

Financial system in bangladesh essay sample

[Literature](#), [Russian Literature](#)



Without a sound financial system it is quite difficult and expensive to allocate resource and shift risks to its lowest level (low economic development).

Financial system plays an important role in the economic development and it is divided into financial markets and institutions. The role of the financial system is to gather or pool money from people and businesses that have more than they need currently and transmit those funds to those who can use them for either consumption or investment. A healthy economy is dependent on efficient transfers of resources from people who are net savers (surplus) to firms and individuals who need capital. Without efficient transfers, the economy simply could not function. Obviously, the level of employment and productivity, hence our standard of living, would be much lower. Therefore, it is absolutely essential that our financial market functions efficiently, not only quickly, but also at a minimal cost.

The financial system in Bangladesh includes Bangladesh Bank (the Central Bank), scheduled banks, non-bank financial institutions, microfinance institutions (MFIs), insurance companies, co-operative banks, credit rating agencies and stock exchange. Among scheduled banks there are 4 nationalized commercial banks (NCBs), 5 state-owned specialized banks (SBs), 30 domestic private commercial banks (PCBs), 9 foreign commercial banks (FCBs) and 29 nonbank financial institutions (NBFIs) as of December 2006. However, Rupali Bank, an NCB is being sold to a foreign buyer, and once this transaction is completed, the country will have only 3 NCBs, which are being corporatized. Over and above the institutions cited above, three development financial institutions namely House Building Finance

Corporation (HBFC), Ansar- VDP Unnayan Bank and Karma Shangsthan Bank are operating in Bangladesh, all of which are state owned. Introduction:

Financial system is a system which tones up the savings-investment process of a country. Financial system plays a significant role in the economic development of a country. The importance of an efficient financial sector lies in the fact that, it ensures domestic resources mobilization, generation of savings, and investments in productive sectors. In fact, it is the system by which a country's most profitable and efficient projects are systematically and continuously directed to the most productive sources of future growth. The financial system not only transfers funds from savers to investors, it also selects projects which will yield the highest returns, accumulates sufficient quantities of capital to fund the range of investment projects across economic activities, accounts for price risks across assets, monitor performance, and enforce contracts.

According to the McKinnon- Shaw hypothesis (1973), the conventional wisdom is that flexibility and efficiency of the financial system are crucial to the growth and development of a market economy. A comprehensive study by King and Levine (1993) from across 119 developed and developing countries over the 1960-1989 period provides compelling evidence that economic growth is dramatically dependent on the size of financial sector, credit to private sector and enterprises and interest rates. The larger the financial sector in the context of the overall economy, the greater the share of lending by depository rather than central banks, and the greater the share

of credit to private sector rather than public sector, the greater is the rate of economic growth.

Major Components of a Financial System and their roles:

The financial sector in Bangladesh basically comprises the money and capital markets, insurance and pensions, and microfinance. In addition to the Bangladesh Bank (The Central Bank), there are 4 state-owned commercial banks (SCBs), 5 state-owned specialized banks, 30 domestic private commercial banks (PCBs), 9 foreign commercial banks, and 29 nonbank financial institutions (NBFIs) as of 2008. Figure 1 depicts the components of the financial sector in Bangladesh in brief.

Like many other developing countries, the financial system of Bangladesh is mainly bank dependent. While the Bangladesh Bank has regulatory and supervisory jurisdiction over the entire banking subsector as well as the NBFIs, the Securities and Exchange Commission (SEC) exercises similar functions for the stock exchanges and the merchant banks. Most of the institutions in the financial sector are characterized by a mix of public and private ownership. The specialized banks are often called development finance institutions (DFIs). Out of the five specialized banks, the Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank were created to meet the credit needs of the agriculture sector, while the Bangladesh Shilpa Bank and Bangladesh Shilpo Reen Shangstha were set up to extend term loans to industry. Of the 29 NBFIs, 1 is government owned, 15 are local (private), and the other 13 were established as joint ventures with foreign participation.

