deregulation	Competitiveness	Interest spread	Government led distortion, NPA, Collusive Behavior, Misconceived Price Strategies.
Interest Rate Deregulation and Decontrol of credit	Improved Resource Allocation	Loan-Deposit Ratio, Sectoral Allocation and Credit Allocation Index, loan Quality	High Perceived risks and Costs, High Capital Requirement
Strengthening FIs	Risk Control in bank lending Management Efficiency of NCBs	Loan classification and provisioning; capital adequacy New Operational and Management Tools/Loan Quality	CL↑ → Up gradation of classification standard CL Suppressed → Ever greening, classification based on loan repayment Sheer negligence of the banks Supervisory and Regulatory Forbearance ⇒ Lack of autonomy and quality of supervisor. Ineffective legal system Lack of Leadership, expertise and Motivation Mismatch between loan classification requirement and improvement in loan screening and Monitoring skill Mismatch between economic Deregulations and enforcement of prudential regulations
Restructuring Rural Banking	Viable Rural Banking	Increased Flow of Credit, Deposit and Loan Quality	Deposit and Loan Quality Change of rural branching policy PCBs did not open any new branch NCBs tried to consolidate BKB was entrusted with all losing rural branches of NCBs (Nationalization of Loss). Negative Net Flow of Credit⇒ Low Recovery and withdrawal of refinance and subsidized interest rate. Political influence Faulty Borrower Selection, Over-staff Inefficient staff, complex procedure, low volume of Business Wrong Marketing and Institutional Policy.
Role of PCBs	Competition	Increase in the share of	Could not break-through NCBs

		PCBs Decrease the share of NCBs	dominance Share of business between old and new PCBs
Improving Debt Recovery Environment	Reduce NPA	Reduce NPA	Ineffective publication of default list Lawlessness Slow MLC Influence of vested interest Group Collusion between Political Parties and Defaulter.

Establishment

The ministry of finance of Bangladesh has adopted Bank Company Act 1991 and Company Act 1994 to operate banking business in Bangladesh. The Ministry of Commerce regulates insurance business by following the Company Act 1994 and Insurance Act 1938. To conduct banking and insurance business in Bangladesh the following procedures have to be completed

Licensing

Bank Company Act, 1991, empowers BB to issue licenses to carry out banking business in Bangladesh. Pursuant to section 31 of the Act, before granting a license, BB needs to be satisfied that the following conditions are fulfilled: "that the company is or will be in a position to pay its present or future depositors in full as their claims accrue; that the affairs of the company are not being or are not likely to be conducted in a manner detrimental to the interest of its present and future depositors; that, in the case of a company incorporated outside Bangladesh, the Government or law of the country in which it is incorporated provides the same facilities to banking companies registered in Bangladesh as the Government or law of Bangladesh grants to banking companies incorporated outside Bangladesh and that the company complies with all applicable provisions of Bank Companies Act, 1991."Licenses may be cancelled if the bank fails to comply with above provisions or ceases to carry on banking business in Bangladesh.

The insurance sector is regulated by the Insurance Act, 1938 with regulatory oversight provided by the Controller of Insurance on authority under the Ministry of Commerce. Twenty one companies provide general insurance and 6 companies provide life insurance. The industry is dominated by the two large, state-owned companies--SBC for general insurance and JBC for life insurance--which together command most of the total assets of the insurance sector.

a) Rules on ownership: According to the Bank Company Act 1991 and Company Act 1994, selling primary share in the secondary market can change rules on ownership and a shareholder has the right to become a director of a company.

b) Rules on location: In the application form the promoter has to mention the location of doing business. Bank or insurance can open branches anywhere Bangladesh. But to open a branch abroad a company has to seek permission from Bangladesh Bank and the Ministry of Commerce.

c) Legal reforms: Bank companies do their business under the rules and regulations given in the Bank Company Act 1991 and Company Act 1994. Insurance companies do their business under the rules and regulations given in the Insurance Act 1938 as well as the Company Act 1994.

Operations

The banking and insurance sectors are operating their activities by following the guidelines of Bangladesh Bank, Company Act 1994 and supervision of Ministry of Finance and inistry of

Commerce. The activities of banking and insurance business can be summarized in the following manner:

a) Branching: There are four major types of bank in Bangladesh. These banks have branches all over the country. But most of the foreign banks have branches only in Dhaka and Chittagong. There are no foreign bank branches in rural areas. There are around 58 listed insurance companies in Bangladesh. Besides, some other unlisted insurance companies are also doing business all over the country. The total number of insurance company branches is around 7500. Most of the insurance companies have their branches in rural areas.

b) Scope of business: The scope of banking and insurance business is diversified. Many sectors are fully or partially dependent on banking and insurance. Import-export, agriculture, real estate, garments industry, service sector as well as overall business of the country are completely dependent on its sound operation. Major clients of bank and insurance business are garments industry, medicine industry, multinational companies etc.

c) Rules on employment: In the matter of recruiting new employees, all the banks follow almost identical procedures. Candidates must go through a written test as well as viva-voce. The employees of the banking sector are more meritorious and expert than in any other service sector in Bangladesh. The rules on employment salary and benefit vary from bank to bank. Each bank has its own rules and regulations. Insurance companies also follow the same policies as the banks.

d) Rules on provision of services: Rules on provision of services differ among the various types of banks and insurance companies in Bangladesh. Private and foreign commercial banks and insurance provide higher services and facilities to their customer in comparison to government owned banks and insurance providers.

e) Rules on board membership: Bangladesh Bank has adopted policies for board membership for government and private banks. Insurance companies also have rules on board membership according to the Insurance Company Act 1938. At least 80 percent of board members must be Bangladeshi citizens.

f) Treatment of new services: Although most bank and insurance companies provide the same services to customers, they adopt new services from time to time. For example the banking sector innovated online service, mobile service, and ATM service for better facilities to the clients. Insurance companies also provide new services for their customers such as pension schemes, deposit schemes, marriage schemes, education schemes etc.

g) Data transfer/privacy: Every private and foreign commercial bank and insurance company uses their own software for their data transfer and privacy so that their competitors cannot access those data easily.

h) Local presence required: Among the 49 banks, 39 banks are owned by local investors which means 80 percent investors are Bangladeshi citizens. But in the insurance sector, only one foreign insurance company (ALICO) operates in Bangladesh among the 58 listed insurance companies.

i) Repatriation: Bank and insurance companies have been subject to the following non-exhaustive list of repatriation such as-

- Restriction of branching and new entry.
- Restriction of exit of bank and insurance

- Reserve requirements
- Requirement to direct control on repatriation etc.

J) Controls on interest rates: Bangladesh Bank controls the interest rates on deposits and loans. Commercial banks must follow the Bank's rules and regulations in the matter of interest rate. At present the bank interest rate of bank is only 5 percent, which is the lowest since the liberation of Bangladesh.

Prudential Regulation

Bangladesh Government has adopted different regulations to operate banking and insurance business in Bangladesh. The Government introduced different policies to run banking and insurance business operations smoothly, for example, money laundering, loan policy etc.

IV: Unilateral, Multilateral and Regional Commitments on Trade in Financial Services

4.1 Commitments under GATS on Trade in Financial Services

Bangladesh is one of the earliest members of the WTO. However, Bangladesh did not make any commitment in financial sector under GATS. The rate of liberalization in the financial sector has been quite rapid. The regulations regarding foreign direct investment have been liberalized. Bangladesh is now working on meeting commitments with respect to the financial sector under GATS.

4.2. Autonomous reforms

Unilateral financial sector reforms have been implemented by the Bangladesh Bank. The reforms were initially designed by the financial sector reform program. Further task forces were formed with experts from different segments of the society to enhance competition and healthy development of the financial sector. In order to stop the financial indiscipline of Nationalized Commercial Banks, privatization of NCBs was begun so that they would not have negative spill over effect on the entire financial system. The Privatization Board was responsible for reforms including strengthening of Bangladesh Bank, Commercial Bank, and legal reforms assisted by the development partners.

