AN ANATOMY OF CENTRAL BANK'S SUPERVISORY FUNCTIONS WITH SPECIAL REFERENCE TO BANGLADESH BANK

by

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Abstract

In the early days the main functions of commercial bank were to collect deposit and extend credit. But now-a-days the functions of bank have become more complex and manifold. The role of the central bank as the supervisory authority is also increasing alongside the increasing functions of commercial banks. The development of a country is mainly dependent on a well developed banking system and so the role of Bangladesh Bank (the central bank of Bangladesh) is getting much more importance day by day. In Bangladesh, Bangladesh Bank is the sole authority to supervise the banks and the banks are supposed to obey Bangladesh Bank regulation and supervisory guidelines. In this context, the various approaches to bank supervision, the coverage of bank supervision and the modes of bank supervision have been discussed. I have endeavored to find out the various supervisory issues prevalent in the G-7 countries and Risk Based Supervision also been pointed out.

The Basle Agreement on bank supervision is the internationally practiced standard for the banking supervision. Bank supervision by Bangladesh Bank is in line with Basle core principles. To measure the health of a bank it is much more important and the CAMELS rating system is the internationally approved rating system for the banks. But due to the increasing risk of failure in the banking system, only the supervisory guidelines are not sufficient to ensure a healthy banking system. Developed countries now-a-days following a new method called Risk Based Supervision. It is also discussed. On the other hand, in the wake of recent global financial crisis we have seen series of bank failure. The causes and effect of bank failure is also discussed.

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LIST of ABBREVIATIONS

AMLD	Anti Money Laundering Department
BB	Bangladesh Bank
BRPD	Banking Policy and Regulation Department
BCA	Bank Company Act, 1991
BCP	Basel Core Principles for Effective Banking Supervision
CAMELS	**C**apital adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, **S**ensitivity to market risk
DBI	Department of Banking Inspection
EWS	Early Warning Signal
EI	Expenditure Income Ratio
FIMD	Financial Institution and Market Department
FEIVD	Foreign Exchange Inspection & Vigilance Department
NBFI	Non-Bank Financial Institution
NPL	Non-Performing Loans
NII	Net Interest Income
OCC	Office of Comptroller of Currency of the USA
OECD	Organization of Economic Cooperation and Development
RBS	Risk Based Supervision
RATE	Risk Assessment, Tools of Supervision and Evaluation
ROA	Return on Asset
ROE	Return on Equity

Chapter 1
Introduction

1.1 Background of the Study

In order to have a strong economic environment, continuous monitoring and supervision are essential to the country's banking industry because of its vital role in making payments as well as mobilizing and channelizing savings. Supervision of the banking system is the major function of any Central Bank. The mission of supervision is to ensure sound financial position of banks and maintaining adequate capital and reserves to supports the probable risks of banking operation. Though efficient supervision of banks is much costly, it is universally proved that poor supervision is even costlier. For supervision to be effective the following guidelines are essential:

1. The duty of the supervisor is that they encourage and promote financial discipline by ensuring good corporate governance and improving transparency and surveillance;
2. The main purpose of supervision is to maintain financial stability and depositors' confidence;
3. For effective bank supervision, particular risks associated with individual banks needs to be reviewed and supervision should be conducted accordingly;
4. To perform his job effectively and efficiently, a supervisor has to work independently without any interference from the authority. He has to be empowered to gather all the required information and enforce the recommendations comes out from supervision;
5. Supervisors must look into the fact that banks have sufficient resources include adequate capital, efficient management and effective internal control system; because these should be sound before going to take any risky venture;
6. Close cooperation among other financial sector regulators is must because most of the operations of modern banking is global now.

In most of the countries, banks and non-bank financial institutions are supervised by their respective Central Banks with an aim to protecting depositor's interest and also ensure the financial soundness of the banks and financial institutions. The process of supervision differs from country to country, depending on type, nature, dimension and intricacy of its financial systems.

The aim of banking supervision should promote an effective as well as efficient banking system that quickly responds to the need of public for effective banking services at a logical cost. Usually, supervision provides some sort of protection which should be balanced with the cost of financial intermediation.

Supervisory system should consider the nature of risks associated with the country's banking industry. To address specific risks, every country should deploy resources based on the existing standards. Bank supervision should be dynamic and flexible enough to respond the transformation in the industry. Supervisory techniques should be upgraded according to the recent changes and supervisors have to reassess accordingly.

Supervision cannot provide any guarantee against bank failure. Failure is a part of taking risk in modern market economy. It is largely a political matter how much public money will be spend to support banking system. So it cannot solely the responsibility of banking supervisors, but they must have contingent plan to resolve any situation that arises from any problem bank.

This study attempts to show various aspects of bank supervision. We need to know in depth what is actually meant by supervision and what the principles of supervision are. This study has been undertaken to show the existing supervisory practices prevalent in Bangladesh and in some other developed countries. It is expected that various aspects of bank supervision will create new thoughts needed to be considered for more effective supervision of banking system.

1.2 Objective of the study

- **a)** To study the present supervisory role of Bangladesh Bank (BB);
- **b)** To review the supervisory methods used in developed countries and Risk based supervision;
- **c)** To identify the causes of Bank Failure and its effect;
- **d)** To analyze the effectiveness of BB's supervision in the Banking sector of Bangladesh;

1.3 Data and Methodology

The study conducted with the data collected mainly from secondary sources. For the purpose of the study, data were collected from related books, journals specially from Bangladesh Bank and Bangladesh Institute of Bank Management. Information regarding different types of Laws, rules and regulation were collected from Bank Company Act (of Bangladesh) 1991, different circulars of Bangladesh Bank, Bangladesh Bank order 1972. Websites of different organization such as Bangladesh Bank (BB), Bank for international Settlement (BIS), World Bank Group and Central Bank's of G-7 countries are also visited for the purpose of Data collection. For analysis part time series data, various ratio analysis has been done and the results has been shown on graphically on various charts.

1.4 Chapter plan

To make the discussion clear, I have divided the study into some chapters. **In Chapter-1,** some introductory discussions have been made**. In Chapter-2**, Bank supervision in some developed countries and Risk based supervision**. Chapter-3**, Bank Supervision by Bangladesh Bank. **Chapter-4**, To identify the causes of Bank Failure and its effect. **Chapter-5**, the effectiveness of Bangladesh Bank's supervision in the Banking sector of Bangladesh. Conclusion and recommendations have been made in **Chapter 6.**

1.5 Limitations

In this study, I have tried no stone unturned to collect relevant information from various sources amidst some major constraints, viz

a) All the data are secondary in nature. There was no scope for researcher to visit the commercial banks and watch how supervisory measures are actually being implemented.
b) Lack of proper access to information—in the required format—was also one of the major limiting factors in this study.

