Evaluation of the Risk Management System in banking sector of Bangladesh

WITH SPECIAL FOCUS ON WEAKNESS AND POSSIBLE WAYS TO IMPROVE THOSE AREAS

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Introduction:

1.0 Risk Management:

Risk Management is the deliberate acceptance of risk for profit making. It requires informed decisions on the tradeoff between risk and reward, and uses various financial and other tools to maximize risk-adjusted returns within pre-established limits.

2.0 Gradual Development of Risk Management Process in Bangladesh

Pro-active risk management practices that we observe today in Bangladesh have passed through several major logically sequenced stages. The major concern in the 70's was to rebuild and develop the financial sector rather than focusing on achieving

micro level operational efficiency. The objectives of allowing competition did not produce expected result during the period 1982-89 because of not having well defined prudential norms, absence of formalized loan classification and provisioning system, wide scale erosion of credit discipline arising mainly from the loans to insiders and connected parties and un-healthy intervention from different quarters. Faced with these severe indiscipline and operational inefficiency, a number of major reform measures were initiated based on the recommendations of National Commission on Money, Banking and Credit that include liberalization of interest rate, introduction of a loan classification and provisioning guideline, strengthening the legal framework through enactment of the Bank Company Act, 1991, and Money Loan Court Act, 1990 to name a few. Financial Sector Reform Project (FSRP) was undertaken in 1992 to make the earlier reform measures more effective and to enlarge the scope of measures through allowing more private banks in the industry, further deregulation of interest rate structure, strengthening the Bangladesh Bank supervision and so on.

The establishment of Credit Information Bureau in Bangladesh Bank (BB) in 1992 to facilitate the lending decision of the banks by making borrowers' information available to all the banks and Lending Risk Analysis (LRA) instituted in 1993 were the first regulatory moves in introducing a uniform best practice to assess the credit worthiness of the borrowers in Bangladesh banking sector. BB also started making the capital adequacy regulations for the banks in line with the international best practice named as BASEL accord (BASEL I) from 1996 by requiring the banks to maintain at least 8% of risk weighted asset as their capital. Basel committee has progressively gone on making banks' capital more and more risk sensitive since 1988 when Basel I was introduced. The second version of Basel (Basel II) was accordingly adopted in Bangladesh in 2009 maintaining parallel run with Basel I. Banks were advised to maintain capital as per Basel II from 2010. In the Basel II, global community and BB as well, introduced a mechanism to improve the market discipline under pillar III. In the aftermath of the financial crisis of 2007-2009 the Basel Committee introduced Basel III by extensively revising the existing guideline. In response to that, BB has issued "Guidelines on Risk Based Capital Adequacy (Revised Regulatory Capital Framework for banks in line with Basel III)" in 2014 along with the phase-wise action plan/roadmap to be fully implemented in January 2020.

The most path breaking and rigorous regulatory move so far taken by BB to develop and standardize risk management capacity was the formulation of five core risk management guidelines in 2003. These are - Credit Risk Management Guideline, Asset-Liability Management, Foreign Exchange Risk Management, Internal Control and Compliance, and Prevention of Money Laundering. Another such risk management guideline on Information & Communication Technology was introduced in 2005. All of the Guidelines were revised in 2015 and 2016.

3.0 Organizational Structure in Managing Risk of Banks

Success of any organization largely depends on the way the activities and operations are organized. Logical organizational structure reduces wastage of time and money by reducing duplication of works and elimination of non-value added activities of the process. A brief description of the various segment of the organizational structure in managing risks of banks is given below:

i) Risk Management Division (RMD)

RMD is the operational unit/layer of risk management in a bank. Erstwhile it was RMU (Risk Management Unit) and renamed as RMD in the year 2013. As per DOS Circular No.04 dated 08.10.2018, RMD should have desks for each core risk. Top level management form Executive Risk Management Committee (ERCM) with direct reporting to the CRO and indirect reporting to MD & CEO. Head of RMD will act as CRO.