4.3 Regional Commitments

4.3.1 SAFTA

In a major effort to promote regional trade, leaders of the SAARC member countries finalized the agreement on free trade area (SAFTA) at Islamabad SAARC Summit in 2004. Its objectives as stated in the preamble of the agreement are, “to strengthen intra-SAARC economic cooperation to maximize the realization of the region’s potential for trade and development for the benefit of their people, in a spirit of mutual accommodation, with full respect for the principles of sovereign equality, independence and territorial integrity of all states.” The SAFTA Committee of Experts (COE), set up to resolve outstanding issues, has carried out strenuous negotiations and held 12 meetings to reach the final decision. The 12th meeting of the COE that ended in Kathmandu on 2 December 2005 took the final decision and cleared the way for enactment of SAFTA accord by January 1, 2006.

The SAFTA among others covers tariff rules of origin, safeguards, institutional structures, and dispute settlement issues. It also calls for the necessity of adopting various trade facilitation measures such as harmonization of standards and mutual recognition of test results, harmonization of customs procedures, and cooperation in improving transport infrastructure.

Services, including financial services are not included in the SAFTA so far. However, initiatives are underway to include services within the South Asian Free Trade Agreement (SAFTA) framework. The Ministerial Council Meeting of SAFTA, held in Dhaka in April 2006, has assigned the Committee of Experts (CoE) to explore such a possibility.

4.3.2 BIMSTEC

The idea of regional co-operation in South and South East Asia was first mooted by Bangladesh, India, Sri Lanka and Thailand at a meeting in Bangkok in June 1997. This inter-regional grouping is supposed to serve as a bridge between the five SAARC countries (India, Bangladesh, Sri Lanka, Nepal and Bhutan) and two ASEAN countries (Myanmar and Thailand). Among its most significant goals, BIMSTEC proposes an FTA accord on services and investment in July 2007. A comparison with established regional blocks reveals the daunting challenge BIMSTEC faces. In 2004, exports among the Association of Southeast Asian Nations (ASEAN) were at the level of USD 123.7 billion. Current intra-BIMSTEC trade, for its part, stands at just 4 percent of total trade.

4.3.3 Commitments in other Regional Agreements

South Asian Association for Regional Cooperation **(SAARC)** countries now see the formation of FTAs with extra-regional countries as an important and tangible policy option, though they used it to promote the SAARC Free Trade Area (SAFTA) as their most important trade liberalization framework. Considering these trends, there may emerge a complicated “web” of FTAs in the region. Bangladesh signed FTAs with India and Nepal. Bangladesh-India FTA and the Bangladesh-Nepal FTA apply different tariff rates on the same product, the exporters and importers in Bangladesh would face three different tariffs on the product: the Bangladesh-India FTA rate, the Bangladesh-Nepal FTA rate and the MFN rate. This would increase the transaction costs for the exporters and importers in Bangladesh. Moreover, if the rules that usually accompany the tariff element in an FTA, such as the rules of origin, were set differently, or even in conflict, between the Bangladesh-India FTA and the Bangladesh-Nepal FTA, it would complicate their international economic transactions even more.

4.4 Implication for Policy Design and Implementation

While unilateral liberalization continues through policy design and implementation in the financial sector, service sector liberalization through FTA will start in few years. Recent interest in bilateral FTAs is partly driven by a desire to find potential ways around the challenges and difficulties presented in the multilateral negotiating framework. In particular, the negative list approach increasingly adopted in FTAs seems to offer good governance benefits in terms of enhanced transparency.

The most important factors for managing change are the strengthening of Bangladesh Bank (BB) for ensuring a strong system of supervision over the banks, which is necessary in order to see that the banks strictly follow the financial regulations. Before 1990, bank supervision in Bangladesh was focused on implementation of economic directives of the GOB. Since banking strategy has changed (from controlled to liberalization), now BB needs to pay more attention to prudential and less to economic regulations, leaving the decisions of who is to get credit and at what price to the bank management themselves.

The banking supervision by BB has also been restructured through adding off-site surveillance function with the on-going on-site supervision. In respect of off-site supervision, the banks in Bangladesh have started to be CAMEL rated since 1994. BB has also organized a Problem Bank Cell for efficient handling and improvement of financial health of problem banks. On the basis of ratings, early warning signals (EWS) are also being issued to some banks and memorandum of understandings (MOUs) were signed with the problem banks. To help in the improvement of asset quality, one Credit Information Bureau (CIB) as a separate department has been set-up in BB. One large loan Review Cell has also been installed at BB. For licensing and monitoring NBFIs, one new department has been opened in BB. The first line of defense against bank insolvency and financial system distress is the quality and character of management within the banks themselves (Pollizatto, 1992) and therefore, efforts to strengthen the financial system through building strong management cadre were also focused in the financial sector reform program of Bangladesh.

There are different elements of prudential regulations for managing reform, but two aspects, namely capital adequacy and appropriate loan classification and provisioning have assumed greater importance in financial reform programs of various countries. The banking system of Bangladesh had been ignorant in regard to both of these aspects. Since 1996, BB has started calculating capital adequacy of the banks as per internationally accepted norm of 8 percent of risk-weighted assets. Another important aspect of prudential regulation is loan classification and provisioning, on which highest thrust has been placed during reform era. Since 1999 the norms of classification and provisioning have been elevated to international standards in five phases

Better governance including rules to promote transparency, accountability and strict discipline are critically important in the whole reform and restructuring process However in reality, complete free trade has never been realized even at the level of an individual country, because policy decisions are made not only to pursue the pure economic welfare of the domestic economy as a whole, but also to achieve policy objectives according to domestic political and strategic preferences.

V: *Performance of Banking and Insurance Sectors*

In this chapter, banking and insurance sector performance has been assessed based on key performance indicators. Competition and efficiency related indices have been calculated for this purpose. The financial index has been calculated using Principal Component Analysis techniques. The role and importance of banks in expanding credit and generating employment has also been examined. Insurance sector performance has been assessed separately by examining the pattern of insurance premia and lending.

5.1 Performance and Efficiency of the Commercial Banks

Sound management is the most important pre-requisite for the strength and growth of any financial institution. For assessing the performance and efficiency of the commercial banks, total expenditure to total expenses, earnings and operating expenses per employee and interest rate spread have been used.

Earnings and Profitability/Margin

Strong earnings and profitability of a bank reflects its ability to support present and future operations. It helps to build adequate capital base.. To assess the efficiency and profitability, return on assets (ROA) supplemented by return on equity (ROE) and net interest margin (NIM) have been used.

Earnings as measured by return on assets (ROA) and return on equity (ROE) vary largely from one bank to another. Table-5.1A shows ROA and Table-5.1B shows ROE by types of banks and Graph-5.1 shows the aggregate position of these two indicators for all banks. Analysis of these indicators reveals that the ROA of the NCBs has been very low and turned out to be negative in 2004. These ratios have been found worse to DFIS. Trend in PCBS and FCBS is also quite inconsistence during the period 1997 to 2004. NCBs return on equity ratio rose from -1.1 percent in 1999 to 3.0 percent in 2003. It again declined to -5.3 percent in 2004. In case of DFIs, the ROE sharply rose from -68.01 percent in 2000 to 12.3 percent in 2001 and again declined to -2.1 percent in 2004. Despite ROE of PCBs and FCBs fluctuating from one year to another, their ROE is higher than the average ROE of the banking system.