The Office of the Chief Controller of Insurance (OCCI) has supervision authority over the insurance industry.

General insurance is provided by 21 companies and life insurance is provided by 6 companies. The industry is dominated by the two large, state-owned companies – the Shadharan Bima Corporation for general insurance and the Jibon Bima Corporation for life insurance – which together command most of the total assets of the insurance subsector. Microfinance institutions grew rapidly and microcredit programs in Bangladesh are implemented by various formal financial institutions (SCBs and specialized banks), specialized government organizations, and nongovernment organizations (NGOs). The Government of Bangladesh enacted the Microcredit Regulatory Authority Act 2006 on 16 July 2006 to improve transparency and accountability in the activities of the country's microfinance institutions. The Microcredit Regulatory Authority has been established to implement the act and to bring the microcredit subsector under a full-fledged regulatory framework.

Structure of financial system in Bangladesh:

Money market

Money market

Capital market

Capital market

Microfinance

Microfinance

Financial system in Bangladesh

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1. Bangladesh Bank
2. All Banks
3. Non-Bank financial institutions
4. Money Changers
5. Credit rating agencies

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1. NonGovernmentOrganizations(NGOs)
2. Palli Karmo Shahayok Foundation (PKSF)
3. Grameen Bank
4. Bangladesh

Rural Development Board

5. Other non-government and development organizations.

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Securities Market

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2. General and life insurance companies
3. Government Pension Scheme
4. Central Provident Fund
5. Private sector pension funds (typically small)

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Figure 1: Financial System in Bangladesh, Source: Policy Analysis Unit (PAU), Bangladesh Bank.

Reforms in financial sector over last few decades:

Many countries of the world have undertaken reform measures for their financial sector since 1970s, though the motivation for reforms varies from country to country. Reforms are initiated basically to improve the financial intermediation and ensure efficient allocation of financial resources and in ultimate analysis improve the competitiveness of the private sector and thereby promote investment and growth in the real sector. The key targets of the financial sector reform program are: 1. To bring about greater autonomy of the Central Bank.

2. Strengthening the capabilities of the Central Bank to perform its enhanced responsibilities.
3. Strengthening prudential regulations and supervision.
4. Restructuring the management and internal processes of NCBs and ultimately privatization of selected NCBs and DFIs.
5. To promote competition by creating level-playing fields.
6. Strengthening the legal and judicial processes.

To improve the money and debt market condition membership of the board of directors; the roles and functions of the board and management were clarified and redefined. Bangladesh Bank's capacity to supervise and regulate bank effectively, monitor non-performing loans and enforce actions against banks violating regulations and laws has been strengthened. Audit committees (EWS) was introduced. To strengthen the banking operation, minimum capital requirement was raised from Tk. 400million to Tk. 1000

million and the requirement on risk weighted basis was also increased. Tight loan rescheduling conditions were introduced to stop ever greening of loans. An upper limit on a bank's exposure to a particular customer or group was introduced.

Strict measures have been laid and enforced on loan loss provisioning. Loan write off guidelines were issued by the Bangladesh Bank, allowing the banks for the first time, to write off " bad" debits against full provisioning. Large loan limit has been linked to bank's NPL ratio. The Core Risk Management guidelines on five major risks has been introduced by Bangladesh Bank (credit, foreign exchange and assets-liabilities risk management, internal control and compliance and anti-money laundering) laying down policies, processes, procedures and structures that will lead to better governance and improved services. Presently, Bangladesh Bank has a market determined Exchange rate authority in the monetary and exchange rate front.

Floating of taka since June 2003 was achieved without encountering undue volatility. Further reforms in simplifying and streamlining foreign exchange operations and payment system are in the pipeline. To avoid private sector crowding out, the annual volume of government borrowings from bank is limited and is now market based. Financial instruments like repo, reverse repo, five year and ten year bonds have been introduced. Bangladesh Bank and Securities exchange commission agreed to allow government bonds to be traded in the stock exchange. A capacity building program has been initiated in the Bangladesh Bank. Service standards and work flow analysis have been introduced in different departments to ensure quality a speed.