ii) Executive Management Risk Committee (EMRC)

ERMC comprises of CRO (as the Chairman), Head of ICC, CRM/CAD, Treasury, AML, ICT, ID, Operation, Business, Finance, Recovery and Head of any other department related to risk if deemed necessary. RMD acts as secretariat of the committee.

iii) Board Risk Committee (BRC)

Board Risk Committee (BRC) is the committee comprising of board members. The composition, qualification, duties & responsibilities, frequencies of meetings are enumerated in the BRPD circular # 11 dated October 27, 2013. RMD presents the findings of RMP/MRMR/CRMR, ICAAP, Stress Testing report, MCR report etc and communicates the directives to

management. The BRC also evaluates the RAS (Risk Appetite Statement) of the bank, being prepared by RMD, before getting it evaluated and approved by the BOD.

iv) The Chief Risk Officer (CRO)

The Chief Risk Officer (CRO) or Chief Risk Management Officer (CRMO) is an executive responsible for proper guidance to RMD officials engaged in identifying, analyzing, measuring, reporting, mitigating and monitoring internal and external events that could threaten the bank. S/he is accountable to the Risk Management Committee of the Board of Directors for enabling the efficient and effective governance of significant risks, and related opportunities, to a business and its various segments for enabling the bank to balance risk and reward. The CRO will review all the risk related reports, MCR, Stress Testing, RMP/MRMR/CRMR, ICAAP etc., before presenting to next level meeting/ committee for review.

v) SRP Team

It is the team headed by CEO to look after the Pillar-2 risk and capital there-against. The team meets bi-monthly and discusses the progress and mitigation against the BB defined risks under Pillar-2 of Basel-III. The team also takes initiatives to improve the overall risk culture of the bank so that the return on capital increases and capital requirement decreases. SRP team guides RMD to prepare ICAAP report embodying the macro and micro economic issues (global and local) affecting banks' risk profile, banks' strategy, tolerance etc. SRP team also discusses the Pillar-2 risk related issues that come from central bank.

4.0 Scenario analysis of the Risk Management system in the Banking Industry of Bangladesh

4.1 Capital to Risk Weighted Asset Ratio (CRAR)

CRAR of the banking industry stood at 10.8 percent at the end of December 2017. For the third consecutive year, banking sector CRAR remained almost stable at 10.8 percent. Out of 57 scheduled banks, 48 were able to maintain their CRARs at 10.0 percent or higher in line with minimum capital requirement (Pillar 1) of the Basel III framework.

The capitalization of the banking sector of the country is still lower compared with the ratios of India, Sri Lanka and Pakistan.

Comparison of Capital Adequacy Indicator:

Particulars	CAR/CRAR (%)			
	2014	2015	2016	2017
India	12.8*	12.7*	13.3*	13.9*
Pakistan	17.1	17.9	16.2	15.8
Sri Lanka	17.2	15.4	15.6	15.2
Bangladesh	11.4	10.8	10.8	10.8

** as of end-September,*
Source: RBI, SBP, CBSL and BB

4.2 Leverage Ratio

In order to avoid build-up of an excessive on- and off-balance sheet leverage in the banking system, a simple, transparent and non-risk based leverage ratio has been introduced under the Basel III framework released by BB on 21 December 2014. The leverage ratio is calibrated to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to achieve the following objectives: a) constrain the build-up of leverage in the banking sector which could damage the broader financial system and the economy; and b) reinforce the risk based requirements with an easy-to-understand, non-risk based measure.

During the end of December 2017, the banking sector maintained a leverage ratio of 4.6 and 4.8 percent on solo and consolidated basis respectively against the minimum requirement of 3.0 percent in both cases.

4.3 Internal Capital Adequacy Assessment Process

Internal Capital Adequacy Assessment Process (ICAAP) focuses on banks' own internal review of its capital positions, aiming to reveal whether it has prudent risk management procedures and adequate capital to cover all the risks in their business. BB reviews and evaluates banks' ICAAP report and their strategies to ensure their compliance with the capital adequacy requirement under the Basel Framework. ICAAP emphasizes having dialogue or interaction between the regulator and banks, rather than being simply a one-sided compliance framework. Banks in Bangladesh have entered into the Basel III regime in a phased manner which started from January 01, 2015 with full implementation planned to be achieved by the end of 2019.