Table-5.1A
Return on Assets (ROA) (per cent)

Bank type	Return on assets (ROA)							
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
NCBs	0.0	0.0	0.0	0.1	0.1	0.1	0.1	-0.1
DFIs	-2.1	-2.8	-1.6	-3.7	0.7	0.3	0.0	-0.2
PCBs	1.1	1.2	0.8	0.8	1.1	0.8	0.7	1.2
FCBs	4.8	4.7	3.5	2.7	2.8	2.4	2.6	3.2
Total	**0.3**	**0.3**	**0.2**	**0.0**	**0.7**	**0.5**	**0.5**	**0.7**

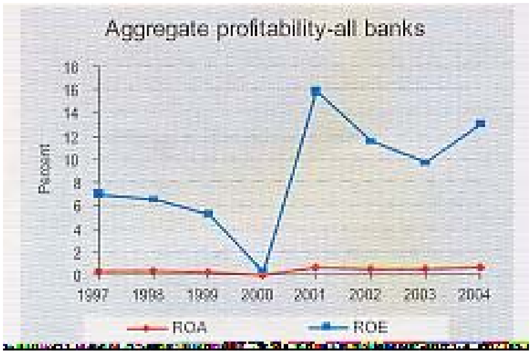
Source: Bangladesh Bank

Table-5.1B
Return on equity (ROE) (per cent)

Bank type	Return on equity (ROE)							
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
NCBs	1.3	0.3	-1.1	1.7	2.4	4.2	3.0	-5.3
DFIs	-29.1	-36.3	-29.4	-68.0	12.3	5.8	-0.6	-2.1
PCBs	24.4	26.8	15.3	17.0	20.9	13.6	11.4	19.5
FCBs	38.2	40.7	41.8	27.3	32.4	21.5	20.4	22.5
Total	**7.0**	**6.6**	**5.2**	**0.3**	**15.9**	**11.6**	**9.8**	**13.0**

Source: Bangladesh Bank

Aggregate Profitability-All Banks



Source: Bangladesh Bank

Graph 5.1

Net Interest Income

Table-5.3 and Graph-5.2 show that aggregate net interest income (NII) of the banks has been positive and consistently increased from Taka 6.3 billion in 1997 to Taka 18.3 billion in 2004. However, the NII of the NCBs sharply declined from Taka 3.1 billion in 1999 to a negative amount of Taka 1.2 billion in 2000. The negative trend continued thereafter also. The NCBs' interest income in 2001 was less by Taka 1.8 billion than interest expenses, and by Taka 1.1 billion in 2004. The DFIs had a negative NII in 1997 and 1999, which was reversed in 2000. Since then it has been positive.

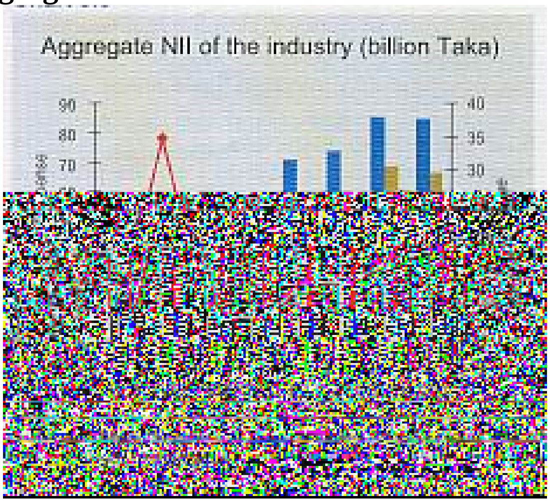
Although the net interest income of the NCBs has been negative during the last five years, the overall NII shows a consistently upward trend. This is because the rate of increase in NII of the PCBs and FCBs has been very high during the period 1997 to 2004. This trend partly indicates that the PCBs and the FCBs are charging interest at a high rate as compared to interest they pay to the depositors.

Table 5.2
Net Interest Income by Type of Bank
(Billion Taka)

Bank type	1997	1998	1999	2000	2001	2002	2003	2004
NCBs	2.7	2.2	3.1	-1.2	-1.8	-1.5	-0.3	-1.1
DFIs	-0.1	0.5	-0.1	1.0	2.7	1.4	1.3	1.8
PCBs	1.7	2.3	3.0	6.1	9.2	10.2	12.0	13.7
FCBs	2.0	2.2	1.8	2.5	3.3	3.4	3.6	4.2
Total	**6.3**	**7.1**	**7.8**	**8.4**	**13.4**	**13.5**	**16.6**	**18.3**

Source: Bangladesh Bank

Aggregate Net Interest Income of the Industry



Source: Bangladesh Bank
Graph 5.2

Interest Rate Spread

Different banks offer different interest rates on both deposits and loans. Nonetheless, the gap between deposit and lending rate is decreasing over time with open up and liberalization policies. Table-5.3 shows that interest rates on deposits in private commercial bank are higher than those of other banks. Weighted average interest rate on deposits in private commercial bank is 6 to 9 percent whereas it is 3.5 to 5.5 percent in government owned commercial banks, 4 to 6 percent in foreign commercial banks and 4 to 8 percent in specialized banks. The table also shows that interest rate on loans differs among various type of banks. Weighted average lending rate in private commercial banks is 9 to 15 percent whereas it is 8 to 10.5 percent in government commercial banks, 8.5 to 11.5 percent in specialized banks and 10.5 to 14 percent in foreign commercial bank.

Table 5.3
Interest Rate Spread
(Rate of Percentage)

Name of the Bank	Type of the Bank	Time	Deposit				Loan Given			
			Savings A/C	Short-term A/C	Fixed Deposit DPS-15 SDPS-	Weighted Average	Agriculture	Industry	Service	Weighted Average
Sonali Bank	Govt. Commercial	2004 2005 30-06-06	3.5 4.0 5.0	2.0 2.5 3.5	5.25-6.25 5.25-6.25 6.25-7.25	5.12 4.75 5.38	8.0-9.0 2.0-16.0 2.0-16.0	9.0-11.0 9.0-11.0 9.0-12.0	12.0 13.0 13.0	9.89 10.40 10.58
Janata Bank	Govt. Commercial	2004 2005 30-06-06	3.5 3.5 4.0	2.0 2.0 3.0	6.25 6.25 7.25	3.64 3.63 3.60	8.0 8.0 8.0	10.0 10.0 10.5	12.0 12.0 13.0	8.22 8.70 8.50
Uttara Bank	Private Commercial	2004 2005 30-06-06	5.0-5.5 5.0-5.5 5.0-6.5	4.5-5.0 4.5-5.0 5.5	6.5-8.25 6.5-8.25 8.25-9.5	6.02 5.94 6.82	10.0 10.0 10.0	13.0 12.0 15.0	13.0 12.0 14.0-15.0	12.99 11.97 14.67
Islami Bank BD Ltd.	Private Commercial	2004 2005 30-06-06	5.13 6.23 6.00	3.76 4.57 4.40	6.84 8.31 8.00	6.01 8.31 8.00	10.0 8.0-10.0 9.0	13.5 10.0-12.5 14.0	14.5 13.0 15.0	13.94 8.64 8.80
UCBL	Private Commercial	2004 2005 30-06-06	6.0 6.0 6.0	5.0 5.0 5.0	8.25 9.78 10.34	6.54 6.93 7.11	10.0 10.0 10.0	13.0 13.0 13.5	13.5 13.5 14.0	12.17 12.17 12.5
Prime Bank	Private Commercial	2004 2005 30-06-06	6.5 6.0 6.0	5.5 5.17 6.38	7.62 10.25 11.88	7.18 7.85 9.07	11.0 11.0 11.0	13.0 13.0 13.0	13.25 13.0 16.0	12.81 12.92 15.39

