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Report No: PAD1155

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED CREDIT

IN THE AMOUNT OF SDR 213.4 MILLION
(US$ 300 MILLION EQUIVALENT)

TO THE

PEOPLE'S REPUBLIC OF BANGLADESH

FOR A

FINANCIAL SECTOR SUPPORT PROJECT

May 12, 2015

Finance and Markets Global Practice
South Asia Region

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CURRENCY EQUIVALENTS
(Exchange Rate Effective April 30, 2015)

| | | |
|---|---|---|
| Currency Unit | = | Bangladesh Taka - BDT |
| BDT 77.8 | = | US$1 |
| US$ 1.40642000 | = | SDR 1 |

FISCAL YEAR
July 1 – June 30

## ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| AML | Anti-Money Laundering |
| BACPS | Bangladesh Automated Cheque Processing System |
| BB | Bangladesh Bank |
| BEFTN | Bangladesh Electronic Funds Transfer Network |
| BFID | Bank and Financial Institutions Division |
| BFIU | Bangladesh Financial Intelligence Unit |
| BGMEA | Bangladesh Garment Manufacturing Exporters Association |
| BKMEA | Bangladesh Manufacturing Exporters Association |
| CAMS | Certified Anti-Money Laundering Specialist |
| CAR | Capital Adequacy Ratio |
| CAS | Country Assistance Strategy |
| CASPR | Country Assistant Strategy Progress Report |
| CBSP | Central Bank Strengthening Project |
| CFT | Countering Financing Terrorism |
| CIB | Credit Information Bureau |
| CL | Component Leaders |
| COBIT | Control Objectives for Information and Related Technology |
| CPTU | Central Procurement Technical Unit |
| CSR | Corporate Social Responsibility |
| DPD | Deputy Project Director |
| DGM | Deputy General Manager |
| ED | Executive Director |
| EDF | Exporters' Development Fund |
| EMP | Environmental Management Plan |
| ERM | Environment Risk Management |
| ESMF | Environmental and Social Management Framework |
| ESRM | Environmental and Social Risk Management |
| FAPAD | Foreign Aided Projects Audit Directorate |
| FEPD | Foreign Exchange Policy Department |
| FM | Financial Management |
| FRTMD | Forex Reserve and Treasury Management Department |
| FSSP | Financial Sector Support Project |
| GAAP | Governance and Accountability Action Plan |

| | |
|---|---|
| GOB | Government of Bangladesh |
| ICB | International Competitive Bidding |
| IDA | International Development Agency |
| IFC | International Finance Corporation |
| IMF | International Monetary Fund |
| IPF | Investment Project Finance |
| IPFF | Investment Promotion Financing Facility |
| IRR | Internal Rate of Return |
| IT | Information Technology |
| M&E | Monitoring & Evaluation |
| MOF | Ministry of Finance |
| MRA | Microcredit Regulatory Authority |
| NBFI | Nonbank Financial Institution |
| NCB | National Competitive Bidding |
| NPV | Net Present Value |
| OM | Operations Manual |
| PD | Project Director |
| PDO | Project Development Objectives |
| PFIs | Participating Financial Institutions |
| PIU | Project Implementation Unit |
| PPA | Public Procurement Act 2006 |
| PSC | Project Steering Committee |
| RISS | Risk-Based Integrated Supervisory System |
| RMG | Ready-Made Garments |
| RTGS | Real-Time Gross Settlement |
| SME | Small and Medium Enterprise |
| SMP | Social Management Plan |
| SOCB | State-Owned Commercial Bank |
| TA | Technical Assistance |
| TOR | Terms of Reference |
| TOT | Training of Trainers |

| | |
|---|---|
| Regional Vice President: | Annette Dixon |
| Country Director: | Johannes C.M. Zutt |
| Senior Global Practice Director: | Gloria M. Grandolini |
| Practice Manager: | Niraj Verma |
| Task Team Leaders: | Korotoumou Ouattara, Shah Nur Quayyum |

**BANGLADESH**
**Financial Sector Support Project**

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*Bangladesh*

*Financial Sector Support Project (P150938)*

**PROJECT APPRAISAL DOCUMENT**

*SOUTH ASIA*

*0000009086*

Report No.: PAD1155

| Basic Information | | | |
|---|---|---|---|
| Project ID<br>P150938 | | EA Category<br>F - Financial Intermediary Assessment | Team Leader(s)<br>Korotoumou Ouattara, Shah Nur Quayyum |
| Lending Instrument<br>Investment Project Financing | | Fragile and/or Capacity Constraints [ ] | |
| | | Financial Intermediaries [ X ] | |
| | | Series of Projects [ ] | |
| Project Implementation Start Date<br>01-Jul-2015 | | Project Implementation End Date<br>30-Sep-2020 | |
| Expected Effectiveness Date<br>01-Oct-2015 | | Expected Closing Date<br>30-Sep-2020 | |
| Joint IFC<br>No | | | |
| Practice Manager/Manager<br>Niraj Verma | Senior Global Practice Director<br>Gloria M. Grandolini | Country Director<br>Johannes C.M. Zutt | Regional Vice President<br>Annette Dixon |

| | | | |
|---|---|---|---|
| Borrower: Government of Bangladesh | | | |
| Responsible Agency: Bangladesh Bank | | | |
| Contact: | Md. Ahsan Ullah | Title: | Executive Director |
| Telephone No.: | +8801730009337 | Email: | ahsan.ullah@bb.org.bd |

| Project Financing Data(in USD Million) | | | | | |
|---|---|---|---|---|---|
| [ ] | Loan | [ ] | IDA Grant | [ ] | Guarantee |
| [ X ] | Credit | [ ] | Grant | [ ] | Other |

| | | | |
|---|---|---|---|
| Total Project Cost: | 350.00 | Total Bank Financing: | 300.00 |
| Financing Gap: | 0.00 | | |

| **Financing Source** | **Amount** |
|---|---|
| BORROWER/RECIPIENT | 50.00 |
| International Development Association (IDA) | 300.00 |
| Total | 350.00 |

**Expected Disbursements (in USD Million)**

| Fiscal Year | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 0000 | 0000 | 0000 |
|---|---|---|---|---|---|---|---|---|---|---|
| Annual | 0.00 | 35.00 | 65.00 | 80.00 | 70.00 | 45.00 | 5.00 | 0.00 | 0.00 | 0.00 |
| Cumulative | 0.00 | 35.00 | 100.00 | 180.00 | 250.00 | 295.00 | 300.00 | 0.00 | 0.00 | 0.00 |

## Institutional Data

**Practice Area (Lead)**

Finance & Markets

**Contributing Practice Areas**

Environment & Natural Resources, Governance, Social, Urban, Rural and Resilience Global Practice

**Cross Cutting Topics**

[ ] Climate Change
[ ] Fragile, Conflict & Violence
[ ] Gender
[ X ] Jobs
[ ] Public Private Partnership

**Sectors / Climate Change**

Sector (Maximum 5 and total % must equal 100)

| Major Sector | Sector | % | Adaptation Co-benefits % | Mitigation Co-benefits % |
|---|---|---|---|---|
| Finance | SME Finance | 50 | | |
| Finance | Banking | 25 | | |
| Finance | Payments, settlements, and remittance systems | 15 | | |
| Finance | General finance sector | 10 | | |
| Total | | 100 | | |

☑ I certify that there is no Adaptation and Mitigation Climate Change Co-benefits information applicable to this project.

| **Themes** | | |
|---|---|---|
| Theme (Maximum 5 and total % must equal 100) | | |
| Major theme | Theme | % |
| Financial and private sector development | Other Financial Sector Development | 75 |
| Financial and private sector development | Infrastructure services for private sector development | 15 |
| Financial and private sector development | International financial standards and systems | 10 |
| Total | | 100 |

**Proposed Development Objective(s)**

The project development objective is to improve financial market infrastructure, regulatory and oversight capacity of Bangladesh Bank and access to long term financing for private firms in Bangladesh.