The Central Bank Strengthening Program (CBSP) includes,

- (a) Computerization of operations
 - (b) Human resource development
 - (c) Restructuring different departments
 - (d) Organizing business processes
 - (e) Automation of clearing house
- Performance of Banks & Financial

Institutions:

In Bangladesh, following independence, the banking sector was nationalized.

The dominance of these nationalized banks continued well until the late 1990s, even though gradually private banks were allowed entry into the banking business. The combination of public ownership and lack of competition contributed to not only weak performance of the banking sector measured in terms of what is known as the CAMELS indicators, but very importantly, the banking sector became a huge source of rent seeking and corruption. One key indicator of this is the volume of non-performing loans (NPLs). For example, as of 2000, total NPL of the state-owned commercial banks (SCBs) stood at a whopping 39 per cent of total loans (Taka 110 billion or 10 per cent of GDP). While some of the NPL reflected bad lending decisions, especially those given to weakly performing public enterprises, a large part reflected the non-servicing of loans by politically well-connected private business.

The financial soundness indicators show marginally weakened performance for the banking system in 2012. The ratio of gross non-performing loans (NPLs), to total loans in the banking system, rose to 7.2 per cent, at the end of June 2012, from 7.1 per cent at the end of June 2011. Although the gross NPL ratio for state-owned commercial banks (SCBs) declined to 13.5 per

cent, at the end of June 2012, from 14. 1 per cent at the end of June 2011, the gross NPL ratio for other banks have increased. In 2012, the gross NPL ratio for private banks rose from 3. 5 per cent, to 3. 8 per cent, for specialized banks, from 21. 8 per cent to 23. 8 per cent, and for foreign banks from 3. 1 per cent to 3. 2 per cent. Because of the central bank's restrictive monetary policy, broad money growth moderated to 18. 2 per cent year-on-year, in September 2012, from 19. 6 per cent in September 2011, although remained higher than the 2013 growth target of 16. 5 per cent.

Bangladesh asked Japan to set up a Bangladesh-Japan friendship economic zone, to improve trade relations about the growth target, the Asian Development Bank (ADB) forecast that Bangladesh faces enormous challenges to achieve the Sixth Five Year Plan (SFYP) target of raising GDP growth, to 8 per cent, by 2015. As envisaged in SFYP, investment needs to be quickly raised from the current 25. 5 per cent of GDP, to 29. 6 per cent in 2013, and 32. 5 per cent in 2015. Infrastructure investment is to be scaled up from 2 per cent of GDP in 2010 to 4. 5 per cent in 2013, and 6 per cent in 2015. In particular, tepid investment in core infrastructure, including power, gas, and transport, is a key obstacle to attaining growth targets. The report said that a major development challenge is to address the country's massive skills shortage. " Another priority is to create better paying jobs for the labor force, which is growing at 3. 2 per cent annually, adding close to 2 million new entrants to the labor force each year, including an increasing number of female workers." Financing this huge investment is a major challenge. The government expects to mobilize a large part of the financing from domestic

resources through sustained tax reforms and higher private savings. Healthy remittance inflows will be a major driver in boosting national savings. In addition, attracting FDI has been emphasized, along with mobilizing more external assistance.

Access to finance for Small & Medium Enterprises:

The growth of small and medium enterprises (SMEs) in terms of size and number has a multiplier effect on the national economy, specifically on employment, GDP growth, and poverty reduction in Bangladesh. There are nearly 1.5 billion SMEs in Bangladesh, 60%-65% of which are located outside the metropolitan areas of Dhaka & Chittagong. There is a very high density of SMEs in the industrial economy of Bangladesh. SMEs constitute over 99% of private industrial establishments and provide job opportunities to about 70%-80% of the non-agricultural labor force. The SMEs share in manufacturing value added GDP varies at 28%-30%. The service sector is primarily composed of SMEs, which is responsible for the bulk of employment growth. SME contribution to national exports is significant through different industries such as ready-made garments, jute, and leather. In almost every part of the world, limited access to finance is considered a key constraint to private sector growth. This is especially true for SMEs of our country as they are facing different types of problems for availing institutional finance though SMEs play dominantly important role.