Brac Bank	Private Commercial	2004 2005 30-06-06	7.5-10.0 7.0-11.0 11.0-12.0	5.0 5.0-6.0 5.0-6.0	5.5-6.5 55-6.5 5.5-6.5	6.18 6.97 6.75	9.0 9.0 9.0	10.5-14.5 10.5-15.5 12.5-15.5	15.0-18.0 14.0-17.0 14.5-17.5	12.0 10.73 11.12
Bangladesh Krishi Bank	Specialized Bank	2004 2005 30-06-06	3.5 3.5 4.0	3.0 2.0 3.0	5.75-6.75 5.50-6.50 6.00-7.25	5.70 5.14 5.75	8.0 8.0 8.0	10.0 9.0 9.0	10.0 10.0 10.0	8.72 8.55 8.50
Bangladesh Shilpa Bank	Specialized Bank	2004 2005 30-06-06	3.5 3.5 4.0	2.0 2.0 2.0	5.75 5.75 6.25	4.58 3.75 4.25	10.0 10.0 10.0	10.0 10.0 10.0	11.0 12.0 13.0	10.33 10.66 11.33
Standard chartered Bank	Foreign Private Bank	2004 2005 30-06-06	2.41 1.59 1.55	4.71 3.84 3.87	7.63 7.13 7.04	4.90 3.94 3.91	9.5 10.0 10.0	10.41 10.26 10.77	10.91 10.76 11.27	10.43 10.36 10.88
HSBC	Foreign Private Bank	2004 2005 30-06-06	3.75-4.0 3.75-4.0 3.75-4.0	4.0-7.25 3.0-7.75 3.0-7.75	3.75-7.80 4.0-9.25 4.0-9.50	6.21 5.76 5.89	10.5-12.5 11.5-12.5 11.5-12.5	8.5-13.5 10.0-14.5 10.0-14.5	10.5-15.0 10.5-18.0 10.5-18.0	11.49 11.44 11.55
City Bank N.A	Foreign Private Bank	2004 2005 30-06-06	6.0 6.0 6.0	4.5 4.5 4.5	10.0 10.5 10.65	9.11 10.34 7.08	12.5 13.0 13.25	13.0 13.5 13.5	13.5 14.0 14.0	12.86 13.44 13.59

Source: Finance Division, Finance Ministry-Bangladesh Government

Non-Performing Loans (NPLs) to Total Loans

The most important indicator of problems with asset quality is the percentage of gross and net non-performing loans (NPLs) to total assets and total advances. FCBs have the lowest and DFIs have the highest ratio of NPLs. NCBs have gross NPLs to total assets of 14.6 percent whereas in case of PCBs, FCBs and DFIs, the ratios are 5.6 percent, 0.9 percent and 26.6 percent respectively. Similarly, NPLs net of assets is 9.1 percent, 2.1 percent and 10.5 percent for NCBs, PCBs and DFIs. FCBs are having excess provision for loan losses. The ratio of NPL to total loans of all the banks (Table-5.4) shows an encouraging trend since its declined from peak in 1999, although the aggregated ratio is still high at 17.6 percent (in 2004). Very high NPL of the NCBs and the DFIs has contributed for this. The NCBs and DFIs provided small directed credit programmes during the 70s and 80s. Poor appraisal and inadequate follow-up and supervision of the loans disbursed by the NCBs and DFIs in the past eventually resulted in massive booking of poor quality assets which still continue to remain high. Furthermore, the banks were reluctant to write off the historical bad loans because of the poor quality of underlying collateral and to avoid any possible legal complications due to lacunas in the judicial framework. Recovery of NPLs, however, witnessed some signs of improvement in recent years; mainly because of the steps taken with regard to internal restructuring of these banks to strengthen their loan recovery mechanism including measures taken to write off the bad loans.

Table 5.4
Ratio of NPL to Total Loans by Type of Banks (per cent)

Bank type	1997	1998	1999	2000	2001	2002	2003	2004
NCBs	31.4	35.6	41.3	34.1	32.8	30.1	28.3	17.6
DFIs	56.9	59.1	58.5	54.6	54.5	48.0	38.3	23.0
PCBs	25.1	26.3	21.2	15.5	10.5	10.5	8.3	3.4
FCBs	-0.5	0.1	0.9	-0.1	-0.3	-0.4	0.1	-1.5
Total	**30.7**	**34.4**	**35.6**	**28.8**	**25.6**	**22.6**	**18.8**	**9.8**

Source: Bangladesh Bank

Islamic Banking

The banking system of Bangladesh is composed of a variety of banks working as Nationalized Commercial Banks (NCBs), Private Banks, Foreign Banks, Specialized Banks and Development Banks. However, 30 out of 50 banks in Bangladesh are private, of which 13 have been operating as Islamic banks. Besides these full-fledged Islamic banks, two conventional banks in the private sector namely the Prime Bank Limited and Dhaka Bank Limited have opened two full-fledged Islamic banking branches and Islamic Banking Counter respectively to deal with the Islamic banking business parallel to their conventional operations. The operations and accounts of these branches and counters are maintained separately from the mainstream business of the respective banks.

Bangladesh inherited an interest based banking system from the British Colonial period and employment of Muslims in banks was more or less restricted. During the period 1947-1971 when country was a part of Pakistan, banking came under Muslim control but the system did not change (M.A.Haque, 1994).

Since independence, Bangladesh saw a new trend in banking both at home and abroad. Islamic banking successfully operated in Egypt. During the seventies, Islamic Development Bank (IDB) at the international level and a number of Islamic banks at national levels were established in the Muslim world. At home, some entrepreneurs were actively working for the introduction of Islamic banking. Two professional bodies "Islamic Economics Research Bureau" (IERB) and " Bangladesh Islamic Bankers Association" (BIBA) were taking practical steps to impart training on Islamic economics and banking to a group of bankers and to arrange national and international seminars/workshops to mobilize local and foreign people as investors. Their professional and right-thought activities were streamlined by a number of enthusiastic businessmen in Bangladesh. They concentrated mainly in mobilizing equity capital for the prospective Islamic Bank. Due to continuous and dedicated work of the above groups and individuals and active support from the Government, Islamic banking wasestablished in early eighties. Islamic banks have been operating in Bangladesh for about one and half decade. The six Islamic banks operating in Bangladesh are:

1. Islami Bank Bangladesh Limited (IBBL);
2. Al Baraka Bank Bangladesh Limited (AL-Baraka);
3. Al-Arafah Islami Bank Limited (Al-Arafah);
4. Social Investment Bank Limited (SIBL); and
5. Faysal Islamic Bank of Bahrain EC (FIBB).
6. Shahjalal Islami Bank Limited

Besides the above six Islamic banks, Prime Bank Limited has opened two Islamic Banking branches since 1995 and 1997. Dhaka Bank Limited has started operation with an Islamic counter at its principal office in conjunction with conventional banking operations since inception of the bank in July, 1995 alongside traditional banks. Like any other traditional commercial banks, they mobilize deposits and provide loans. But their modes of operation, based on Shariah, are different from other commercial banks.

5.2 Insurance Sector Performance

With a combined life and non life insurance market premium of approximately Taka 20 billion, Bangladesh ranks 78th in the world and has world market share of 0.01 percent. Per capita spending on insurance is only US dollar 2.3. Insurance premia as a percentage of GDP remains low at 0.57 percent (0.37 percent for life insurance and 0.2 percent for non-life). However the market has been steadily growing at a double-digit rate.
Economic growth, expansion of infrastructure, industries, trade and commerce is leading to the expansion of the insurance market. The present low insurance penetration in the country points to the potential for future expansion.

In 1986 the total premium income of the private sector insurance companies was Taka 28 crore. In 2004 it rose to 2031 crore of which life insurance premium wasTaka 1409 crore and general insurance premium was Taka 622 crore, which represents 88 percent of the total country's premium income. Similarly, profit of the large general insurance companies grew at a modest rate of 11.83 percent in 2004.

In order to ensure long-term growth and sustainable income, the insurance companies of Bangladesh are building up reserves and assets. In 2005, for instance, the total reserves and assets of the insurance companies increased by 6.59 and 23.46 percent respectively compared to previous year. The dimension of a good investment climate include macro economic stability, open and competitive markets, strong property rights, rule of law and good governance, as well as an adequate supply of infrastructure and financial services. Although Bangladesh has opened up its economy considerably in recent years with various reforms aimed at creating favorable investment environment, there are many barriers to encourage both foreign and domestic investment in the insurance sector.

The insurance industry in Bangladesh is innovating.new services such as online insurance, annuities, mortality tables, various deposit scheme etc.