**Components**

| **Component Name** | **Cost (USD Millions)** |
|---|---:|
| Strengthening Financial Market Infrastructure | 50.00 |
| Strengthening Regulatory Capacity | 5.00 |
| Supporting Long Term Finance | 292.50 |
| Project Implementation and Monitoring | 2.50 |

**Systematic Operations Risk- Rating Tool (SORT)**

| **Risk Category** | **Rating** |
|---|---|
| 1. Political and Governance | High |
| 2. Macroeconomic | Moderate |
| 3. Sector Strategies and Policies | Moderate |
| 4. Technical Design of Project or Program | Moderate |
| 5. Institutional Capacity for Implementation and Sustainability | Moderate |
| 6. Fiduciary | Substantial |
| 7. Environment and Social | Moderate |
| 8. Stakeholders | Low |
| 9. Other | |
| **OVERALL** | Moderate |

**Compliance**

**Policy**

| | |
|---|---|
| Does the project depart from the CAS in content or in other significant respects? | Yes [ ] No [ X ] |

| | | |
|---|---|---|
| Does the project require any waivers of Bank policies? | Yes [ ] | No [ X ] |
| Have these been approved by Bank management? | Yes [ ] | No [ X ] |
| Is approval for any policy waiver sought from the Board? | Yes [ ] | No [ X ] |
| Does the project meet the Regional criteria for readiness for implementation? | Yes [ X ] | No [ ] |

| **Safeguard Policies Triggered by the Project** | **Yes** | **No** |
|---|---|---|
| Environmental Assessment OP/BP 4.01 | **X** | |
| Natural Habitats OP/BP 4.04 | | **X** |
| Forests OP/BP 4.36 | | **X** |
| Pest Management OP 4.09 | | **X** |
| Physical Cultural Resources OP/BP 4.11 | | **X** |
| Indigenous Peoples OP/BP 4.10 | | **X** |
| Involuntary Resettlement OP/BP 4.12 | | **X** |
| Safety of Dams OP/BP 4.37 | | **X** |
| Projects on International Waterways OP/BP 7.50 | | **X** |
| Projects in Disputed Areas OP/BP 7.60 | | **X** |

**Legal Covenants**

| **Name** | **Recurrent** | **Due Date** | **Frequency** |
|---|---|---|---|
| Sub-loans | **X** | | CONTINUOUS |

**Description of Covenant**

Bangladesh Bank shall: (a) (i) appraise/select PFIs per criteria in the Operations Manual; (ii) relend to PFIs on the terms and conditions identified in the Project Agreement; and (b) cause the PFIs to: (i) appraise and select eligible firms; (ii) make sub-loans to firms on the terms and conditions spelled out in the Project Agreement.

| **Name** | **Recurrent** | **Due Date** | **Frequency** |
|---|---|---|---|
| Safeguards Documents | **X** | | CONTINUOUS |

**Description of Covenant**

The Bangladesh Bank shall, and shall cause each PFI to, carry out the Project in accordance with the ESMF and the relevant instruments to be prepared under the ESMF.

| **Name** | **Recurrent** | **Due Date** | **Frequency** |
|---|---|---|---|
| Governance and Accountability Action Plan | **X** | | CONTINUOUS |

**Description of Covenant**

The Bangladesh Bank shall ensure that the Project is carried out in accordance with the provisions of the Governance and Accountability Action Plan.

**Conditions**

| Source Of Fund | Name | Type |
|---|---|---|
| IDA | Subsidiary Loan Agreement | Effectiveness |

**Description of Condition**

The Subsidiary Loan Agreement shall be executed on behalf of the Recipient and the Bangladesh Bank.

## Team Composition

**Bank Staff**

| Name | Role | Title | Specialization | Unit |
|---|---|---|---|---|
| Korotoumou Ouattara | Team Leader (ADM Responsible) | Sr. Financial Economist | Task Team Leader | GFMDR |
| Shah Nur Quayyum | Team Leader | Financial Sector Specialist | Co-Task Team Leader | GFMDR |
| Tanvir Hossain | Procurement Specialist | Senior Procurement Specialist | Procurement | GGODR |
| Mohammed Atikuzzaman | Financial Management Specialist | Financial Management Specialist | Financial Management | GGODR |
| Ahmed Mohamed Tawfick Rostom | Team Member | Financial Sector Specialist | Islamic Finance | GFMDR |
| Ananya Wahid Kader | Team Member | Operations Officer | Access to Finance | GFMDR |
| Aza A. Rashid | Team Member | Program Assistant | Program Assistant | GFMDR |
| Bridget Rosalind Rosario | Team Member | Program Assistant | Program Assistant | SACBD |
| Dipanwita Chakraborty | Team Member | Program Assistant | Program Assistant | SACBD |
| Douglas Pearce | Peer Reviewer | Lead Financial Sector Specialist | Peer Reviewer | GFMDR |
| Francesca Lo Re | Team Member | Senior Operations Officer | Access to Finance | GFMDR |
| Harish Natarajan | Team Member | Senior Financial Sector Specialist | Financial Sector Infrastructure | GFMDR |
| Ilias Skamnelos | Peer Reviewer | Senior Financial Sector Specialist | Peer Reviewer | GFMDR |
| Jorge Luis Alva-Luperdi | Team Member | Senior Counsel | Legal | LEGES |
| Junxue Chu | Team Member | Senior Finance Officer | Disbursement | WFALN |
| Marta Elena Molares-Halberg | Team Member | Consultant | Legal | LEGES |

| | | | | |
|---|---|---|---|---|
| Mihasonirina Andrianaivo | Team Member | Financial Sector Specialist | Financial Sector | GFMDR |
| Niraj Verma | Program Manager | Practice Manager | Team Lead | GFMDR |
| Nusrat Mehzabeen | Team Member | Temporary | Program Assistant | GFMDR |
| Priyani Malik | Team Member | Financial Sector Specialist | Financial Integrity | GFMDR |
| Sabah Moyeen | Safeguards Specialist | Senior Social Development Specialist | Social Safeguards | GSURR |
| Salman Zaidi | Peer Reviewer | Practice Manager | Peer Reviewer | GPVDR |
| Satish Kumar Shivakumar | Team Member | Finance Officer | Disbursement | WFALN |
| Shakil Ahmed Ferdausi | Safeguards Specialist | Senior Environmental Specialist | Environmental Safeguards | GENDR |
| Shiny Jaison | Team Member | Program Assistant | | SACIN |

**Extended Team**

| Name | Title | Office Phone | Location |
|---|---|---|---|
| Anwar Shah | Consultant | | |
| Carel Oosthuizen | Regulation and Supervision Expert | | |
| Mingli Pang | Deputy Dean | | |
| Shantanu Roy | Safeguards Expert | | |

**Locations**

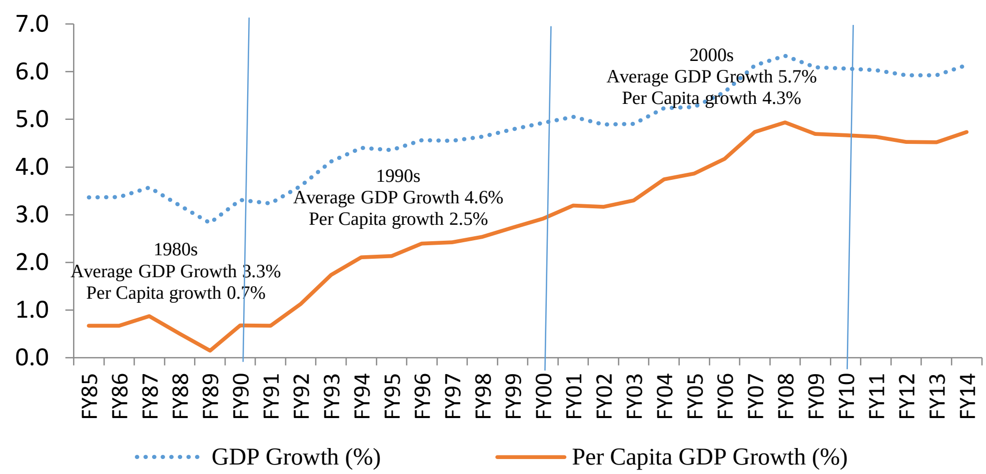
| Country | First Administrative Division | Location | Planned | Actual | Comments |
|---|---|---|---|---|---|
| | | | | | |

# I. STRATEGIC CONTEXT

## A. Country Context

1. ***Over the past twenty years, Bangladesh has made significant gains in economic growth, development and poverty reduction.*** Bangladesh's per capita gross national income (GNI) grew at a compound annual rate of 6.1 percent, from around US$100 in 1972 to US$1,190 in 2014 (figure 1). While growth in GNI in the 1980s and 1990s came almost entirely from growth in gross domestic product (GDP), remittances from workers abroad have emerged as a significant source of income in the last decade. Average annual GDP growth has risen steadily over the last three decades (see figure), and grew by more than 6 percent a year on average during the past 5 years despite the adverse impacts of the global recession, oil price rise, and unrest in the Middle East (an important destination for migrants), and natural disasters. Several factors explain its resilience to global and domestic shocks so far, including good macroeconomic fundamentals, resilience of exports and remittances, relatively under-developed and insulated financial markets, and a pre-emptive policy posture.

**Figure 1: GDP Growth Trend (5 Year Moving Average, 2005-06 base)**




*Source: Bangladesh Bureau of Statistics and WB Staff*

2. ***Despite this progress, growth remains below potential and to achieve its objective of becoming a middle-income country by 2021, Bangladesh faces myriad challenges***. Building on its strong social and economic performance over the past 20 years, overall annual growth of around 8 percent[1] will be needed for the country to achieve its ambitious aspiration of reaching middle-income status and reducing poverty from 31.5 percent currently to less than 15 percent by 2021. The increase in gross domestic product (GDP) growth requires a range of initiatives, including maintaining macroeconomic stability, investing in transformative infrastructure, streamlining trade and investment regulations, strengthening the financial sector, and furthering human development.