Chapter 2
Banking Supervision in some Developed (G-7) countries and Risk based Supervision

2.1 Bank Supervision in G -7 countries

In first half this chapter we briefly deal with the central bank's involvement in banking supervision primarily in the Group of Seven (G-7) countries. And second half deals with risk based supervision. Central banks were found in all but one G-7 countries (Canada) to be either de jure or de facto involved with the supervision and regulation of banks. More broadly, central banks have either total or shared responsibility for banking supervision in three-fourths of the member of the Organization for Economic Cooperation and Development (OECD). Therefore, one can assume that most countries have come to understand that banking supervision and regulation have economic consequences that are important for economic stabilization and growth.

2.1.1. The United States

The United States of America with its dual banking system where in most cases, federal and state officials share authority over individual institutions. Also in the United States, a large number of small institutions and a system that until recently limited the activities of individual banks primarily to one state.
The dual banking system in the United States has led to the creation of a rather complicated banking supervisory structure. Commercial banks in the United States have the option of obtaining state or federal charters. National banks or those with federal charters are supervised by the Office of the Comptroller of the Currency (OCC). Proposals are made periodically in the United States to streamline the banking supervisory structure, especially after the subprime mortgage crisis.

2.1.2. The United Kingdom

Financial stability is the central aim of financial regulation. A 'tripartite authorities' is responsible to maintain the financial stability in the United Kingdom which consists of HM Treasury, the Bank of England and the Financial Services Authority (FSA). The responsibilities of the above three organizations are as follows:

- The Bank of England formulates the monetary policies and is responsible for the stability of the monetary system. Another role of the Bank of England is also to monitor the financial system infrastructure of the UK;
- The FSA's role is outlined in the Financial Services and Markets Act (FSMA) 2000. It is engaged in supervision of institutions operating in financial markets;
- The responsibility of the HM Treasury is to formulate financial regulations and to enact the legislations.

2.1.3. France

In France multiple agencies are involved in bank supervision. These agencies are divided according to their functional responsibility. Several agencies are now involved in banking supervision in France. The Banque De France (the central bank) exercises indirect but significant authority over the supervision and regulation of the banking system. It is the responsibility of the Commission Bancaire (banking Commission) to maintain the soundness of all credit organizations and monitoring compliance with banking rules. It is chaired by the Governor of the Bank of France and is staffed by central bank employees. The Banking Regulations Committee, on which the Governor of the Bank of France acts as Vice-Chairman, establishes prudential regulations and accounting standards. The Credit Institution Committee, on which the Governor of the Bank of France serves as Chairman, is responsible for chartering individual banking institutions.

2.1.4. Japan

The Banking supervision and regulation in Japan is the legal responsibility of Ministry of Finance, although the Bank of Japan (the central bank) is also involved de facto in supervision, analyses and in the resolution of problems within the banking sector. After the supervisory reforms of June 1998 the "Financial Supervisory Agency" (**FSA**) was created. FSA is responsible of licensing, inspection and supervision of financial sector which was previously performed by the Ministry of Finance. The authority of the Ministry of Finance is statutory but the Bank of Japan’s authority is contractual.

2.1.5. Germany

In Germany, the supervisory institutions are particularly interesting because of the frequent misperception that the Deutsche Bundesbank (the central bank) is not involved in the supervision of German financial sector. The Federal Banking Supervisory Office was created as the primary banking supervisory body in close coordination with the Bundesbank. As it is the lead supervisor and with a single office in Berlin, it relies heavily on the Bundesbank, which regularly deals with banks and a network of offices throughout Germany. In practice, a partnership exists between the Supervisory Office and the Bundesbank.

2.1.6. Italy

Another G-7 country with essentially a single supervisor is Italy. The Banca D’italia (the central bank) is responsible for the supervision and regulation of the banking system, subject to broad directives from the International Committee for Credit and Savings. The Bank of Italy is empowered to authorize the establishment of new banks and opening of new bank branches. The Bank of Italy is responsible for formulating regulations for credit institutions. It also has the power to prescribe acceptable capital requirement, credit limit for banks and exercise ongoing controls through offsite statements, onsite supervision and various ratio analysis. The Bank of Italy is also responsible for ensuring that the banks comply with these regulations.

2.1.7. Canada

Canada is the only G-7 country where the central bank has a very limited role in supervising and regulating the banking system. The Office of the Superintendent of Financial Institutions (OSFI) is the sole supervisory authority for financial sector of Canada. OSFI, a wing of the Department of Finance, reporting to the Minister of Finance.The Bank of Canada does not have any responsibilities for prudential supervision but it regularly receives reports filed with the superintendent.

The Governor of the Bank of Canada is a member of the Financial Institution Supervisory Committee, which was established to facilitate the confidential exchange of information among its members on all matters related to the supervision of financial institutions. The other members of this committee are the Superintendent of OSFI, the Deputy Minister of Finance and the Chairman of the Canadian Deposit Insurance Corporation.

2.2 Risk-Based Supervision

Traditionally bank supervision is compliance based i.e. it checks any deviation from established laws, guidelines, rules, policies and regulations related to banking services and banking supervisors depend mostly on the various process of transaction. As a matter of fact it is nothing but duplicating the work of certified auditor. As a result, this process requires more resources, costlier, and sometimes less effective.

During the first half of 1980's the Office of Comptroller of Currency (of U.S.A) introduced a modern approach which is designed from top to bottom and provides more focus on risk. In case of large and complex banking organizations, the Federal Reserve System adopted a separate system of inspection which focused mainly on risk.

In 1997 the Central Bank of England circulated the risk-based approach. Afterwards, FSA first introduced RATE Framework and then the ARROW Risk Model. All these illustrates the dawn of a new supervisory approach which focuses on areas with comparatively greater risks. However, risk-based or risk-focused approach was not clearly defined at that time. As a result, countries in different region developed different types of framework in this regard.

Comprehensive risk management process is mandatory by banks for Effective Banking Supervision as per the recommendation of the Basel Core Principles (BCP-7). BCP No. 7 is stated below:

Principle 7 - "Supervisors must be satisfied that banks and banking groups have in place a **Comprehensive risk management process** (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution."

Before discussing further we need to understand what is meant by Risk Based Supervision (RBS).

2.2.1 Definition

Theoretically, we can define RBS in two ways, broad and narrow way. Policy and implementation levels are discussed in broad scope. In case of policy level, RBS gives attention to the capability of Board of Directors and the responsibility of executive management for risk management and maintenance of sufficient capital. This is also reflected in the principles given in the Basel II accord. And in the implementation level, RBS gives attention to make the priority of activities related to supervision and then to make an allocation of required supervisory resources according to perceived risks. And in narrower scope RBS highlights to the guidelines for on-site inspections.