5.3 Financial Sector Performance: A Quantitative Analysis

We have constructed a composite index. For this, a number of linear combinations have been made in the absence of long time series data for a large number of variables. A Principal Component Analysis technique has been followed for detailed calculation. The principal components are orthogonal, and taken together they explain all the variance of the original data. Since the study involved a number of variables for different types of bank ordered by time, we developed a composite index of the financial sector by identifying one or two orthogonal function that are independent and explain about 85-90 percent of the variation in the original variables.

The results of the principal component analysis are as follows:

Table 5.5
Loadings of the First Five Empirical Orthogonal Functions along with their Standard Deviation and Proportion of Variance Explained

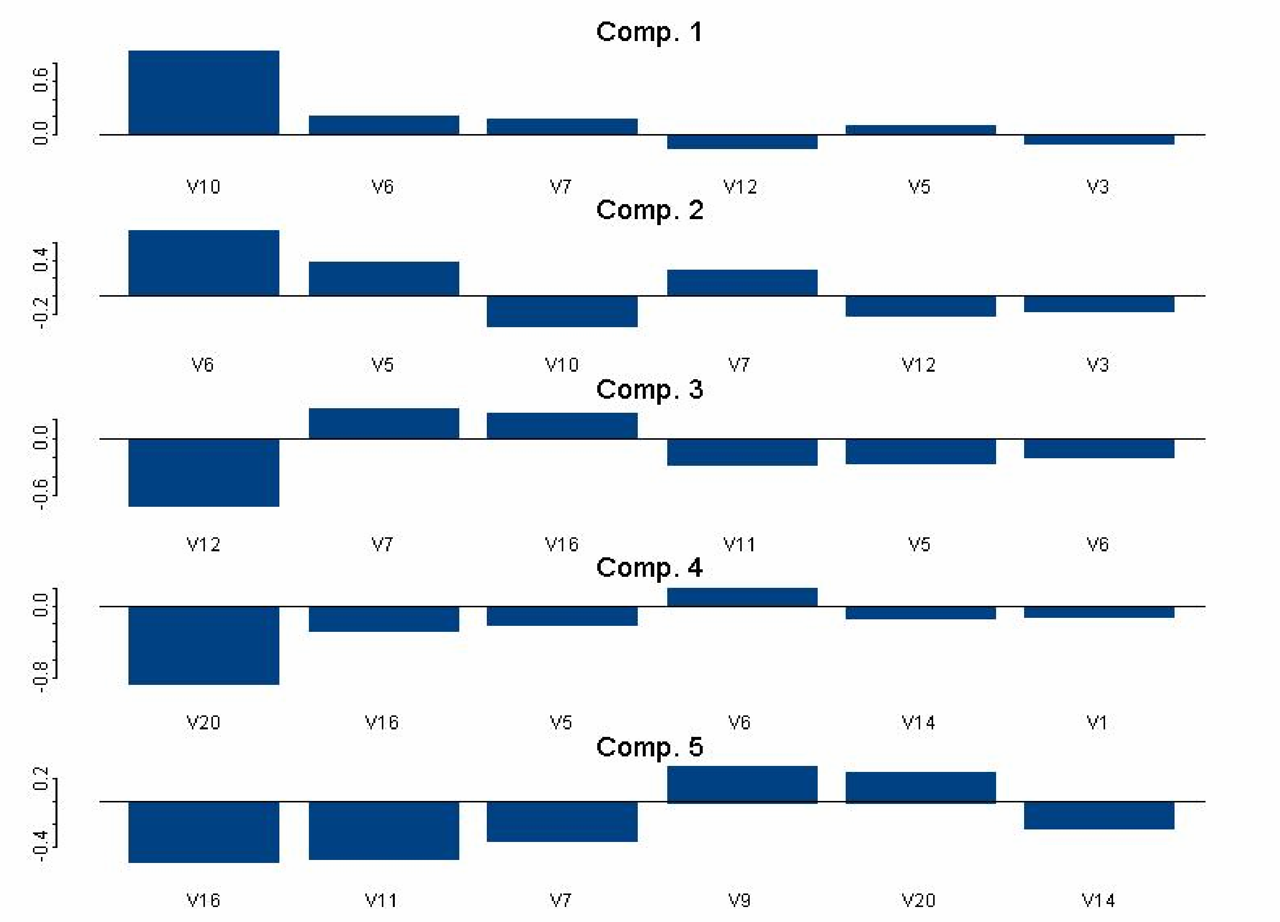
Variables	Bank Type	Analytical Name	EOF1	EOF2	EOF3	EOF4	EOF5
Net Interest Income	NCBs	V1	0.03	0.05	0.13	-0.13	-0.07
	DFIs	V2	-0.02	-0.01	-0.03	0.05	0.1
	PCBs	V3	-0.1	-0.17	-0.13	0.02	-0.06
	FCBs	V4	-0.02	-0.03	-0.01	0.01	-0.01
Ratio of Net NPL of Total loans	NCBs	V5	0.11	0.37	-0.27	-0.21	0
	DFIs	V6	0.21	0.74	-0.19	0.2	-0.04
	PCBs	V7	0.18	0.29	0.32	-0.06	-0.34
	FCBs	V8	0.01	0.03	-0.03	-0.04	-0.06
Expenditure Income Ratio	NCBs	V9	0	-0.06	0.05	-0.07	0.31
	DFIs	V10	0.93	-0.33	-0.09	-0.01	-0.04
	PCBs	V11	-0.03	0	-0.27	-0.1	-0.51
	FCBs	V12	-0.14	-0.21	-0.71	0.11	-0.23
Capital to risk assets Ratio in percent	NCBs	V13	0.01	0.03	0.07	0.01	-0.02
	DFIs	V14	-0.02	-0.07	0.13	-0.14	-0.23
	PCBs	V15	0	-0.02	-0.09	-0.05	0.09
	FCBs	V16	-0.09	-0.09	0.28	-0.27	-0.54
Liquidity Ratio	NCBs	V17	0	0.04	-0.17	0	-0.06
	DFIs	V18	0.04	0.1	0.01	0.08	0.12
	PCBs	V19	0.01	0.04	-0.06	-0.07	-0.12
	FCBs	V20	0.01	0.08	-0.18	-0.87	0.26
Stdev			36.36	11.81	7.5	6.25	2.2
Proportion of Variance Explained			0.84	0.09	0.04	0.02	0
Cumulative Proportion			0.84	0.93	0.97	0.99	1

Table 5.5 shows that 84 percent variability of the variables is explained by the first principal component (EOF1) and 93 percent variability of the variables is explained by the first two components (EOF1 and EOF2). So the EOF1 can be explained as the weights of the variables to obtain the composite index of the financial sectors. As shown in the table, performance of the financial sector has varied considerably between the periods 1997 to 2004. The results indicate that, compared to the first half, the performance of the financial sector has deteriorated in the second half. Figure 1 additionally reveals that expenditure income ratio of the development financial institutions explained the highest variability of the performance of the financial sector.

Table 5.6
COMPOSITE INDEX OF FINANCIAL SECTOR

YEAR	**(1ST TRANSFORMED VARIABLE)**
1996-97	**140-866**
1997-98	**177.328**
1999-00	**143.215**
2000-01	**167.184**
2001-02	**85.117**
2002-03	**88.788**
2003-04	**90.262**
2004-05	**88.003**

Figure 1. Contribution of each variable to the first five PCs



5.4 Lending Pattern of Commercial Banks and Access to Credit

With liberalization of the banking system, rapid growth in the lending has taken place. In 1990, total lending of the commercial banks was in the order of Taka 199.1 billion. The size of the lending increased markedly from one year after another to reach Taka 1117.3 billion in 2005. But when the lending pattern of the commercial banks is observed, a diverse trend is found. The share of the agriculture sector in total lending of the commercial banks was 23.27 percent in 1990. This share decreased rapidly to 9.55 percent in 2005. Similarly, a steady fall in the share of manufacturing is observed, from 27.60 percent in 1990 to 19.75 percent in 2005. However, it is worth nothing that WC for the manufacturing has increased continuously during the period under consideration. Similarly, a persistent rise in the share of trade is found when both level and share of trade in total lending is observed. As in many other countries, the sector most disadvantaged by reform has been the agricultural sector. Non-commercial banks and micro-financing institutions have been entrusted with the role of meeting the credit demands of deprived sectors. In a bid to enhance agricultural output the Government continues its agricultural credit schemes through NCBs and DFIs. From the Table 5.8, it is clear that out of the total credit requirement, 8 percent of the poor get credit through the banking system. Grameen bank, cooperatives, and NGOs fulfill almost 36 percent of credit requirement of the poor. Although parallel attempt to enhance credit to the poor is a welcome development, from the table it is clear that access to financial services or credit is still limited, needing further financial deepening and widening of institution based lending especially in the rural areas.