[1] By a combination of annual average 14 percent export growth, 13 percent remittance growth, and 15 percent growth in public investment, compared with 11.6 percent, 13.3 percent, and 8.5 percent, respectively, average growth rates achieved in the past 10 years.

3. ***In addition, the Bank's 2012 Growth Report argued that faster growth will depend on four main factors***: increase in investment by at least five percentage points of GDP, improvement in the quality and relevance of education, increase in productivity growth by accelerating the shift from agriculture to higher productivity manufacturing and services, and finally deepening and diversifying labor-intensive exports. The country is indeed well placed to expand manufacturing exports given its geographic proximity to two of the world's most populous countries, as well as other fast-growing economies.

4. ***Building a strong financial sector that can cater to the needs of the growing economy is one of the essential ingredients in meeting Bangladesh's long-term development goal as well as supporting short- to medium-term growth***.[2] Bangladesh will need to develop a financial sector that is stable, inclusive, and capable of providing efficient financial intermediation to the productive sectors of the economy, facilitating capital accumulation and investment to generate faster growth. On financial intermediation, given the importance of the manufacturing sector and of the export sector, it is particularly important to cater to the evolving financing needs of these sectors.

## B. Sectoral and Institutional Context

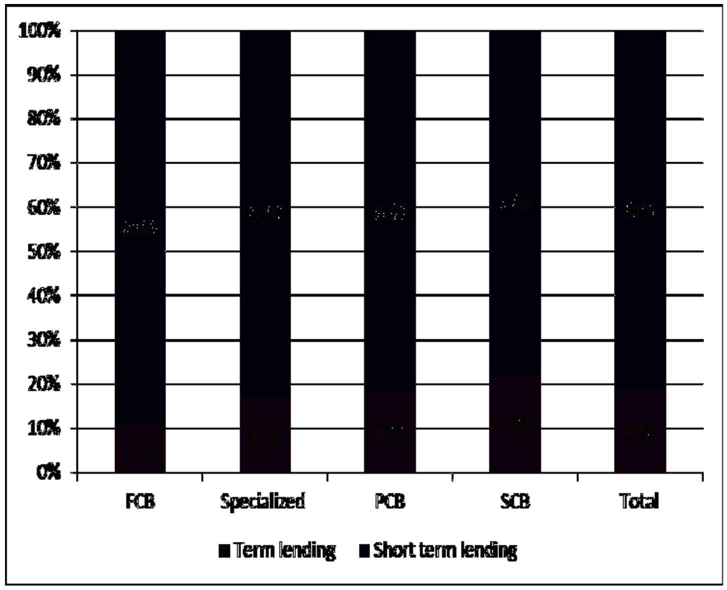
5. ***To strengthen its financial sector, Bangladesh needs to address several key issues***. First, it must improve stability by strengthening weak banks, particularly state-owned banks but others as well; there has been a steady rise in nonperforming loans (NPLs) from 6.1 percent in December 2011 to 11.6 percent in September 2014. Some of these banks may also require recapitalization and cleaning up of unrecognized loan losses from the ever-greening of loans (repeated loan rescheduling), inadequate loan classification, and provisioning requirements—especially true in state-owned commercial banks (SOCBs). Second, governance and management systems—including risk management, internal controls, and credit appraisal in parts of the banking sector and especially the SOCBs—need to be enhanced to mitigate the risk of suboptimal loan decisions, and overall operations need to be automated to enhance data integrity, efficiency and competitiveness. Third, the supervisory and regulatory capacity of the central bank, Bangladesh Bank (BB), needs to be further enhanced, given the issues discussed above but also to meet the growing complexities of financial markets. Fourth, financial market infrastructure needs to be strengthened to improve efficiency and stability and to enhance the efficiency and effectiveness of monetary policy transmission. Fifth, financial intermediation remains modest, with a credit to GDP ratio of 48 percent.

6. ***In particular, limited financial intermediation results in constrained access to finance as well as the high cost of finance for manufacturing exporters, including small and medium enterprises (SMEs) and the agriculture sector***. Although Bangladesh is rightly acknowledged for its thriving and innovative microfinance sector, financing to these market segments beyond microfinance has lagged behind. Access to affordable finance is identified as one of the top four obstacles to doing business in the country (2013 *Doing Business* report); and in the 2008 Investment Climate Assessment, one-third of small firms reported that available lending products were inappropriate, as opposed to 4.2 percent of large firms.

[2] As also reflected in the draft Systematic Country Diagnostic being prepared by the Bank where the financial sector is identified as a key constraint to the country's development.

7. ***In particular, long-term finance, especially for exporters and manufacturing firms, is limited, and the financial sector remains ineffective in its capacity to perform its term transformation functions***. Supply of long term financing (figure 2) remains constrained by the limited access of banks to longer term resources[3] and banks' relative comfort and preference to undertake shorter term financing, capacity constraints, information asymmetries and underdeveloped capital markets. All of these factors inhibit long term investments by households and the ability of Bangladesh's firms to invest in capital up-gradation and technology, expand and grow businesses and jobs at the pace they might otherwise have been able to. As a consequence, private investment in Bangladesh, at 19 percent of GDP, is lower than in countries such as India (at 23 percent of GDP in 2012) or those in East Asia; a key challenge to raising growth to the targeted level of the country's Sixth Five-Year Plan is to increase the investment rate to 32.5 percent by the end of the plan period.[4] The scarcity of long-term financing (only 19 percent of total lending in June 2013) leads sectors in need of long-term credit—e.g., the capital-intensive export industry or the labor-intensive ready-made garments (RMG) or footwear industries—to underinvest, thereby constraining employment and growth. The inability to provide long-term financing particularly affects entrepreneurial exporters who consequently have difficulty capturing emerging business opportunities and upgrading equipment and facilities. Indeed there is a significant demand for long term financing by firms, conservatively estimated at US$1.5-2 billion per annum for the export market, and yet supply by the market and by private provision, lags behind significantly.[5]

**Figure 2: Short term versus term lending (as of June 2013)**




8. ***A market study conducted by the World Bank showed that less than 3 percent of foreign-currency denominated loans to exporters was greater than three years in tenor, and none of the banks and financial institutions surveyed, extended any loans of five years or more.[6]*** Such long-term funding is needed to capture the opportunities for economic growth in Bangladesh spurred

[3] Banks which dominate the financial sector, have less than 20 percent of their liabilities in term deposits. Access for banks to long term foreign exchange resources is very miniscule/virtually nil (only 2-3 transactions in 2014), leading to an acute shortage of foreign exchange based long term financing, which can be so critical for the export sector.

[4] IMF/WB, 2013, "Bangladesh: Joint Staff Advisory Note on the Poverty Reduction Strategy Paper.

[5] The limited supply of foreign exchange based long term financing that exists is typically for the top most large firms in the country and is provided by the overseas business units of domestic banks (which use short term resources to lend up to five years, and thereby run the risk of downstream problems arising out of asset liability mismatches, and rendering such supply risky, with growth constraints and potentially unsustainable), and to a lesser extent by foreign banks and institutions.

[6] This excludes lending by overseas business units.

by relocation of labor-intensive production from fast-growing countries like China. This current economic opportunity underscores the time factor in addressing this gap in access to finance, which is one of the factors preventing Bangladeshi firms from capitalizing on this opportunity. In addition, investment in energy-efficient and environment-friendly technologies, as well as investments in mechanisms for complying with international safety standards, remains limited, in large part because of this lack of long-term funding, according to the market study (see box 1).

***Box 1: Key Highlights of Market Study***

*Supply side*

- 94 percent of bank loans denominated in foreign currencies are short-term loans, and generally (99 percent) granted to large businesses and corporates.
- Banks provide loans mainly to the ready-made garments, agro-based and pharmaceuticals industries, and these industries hold 56 percent, 26 percent, and 7 percent of their lending portfolio. But only 12 percent of these loans are long-term with a maturity of five years.
- The limited long-term lending that is undertaken leads to a maturity mismatch between the source of funds and the use of those funds for long-term lending.

*Demand side*

- The demand for long-term credit arises mainly from the exporters and manufacturers for capital machinery import for their capacity expansion and upgradation for competitiveness.
- The bulk of financing obtained by firms in 2013 consisted of trade finance and cash credit.

*Source:* World Bank study undertaken by A. C. Nielsen (2014).

9. ***The proposed project supports Bangladesh's efforts to develop the financial sector, by strengthening financial market infrastructure;[7] improving regulatory, supervisory, and sector developmental capacity of BB; and building the market for and scaling up long-term finance especially to exporters and manufacturing firms to spur competitiveness, investment, and growth.*** In so doing, it addresses some of the key financial sector constraints identified above and complements other parallel efforts to address remaining constraints.[8] A stable and efficient financial system with low transaction costs is an essential foundation for the financial market. By strengthening financial market infrastructure, the project contributes to a key public good: the smooth, stable, and efficient functioning of financial markets. By strengthening the regulator's capacity building—including its supervisory and oversight functions—the project would contribute to financial sector stability and to mitigation of financial sector risks. By strengthening

[7] Financial market infrastructure encompasses all the system infrastructure components; legal, regulatory, and oversight framework; operational procedures and agreements; the operator of the infrastructure; and the users of the infrastructure, not just payment and settlement systems (as used in the CPSS-IOSCO - Committee on Payment and Settlement Systems of the Bank for International Settlements; and, International Organization of Securities Commissions principles). In the context of this document, it also includes the internal systems of the Bangladesh Bank that support the functioning of the payment and settlement systems; the credit information bureau; and the Financial Intelligence Unit (FIU)–related systems and processes.