So, we can define RBS as a supervisory technique to detect the functions and practices related to high risk areas and accordingly allocating supervisory resources in order to mitigate those risks.

2.2.2 Who needs RBS?

Risk-Based Supervision (RBS) is a modern approach that is rapidly achieving popularity as a better supervision over the traditional system that focuses mainly compliance status of banks, based on historical financial information and assessing the present problems by auditing.

Contrarily, the main focus of RBS is to identifying poor risk management practice in a bank. To understand and determine the quality of managing risks by banks are given priority in RBS.

Supervisors around the world prefer such an approach, because it facilitates them to concentrate and allocate supervisory resources in order for identifying greater risky areas. Moreover, it helps them to determine the banks with high risk exposure. When those areas and banks are detected, supervisors can pay attention to quantify and mitigate those risks. The main feature of effective RBS is to detect primary risks those have impact on banks and to evaluate the consequence of those risks. After that supervisory resources can be dedicated more effectively to pay attention to those detected risks. By this, RBS helps the supervisors to utilize supervisory resources efficiently. For this reason supervisors around the world are exercising RBS.

Various international standards such as Basel II accord and the Basel Core Principles are now frequently found in different forms of RBS. For example, as per the Basel II accord, banks should establish an effective risk management system, effectiveness of which should be assessed by the supervisors.

2.2.3 RBS- On-Site and Off-Site

RBS is another form of on-site supervision of banks which is a narrow definition of RBS. But this definition does not reflect the true picture of supervisory framework which consists of onsite and offsite inspections. Both onsite and off-site supervision in RBS are incorporated to a single system, in which one supplements the other. As these processes are dependent on the other, they cannot function effectively in case of absence of the other.

Thus, RBS should be established comprising both on-site inspections and off-site supervision, for example, the RBS broadly includes policies and enforcement to detect functions and practices of highest risks for ensuring a safe and sound financial system.

2.2.4 Benefits of RBS

- Rationalize the use of scarce supervisory resources in higher risk areas of banks;
- a suitable technique for assessing banks by a different evaluation and processes for managing risk;
- timely detection of imminent risks on each banks and on a industry basis;
- better apprehension by the supervisors about the business nature of the banks and their potential risks and the quality of risk management process;
- RBS helps to implement the culture of risk management into management of banks'.

2.2.5 Comparison between Traditional Vs. Risk Based Supervision (RBS):

RBS emphasizes on understanding and assessing the adequacy of each bank's risk management system for identifying, measuring, controlling and monitoring risk adequately. It is a continuous process where the risks of a bank are assessed and an appropriate supervisory plan is put into action. The key feature of RBS is suppleness.

Table 1: Traditional vs. Risk-based Supervisory approaches

Traditional Approach	Risk based Approach
Testing of Transaction	Focusing on Process
Assessment for point-in-time	Assess continuously
Standardized procedures	Risk profile driven procedures
Historical performance	Forward-looking
Main focus on risk avoidance	Main focus on risk mitigation

2.2.6 RBS Framework

The RBS framework has six key steps, each of which requires the preparation of specific documentation.

Table 2: Risk Based Supervision Framework

	Steps	Risk based tools/reports
1	Understand the institution	1. Institutional Profile
2	Assess the institution's risks	2. Preliminary Risk Matrix 3. Risk Assessment Summary
3	Plan and Schedule Supervisory Activities	4. Supervisory Plan
4	Define the Examination Activities	5. Scope Memorandum
5	Perform Examination Procedures	6. CAMELS Rating, Risk Matrix
6	Reporting findings and recommendations and follow-ups	7. Supervision Reports 8. Updated Institutional Profile

2.2.7 **RBS scenario in Bangladesh:**

RBS scenario in Bangladesh is not so old. Risk based inspection/system audit started by Bangladesh Bank in the year 2005 to evaluate and monitor risk management systems and control measures within the banks in operation. The system audit is conducted annually and areas covered are risks associated with foreign exchange, credit, internal control and compliance, asset liability management, information system and anti-money laundering. In Bangladesh RBS and traditional approach of supervision is going on parallel but more focus on risks is inevitable.

Chapter 3
Banking Supervision by Bangladesh Bank

The central bank of Bangladesh is Bangladesh Bank (BB) and responsible for the banking supervision in Bangladesh. The core legal framework for banking supervision in Bangladesh is laid down in article 7A (f), the Bangladesh Bank Order, 1972 and in section 44 of the Bank Company Act, 1991(BCA). In this chapter, I have tried to explain the banking supervision in respect of these two and considering how the various principles of Basle Agreement are being followed in Bangladesh:

3.1 Precondition of Effective Banking Supervision (Principle 1):

Bangladesh Bank was created under the President's Order no.127 of 1972 and it has the exclusive responsibility for regulating and supervising of banking companies operating in Bangladesh. The Banking Companies Act 1991, section 44 vested power to Bangladesh Bank for inspection of books of accounts of any banks whenever it deem necessary:

1) In Bangladesh Bank, Banking Regulation and Policy Department (BRPD), Department of Off-site Supervision (DOS) carries out off-site functions. The Department of Banking Inspection (DBI)-1, 2 & 3, Anti-Money Laundering Department (AMLD) and Foreign Exchange Inspection and Vigilance Department (FEIVD) are carry out on-site inspection. In case of CAMELS rating, bank branches are being inspected by DBI in alternative years. Generally corporate branch are being

inspected each year and small branches are being inspected in 3 years. Foreign Currency inspection is performed on the basis of volume of Foreign Exchange transaction of the respective banks. Vigilance or surprise inspection is being conducted as and when required. System Audit or risk based audit is conducted once in a year.

2) Financial Institution and Market Department (FIMD) is responsible for supervising and regulating of Non-bank financial institutions (NBFI's) of Bangladesh. Certificate of registration from this department is required for commencement of business for any NBFI in Bangladesh.

3) The Supervision Committee for Banks and Financial Institution has been constituted. It formulates policy matter and guidelines for supervision of Banks and NBFI's. With its 13 member committee it meets once in a month and plan new strategic guideline for both on-site supervision of banks and off-site monitoring based on quarterly reporting system;

4) Bangladesh Bank trains its officials with modern methods of supervision through various training programs organized by Bangladesh Bank Training Academy (BBTA) and Bangladesh Institute of Bank Management (BIBM). Bangladesh Bank also sends its officials to overseas training programs, seminars and conferences;

5) BCA, 1991 provides explicit protection to Bangladesh Bank. No suit or other legal proceeding shall lie against Bangladesh Bank or any of its officers for anything or any damage caused or likely to be caused by anything done in good faith or intended to be done in pursuance of BCA, 1991.

3.2 Licensing and Structure (Principle 2-5) :

1) The allowable activities of any banking company in Bangladesh are defined in section 7(1) of the BCA, 1991 that allows banks to undertake commercial banking. A Banking company is allowed to establish subsidiaries only for undertaking activities that are permissible under section 8(a) of the BCA, 1991.