Table 5.7

Sectoral Lending of the Commercial Banks

Sector (in Crore Taka)

Year	Agri.		Manuf.		WC for Manuf		Constr.		Utility		Trans.		Storage		Trade		Misc.		Total
		Ratio		Ratio		Ratio		Ratio		Ratio		Ratio		Ratio		Ratio		Ratio	
1990	4632	23.27	5495	27.60	1922	9.65	782	3.93	47	0.24	335	1.68	195	0.98	5627	28.26	874	4.39	19909
1995	5895	17.88	9029	27.38	2811	8.52	1943	5.89	80	0.24	505	1.53	329	1.00	10142	30.75	2245	6.81	32979
2000	8675	14.61	16895	28.46	5199	8.76	3406	5.74	20	0.03	817	1.38	909	1.53	17224	29.02	6217	10.47	59362
2001	9315	13.54	18155	26.40	6209	9.03	3919	5.70	94	0.14	990	1.44	987	1.44	20361	29.60	8748	12.72	68778
2002	9646	12.56	17854	23.26	9801	12.77	4573	5.96	162	0.21	1265	1.65	990	1.29	23607	30.75	8874	11.56	76772
2003	9340	11.02	16895	19.94	14972	17.67	5637	6.65	8	0.01	1275	1.50	869	1.03	27867	32.89	7871	9.29	84734
2004	9844	10.35	18379	19.32	17496	18.39	6426	6.76	2	0.00	1165	1.22	843	0.89	32026	33.67	8941	9.40	95122
2005	10675	9.55	19952	17.86	22069	19.75	7456	6.67	6	0.01	1384	1.24	779	0.70	39494	35.35	9917	8.88	111732

Source: Bangladesh Bank

Table 5.8
Distribution of Households by Sources of Credit
2004-05 (per cent)

Source of Credit			
Institutional Sources			
	All	Poor	Non Poor
Banks	13	8	17
Grameen Bank	10	11	9
Co-operatives	1	1	0
NGOs	21	24	19
BRDB/Youth/Social Welfare	3	4	2
Non-Institutional Sources			
Relatives	22	21	23
Non Relatives	12	11	12
Money lenders	11	11	11
Others	8	9	8
Total	100	100	100

Source: Bangladesh Bureau of Statistics

5.5 Profit per Employee, Expenses per Employee and Employment Pattern in the Commercial Banks

The banking sector employs about 110,000 people. Number of employees per branch was the highest (43) in the FCBs followed by the PCBs (22) in 2004. Number of employees per branch of NCBs was 17 and DFIs 12 in 2004. Expenses per employee of the NCBs were Taka 182,300 and the DFIs Taka 201,600 in the same year. The NCBs and DFIs incurred losses in 2004. Their losses per employee were Taka 15,600 and Taka 12,600 respectively. The PCBs' profit per employee was Taka 270,800 against expenses of Take 4, 48,400 per employee. FCBs' expenses per employee were as high as Take 2.0 million against per employee profit of Taka 2.5 million in the year 2004. Evidently, there exists a positive correlation between the compensation and the employee output in general.

Table 5.8
Employment Pattern in the Commercial Banks

Bank types	Number of branches		Number of employees		Operating expenses (billion Taka)		Net profit (billion Taka)		Number of employees per branch	Expenses per employee (Taka)	Profit per employee (Taka)
	2003	2004	2003	2004*	2003	2004	2003	2004*	2004	2004	2004
NCBs	3,397	3,388	59,630	57,588	10.0	10.5	0.5	-0.9	17	182,300	-15,600
DFIs	1,314	1,328	16,420	15,877	2.9	3.2	-0.1	-0.2	12	201,600	-12,600
PCBs	1,510	1,550	31,905	34,343	13.2	15.4	4.3	9.3	22	448,400	270,800
FCBs	32	37	1,502	1,582	3.0	3.1	2.8	3.9	43	1,959,500	2,465,200
Total	**6,253**	**6,303**	**108,457**	**109,390**	**29.1**	**32.2**	**7.5**	**12.1**	**18**	**294,400**	**110,600**

* Provisional.

Source: Bangladesh Bank

VI: Banking Sector Performance: Case Studies

To get the general impression of the people working in the banks, 20 banks were surveyed. For the specific case study, three banks viz Sonali Bank (government owned commercial bank), Prime Bank (private domestic commercial bank) and Standard Chartered Bank (joint venture bank) were considered. Sonali Bank is a nationalized commercial bank established by the Bangladesh Banks (Nationalization) and is fully owned by the Government of the Peoples' Republic of Bangladesh. In order to examine their performance, the ratios of interest income to loans and advances, interest expenses to deposits, NPL to total loan and advances and total loan to total deposits were calculated. Net worth position of these banks also has been separately reported. For assessing the efficiency more specifically, profitability indicators such as the ratios of net interest income to total assets, total deposits, loans and advances and NPL were also computed.

6.1 Performance of Individual Banks

6.1.1 State Owned Bank (Sonali)

This bank had 1,183 branches including two overseas branches as of 30 June 2006. Sonali bank is the largest commercial bank in Bangladesh. This bank is also the largest in providing loans and advances.

As shown in the Table 6.1, the share of interest income in loan and advances was almost constant during the period 2001 to 2005. The share was 8.89 percent in 2001. It went up to 9.36 percent in 2004 and stood at 8.75 percent in 2005. On the other hand, the share of interest expenses against total deposits is increasing every year though modestly. Its percentage share reached 7.09 percent in 2005 from 5.78 percent in 2001. Despite some fluctuations, an upward trend in the ratio of total loans to total deposits is also found. The share has jumped to 81.92 percent in 2005 from the lowest share of 63.37 percent in 2003. One of the important features of this bank is that the NPL is still high at 22.52 percent in 2005, despite a sharp fall in this year from 29.22 percent in 2003. Another important feature is that the net worth of this bank is fairly high through out the period under consideration, unlike in many countries where in a situation of high NPL ratio it becomes negative.

Table 6.1
Selected Indicators of Sonali Bank (per cent)

Description	2001	2002	2003	2004	2005
Interest Income to Loan and Advances	8.89	8.83	9.23	9.36	8.75
Interest Expense to Deposit	5.78	5.62	5.72	6.18	7.09
NPL to Total Loan	27.46	27.81	29.22	28.31	22.52
Total Loan to Total Deposit	69.54	69.62	63.37	66.71	81.92
Net Worth (Taka in million)	122300	121156	116795	123899	110677

Source: Bangladesh Bank and Various Annual Reports of Sonali Bank

6.2.2 Private Domestic Bank (Prime Bank)

Prime Bank ltd is one of the leading private domestic commercial banks in Bangladesh. The Bank was incorporated as a public limited company in Bangladesh under the Companies Act 1994. It commenced its banking business with one branch from April 17, 1995 under the license issued by Bangladesh Bank. Presently the Bank has 43 branches all over Bangladesh and a booth is located at Dhaka Club, Dhaka. Out of the 43 branches, 5 branches are designated as Islamic Branch complying with the rules of Islamic Shariah, the modus operandi of which is substantially different from other branches of commercial banks. Table 6.2 shows that shares of interest income to loan and advances of this bank have increased continuously except in the year 2005. The share reached 20.84 percent in 2004 from 17.60 percent in 2001 and again reduced slightly to 20.49 percent in 2005. On the other hand, the ratio of interest expenses to deposits is reducing steadily with some fluctuations from 14.27 percent in 2001 to 13.54 percent in 2005. With some fluctuations, the NPL is also reducing over time at 10.98 percent in 2005 from 12.22 in 2001. Another phenomenon is that the total loan to deposit ratio is also fairly high which has contributed to enhance the growth in total net worth of the bank. As evident from the table, there has been continuous rise in the level of net worth from Taka 2685 million in 2001 to Taka 9590 million in 2005.