[8] For instance, issues around the state owned banks' weak systems and capacities, which directly relate to their ability to demonstrate strong financial performance, is proposed to be addressed through a parallel initiative from the World Bank. Building capital markets – while initial foundational work will be supported through this project – will be again covered through ongoing parallel support to government from the Asian Development Bank, and for building the insurance and pensions markets, through a parallel, upcoming World Bank support program. The International Monetary Fund has supported Bangladesh, including through some financial sector actions, including partial capitalization of state owned banks. The Bank is also engaged in support on secured transactions reform, which will complement project initiatives.

Bangladesh's capacity to meet the ever-growing complexity of international financial markets and the country's own particular financial sector stresses,[9] the project could help protect the financial system from the stability risks that hamper its effective functioning and constrain investment and growth. Capacity building would also support progress on innovative new products for underserved market segments, as well as initiatives on consumer protection. By supporting long-term finance through participating financial institutions (PFIs, which could include Islamic Finance banks[10]) to firms especially in the manufacturing sector[11] and associated technical assistance, the project would serve as a catalyst for building a market for long-term lending, where little such funding currently exists and is not likely to develop organically in the near term.

### C. Higher-Level Objectives to Which the Project Contributes

10. This project strengthens the financial sector and in doing so, contributes to the higher-level objective of accelerating growth by providing access to long-term finance to the export and manufacturing sector, by supporting better capacity to regulate and supervise the financial sector and by strengthening the financial system's capacity to intermediate efficiently and boost capital accumulation to generate faster growth. Through financing to productive firms, particularly mid-sized exporting firms which are the engines for future growth and employment, the project would support the growth of exports, jobs, a higher rate of growth especially in manufacturing, and a reduction of losses (or opportunity cost) from underinvestment.

11. The operation is well grounded in the Country Assistance Strategy (CAS) for Bangladesh (IDA/R2010-0232/4; IFC/R2010-0248/4) discussed by the Board on July 8, 2010, and the CAS Progress Report's (CASPR, FY11–15 - IDA/R2013-0299; IFC/R2013-0388) endorsed by the Board on January 14, 2014 that focus on accelerated, sustainable, and inclusive growth, underpinned by increasing investments, enhancing the business environment, and achieving stronger governance. Specifically, the project contributes to achieving the second CASPR pillar on accelerated growth mainly by improving the environment for private sector investment through the greater availability of long-term funds and the strengthened capacity of the financial system to fund sustainable economic growth in the future and continued strengthening of regulation and supervision. The focus of the project on exporters and midlevel firms contributes directly to higher growth, competitiveness, investment, and employment creation. The project will also contribute to enhancing bankers' skills and to improving the safeguards practices of industry and support pillar four of the CASPR: strengthening governance through better transparency and accessibility

[9] Reflected in growing nonperforming loans, the weak capital position of banks, and prevalent irregularities and malpractices in the banking sector which have resulted in some massive scams and the like.

[10] The Islamic finance component within the long term financing support will also help Islamic banks – currently accounting for 15 percent of the sector's deposits and 17 percent of total credit and financing – access longer term financial resources and avail *Shariah* compliant products with longer maturities to the clientele base seeking the service.

[11] The manufacturing sector is considered as a driver of job creation. Also, relative to manufacturing firms, service sector firms tend to have lesser need for long-term financing due to relatively lower capital needs. Hence, the project keeps its focus on manufacturing firms where the demand for long-term financing is clearly manifest. Financing will be to a segment much smaller (around a tenth in terms of expected loan size) than the typical financing being done currently – around just 30-35 large sized firms (out of more than 6,000 firms countrywide) were supported in 2014 through foreign exchange based long term financing.

of financial services, including government payments[12] and improved security, governance and adoption of information, communication and telecom (ICT) infrastructure for digitization of processes, transactions and controls in government agencies (including BB, the central bank) and improved infrastructure and capacity on aspects related to money laundering. The project is in line with Bangladesh's Sixth Five-Year Plan for FY11–FY15, which emphasizes private enterprise development for sustainable growth and employment creation.

12. Overall the project contributes to building a stronger financial sector, which contributes to stability and through facilitating improved financial intermediation promotes inclusive growth, thereby contributing to the World Bank Group's twin goals of ending extreme poverty by 2030 and boosting the incomes of the bottom 40 percent. For instance, support to build regulatory capacity directly contributes to enhancing financial stability and mitigating potential costs of instability – for instance, it is a well understood fact that the costs of financial crises are high as the global financial crisis of 2008 pushed 120 million people below the poverty line and created 22 million new unemployed persons just in a single year in the aftermath of the crisis. Support to build financial infrastructure including strengthening the payments system, enables enhanced access to financial services; better credit reporting systems, reduce information asymmetries and enhance opportunities for access to finance for underserved firms and households. For instance, payment systems promote economic and financial development: improvements in the national payments system contribute to financial stability and access and lead to savings for the overall economy: 1.22 percent of GDP was estimated to have been saved in Vietnam as a result of payments reform (World Bank estimates). Payment systems are a critical enabler of financial access: transactions accounts allow people – including the "unbanked" – to make and receive payments in a cost-efficient way. Instruments like e-money and debit cards have great potential to reach the excluded and help realize the Universal Financial Access by 2020 goals put forth by the World Bank. Long term financing support to manufacturing firms enables them to invest in new equipment and enhance productivity, expand business and create new jobs, including for those in the bottom 40 percent of the economy, thereby promoting growth and shared prosperity.

## II. PROJECT DEVELOPMENT OBJECTIVES

### A. PDO

13. The project development objective is to improve financial market infrastructure, the regulatory and oversight capacity of Bangladesh Bank, and the access to long-term financing for private firms in Bangladesh.

[12] Includes payments to and from the government to and from persons and businesses. Examples include tax collections, public sector salary payments, tax refunds, social benefit transfers, and collection of miscellaneous fees.

## B. Project Beneficiaries

14. The primary project beneficiaries include the following: (1) private firms in Bangladesh, mainly mid-sized manufacturing firms[13] including exporters, and some small and medium enterprises and firms in sectors that are crucial for growth; (2) financial sector stakeholders, including its clients, regulators, and PFIs; and (3) BB.

15. The components of the project and the technical assistance (TA) therein will benefit a wide range of financial sector stakeholders and participants by supporting the smooth, stable, and efficient functioning of financial markets. In addition, the TA activities related to the long-term financing of firms' investments to comply with international safety standards (with implementation arrangements promoting good practices on safeguards among lenders and funded firms) will ultimately contribute to workers' health and safety in the export sector and the overall economy and support firms that might otherwise not have been able to make the investments required to meet the recently imposed compliance requirements from the importers.

## C. PDO Level Results Indicators

16. The PDO-level results indicators are as follows: (1) shift of government payments to electronic means; (2) high-level of operational reliability as measured by compliance;[14] (3) certification of BB against quality standards;[15] (4) number of Basel Core Principles on which BB is judged as compliant and largely compliant; and (5) Outstanding long term foreign exchange loans of PFIs. The project results framework is detailed in annex 1.

# III. PROJECT DESCRIPTION

## A. Project Components

***<u>Component 1: Strengthening Financial Market Infrastructure</u> (US$50 million, of which IDA is US$40 million).***

17. The proposed component will build on previous efforts and improve financial market infrastructure further, specifically focusing on activities in the following four broad areas: (1) payment and settlement system development; (2) expanding and modernizing the Credit Information Bureau (CIB); (3) strengthening the systems of the Bangladesh Financial Intelligence Unit (BFIU) and integration with systems of other stakeholders; and (4) strengthening the information technology (IT) governance and IT management of the BB, optimizing the IT assets of the BB, and raising awareness of IT security aspects for the financial industry.

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[13] The project seeks to typically cover mid-size manufacturing firms as its primary focus and many are expected to be exporting firms and some will be SMEs (by the somewhat narrow definition used in Bangladesh). Expected loan size will be around a tenth of the loan sizes currently evidenced in the market (in the limited cases, just 30-35 per year, of long term financing currently taking place). In addition, the component remains open to firms manufacturing for the domestic industry but most firms are expected to have an exporting bias (domestic term financing constraints are also sharp, though relatively lower than similar constraints for LT finance for exporting firms). Definition of eligible firm and exposure limits are detailed in the Operations Manual.

[14] Against the Principle 17 of the CPSS-IOSCO PFMI of the RTGS system, BACH and the MI module.

[15] ISO270001 and Control Objectives for Information and Related Technology (COBIT).