Suggested measures to improve performance of banks and financial institutions: 1. Restructure, Corporatize & Privatization:

a) Nationalized Commercial Banks (NCBs): Sonali Bank, Janata Bank and

Agrani Bank have been corporatized and incorporated as public limited company. Sale of Rupali Bank to a foreign private entrepreneur is underway. These banks will be more accountable to the central bank.

b) Specialized Banks (SBs): Public sector banks in charge of agricultural and industrial term lending suffer from poor decision making and low efficiency. In order to make them efficient and financially viable, restructuring of these institutions is necessary. Otherwise, it will hinder the overall financial sector stability and soundness

2. Non-bank financial institution (NBFIs): Non-bank financial institution (NBFIs) play a significant role in meeting the diverse financial needs of various sectors of an economy as well as to the deepening of the country's financial system. At present, almost all private commercial banks are involved in non-bank financial operations. Banks wishing to enter in the leasing business, which is essentially a core operation of NBFIs, can do so through opening subsidiaries so that a level playing field for NBFIs can be maintained. Alternatively, banks can go for joint financing under syndication arrangements with leasing companies on any project proposal. Again, banks can concentrate on working capital finance and foreign exchange operations, which matches more with their asset-liability management.

Long term investment like financing capital machineries can be done by NBFIs and in the event when banks want to engage in such activities they can place their funds with an NBFIs to extend lease facility for those machineries. The success of merchant banking operations is largely linked to the development of the security market. So NBFIs should concentrate more on their opportunities in the capital market.

3. NGO-MFIs : Microcredit

Regulatory Authority should consider the following steps:

- The NGO-MFIs may be required by law to disburse a certain percentage of their loan to agriculture, small, medium and micro enterprises.
- The authority can also replicate the wholesale lending approach which is now being executed by PKSF for microcredit purpose, to reach the farmers, SME and micro entrepreneurs.
- Equal access to the services under consideration in terms of geographic location should be ensured by giving license to NGO-MFIs in such a way that every geographic location be covered by NGO-MFIs with equal intensity.

- A restructuring of regulatory framework, i. e. Microcredit Regulatory Authority Act (MRAA) may take up measures to introduce simple and conducive regulatory regime for the MFIs.

4. Capital Market: Capital market, comprising of debt and equity instruments, can play a key role in economic development by channeling surplus resources to the most productive uses. Though the stock market in our country started its operation some 50years ago, the contribution of the capital market towards economic growth in a significant way is yet to make its mark. The capital market is still having low level of capitalization, liquidity and depth; it lacks active trading in fixed income securities (bond and debentures). Following steps can be adopted to develop the capital market of Bangladesh, To raise the market capitalization,

5. Bond Market: Presently, Bangladeshi Bond Market is not in a good shape. Investors across the world are using different sources for raising their funds. They may also explore the possibilities of funds like insurance of commercial paper, certificates of deposits and other money and capital market instruments.

Further steps like developing benchmark yield curve is also needed in order to ensure the proper development of the bond market. Although a recent decision of the government to introduced pre-announced volume based auctions will definitely bring more transparency in the country's money market and avoid mismatch between cash and debt management. Recently the Cash and Debt Management (CDMC) has agreed in principle that from the beginning of FY08 the development system will be replaced by a system where the extra amount will be developed on the primary dealers on the basis of underwriting. This new system will entuse the primary dealers to create a secondary market for government securities. 6. Insurance:

Insurance industry is an integral part of the financial system. In our country both insurance penetration and insurance density is comparatively lower in comparison to other south Asian countries. Its development and efficient functioning is crucially linked to the growth and stability of the financial system. Lack of competence from the regulator's side can lead to an unstable industry, with a latent threat to overall financial system.