4.4 Banking Sector Liquidity

The liquidity situation in the banking industry moderated in CY17. Still there was adequate liquidity in the banking sector to absorb any liquidity shocks.

Due to the robust private sector credit growth in Bangladesh in CY17, the excess liquidity observed

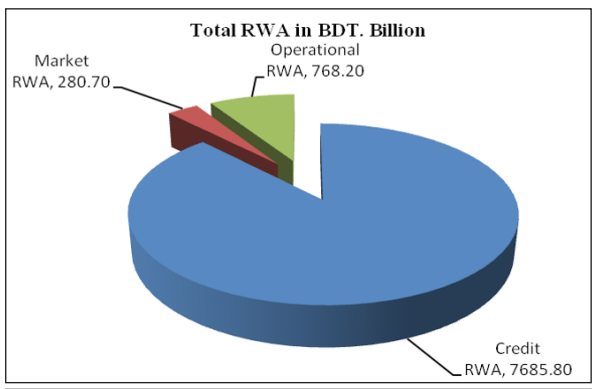
in the banking sector throughout CY16 moderated in CY17. The ADR of the banking industry increased to 75.9 percent in CY17 from 71.9 percent in CY16.

4.5 Credit Risk, Market Risk and Operational Risk Structure under Basel III

The nominal value of RWA for credit risk was BDT 7,685.8 billion for both funded and non-funded

credit exposures, while the value of RWA for market risk and operational risk were BDT 280.7 billion and BDT 768.2 billion respectively.

The credit risk was 88.0 percent of the total RWA of the banking system as of December 2017, whereas the RWA associated with market and operational risks were 3.2 and 8.8 percent respectively.



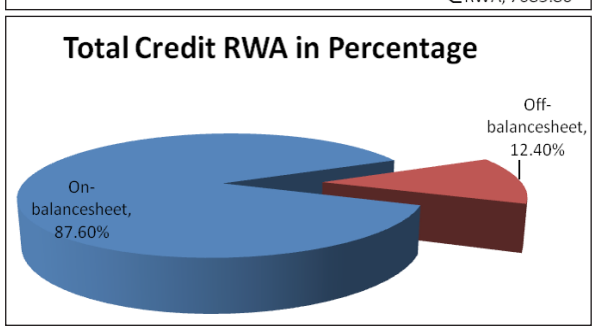


Chart: RWA structure

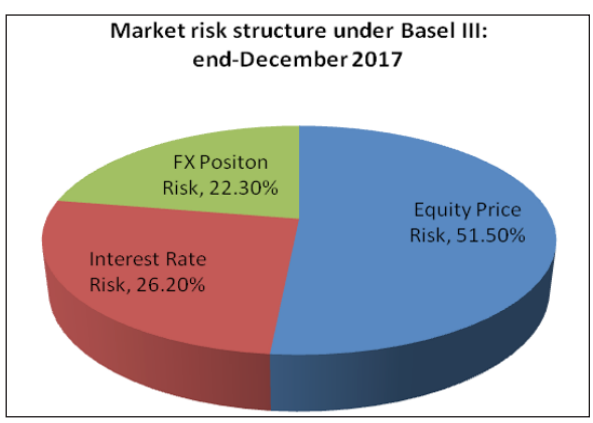


Chart: Market Risk structure

5.0 Evaluation of Risk Management activities of various private commercial banks:

Although banks are trying to implement the Risk Management initiatives of Bangladesh Bank, few issues are yet to be resolved

a. Organogram of RMD as per DOS Circular No.04 Dated: 08.10.2018 to be developed
b. Banks' are not aligning their Risk Appetite Statement with capital constraint i.e. Risk Weighted Assets
c. ICT Risk is not emphasized by most of the banks.
d. Risk Management related Guidelines/Manuals/ Policies are not being updated on a timely basis.
e. Analysis on Top-10 depositors, Top-20 borrowers, defaulters and asset quality of the bank are escalated to the Top Management/Board without comprehensive analysis.

