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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the development of new banking technologies, computerization of banking operations, upgrading of skills, changing outdated internal banking practices and corporate and credit cultures.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

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[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