The present regulatory and supervisory mechanism of the industry remains underdeveloped to manage a sizeable number of companies in the industry. Lack of proper monitoring mechanism, experienced staff and inadequate technological support are some of the key problems of the present regulatory body, limiting its role in the development of the sector.

Considering the role of this industry's growth and stability for the entire financial market the present regulatory body need to be connected with the other regulators (such as BB, SEC). Such a development can significantly improve the efficacy of the regulatory mechanism by adopting coherent and

mutually beneficial programs and policies. Insurance industry is one of the major institutional investors of the capital market. They can play a vital role in capital market development by investing large amount of fund for long term. As institutional investors they are more informed about the company fundamentals, thereby increase informational efficiency of the capital market.

7. Creating: Public-private Partnership for Infrastructure Finance: Public-private partnership (PPP) describes a government service or private business venture which is funded and operated through a partnership of government and one or more private sector companies. Investment Climate Assessment (ICA) by the World Bank and Bangladesh Enterprise Institute (WB and BEI, 2003) shows that poor infrastructure is one of the major obstacles for private sector development in Bangladesh. Lack of efficiency in public sector services has imposed significant costs and hindered the growth of the country's economy. Already government has taken several steps. More steps should be taken to strengthen the infrastructural condition and to remove the private sector lacks. 8. Autonomy of Bangladesh Bank: Former Governor of Bangladesh Bank Dr Salehuddin Ahmed stressed the need for full autonomy of BB for smooth functioning of the banking sector.

He said, " Bangladesh Bank does not enjoy full autonomy like the other central banks in the world." H also says that, " Obviously, full autonomy does not mean lack of accountability—there must be a process to make us accountable." 9. Compliance of Basel II: Banks operating in Bangladesh are maintaining Risk Based Capital (Basel I) instead of capital-to-liabilities

approach from 1996. According to Basel I banks are maintaining Minimum Capital Requirement (MCR) on the basis of Risk-Weighted Asset (RWA) and Risk Weights were fixed i. e. 0%, 20%, 50%, & 100%. But this 'one size fits to all' approach nowadays lost its acceptability. To make the bank capital more risk sensitive and more shock absorbent Bangladesh Bank (BB) decided to introduce Basel II.

In order to make the banks prepared Bangladesh Bank (BB) started parallel run of Basel I& Basel II for one year from January 01, 2009 and has formally introduced Basel II rules titled Risk Based Capital Adequacy (RBCA) for banks (Revised Regulatory Capital framework in line with Basel II) from January 2010. As in many other developing countries, implementation of Basel II is a challenging issue for banking sector of Bangladesh. Compliance of Basel Core Principles (BCPs) requires providing a solid foundation for the eventual implementation of the new accord. As an initial strategic move, a survey has been conducted to understand the choices of banks for adopting different approaches of risk measurements for regulatory capital requirement. The study shows that most of the banks in Bangladesh like to follow simplified standardized approach for credit risk, basic indicator approach for operational risk and standardized approach for market risk. Concluding remarks:

Today, almost everyone agrees that the financial system is essential for development of a country. Improving the financial system can lead to higher growth and reduce the likelihood and severity of crises. While Bangladesh has achieved relatively high economic growth over the past years with a

distorted financial system and in spite of its governance problems, cross-country experience has shown the importance of financial and institutional development to sustain long-term economic growth. Faster GDP growth consistent with the poverty reduction goals cannot be met unless the extent and quality of financial intermediation in Bangladesh advances significantly. In particular, this would require more competitive banking and non-banking financial sectors capable of reaching out to all sections of the community, rural & urban, catering to all types of marketable financial service. The proactive measures taken in the financial sector in recent years have put salutary impact on the financial system. Hopefully, the on-going reform process in the financial system of Bangladesh will bring more stability and transparency. In this regard, proper care should be taken in the reform process so that reformism the financial sector embraces the socio-economic realities in Bangladesh.