2) Under section 31 of the BCA, 1991 a company intends to carry out banking business must obtain license from Bangladesh Bank. Bangladesh Bank issues license only if "tests of entry" are fulfilled.

3) For opening a new branch in Bangladesh, Bangladesh Bank's permission is needed. However, banks those have achieved 9% capital adequacy ratio; directors loan not exceeding 10%, CAMELS Rating position 1 or 2 may be permitted to set up new branches.

4) Section 31(4) of the BCA, 1991 empowered Bangladesh Bank to cancel a license granted to a banking company provided that the company ceases to carry on banking business or is unable to pay its current obligation or the nature of banking business by the company is detrimental to the public interest or to the interest of its depositors.

3.3 Prudential Regulations and Requirements (Principle 6-15) :

1) Bangladesh Bank has introduced new Risk Based Capital Adequacy (RBCA) frameworks for banks from 2009;

2) Absolute amount of capital for setting up new bank is BDT.4000 million;

3) Bangladesh Bank has issued a series of instruction manual/guidelines from time to time to guide its inspectors in analyzing various loan and asset portfolios of a bank;

4) During on-site inspection if inspectors can unearth any malpractice in asset classification, it is immediately taken up with the bank management and also with the external auditors of the bank;

5) Bangladesh bank issued a circular no.16/98 (subsequently amended on later years) according to which the following criteria and provisioning of classification has been applied;

Table 3.3.1: Rate of provisioning of classified loans

Period of Overdue	**Status**	**Required provision**
Overdue less than 6 months	Unclassified	1%
6 months or more but less than 9 months	Substandard	20%
9 months or more but less than 12 months	Doubtful	50%
12 months or above	Bad/Loss	100%

6) The major legal actions available to banks as of now for recovery of bank's advances :

a) Filing certificate case under Public Demands Recovery Act 1913,
b) Filing money suits under Artha Rin Adalat Act 2003,
c) Filing bankruptcy cases under Bankruptcy Act 1997.

7) Credit Information Bureau (CIB) established in Bangladesh Bank in 1992 which is a central database of large loans, past due and classification status of credit. From July 2011 CIB started providing information to banks and financial institutions online;

8) In 2005 Bangladesh Bank issued Core Risk Guidelines for Credit Risk, Foreign Exchange Risk, Asset-Liability Management, Anti-Money Laundering Risk, Information Technology Risk and Internal control and compliance risk;

9) Government of Bangladesh has enacted Money Laundering Prevention Act, 2002 (subsequently amended in 2012) and Anti Terrorism Act, 2009 and Bangladesh Bank is implementing agency of the above mentioned acts.

3.4 Methods of Ongoing Banking Supervision (Principles 16-19):

1) The main supervisory weapon of Bangladesh Bank is the regular on-site inspection and aided by off-site monitoring and supervision. Started in the year 1995 on-site inspections are conducted on the basis of CAMEL Rating.

2) The locally incorporated banks are rated on CAMELS model. The on-site inspections are generally conducted annually but the frequency can be increase/decrease depending on the financial condition, operating method and also on how compliant the bank is. The bank inspectors prepare their reports based on the primary records at selective representative cross section of branch, regional offices and the head office of the bank. Additionally, inspection team also collects pre-inspection feedback from other relevant departments of Bangladesh Bank. The other inputs used for on-site inspection are off-site supervision reports, market reports, media report, internal audits and previous inspection report of Bangladesh Bank. Foreign Exchange inspection is carried out based on volume of foreign exchange transaction of the bank/branches. Vigilance or surprise inspection are carried out on the basis of complain, media report, at the request of different governmental bodies and by the order of higher authorities. All banks established "**Complaint Cell**" at the order of Bangladesh Bank where aggrieved customers can make complains and banks report the summery of this to Bangladesh Bank on monthly basis.

3) With the issuance of core risk guidelines in 2005 Bangladesh Bank entered the era of risk based supervision. Risk based inspection is conducted once in a year in core risk areas of bank ,i.e., Credit risk, Asset Liability, Foreign Exchange risk, Anti-money laundering and Information technology and Internal control and compliance. Traditional compliance based on-site inspection and risk based inspection are going on parallel.

4) In the wake of recent global financial crisis, Bangladesh Bank prepared guidelines of **Stress Testing** for banks and financial institutions in 2010. Banks and financial institutions conduct stress testing twice a year, in June and December and submit the report to Bangladesh Bank.

5) Section 36 of the BCA, 1991 empowered Bangladesh Bank to call for any information at any time from a banking company relating to its affairs.

6) If any banking company provides inconsistent or inaccurate report to Bangladesh Bank it is dealt with relevant section of BCA, 1991.

7) Financial statements of bank are to be audited by statutory auditors appointed by Bangladesh Bank or Ministry of Finance (in case of state controlled banks).

8) Bangladesh Bank established "**Customer Interest Protection Center**" or CIPC on 2011.Where any customer can lodge complain by sending letter, Short Message Service (SMS), Fax, E-mail against any bank or financial institution. Recently a 24 hour Hotline (16236) has been establish in CIPC.

3.5 **Information requirement of Banking companies (Principal 21-22):**

1) Bangladesh Bank is working relentlessly to ensure transparency and disclosure in the financial statements of banks in line with International Financial Reporting Standard (IFRS). The formats for preparations of financial statements for banks are prescribed under section 38 of BCA, 1991.

2) Where Bangladesh Bank is satisfied that it is necessary to remove the chairman, director or chief executive of a banking company in the public interest, the Bangladesh Bank may, for reasons to be recorded in writing, by order, remove from office, as per the Bank Company Act 1991.

3) Bangladesh Bank signed memorandum of understanding with central bank of several countries for exchange of financial information, such as recovery of stolen or siphoned money. In fact Bangladesh Bank is trying hard to be a member of "Egmont Group" which is a organization of Financial Intelligence Unit of different countries, which voluntarily exchange information among the members regarding financial information.

3.5 Key events of bank supervision in Bangladesh (2000 – 2010):

The major key events that affect the supervisory regime of Bangladesh Bank are as follows:

- ✓ Introduction of loan right-off system which significantly reduces the NPL. It is an international practice where long outstanding bad loans are wiped out in the banks book. Although it is out of banks book but bank should try to recover it.
- ✓ Some corporate governance measures have been introduced in banking arena such as responsibility and accountability of board of directors and CEO of private banks.
- ✓ Introduction of the guidelines for major core risk areas in banks such as credit risk, foreign exchange risk, asset liability management, information technology, anti money laundering and internal control and compliance.
- ✓ Introduction of risk based inspection or system audit in major core risk areas.
- ✓ Introduction of Credit risk grading manual
- ✓ Limiting banks exposure to capital market
- ✓ Single borrower exposure limit has been fixed
- ✓ Some amendment in Bank Company Act,1991
- ✓ Introduction of Money Laundering Prevention Act,2002 and Anti-terrorism Act, 2009
- ✓ Introduction of Risk Management Unit in all banks
- ✓ In order to understand and appreciate the risks in banking industry is exposed to, ensure the soundness and sustainability of the banking industry and make the banks more shock resilient Bangladesh Bank issued stress testing guideline.
- ✓ Establishment of customer complain cell in all banks and NBFI's of Bangladesh.