18. The project will support BB's IT investments to strengthen financial market infrastructure to: (1) enable a large-scale shift to electronic payments in Bangladesh in general and in particular for government payments, thereby increasing the efficiency of the financial system; (2) broaden the coverage of the CIB by including credit information on the microfinance sector and increasing the reliability of the credit reporting system, which will lead to better credit risk management; (3) increase the effectiveness of the BFIU, which will lead to the improved safety and integrity of the financial system; and finally (4) enhance the reliability and robustness of the IT systems of the BB.

19. The project will also support the capacity building of the BB staff so that they can effectively implement financial infrastructure reforms and oversee the financial infrastructure in Bangladesh. The areas of capacity building will, among others, include IT management, IT governance, best practices in monitoring and supervising compliance to anti-money laundering (AML) and countering financing terrorism (CFT) standards; payment and settlement systems; and credit reporting systems. Helping the BB staff acquire internationally recognized certifications in these areas would also be supported, along with a detailed technical assessment of the automation and modernization needs of state-owned banks.[16]

***<u>Component 2: Strengthening the Financial Sector Regulator</u> (US$5 million; of which IDA is US$4 million)***

20. This component aims to strengthen BB's capacity to regulate and supervise the scheduled financial institutions (banks and nonbank financial institutions), run the FIU more efficiently, and further develop and deepen the financial sector with new and innovative products. The component would support regulatory and supervisory strengthening. Recognizing that a rigid, rules-based approach to supervision can result in a reactive response to events, BB wants to migrate to a risk-based approach to regulation and supervision that makes the supervisory process more anticipatory. To pursue its mandate more effectively and efficiently, BB would like to review its current system of banking supervision, consolidate and streamline its eight supervisory departments, and migrate to a risk-based integrated supervisory system (RISS). The project will provide technical assistance to BB to develop a corrective and remedial action policy, including a prompt corrective action policy. Support will also be provided to build capacity to review and strengthen prudential regulations. In addition, support will be provided to strengthen the Financial Intelligence Unit. Further, activities will include support for human resource development which will be an integral part of the regulatory and supervisory capacity building. Banking legislation, regulation, and supervision constitute specialist areas that require specialist knowledge, skills, and experience. The project will provide technical assistance to conduct a review of the human resource (HR) policy on banking regulation and supervision to ensure that these functions are being effectively carried out in fulfillment of BB's mandate. This component of the project will also support BB in developing a comprehensive program that covers induction training, on-going training and development, and career path planning.

[16] This will feed into the appraisal of a separate request from government of Bangladesh to support an IT automation project with state owned banks, with a view toward improving data integrity, efficiency, and service delivery and to enabling better supervision of operations.

21. Lastly, the project will provide technical support for enhancing BB's development capacity and for creating new and innovative products. BB expressed an interest in expanding its capacity to facilitate provision of agricultural finance and in developing a national financial inclusion strategy. With regard to agriculture finance, and given that the Bank and Financial Institutions Division (BFID) expressed an interest in complementary technical assistance on agriculture insurance, it was agreed that the project would include a study on warehouse receipts financing. Technical support will also better understand constraints to the sustainable development of the long-term financing market. In that light, the component will support analytical and policy research on long-term capital markets (particularly secondary bond markets) and the pensions market, both of which are crucial to the development of the long-term financing market. In addition, in response to the current absence of long-term deposit instruments in the PFIs, sector focused technical support will be extended to develop the use of those products.

***<u>Component 3: Supporting Long Term Finance</u> (US$292.5 million; of which IDA is US$254 million)***

22. This component will support long-term financing (an expected average of five years of financing) through PFIs to firms, particularly exporters,[17] in Bangladesh. Funding will be focused on manufacturing sector firms (such as those listed in box 3 Annex 2), although it will not be restricted to such firms.[18] BB will channel the long-term finance line to PFIs and, through a demonstration effect and the associated technical assistance described below, this component will serve to build markets for long-term finance. In addition, the project is expected to contribute to the improvement of health and safety standards in industry through the application of agreed environmental and social safeguard standards, thereby reducing credit risk.

23. The long term financing will be accompanied by technical assistance to support capacity building of Financial Institutions (FIs) and industry associations. Sector-wide TA will be provided to financial sector on two areas: credit risk management and safeguards for long-term financing projects. This will help FIs to develop improved processes for risk assessment/due diligence, monitoring and management, thereby lowering their credit and environmental and social risks. Partnerships with industry associations will be forged to raise awareness of safeguards practices and to improve those practices across the private sector.[19]

[17] Long-term financing for the export sector is becoming increasingly critical to the sector's ability to remain competitive and contribute to job creation and growth.
[18] Although the credit line is anticipated to be mainly absorbed by the manufacturing sector, service sector firms are also eligible. Detailed definitions of eligible firms are provided in the project's Operations Manual (OM).
[19] These partnerships will help the industry improve occupational health and safety through structured training programs, sharing good-practice experience, and developing awareness-raising tools and will be operated through the industry associations.

***Component 4. Project Management and Monitoring*** ***(US$2.5 million; of which IDA is US$2 million)***

24. Management of project implementation will be assumed by the Financial Sector Support Project (FSSP) cell in BB. The component will include costs for project management[20], monitoring and evaluation (M&E), capacity building and Governance and Accountability Action Plan (GAAP) implementation.

## B. Project Financing

25. The lending instrument will be investment project financing (IPF), with an implementation period of five years. Project costs will be financed by an IDA credit in SDR of US$300 million equivalent, and a government contribution in the amount of US$50 million.

## C. Project Cost and Financing

The project is estimated to cost US$350 million, which is proposed to be financed through an IDA Credit of US$300million equivalent and a BB contribution of US$50 million including for project implementation costs[21]. It was agreed during appraisal that retroactive financing of up to 10 percent of approved financing will be allowed for eligible expenditures made during the period of retroactivity. [22] A breakdown of project costs at the component level is presented in the table below.

| Project Components | Project cost including Contingencies (US$ millions) | IDA Financing | % Financing |
|---|---|---|---|
| 1. Strengthening Financial Market Infrastructure | 50.00 | 40.00 | 80.00 |
| 2. Strengthening the Financial Sector Regulator | 5.00 | 4.00 | 80.00 |
| 3. Supporting Long-Term Finance | | | |
| 3a. Sub-loans | 291.25 | 253.00 | 86.87 |
| 3b. TA | 1.25 | 1.00 | 80.00 |
| 4. Project Implementation and Monitoring | 2.5 | 2.00 | 80.00 |
| **Total Project Costs** | **350.00** | **300.00** | **85.71** |

[20] Project management costs include all expenditures incurred by the FSSP cell in coordinating and implementing the project. It has been agreed that, out of these FSSP cell operating costs, BB staff salaries, GOB civil servant salaries, sitting allowances, honoraria, and cash per diem would be ineligible for IDA financing and would be financed by the Government contribution.

[21] The government of Bangladesh (GOB) through BB will provide PD, DPD, component leaders, technical and operational staff including procurement and FM-trained/experienced staff, and other support staff as needed by the project.

[22] Retroactive payments can be made up to 12 months before the expected date of signing of the legal agreements as long as project implementation arrangements, including fiduciary and safeguards procedures as applicable, agreed with IDA have been used. The tentative signing date for FSSP is June/July 2015 and hence the date for inclusion of retroactive expenses is expected to be July 1, 2014.

## D. Lessons Learned and Reflected in the Project Design

26. The project has factored in lessons learned from previous and ongoing operational work in Bangladesh and elsewhere, in particular, on reforms in the financial sector, strengthening regulatory capacity and long-term financing. On the choice of the central bank to wholesale the long-term financing—given that no other viable alternative exists in Bangladesh—the project has looked at other Bank projects that used a similar channel (for instance in Jordan and Tunisia but also the existing infrastructure finance project with BB) and ensured that adequate checks and balances are maintained and captured in the Operations Manual (OM) that has been developed. The project also complements other parallel and independent efforts of the government of Bangladesh (GOB) and BB, including those to strengthen the governance, management, and financial position of state-owned commercial banks. The project is also complementary to the International Monetary Fund's (IMF) facility for Bangladesh and coordinates with on-going International Finance Corporation (IFC) activities in the SME finance sector. The project would also complement other efforts in the real sector to remove constraints and unleash the growth potential by focusing on financial sector development.

27. Experience with refinancing operations funded through IDA credit lines to financial institutions has been successful, and BB already has a long track record of implementing Bank-financed operations, consistent with the Bank's policies and procedures, including fiduciary and safeguards requirements. The Investment Promotion and Financing Facility Project (IPFF, Cr. No 4693-BD), which supports infrastructure financing, and the Central Bank Strengthening Project (CBSP, Credit # 3792-BD), which supported BB's automation program, provided important lessons for designing the project's results framework and implementation arrangements. In particular, key lessons included the need to: (1) pay early attention to the detailed technical design and procurement plans for the financial infrastructure component; (2) identify appropriate consultant services to support project implementation; (3) establish a strong and well-staffed project implementation unit (PIU) with qualified fiduciary, technical, and project implementation experience; (4) define clear implementation arrangements for the long-term finance component, drawing on the good practices of the Exporters' Development Fund (EDF) and on the established experience of the Forex Reserve and Treasury Management Department (FRTMD); (5) identify quantifiable financial and other results indicators upfront to monitor project performance; and (6) formulate a detailed monitoring and evaluation framework with quantifiable targets. Annex 3 provides details on the lessons learned from the IPFF and the CBSP. Critically, the CBSP helped build the capacity of BB in procurement of IT. BB now has a substantial team of qualified IT staff who are both well versed with the technical aspects critical for implementing component 1 of this project and familiar and capable in terms of handling IT procurement.