6.0 Risks scenario in the Banking industry

6.1 Non-performing Loans

Banks' non-performing loans hit nearly Tk 1 lakh crore at the end of September -- the largest yet in Bangladesh's 48-year-history. The amount of toxic increased 11.23 percent to Tk 99,370 crore at the end of the third quarter of 2018, compared to the previous quarter, according to data from the central bank. The amount is up 24 percent from a year earlier.

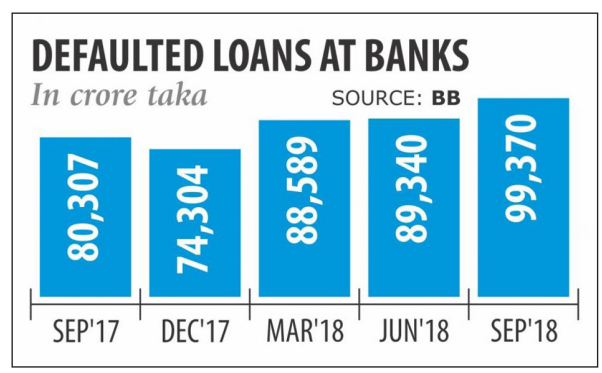


Chart: Quarter-wise NPL upto Sept-2018

Political intervention has worsened the corporate governance in the banking sector. The government should promptly take action to restore discipline in the financial sector

6.2 Some major Scams, Irregularities, & Heists in Banks form 2008-2018

i. Sonali, Janata, NCC, Mercantile and Dhaka Bank (2008 -2011)
   Bank loan of BDT 4.89 crores with forged land documents. (Dhaka Tribune, 28th August 2013).

ii. BASIC Bank (2009-2013)
Embezzlement of BDT 4,500 crores through fake companies and dubious accounts. (The Daily Star, 28th June 2013)

iii. Sonali Bank (2010-2012)
Hall Mark and some other businesses embezzled BDT 3,547 crores.(The Daily Star, 14th August 2012)

iv. Janata Bank (2010-2015 & 2013 to present)
Fraudulence by Crescent and AnonTex involving BDT 10,000 crores.(Dhaka Tribune, 3rd November 2018)

v. Janata Bank, Prime Bank, Jamuna Bank, Shahjalal Islami Bank Ltd and Premier Bank (June 2011-July 2012)
Embezzlement and laundering of BDT 1,174.46 by Bismillah Group and its fake sister concerns. (The Daily Star, 7th October 2016)

vi. AB Bank (2013-2014)
Money laundering of BDT 165 crores.(The Daily Star,12th June 2018)

vii. NRB Commercial Bank (2013-2016)
Gross irregularities over disbursing loans of BDT 701 crores. (New Age Bangladesh, 10th December 2017)

viii. Janata Bank (2013-16)
Loan scam involving BDT 1,230 crores(The New Nation, 22nd October 2018)

ix. Farmers Bank(2013-2017)
Fund embezzlement of by 11 companies e.g.: NAR Sweaters Ltd, Advanced Development Technologies etc. involving BDT 500 crores.(The Daily Star, 24th March 2018).

x. Bangladesh Bank (February 5, 2016)
Heist of BDT 679.6 crores (USD 81million) by international cyber hackers from treasury account of Bangladesh Bank with the New York's US Federal Reserve Bank. (The Daily Star, 5th August 2017)

Total BDT 22,501 crore (USD 2.68 billion) Money Lost through Major Scams, Irregularities, & Heists as reported in the media .