Chapter 4
Bank Failure – Cause and effect

Banking failure can be occurred at both domestic and international banking level. Some banks which were once regarded as "Too big to Fail" but proven wrong after the demise of Lehman Brothers. We have seen series of bank failures in the United States during recent financial crisis (better known as subprime mortgage crisis). So bank failure is concern for bank regulators. Let us concentrate now on the definition of Bank Failure:

4.1 Definition of failure

A number of studies were carried out regarding bank failure. Most of those studies reveal that bank failure occur when a financial institution received external capital injection or directly closed. Some author argued that a financial institution considered to be failed if falls into any of the following categories (Bongini, Claessens, and Ferri 2001; Gonzalez-Hermosillo 1999):

(a) The financial institution was recapitalized by either the central bank or an agency specifically created to address the crisis and/or required a liquidity injection from the monetary authority;

(b) The financial institution's operations were temporarily suspended ("frozen") by the Government ;

(c) The financial institution was closed by Government for public interest;

(d) The financial institution was reconstructed (either absorbed or acquired) by another financial institution.

4.2 Causes of Failure

Governmental policies, economic circumstances and maturity of the banking system vary from country to country and so the causes of failure. The Comptroller of the Currency (OCC) in the United States has observed that 50% of national bank failures were due to depressed local economies, 38% due to incompetent management and 9% due to fraud. Some of the major causes of bank failure are discussed below:

a. **Government permeation of the banking system**: Government interventions in the banking system for the most part based upon short term economic policies which ultimately result in erosion of banks capital, reduction in profits, misallocating credit or interfering foreign exchange rate.

b. **Poor management:** Sometimes poor management of a bank leads to its failure. Poor management results in poor lending or wrong assessment of credit worthiness of borrower. Excess lending can also takes place which does not match with economic potentiality of the country as a whole. Sometime poor management is in able to assess the potential risk in banks foreign exchange position which may result in large loss.

c. **Excessive risk-taking:** Bank business is highly correlated with risks. And risk management process deals with how to minimize risk. Nowadays banks now work with various risks such as **Credit Risk** - the creditworthiness of borrower may not be accurate and creditworthiness may deteriorate over time, **Country and transfer risk** – related with the economic, social and political environment of the borrower's home country. **Market Risk-** where losses may arise in respect of losses in on- and-off balance sheet positions, due to the movement in market prices and which occur most visibly in a banks trading books whether debt or equity or foreign exchange or commodity positions. **Interest rate risk**-when movement in interest rates impact on bank's financial position, earnings and the value of assets, liabilities and off-balance sheet items. **Liquidity Risk-** where banks have obligations to fund increases in assets or decreases in liabilities and sufficient fund cannot be obtained promptly at a reasonable cost affecting profitability or leading to bank insolvency, and **Legal Risk** –arises because of incorrect legal advice or documentation. We have seen during the global financial crisis the main affected banks are those who took excessive risk.

d. **Supervisory Forbearance:** Sometimes lax supervision allows banks to operate with overvalued or substandard loans leading to looting by insiders. The reason behind this is lack of independence, political interference of government in power, fear of legal challenge or lack of consistent information makes it difficult on the part of supervisor to assess the quality of asset or the lack of skills and inadequate resources on the part of supervisors.

- **e. Ineffective market discipline:** When market forces cannot work effectively because market participants do not have access to correct and timely information. Stakeholders also face difficulties to exercise proper market discipline because of lack of transparency and clear picture of financial position on part of banks.

- **f. Supervision is not on a consolidated basis :** When supervisors unable to supervise on consolidated basis I,e, the banking and non-banking activities, directly or indirectly at both domestic and international operation in order to determine whether prudential regulations are being applied and the risks posed by non-financial activities on the overall structure of the banking organization.

All the above mentioned causes of failure indicate both the complexity and vulnerability of banking industry. The other sectors may be subject to negative factors, the highly leveraged banking industry result in a higher risk of failure with small erosion in assets causing significant deterioration of equity or capital.

4.3 Implications of failure:

Bank failures causes' loss to customers, investors and governments impending economic activity and sometimes threatening banking and economic losses internationally.

Nadler and Bergen (1933) stated that "a bank failure is an economic, financial and social disaster." Bank failure has negative impact on growth of credit, government costs, capital accumulation, monetary policy and system liquidity. Both emerging and more mature industrial economies have associated macroeconomic cost due banking failure including development, imperfect competition and deteriorating public confidence in the financial market.

Developing countries have lost productive capital and incurred high government costs. A Basle Committee report has said: "In developing and transition countries resolution cost in the order of $ 250 billion reflects a waste of investible resources in countries where both potential productivity of capital and the need for sound credit decision are great. Assumption of costs by government…. Add to the deadweight cost of taxation."

The consequence of a single banking failure is significant but more severe if the losses spread to other banks domestically, or if a "bank run" occurs when banks in general are unable to meet depositor's demands. Banking collapse may occur in a country where multiple contraction of money supply, prices tend not to be reduced to a level consistent with the lower money supply, people and resources are involuntarily unemployed.

The "domino effect" of a single failure on several banks in other countries may impair significant parts of the world economy. Today's huge international transactions are a source of considerable anxiety. Many of which are related to interbank netting payments, foreign exchange or domestic and international securities' settlement. This risk is more serious because of market linkages where a firm uses a derivative product in one market to hedge against a risk in another market. Thus instability in the other market will cause disruptions in numerous otherwise unrelated markets.

Chapter 5
The effectiveness of Bangladesh Bank's supervision in the Banking sector of Bangladesh

Currently there are 47 banks operating in Bangladesh. Of them 4 are State Controlled Banks,4 are Development Financial Institution, 30 Private Commercial Banks and 9 Foreign Commercial Banks. Bangladesh Bank, being the central bank is the main supervisory authority of banking sector. The Bank and Financial Institutions Division of Ministry of Finance exercises control over the State Controlled Banks through appointment/nomination of the Board of Directors, although they are under the supervisory purview of Bangladesh Bank. Bangladesh Bank supervises all the commercial banks as per instructions given in the Bank Company Act, 1991 in conjunction with the Bangladesh Bank Order, 1972.