# IV. IMPLEMENTATION

## A. Institutional and Implementation Arrangements

28. *Organization responsible for the project*: The Bank and Financial Institutions Division of Ministry of Finance (MOF) will be the executive/nodal division of the government for the project responsible for representing the government of People's Republic of Bangladesh on the project. BB will be the implementing agency and will be responsible for overall project implementation,

and all funds flow for project activities will be through BB. In terms of legal arrangements, in addition to the financing agreement between IDA and the People's Republic of Bangladesh, a project agreement will reflect the agreement between IDA and BB. A Subsidiary Loan agreement will be signed between BB and the Finance Division of MOF.

29. *Policy and overall guidance:* A project steering committee (PSC) will provide the project with overall guidance and monitoring functions and will attend to inter-ministerial issues. The PSC will be chaired by the Governor of BB; and it will include all deputy governors of BB senior representative (joint secretary or above) from Finance Division, BFID, and Economic Relations Division of MOF, Implementation Monitoring and Evaluation Division and Socio-Economic Infrastructure Division of the Planning Commission, and such other entities as the PSC may decide.

30. *Implementation:* Responsibility for project management will be entrusted to an executive director of BB or equivalent or higher, who will be seconded to act as the Project Director (PD). This PD will lead the project coordination unit located at BB. The former PIU for the Central Bank Strengthening Project, which has continued performing project management duties since the CBSP closed in 2012, and will now be designated as the FSSP cell. Each component will be managed by a Component Leader (CL) who is at Deputy Governor rank: It is proposed that under current Deputy Governor configurations, CL for Component 1 will be the Deputy Governor in charge of BB's ICT, CL for Component 2 will be the Deputy Governor in charge of bank regulation and supervision and CL for Component 3 will be the Deputy Governor in charge of Forex Reserve and Treasury Management Department. The CLs will be responsible for the implementation of his/her respective component (the OM carries a summary description of their roles) and will coordinate closely with other concerned departments of BB in the implementation of the project. There will be component coordinators in the FSSP Cell for each component who will be responsible for coordinating the activities under concerned components. The FSSP Cell will also include a monitoring and evaluation (M&E) expert to be hired under the project. The FSSP Cell will also hire necessary support staff as needed. The PD and CLs will be supported by the Deputy Project Director (DPD), who will coordinate and monitor the activities of the various implementing departments and teams of BB and their technical consultants. The consultants will work under the direct supervision of the PD, CLs, and DPD. The FSSP Cell will also coordinate with the other regulators in the financial sector like the Microcredit Regulatory Authority (MRA), Insurance Development and Regulatory Authority, and Bangladesh Securities and Exchange Commission, to implement the concerned project activities and industry associations for implementation of the TA.

31. The FSSP cell will be in charge of overall project coordination as well as overseeing the financial management, procurement, reporting, M&E, audit, public information, and related functions. Annex 4 contains more information on the key responsibilities of the FSSP cell.

32. The FSSP Cell will hire part-time technical specialists as required to support the BB in the implementation of the main components. The FSSP cell will be staffed adequately (at staffing levels between BB's assistant director to deputy general manager levels), who will support implementation of the four components and implementation of the overall project.

33. *Implementation arrangement for Components 1 and 2:* To provide support to BB's technical teams implementing component 1, a number of technical experts and consultants will be

hired and assigned to the concerned departments of BB. To assist BB in implementing the supervisory and regulatory capacity of BB, two consulting firms, one focusing on supervision and the other on regulation, will be hired through single-stage international competitive bidding based on quality and cost. Details are provided in annex 2. In addition, a mentor for the BFIU will be hired for one year to help BFIU strengthen its capacity and comply with international standards for FIUs. Also, for HR capacity building, an HR adviser will be hired to support the HR development activities of the project.

34. The FSSP cell will be responsible for the overall procurement and contract management under components 1 and 2. For the effective implementation of the components, the FSSP cell will coordinate among participating and implementing departments and ensure development of an appropriate regulatory and policy environment, if required, through appropriate channel(s) during implementation. The concerned departments or units of BB will take the responsibility for implementing the activities in their purview.

35. *Implementation arrangement for component 3:* Through its FRTMD, BB will be responsible for managing the long-term finance credit line, and the Forex Exchange Policy Department (FEPD) will be responsible for formulating necessary policy circulars and finalizing and endorsing the OM. Detailed eligibility criteria are defined in the OM, and, based on an appraisal of the PFIs' management and financial performance, PFIs will be selected by BB. FSSP Cell will be responsible for ensuring that sub-project activities comply with the fiduciary and safeguards arrangements. Project funds for the credit line will be channelled through BB; that will then on-lend to eligible financial institutions, and funds will ultimately reach the end-beneficiaries (firms).

36. PFIs will on-lend at commercially determined rates based on an appraisal of the underlying credit risk and final rates to end-clients will be commercially priced. The selected PFIs will appraise firms and take credit decisions in line with their policies and in compliance with the project implementation framework. Financing of firms in accordance with the project implementation framework and terms of financing that will be defined in the OM, including provisions on reporting and fiduciary and safeguards dimensions. BB will monitor overall progress and oversee compliance with all covenants (for instance sustained compliance with respect to key criteria) that are executed as part of the participation arrangement that is executed with PFIs (a template of the participation arrangement will be included in the OM). The project audit will also conduct a sample review of on-lending by PFIs to end-beneficiaries (firms) or sub-borrowers.[23] The component is designed in line with Bank policy OP/BP 10.0 and the accompanying guidance note on financial intermediary lending.

37. Given its financial capacity and track record, BB is well positioned and has the capacity to implement the project and ensure compliance during implementation. Arrangements are in place to ensure adequate project implementation support, covering fiduciary and safeguards aspects, with annual audit of the processes and activities supported under the project.

[23] This will be included in the TOR of the project audit, captured in the OM.

38. *Implementation Arrangement for Component 4:* The FSSP Cell will be responsible for the implementation of Component 4.

## B. Results Monitoring and Evaluation

39. A strong M&E framework to systematically track inputs, outputs, and outcomes is integrated into the various components of the project, and has been discussed and agreed with BB (see annex 1).

40. The FSSP cell will establish standard formats with baseline information and data, guidelines for data collection, and report updates of M&E to the PSC. The FSSP cell will be responsible for overseeing and coordinating this process. The PSC will provide strategic policy guidance and oversight of the project implementation.

41. The World Bank will evaluate progress on the proposed indicators through regular reporting by the FSSP cell and through implementation support missions, including the midterm review. The mid-term review is expected to be in month 30 and assess implementation progress. The FSSP cell will submit quarterly reports, tracking output and outcome indicators, and semi-annual financial management reports. A project audit will be undertaken annually in line with the terms of reference included in the OM. In addition, a beneficiary feedback mechanism has been integrated into the project and will be monitored during implementation through an indicator on citizen engagement (see annex 1). The FSSP cell has been adequately staffed and resources allocated to ensure provision of the monitoring data (see component 4). An M&E specialist will be recruited for the FSSP cell on a short-term basis to help plan and initiate this work, while building capacity within the cell. Further details are provided in annex 4.

## C. Sustainability

42. The project's sustainability depends on a number of key factors, including (1) regular upgrades and development of financial market infrastructure; (2) BB's continued effort to modernize the financial sector's regulatory and supervisory framework; and (3) the project's success at demonstrating the potential of the long-term finance product and market segment to financial institutions. These factors have also been taken into account in the project's assessment and mitigation for risks in the long term. BB is committed to developing the financial market infrastructure as a public good and to strengthening its own capacity in line with financial sector requirements as demonstrated by the bold and effective steps that it has already taken with respect to successfully completing the modernization of the payment and credit information systems and implementing BASEL II. It is also committed to strengthening the regulatory and supervisory framework for the banking sector, as it has complied with the requirements of the IMF's Extended Credit Facility (ECF) program in this regard (including on prudential standards, establishing performance contracts with state-owned banks through memoranda of understanding). Regarding the credit line for long-term finance, the market survey confirmed the demand for such financing and the gaps or constraints in the supply side in meeting the demand. In addition, through efforts to improve the capacity of the banks and FIs and to develop the bond and pension markets and long-term deposit instruments, the credit line is likely to build long-term finance markets through a demonstration effect. The project design includes comprehensive TA in these areas.