Table 6.2
Selected Indicators of Prime Bank (per cent)

Description	2001	2002	2003	2004	2005
Interest Income to Loan and Advances	17.60	19.11	19.81	20.84	20.49
Interest Expense to Deposit	14.27	13.82	12.58	12.38	13.54
NPL to Total Loan	12.22	13.63	13.63	14.15	10.98
Total Loan to Total Deposit	92.12	85.87	81.80	82.72	88.60
Net Worth (Taka in million)	2685.0	5146.0	5314.0	9142.0	9590

Source: Bangladesh Bank and Various Annual Reports of Prime Bank

6.3.3 Joint Venture Bank (Standard Chartered Bank)

The Standard Chartered Bank established in 1948 is a highly reputable bank in terms of flexible and innovative financial services to its customers. With over 140 years of experience in trade, finance and extensive international branch network, Standard Chartered keeps pace with client's changing needs. It constantly reviews the comprehensive cash, trade and treasury products and services to ensure that a full range of flexible and innovative services are always available.

Table 6.3 shows that the performance of this bank is excellent. While the share of interest income to loan and advances is increasing, the share of interest expenses to deposits is decreasing. Equally noticeable is that despite some fluctuations the NPL ratio has also remained very low. The share of interest income to total loan and advances reached 10.12 percent in 2005 from 6.93 percent in 2001. The interest expenses to deposits ratio reduced to 2.95 percent in 2005 from 3.1 percent in 2001. The NPL to total loan and advances ratio has also gone down to 2.49 percent in 2005 from 3.17 percent in 2001. However, compared to other two banks, the share of total loan to deposit ratio is low at 70.99 percent in 2005 from 96.24 percent in 2001. A phenomenal growth in total net worth has taken place in this bank with 5.5 fold increase in the period 2001 to 2005.

Table 6.3
Selected Indicators of Standard Chartered Bank (per cent)

Description	2001	2002	2003	2004	2005
Interest Income to Loan and Advances	6.93	6.32	8.02	9.32	10.12
Interest Expense to Deposit	3.1	3.28	3.96	3.83	2.95
NPL to Total Loan	3.17	1.84	2.75	2.31	2.49
Total Loan to Total Deposit	96.24	90.67	86.30	78.47	70.99
Net Worth (Taka in million)	1318.0	2486.0	4583.0	6325.0	8769.0

Source: Bangladesh Bank and Various Annual Reports of Standard Chartered Bank

6.2 Comparative Assessment of Three Banks

Table 6.4 presents comparative performance indicators of three banks. Net interest income to total assets, total deposits, total loan and advances and NPL ratios in percentage term are reported.

A comparative assessment of the above indicators gives important insight into the role of ownership structure in the performance of the banking system. As evident from the table, net interest income to the major indicators considered in the table have deteriorated in the state owned bank during the period 2001 to 2005. For instance, net interest income to total assets reduced to 0.1 percent in 2005 from 0.3 percent in 2001. Similarly, a declining trend is observed in the net interest income to total deposits and loan and advances ratio. The net interest income to NPL reduced to 0.4 percent in 2005 from 2.1 and 2.7 percent in 2001 and 2002 respectively.

On the other hand, these ratios for both private domestic and joint venture banks show an increasing trend owing to improved performance of these banks over time. Apart from the rise in net interest income to total assets, total deposits and total loan and advances ratios, the net interest income to NPL ratio has risen markedly in these banks. The net interest income to NPL of the Prime Bank rose to 47.3 percent in 2005 from 17.3 percent in 2001. Similarly, such a ratio jumped up to 238.6 percent from 114.0 percent during the same period in the Standard Chartered Bank. It is worth noting that in the joint venture bank, the net interest income to NPL ratio has gone up by almost 2.4 times within four years. This proves that the performance of the joint venture bank has been even better than the performance of the private domestic bank.

Table 6.4
Comparative Performance Indicators of Three Commercial Banks
(percent)

Year	**Banks**	NII/Total Assets	NII/Total Deposits	NII/Total Loan and Advances	NII/Total NPL
2001	Sonali	0.3	0.4	0.6	2.1
	Prime	1.8	1.9	2.1	17.3
	SCB	2.6	3.5	3.6	114.0
2002	Sonali	0.4	0.5	0.8	2.7
	Prime	2.4	2.6	3.0	22.5
	SCB	1.9	2.4	2.7	145.8
2003	Sonali	0.1	0.1	0.2	0.7
	Prime	3.5	3.6	4.4	32.5
	SCB	2.3	3.0	3.4	124.7
2004	Sonali	0.1	0.1	0.1	0.3
	Prime	4.2	4.9	5.9	41.5
	SCB	2.7	3.5	4.4	191.6
2005	Sonali	0.1	0.1	0.1	0.4
	Prime	4.0	4.6	5.2	47.4
	SCB	3.3	4.2	6.0	238.6

Source: Bangladesh Bank and Various Annual Reports of Sonali, Prime and Standard Chartered Bank

6.3 Survey Findings

A detailed survey carried out in the 20 banks provides general impression of the people working in the banks. Their opinions also corroborate the above findings. The respondents observed that among the 20 banks 7 banks (i.e. 35 percent) are partially liberalized and the rest 13 (i.e. 65 percent) are fully liberalized. They also opined that the partial liberalization has only marginally enhanced both domestic and international business of these banks. Respondents also reported that liberalization had no adverse employment effect including female employment. Similarly, respondents reported that they have the impression that foreign equity participation has no adverse effect on the availability of credit to the SMEs. The major finding of the survey is that all of the banks have learned positive lessons in the course of reform and accept the need to pursue more reforms.

Table 6.5
RESULT OF SAMPLE SURVEY OF FINANCIAL SECTOR

Name of Bank	Type of Bank	How liberalization policies have been pursued in your bank	Are liberalization policies and reforms accompanied by strengthening of rule, regulations and regulatory system of your bank	Has liberalization enhanced competition, efficiency to promote domestic business	Has liberalization enhanced competition, efficiency to augment international trade	Do your bank have any adverse employment effect of increased foreign equity participation	Are the small business being deprived of credit facilities after the increased foreign participation from your bank	Is liberalization adversely affecting a process of gender mainstream	How do your bank react when foreign banks are allowed to start operations in Bangladesh	Do the banking sectors need to be cautious while allowing foreign investors in the field of banking	What lessons your bank would learn to be useful for internal policies reforms as well as international referential trade negotiations	What's the percentage of foreign ownership	What is the total amount of Foreign Direct Investment
Sonali Bank	Govt. Com. Bank	Partial liberalized	Ongoing process	Partial enhanced	Partial enhanced	No	No	No	Adverse reaction	Partial	Positive lessons	0%	0
Agrani Bank	Govt. Com. Bank	Partial liberalized	Ongoing process	Partial enhanced	Partial enhanced	No	No	No	Adverse reaction	Partial	Positive lessons	0%	0
Janata Bank	Govt. Com. Bank	Partial liberalized	Ongoing process	Partial enhanced	Partial enhanced	No	No	No	Adverse reaction	Partial	Positive lessons	0%	0
Rupali Bank Limited	Govt. Com. Bank	Partial liberalized	Ongoing process	Partial enhanced	Partial enhanced	No	No	No	Adverse reaction	Partial	Positive lessons	67.29%	35100 million
Bangladesh Krishi Bank	Govt. Spec. Inst.	Partial liberalized	Ongoing process	Partial enhanced	Partial enhanced	No	No	No	Adverse reaction	Partial	Positive lessons	0%	0
Bangladesh ShilpaBank	Govt. Spec. Inst.	Partial liberalized	Ongoing process	Partial enhanced	Partial enhanced	No	No	No	Adverse reaction	Partial	Positive lessons	0%	0
BASIC Bank Limited	Govt. Spec. Inst.	Partial liberalized	Ongoing process	Partial enhanced	Partial enhanced	No	No	No	Adverse reaction	Partial	Positive lessons	0%	0