Bangladesh Bank exercises supervisory activities in terms of off-site and on-site supervision; although all the banks and their branches are being continually comes under regular supervision by the head office of the concerned banks. Bangladesh Bank follows the Basle agreement of for supervision and regulates the banking sector. The capital adequacy status, loan classification status of the banks etc. have been developed as per international standard so that the actual scenario of the banks is being reflected. To ensure the financial health, Bangladesh Bank uses CAMELS rating analysis. But when analyzing the supervisory functions of the developed world we have observed that their supervisory functions are much more different. In the developed world, the supervisory authority mainly depends on both off-site and on-site supervisory activities, whereas Bangladesh Bank depends on both off-site and on-site supervision for the lack of accurate information/data as desired under bank examination and supervisory process.

Even though it cannot be firmly claim that all the improvements have been made in the overall banking sector but significant improvement are the result of central bank's stringent supervisory functions. Some of the major indicators of improvement are focused here.

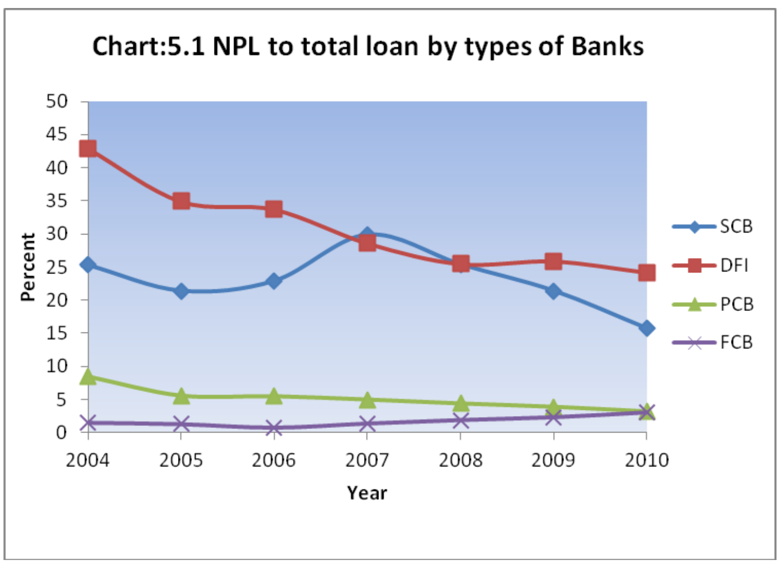
5.1 Non Performing Loans are biggest problem in any banking industry and Bangladesh is no exception to it. A Non-performing loan is either default or close of being default. In the following table and diagram we can see that from 2004-2010 non-performing loans declining gradually due to rigorous monitoring of Bangladesh Bank. It is mentionable here that Private commercial banks and Foreign commercial banks have low NPL compared to State controlled banks and development financial institution.

Table 5.1: NPL to total loan by types of Bank

(Percent)

Bank	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
SCB	25.3	21.4	22.9	29.9	25.4	21.4	15.7
DFI	42.9	34.9	33.7	28.6	25.5	25.9	24.2
PCB	8.5	5.6	5.5	5	4.4	3.9	3.2
FCB	1.5	1.3	0.8	1.4	1.9	2.3	3
Total	17.6	13.6	13.2	13.2	10.8	9.2	7.3

Source: Statistics Department, Bangladesh Bank



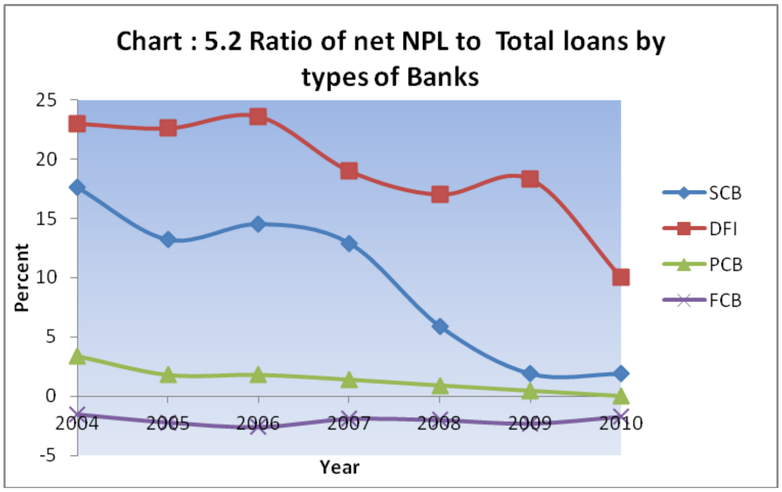
5.2 The ratio of net NPL (net of provision and interest suspense) is also declining for the period 2004-2010. From the data and diagram we see that net NPL is 0 for private commercial banks and negative for foreign commercial banks. And for state controlled banks and development financial institutions is declining.

Table 5.2 Ratio of net NPL to net Total loans by types of Bank

(Percent)

Bank	2004	2005	2006	2007	2008	2009	2010
SCB	17.6	13.2	14.5	12.9	5.9	1.9	1.9
DFI	23	22.6	23.6	19	17	18.3	10
PCB	3.4	1.8	1.8	1.4	0.9	0.45	0
FCB	-1.5	-2.2	-2.6	-1.9	-2	-2.3	-1.7
Total	9.8	7.2	7.1	5.1	2.8	1.73	1.3

Source: Statistics Department, Bangladesh Bank



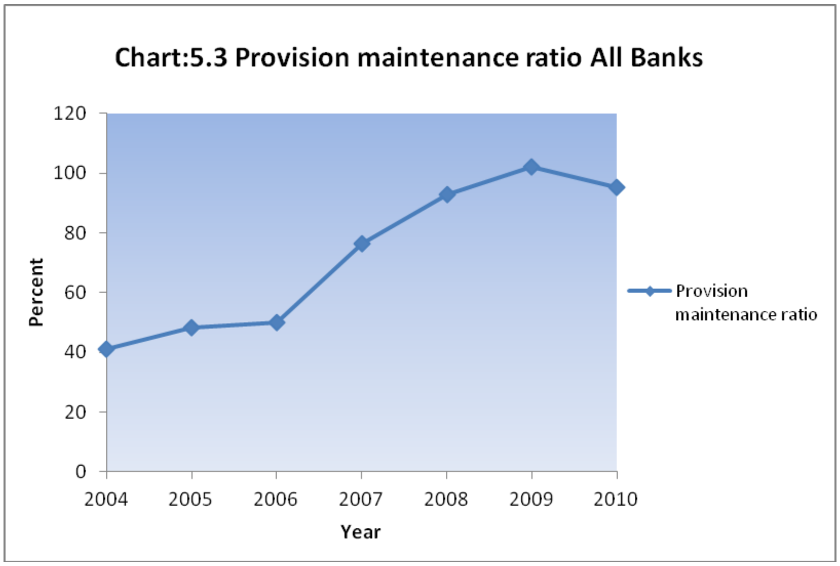
5.3 Provision maintenance ratio is also increasing for the period (2004-2010). Provision maintenance ratio is provision maintained divided by required provision. Here we also see that provision maintenance ratio of all types of banks in Bangladesh are increasing.