Cost of reported Major Scams, Irregularities, & Heists is:

- 34% of total allocation for education in national budget of FY2017-18
- 39% of income tax revenue of GoB in FY2017-18 as of May 2018
- 78.2% of Padma Multipurpose Bridge (PMB)
- 64.3% of Padma Bridge Rail Link
- 62.5% of Matarbari 2x600 MW Ultra-Super Critical Coal-Fired Power Project (MUSCCFPP)
- 40.9% of Deep Sea Port in Sonadia
- 19.9% of 2x1200 MW Ruppur Nuclear Power Plant (RNPP) Main Project

BDT 22,501 crore would be enough for:

- Total allocation for health in national budget of FY2017-18 (BDT 20,651 crore)
- Dhaka Mass Rapid Transit Development Project (DMRTDP) (Cost: BDT 21,985 crore)
- Construction of Single Line Dual Gauge Track from Dohazari-Ramu-Cox's Bazar and Ramu to Ghundum near Myanmar Border (Cost: BDT 18034 crore)
- 2×660 MW Moitree Super Thermal Power Project (MSTPP) in Rampal (Cost: BDT 16000 crore)
- Construction of Bangabandhu Railway Bridge (Cost: BDT 9,734 crore)
- Construction of Multilane Road Tunnel under River Karnaphuli (Cost: BDT 8,447 crore)
- Deep Sea Port at Paira (Cost: BDT 3351 crore)

Recommendations

a) Expedite automation and Management Information System.
Establish transparency in the banking sector, particularly in the Banks through automated banking practices. All banks must adopt IT based banking services and the Management Information System (MIS) in order to detect malpractices in the banks. IT based banking has become critically important in the face of threat of cyber security.

b) Strengthen Internal Control and Compliance Departments.
The Internal Control and Compliance Department of Banks is in need of a serious overhaul. During financial scams of the past, it was discovered that the Internal Control and Compliance Departments either willingly or unwillingly had failed to inform the Board of Directors regarding large losses.

c) Stop recapitalization of Banks year after year.

The practice of bailing out the losing banks with public money is economically unjustified and morally incorrect.

d) Formulate exit policy for troubled banks.
An exit policy for troubled banks needs to be formulated, particularly taking into cognizance the ineffectiveness of the Oriental Bank model.

e) Uphold independence of Bangladesh Bank.
Interference in Bangladesh Bank's activities goes against the spirit of Bangladesh Bank Amendment Bill 2003, which was geared to guarantee the central bank with autonomy.

f) Develop human resource.
Lack of capacity building is a perennial problem that besets the Banks in Bangladesh. Without human resource development through enhanced skills, Banks will not be able to handle the emerging challenges facing the sector

Conclusion

To get rid of the default culture, our National Level policy is required. We may follow China and Nepal to boycott defaulters socially and should not provide passport and immigration facility to those defaulters. Our new Finance Minister Mr. A H M Mustafa Kamal, FCA expressed sooth speech for the Nation and we expect more positive initiatives from him.

Government may deploy more judges in the Artho Rin Adalot and expand the legal proceedings related activities at District Level so that Financial Institutions observe some recovery from defaulters.

A single corporation gained control over 7 private commercial banks in Bangladesh which is very alarming signal for the country and should be restricted.

Monopolization in banking sector should be eliminated.

The culture of giving licenses to new banks on political grounds should be stopped. Given the size of the economy, there is no need for new banks. The market is already saturated and new banks have been performing poorly by extracting public money.

DOS Circular No.04 Dated: 08.10.2018 on Risk Management Guidelines for Banks.

BRPD Circular No. 01 dated: 01.03.2016 on Revised Guidelines on Foreign Exchange Risk Management for Banks

BRPD Circular No. 02 dated: 07.03.2016 on Asset-Liability Guidelines (Revised)

BRPD Circular No. 03 dated: 08.03.2016 on Revised Guidelines on Internal Control & Compliance Risk Management in Banks.

BRPD Circular No. 04 dated: 08.03.2016 on Guidelines on Credit Risk Management in Banks.

Money Laundering & Terrorist Financing Risk Management Guidelines issued by Bangladesh Bank in September, 2015.

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