BRAC Bank Limited	Private Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	0%	0
Dhaka Bank Limited	Private Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	0%	0
Islam Bank Bangladesh Lmited	Private Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	0%	0
Prime Bank Limited	Private Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	0%	0
UCBL	Private Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	0%	0
National Bank Limited	Private Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	0%	0
Bank Asia Ltd.	Private Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	0%	0
AB Bank Limited	Private Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	48%	3900
Citibank N.A	Foreign Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	100%	718
Standard Chartered Bank	Foreign Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	100%	12250
HSBC	Foreign Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	100%	3576
Habib Bank Limited	Foreign Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	100%	1600
Bank Alfalah Limited	Foreign Com. Bank	Full-liberalized	Yes	Fully enhanced	Fully enhanced	No	No	No	Positive reaction	Fully	Positive lessons	100%	1420

VII: Conclusions and Policy Implications

7.1 Conclusions

Reforms in banking and insurance in Bangladesh began in mid 1980s with the implementations of the SAP. Within the SAP, financial sector reform program was one of the major components. The central bank was entrusted with the responsibility of carrying forward the reforms in this area. A project entitled Financial Sector Reform Programme (FSRP) was implemented in the Bangladesh Bank. The major aim of FSRP was to improve the operations of the NCBs through development of new banking technologies, computerization of banking operations, enhancing skills, changing outdated internal banking practices and corporate and credit cultures etc. During the FSRP period (1992-96) a number of new management and operational tools were developed and implemented. During this period Bangladesh also extensively participated in General Agreement on Trade and Tariff (GATT). Bangladesh was one of the earliest members of WTO. Despite making no commitments related financial sector liberalization, financial sector reform has been continuously carried out in Bangladesh. The regulations regarding foreign direct investment have also been liberalized as a part of ongoing reform.

The GDP growth trend indicates that there has been an improvement in the growth performance over the years. Compared with growth rate of 3.6 percent in the 1980s, the average growth rate reached 4.8 percent in the 1990s. Since 2000, the growth rate accelerated further with average growth rate of 5.3 percent during the period 2001 to 2005. However, no structural changes in the economy have taken place commensurate with ongoing reforms.

Banks and other financial institutions (OFIs) have been playing a key role in expanding economic activities for bringing dynamism to the economy. In Bangladesh, there are 49 banks with 6318 branches. Privatization has been accompanied by a spurt in the numbers of private banks. There are now 30 private commercial banks, 4 nationalized commercial banks and 5 specialized banks. There are altogether 10 foreign commercial banks operating in Bangladesh.

Total assets of the commercial banks as a share of total financial assets reached more than 90 percent in 2005. Out of this, nationalized commercial banks (NCBs), PCBs, foreign banks and DFIs held 40.14, 42.67, 9.46 and 7.73 percent respectively. Similarly, total deposits of the banks rose to Taka 1551.5 billion in 2005. The loans and advances amounted to Taka 1047.1 billion out of the aggregate assets of Taka 1725.5 billion in 2005. Such a financial deepening has taken place as a result of intensive reforms in the financial system.

Over the last three decades, Bangladesh's policy orientation has evolved considerably, from a highly interventionist regime with widespread control on trade, the exchange rate and investment, to a substantially liberalized economic regime. The beginnings of policy reform and liberalization can be traced to deregulation measures starting in 1976 under a new government, which increasingly distanced itself from the earlier socialist approach. However, initial reform efforts had neither a clear direction, nor a broad time frame for implementation. During the latter half of the 1980s, a more coherent picture of reforms began to emerge under structural adjustment policies (SAPs) in which financial sector reform was one of the major components. Banking and insurance have made big changes in the financial sector of Bangladesh. After the introduction of Banking Company Act 1991, many policy reforms have been made to strengthen the regulatory and monitoring mechanisms of the banking sector. Bangladesh Bank has implemented wide ranging policies including human resource, bank rate, CRR, SLR, monetary, fiscal and money laundering policies. The Ministry of Commerce has implemented premium, discount and annuity policies to regulate the insurance business.

Performance indicators of the commercial banks show divergence trends. Earnings as measured by return on assets (ROA) and return on equity (ROE) vary largely from one bank to another. Indicators reveal that the ROA of the NCBs has been very low and turned out to be negative in 2004. These ratios have been worse than in DFIS. Trends of these indicators in PCBs and FCBs have also found to be quite inconsistent during the period 1997 to 2004. Despite ROE of PCBs and FCBs fluctuating from one year to another, their ROE was found to be higher than the average ROE of the banking system. On the other hand, aggregate net interest income (NII) of the banks has been positive and consistently increased during the period 1997 to 2004. But when different bank's performance is assessed, large variation is found with negative income in the NCBs. One of the major positive impacts of the reform has been such that the gap between deposit and lending rate has decreased over time in the Bangladesh banking system. When the NPL of different banks is observed, a big gap between the government owned and private banks is found.

With liberalization of the insurance sector, the private sector is increasingly occupying a major share of the insurance business. The general insurance industry witnessed continuous growth. High economic growth rate accompanied by expansion in trade and commerce is leading to the expansion of insurance market in Bangladesh. Nonetheless, still there are many barriers to both foreign and domestic investment in the insurance sector.

The Principle Component analysis indicates that, compared to the first half (1996-2001), the performance of the financial sector has deteriorated in the second half (2001-2005) indicating that more intensive reforms are required.. The analysis also reveals that the expenditure income ratio of the development financial institutions explains the variability in the performance of the financial sector.

Both the level and growth of the commercial banks lending showed a phenomenal growth since 1990. But when the lending pattern of the commercial banks is examineded, a diverse trend is found. The share of agriculture sector in total lending of the commercial banks has reduced considerably in recent years. The same is true of lending in the manufacturing sector. However, WC for the manufacturing increased during the period 1990 to 2005. Similarly, a persistent rise in the share of trade is found when both level and share of trade in total lending is observed. When access to credit is observed, the contribution of banks is found to be still very low, indicating the need to expand the outreach of the financial services especially in rural areas.

Employment patterns shows divergent trends. The banking sector employs about 110,000 employees. Government banks (NCBs and DFIs) employ smaller number of people (17 and 12) than the private commercial banks (22 employees) per branch. What is interesting is that foreign commercial banks have 43 employees per branch.

A case study carried out over three banks with different ownership structures reveals divergent performance trends. Indicators like net interest income to total assets, total deposits, total loans and advances and NPL ratios show that the performance of the nationalized banks deteriorated sharply during the period 2001 to 2005. On the other hand, such ratios of both private domestic and joint venture banks have increased remarkably during the same period. More specifically, the performance of the joint venture bank has been even better than the performance of the private domestic bank. This case study suggests that a liberalization policy without changes in ownership and market structure will be less helpful in improving the performance of the overall banking system. A detailed survey carried out in 20 banks also corroborates this.

7.2 Policy Implications

- Bangladesh's experience shows that ownership structure is a key to improving the performance and enhancing the efficiency of the entire banking system. Structural and institutional reforms in the state owned bank will be necessary for healthy and sustained growth in the banking system. In the whole reform process, the regulating capacity of the central bank needs enhancement.

- More liberalization and opening up of the Bangladesh financial sector will be needed with immediate priority on deregulating the interest rate and withdrawing government and central bank regular intervention in the financial system.

- As Bangladesh is moving toward financial sector reform in order to be compatible with WTO arrangements, it is necessary to revise the law to improve governance in the financial system and to strengthen market institutions. Revision of laws applying to insurance companies will also be needed.

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