Table 5.3: Provision Maintenance Ratio by all banks

(Percent)

All Banks	2004	2005	2006	2007	2008	2009	2010
Required Provision	87.8	88.3	106.1	127.2	136.1	134.8	149.2
Provision maintained	35.9	42.6	52.9	97.1	126.2	137.9	142.3
Provision maintenance ratio	40.9	48.2	49.9	76.3	92.7	102.3	95.4

Source : Statistics Department, Bangladesh Bank



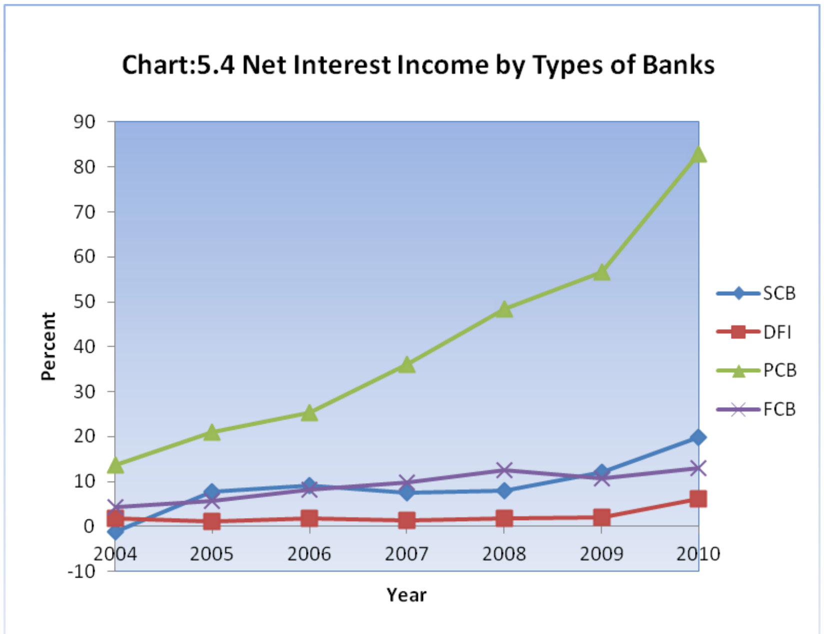
5.4 Net interest income (NII) by all types of banks in Bangladesh is rising for the period (2004-2010). Net Interest Income is the difference between the revenue that is generated from banks assets and the expenses associated with its liabilities. Private commercial bank's NII is highest.

Table 5.4: Net Interest Income by Types of Bank

(Percent)

Bank	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
SCB	-1.1	7.7	9	7.4	7.9	12.11	19.8
DFI	1.8	1	1.7	1.4	1.9	1.92	6.2
PCB	13.7	21	25.4	36.1	48.5	56.71	82.8
FCB	4.2	5.6	8.2	9.9	12.6	10.71	13
Total	18.3	35.3	44.3	54.8	70.9	81.4	121.9

Source: Statistics Department, Bangladesh Bank



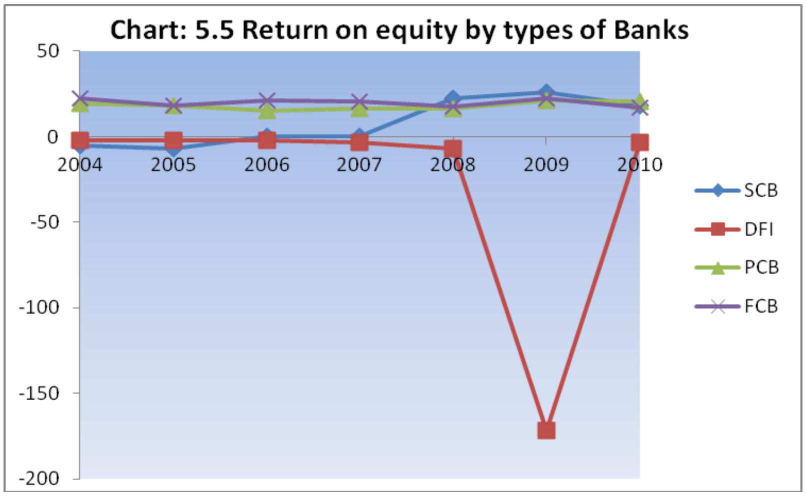
5.5 Return On Equity(RoE) is net income after tax divided by shareholders equity. It measures banks efficiency at generating profit from every unit of shareholders equity. It shows how well a bank uses investment funds to generate earning growth. Here we can see a steady growth of RoE for FCB, PCB and SCB with exception to DFI.

Table 5.5 Return On Equity by types of bank

(Percent)

Bank	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
SCB	-5.3	-6.9	0	0	22.5	26.2	18.4
DFI	-2.1	-2	-2	-3.4	-6.9	-171.7	-3.2
PCB	19.5	18.1	15.2	16.7	16.4	21	20.9
FCB	22.5	18.4	21.5	20.4	17.8	22.4	17
Total	13	12.4	14.1	13.8	15.6	21.7	21

Source: Statistics Department, Bangladesh Bank



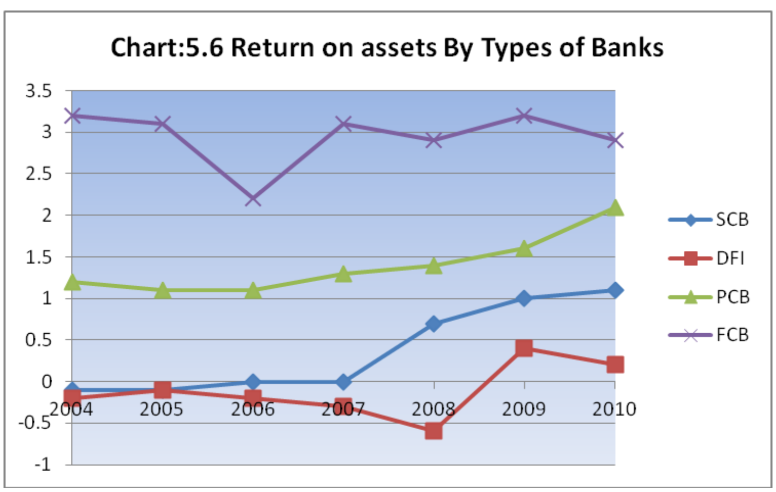
5.6 Return on Assets (RoA) is net income divided by total asset. RoA gives idea as to how efficient management is at using its assets to generate earnings. Here we can see RoA of SCB's and PCB's in Bangladesh increased for the period (2004-2010) with exception to DFI's and FCB's.