## V. **KEY RISKS**

### A. Overall Risk Rating Explanation

43. Key risks have been identified and rated in the Systematic Operations Risk-Rating Tool presented above in the data sheet. The project's risks and all specific measures identified to reduce them were carefully assessed during preparation and appraisal. The overall project risk has been rated as moderate because of the strong record of the implementing agency to implement related projects using Bank guidelines, the ongoing strong preparation effort of BB, and the tested design of the project in successful operations in other countries (e.g., Egypt, India, and Jordan, among others). A critical factor that helps mitigate risks related to IT procurement in component 1, is BB's significant capacity in terms of a strong IT team, but also its experience and capacity on IT procurement aspects. This experience was built through the CBSP and helps mitigate risks related to component 1 on IT procurement.

44. The principal stakeholder risks come from a delay or reversal of policy commitment due to turnover of leadership at the central bank (the governor and the deputy governors). Nonetheless, since the project directly supports the GOB's and BB's priority agendas for financial sector development, as highlighted in the Sixth Five-Year Plan of the GOB and BB's Five-Year Strategic Plan, it is not anticipated that the government or BB would reverse its support for the objectives and activities proposed under the project. Furthermore, the proposed project is designed in close consultation with the concerned functional units or departments of BB, has entailed participation across levels of hierarchy at BB, and the activities planned under the project are fully owned by the concerned departments. These departments are authorized to initiate the policy recommendations needed for the effective implementation of the project.

45. Challenges faced by the country on different fronts can affect appetite to borrow and lend for long-term. This risk is considered moderate, given the high demand and unavailability of long-term credit and the nature of the support to build financial infrastructure and capacity. Economic projections established that the financial support provided through this project will be in high demand and will provide significant value added to manufacturing firms and exporters, including some SMEs. In addition, BB has a track record of effective implementation of credit-line projects as an on-lender and has staffed the PCU (FSSP Cell) with capable and qualified personnel for the implementation of the project, mitigating this risk significantly.

46. The operational capacity and the financial strength of the PFIs are instrumental to the success of the project. Weaknesses could undermine project implementation. However, a significant number of strong PFIs are in the market, and demand for funding from them has been strong. In addition, risk mitigation measures include a maximum amount of funding allocated to each PFI to contain overexposure risks. The TA being provided under the project would also help PFIs improve their portfolio quality and enable them to continuously meet the eligibility criteria for participation in the project. Strong coordination between BB and key partners (private and foreign commercial banks, nonbank financial institutions (NBFIs), and others) and counterparts (industry associations such as the Garment Manufacturing Exporters Association, or BGMEA; the Manufacturing Exporters Association, or BKMEA; and other manufacturers' associations, private firms, and SMEs, among others) will help smooth progress of component 3. Similarly,

complementary TA activities will help address market bottlenecks or capacity issues among project partners and participants.

## B. Governance and Accountability

47. BB has paid considerable attention to maintaining transparency in processes and decision making and ensuring access to information. The details of this proposed project will be available on BB's website (www.bangladesh-bank.org). Also, a detailed Governance and Accountability Action Plan (GAAP) has been prepared with the goal of strengthening management control over the project, reducing potential risks, and ensuring complete realization of project objectives. It has outlined specific responsibilities of BB to facilitate effective and appropriate use of the funds for the project and maintain good governance in the management and implementation of project activities. The key elements of the GAAP are: (i) measures to safeguard procurement and financial management, including developing Environmental and Social Risk Management Framework for the project in line with BB's ERM Guidelines, National Environmental Regulations, and IDA Environmental Policy Guidelines, (ii) measures to ensure coordination among different departments and between government and BB for effective implementation of the project, and (iii) measures to establish an efficient IT procurement management. A detailed GAAP is presented in annex 5.

# VI. APPRAISAL SUMMARY

## A. Economic and Financial Analysis

48. Significant economic benefit is expected to be derived from the project. The project will help improve the efficiency of the long-term credit market; develop the ability of banks to appraise and manage long-term loans, thereby enhancing profitable lending to viable manufacturing firms including some SMEs and reducing banks' NPLs; and develop the market for long-term finance, with positive impacts on growth, development, and employment creation, thus benefiting the manufacturing sector, specifically export firms, including some SMEs. Ultimately, through its economy-wide demonstration effect, the project is likely to generate benefits for a much larger number of banks, manufacturing firms, including some SMEs, with wider implications for growth and poverty reduction.

49. An attempt has been made to quantify the costs and benefits expected to accrue from the US$291.25 million financing support (credit line excluding the TA) to be provided to exporters and manufacturing firms. The net present value (NPV) and internal rate of return (IRR) are calculated from the net cash flow of the manufacturing firms, based on several assumptions and simulated over a variety of scenarios. To that purpose, an export sales profile of the manufacturing firms (RMG) that will avail credit has been developed along with an estimation of profit from sale proceeds. In the base case,[24] the NPV is estimated at US$306.36 million at a 12 percent discount rate, with a 49 percent IRR. The data and the assumptions are based on field research on the RMG sector. Further details are provided in annex 6.

[24] The base case refers to the most plausible scenario for the growth rate of the garment industry.

50. The project will also increase the stability of the financial sector, its ability to mitigate risks, and its efficient functioning by developing financial infrastructure and improving regulatory and supervisory capacity, thereby also strengthening financial institutions. Both financial market infrastructure and regulatory capacity have indeed witnessed increasing complexities and demands as financial markets have evolved. These, therefore, require significant investments and support that the World Bank project and implementation support will provide. Risk-based supervision will allow BB to better anticipate risk events, on a specific bank basis and on a systemic basis, before a crisis mode is triggered. Technology investments in hardware and in software (updates) and capacity building will result in tangible benefits, described in annex 6. Among expected benefits are a rapid shift of government payments to electronic means through a better integration of government payment systems and the national payments system; a dedicated network and Disaster Recovery Center for the financial sector, which will enhance the security and efficiency of financial transactions; a strong Financial Intelligence Unit with full compliance with the UN Security Council Resolution; effective monitoring tools and compliance management system for the regulator and supervisor; enhanced reliability, coverage, and usage of the CIB; and greater efficiency in the internal operations of the BB through the automation of several manual procedures.

*Rationale for public sector provision or financing*

51. Bangladesh's financial sector infrastructure and regulatory capacity need strengthening. In addition, there is a long-term financing gap, critical for investment and growth, which needs to be filled. Indeed, although there is currently a significant demand for long term financing by eligible and bankable firms, supply has not been matched by the market, and by private provision. Only 30-35 (of the 6,000) firms received dollar based long term financing in the year 2014[25]; most firms were large in size and the average loan size was close to US$15 million per firm. In contrast the project aims to focus on mid-sized firms with a loan size nearly a tenth of what is evidenced in the shallow market currently, thereby likely, catering to firms who have not received any such long term financing support thus far, while also enhancing the supply of such financing. Market analysis and discussions with stakeholders and market participants show that one of the major impediments to the expansion of long-term financing supply is the absence of supply of such resources. Part of the problem is the absence of long-term deposit instruments in the financial institutions, and which the project seeks to address through various technical assistance to develop long-term deposit instruments and the pension market (component 3). Information asymmetries and banks' lack of capacity and risk aversion, which further exacerbates the limited supply of long term finance, will also be tackled through the sector wide technical assistance under component 3. The use of public funds for the credit line under the project is an integrated part of the project's catalytic role. Through demonstration effects, it will build financial market experience in long-term funding and "crowd in" private provision of long-term finance to meet the investment needs of firms. The demonstration effect, combined with the technical assistance to develop long-term bond markets, can support the creation of new financial instruments.

[25] As discussed earlier, significant portion of this funding was financed by banks, which borrowed short term, but lent long term, incurring an asset liability mismatch in the process.

52. Public intervention is therefore needed to ensure these areas are addressed so that the financial sector is better able to support the GOB's vision 2021 for growth and poverty reduction (see details in annex 6).

*Value added of Bank's support*

53. The World Bank has played a leading role in the development of the financial sector in Bangladesh. The Bank has been a long-term partner to the authorities on financial sector policy dialogue and to all the relevant stakeholders (including bankers, bank associations' leaders, and other development organizations). This is illustrated by several projects, including the CBSP and the ongoing IPFF, as well as several technical assistance projects to BB. During implementation (see annex 7 for implementation support plan), the World Bank will leverage its broad and deep international experience on the four components of the project (including on new technical areas such as Islamic Finance under component 3; see annex 8). In addition to funding assistance, the implementation support, technical oversight, and inputs from the Bank will benefit the country's own capacity to implement projects. Further details are provided in annex 6.

54. A financial review of several commercial banks that are representative PFIs candidates was conducted. It indicated that these (potential) PFIs meet the eligibility criteria on profitability, capital adequacy, asset quality, and liquidity, under the World Bank OP 10.0 on Financial Intermediary Financing. The reliability of financial information reports is high, and the overall quality and independence of banks' and BB are good. All these institutions have well-developed internal practices, and overall performance is in line with the requirements of Bank lending. Being listed institutions, the banks report quarterly financial results apart from detailed annual audits. The quality of audited statements is good for all institutions. In terms of financial reporting to the project, no issues are foreseen, though for some monitoring indicators PFIs would need to develop or adapt their internal systems (see more details in annex 6).[26]

## B. Technical

55. The overall project is appraised as *viable*. The components incorporate (1) developing key financial market infrastructure, an important public good for the efficient functioning of financial market, through benchmarking against international best practices and standards; (2) strengthening the capacity of the regulator to comply with international standards and accords (Basel) on banking sector supervision and regulation; (3) serving as a catalyst for building a market for long-term finance, a segment where no such funding currently exists nor is likely to develop organically in the near term; and (4) leveraging the Bank's experience with similar projects in other countries.