Table 5.6 Return on Asset by types of bank

(Percent)

Bank	2004	2005	2006	2007	2008	2009	2010
SCB	-0.1	-0.1	0	0	0.7	1.00	1.1
DFI	-0.2	-0.1	-0.2	-0.3	-0.6	0.4	0.2
PCB	1.2	1.1	1.1	1.3	1.4	1.6	2.1
FCB	3.2	3.1	2.2	3.1	2.9	3.2	2.9
Total	0.7	0.6	0.8	0.9	1.2	1.4	1.8

Source: Statistics Department, Bangladesh Bank



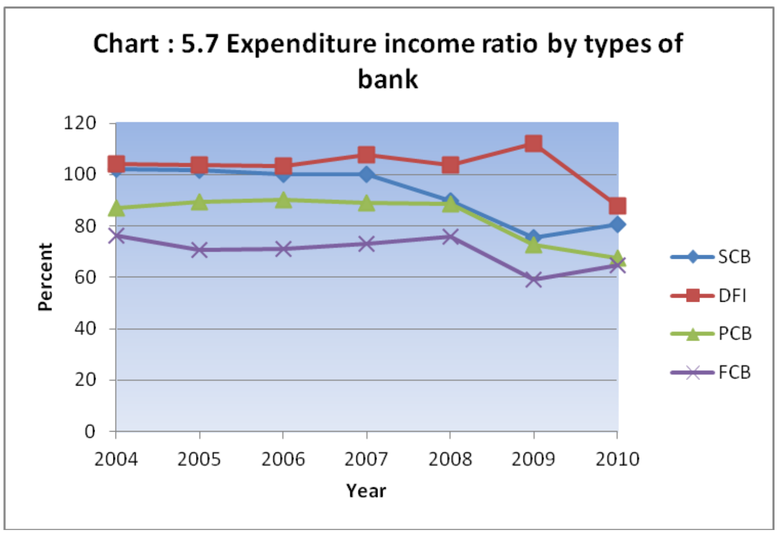
5.7 Banks are able to reduce the expenditure income ratio during the period (2004-2010). It is one of indicator of management efficiency. From the table and diagram we can see that expenditure income ratio is gradually reducing by all types of banks in Bangladesh.

Table 5.7 Expenditure Income ratio by types of bank

(Percent)

Bank	2004	2005	2006	2007	2008	2009	2010
SCB	102.3	101.9	100.0	100.0	89.9	75.6	80.7
DFI	104	103.9	103.5	107.7	103.7	112.1	87.8
PCB	87.1	89.3	90.2	88.8	88.4	72.6	67.6
FCB	76.3	70.8	71.1	72.9	75.8	59.0	64.7
Total	90.9	92.1	91.4	90.4	87.9	72.6	70.9

Source: Statistics Department, Bangladesh Bank



5.8 Problem bank scenario in Bangladesh has also witnessed significant improvement. When Bangladesh Bank introduced problem bank system in 1994 there were initially seven banks. Due to Bangladesh Banks continuous monitoring and supervision all seven banks were able to come out from it before 2005. BB introduced Early Warning System (EWS) of supervision from March 2005 to address the difficulties faced by the banks in any of the areas of CAMELS. Any bank found to have faced difficulty in any areas of operation, is brought under early warning category and monitored very closely to help improve its performance. Presently 2 banks are monitored under EWS.

Chapter 6

Conclusion and Recommendation

This study deals with the supervisory activity of the Bangladesh Bank and its significance. Central bank is the supreme authority to supervise the scheduled banks. As the central bank of Bangladesh, Bangladesh Bank is playing its role positively. For this purpose, it is empowered with some laws like Bangladesh Bank Order,1972, Bank Company Act 1991, Artho Rin Adalat Ain 1990, Bankruptcy Act,1997 etc. Through these laws, Bangladesh Bank guides the commercial banks. On the other hand it has supervisory techniques like on-site supervision, off-site supervision. Bangladesh Bank currently perusing traditional inspection and risk based inspection or system audit simultaneously. In this study the present situation of supervisory approach of developed countries such as G-7 countries and of Bangladesh has been discussed. The situation of supervision on developed countries have somehow different than that of Bangladesh. In the light of discussion of the previous chapters we can proclaim that the supervision of Bangladesh Bank is significantly meaningful; though, it cannot be claimed as 'up to the mark'. Many improvements are yet to be made and some steps should be taken. For this purpose some recommendations are put forward:

- Bangladesh bank is not enjoying the autonomy to its fullest extent. It is very much essential for a central bank to regulate the scheduled banks stringently. So necessary steps should be taken for greater autonomy of Bangladesh Bank. If needed, appropriate amendments in Bangladesh Bank Order, 1972 are required.
- Strict enforcement of policies should be made by the central bank to ensure that no banks, especially private commercial banks, relax credit standards on insider loans and make such loans on preferential terms. The present overdue loans of the directors of private commercial banks must be recovered. For this purpose appropriate legal actions must be initiated by the central bank as per recent amendment of the Banking Company Act 1991.
- Risk Based Supervision (RBS) is getting priority in developed countries for its logical superiority. Because one of the key issues of bank supervision is to keep the risks under control or at a minimum level which is the main focus of Risk Based Supervision.

Bangladesh bank should try to adopt this system of bank supervision as its main supervisory weapon.

- Bangladesh Banks supervision departments are required to take steps for strengthening the on-site inspection. More and more manpower are needed in these departments as banks network (branch) are ever increasing. Also proper and up to date training are needed for the bank supervisors.
- Present banking laws have ineffective and loan defaulters are taking full advantage of this weakness. So it is the crying need of the hour to make suitable amendments to the Artho Rin Adalot Ain 2003. It is also necessary to appoint exclusive, able and experienced judges' for the act in each district. For large cities, more than one financial loan court may be established.
- Guideline under capital adequacy system to be reconciled with the financial system and economic condition of Bangladesh. The weight of different risk categories should be taken into account the practical circumstances prevailing in Bangladesh. By this time few adjustments have been made to the risk weight through various circulars. But more adjustment might be needed to other sectors namely private sector investment, public sector investments.
- World in now a global village. Capital movements have increased more under foreign direct investment and under Public Private Partnership. More multinational corporations are coming to our country. So foreign exchange transaction has increased manifold. So proper amendment in the Foreign Exchange Regulation Act, 1947 is needed.

Before I finish, I would like to say that central bank should have greater autonomy to implement its supervisory authorities and thereby create a healthier banking system. It may take long time to develop a truly effective supervisory authority, but it must be established. There is no alternative but taking a quick initiative in this regard.

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