56. The design of c*omponent 1: Strengthening financial market Infrastructure* is appraised as viable, based on numerous assessments and analytical findings by the Bank, BB, and other donor agencies.[27] These studies have been unanimous in their findings: that Bangladesh needs to further

[26] The capacity of individual PFIs to undertake monitoring and evaluation of sub-loans would be assessed as part of the PFIs' eligibility appraisal by BB.
[27] For example, the 2009 FSAP, the assessment of the payment and settlement systems in 2010 and 2013; the survey on electronic payments conducted by IFC in 2013; the review of the credit reporting systems by IFC and DFID in 2014; AML/CFT Mutual Evaluation Report adopted by the APG in July 2009 and FATF/ICRG Plenary observations/report on Bangladesh's significant progress in February 2014.

develop its financial market infrastructure to facilitate a stable and efficient financial system and that BB—as the only credible and available provider of such facility in the country—needs to build on the existing payments and remittance systems, centralized credit system, securities settlement system, and a compliant and integrated financial intelligence system, all of which are now currently managed by BB. The component is a follow-on for next-phase development efforts, given that the basic platform for these systems has already been developed by BB with the support of donors, including the Bank, the Asian Development Bank, and the Department for International Development of the United Kingdom. In the past few years, the information and communication technology (ICT) assets under the management of the BB has increased rapidly, and the BB now needs to undertake critical steps to enhance the operational reliability of the systems and ensure that these systems remain state of the art. In addition, the BB needs to enlarge its capacity to manage and ensure sound governance of its ICT assets. To maintain the overall integrity of the financial system, the proposed program will foster greater integration among components of the financial infrastructure and also with external systems like the government's financial architecture.

57. *Component 2: Strengthening the financial sector regulator* is appraised as highly viable as it builds on previous efforts, including those under the Bank-funded CBSP and the IMF's TAs in this area, and it supports BB in complying with the international standards for banking sector regulation and supervision and Basel accords for regulation. This was one of the key recommendations of the last Financial Sector Assessment Program (FSAP 2009–10), and there is a common understanding in the market and among the other key stakeholders that the capacity of BB must continue to strengthen to meet the ever-growing complexity and evolution of financial markets and the increasing stresses on Bangladesh's financial sector (reflected in rising NPLs, a capital shortage, financial sector irregularities and scams, and the like) which pose risks to stability. This component also supports innovative and inclusive financial market development activities, focusing on specific areas that have received little attention.

58. The design of c*omponent 3: Supporting long-term finance* is appraised as viable, as it supports a well-established pattern of BB intervention, in which it demonstrates the potential of long-term finance products and market segments and provides immediate access to long-term funding to the manufacturing and export sectors, which currently cannot get such funding from the market. The project design involves addressing the long-term financing and development problem from both the supply and the demand sides. It tackles the immediate challenge of kick-starting bank financing to manufacturing firms. In addition, the project addresses the longer-term challenge of improving the underlying policy, regulatory, and institutional framework (through the TA component). The approach is comprehensive in its coverage. Different elements of the multipronged approach of this project have been successfully tested internationally in other projects to promote access to finance, in particular for SMEs. The component is designed in line with Bank policy OP/BP 10.0 and the accompanying guidance note on financial intermediary lending. The component's design also has wide consensus, as it is based on extensive consultations with the manufacturers and exporters (and their associations), banks and NBFIs, BB, the GOB (Ministry of Finance), and other stakeholders.

## C. Financial Management

59. As an implementing agency, BB has had adequate experience in following Bank procedures for project fund management as evidenced in past (CBSP) and on-going (IPFF)

projects. Further based on an updated assessment, overall experience on managing the fund flow of projects is considered satisfactory, and the associated risk in this area is also considered low. The relevant financial management (FM) officials of the implementing agency, BB, have had sufficient hands-on experience of working on IT systems such as the Client Connection. They have prior experience of the Bank's disbursement procedures and arrangements, and FM staff members are conversant with the prerequisites of financing agreements or grants agreements especially, on aspects such as cost category and eligibility of expenditures. The overall accounting and financial reporting environment of the implementing agency is considered satisfactory, and the assessed associated risk in this area is considered low. BB has adopted acceptable national and international accounting standards and written policies and procedures covering all routine accounting and related administrative activities. It has qualified and experienced staff, and the chart of accounts is adequate to properly account for, and report on, all project activities. The accounting and reporting system is computerized and is adequate to perform all required project activities in a timely manner.

### D. Procurement

60. The fiduciary assessment indicates a "substantial" risk in procurement administration. Risks are due mainly to the challenges of implementing a significant number of IT contracts following international competitive bidding (ICB) methods in a timely manner. Internal control, documentation, information dissemination, contract administration including delivery follow-up, payments, complaints handling, and the like also need to be strengthened for IT procurements. However, a large portion of the project fund will be used under component 3 through PFIs following commercial practices where the private sector has already gained reasonable experience over time. In addition, BB has been operating similar types of projects (credit line) of different donors. However, for this particular operation PFIs will require adequate skilled staff to manage procurement in line with the OM, as well as additional training on commercial best practices following the Bank's guidelines. Several measures will need to be introduced to minimize procurement risks during project implementation, as described in annex 4.

61. A draft procurement plan covering all major procurement has been prepared for the entire duration of the project. This plan will be agreed upon between BB and the Bank during negotiations and be made available on the Bank's external website. The procurement plan would subsequently be reviewed and updated semi-annually in consultation with the Bank. The Bank's review of selected contracts would be determined on the basis of estimated value thresholds, which may be revised upward as procurement performance improves.

### E. Social (including Safeguards)

62. The project will provide firms with financing to upgrade equipment and health and safety standards, as well as to expand existing factories. However, all expansion activities will be limited to the owner's own existing property or designated industrial zones or commercial areas/buildings. No forced land acquisition or displacement of people (physical or economic) will be permitted under the project. The project aims to enhance efficiency in manufacturing and management by allowing investment in new technologies. Any adverse social impacts on livelihoods will be mitigated through the implementation of tailored mitigation measures incorporated in the Environmental and Social Management Framework (ESMF).

63. The ESMF will be the basis for conducting all social screenings, assessments, and management plans as appropriate. The social framework relevant to this project will be those elements related to the labor standards. It will essentially include guidance on (1) social screening of existing facilities and the proposed investment; (2) assessment of proposed investment (for high-risk subprojects) in terms of social risks; (3) stakeholder analysis, consultation and communication, and disclosure; (4) labor and working conditions; (5) gender; (6) grievance and complaint handling mechanism; (7) preparation of social management plan (SMP) with budgeting; (8) implementation and supervision of SMP; and (9) reporting and quality control. The screening of the existing facilities will examine the current labor and working conditions and practices of the firm.

64. BB has reasonable experience in implementing the environmental and social management framework of IDA-funded projects. The Green Banking and Corporate Social Responsibility Department, although very lean in structure, has gained reasonable experience in promoting environmentally sustainable financing in manufacturing sectors. A safeguards specialist will be hired in BB and will be part of the FSSP Cell. For PFIs, capacity support will be provided to further enhance their skills in this area, and a TA consultant for environmental and social management will be on board from the inception of the project. Third-party monitoring will be undertaken as part of the project audit for which the terms of reference have been identified in the OM/ESMF.

### F. Environment (including Safeguards)

65. The project will support long-term financing for purposes of capital equipment purchase for new and existing enterprises, upgrading (including improving health and safety compliance), and expansion of the existing firms. In addition, the project support includes providing technical assistance for capacity building in PFIs and industry associations and strengthening financial market infrastructure and the financial sector regulator. The project is not aimed at supporting large-scale infrastructure. The project investment intends to help the manufacturing sectors improve factory conditions to meet the requirements of buyers and national regulatory agencies. The project will also provide capacity building TA to PFIs on safeguard management.

66. The project activities are not expected to cause any long-term or irreversible environmental impacts. The project has been classified as Category FI since the financing to the manufacturing sectors will be channeled through PFIs. The Bank environmental safeguard policy OP/BP 4.01 Environmental Assessment has been triggered to ensure that the project design and implementation focus on reducing adverse impacts and enhancing positive environmental impacts.

67. Since subprojects will be identified during the project implementation phase, as discussed above, a framework approach has been adopted for the project. The ESMF prepared for the project meets the requirements of Bangladesh’s Department of Environment and the World Bank Environmental Safeguard Policy. The relevant Environmental, Health, and Safety Guidelines of the World Bank Group will also be applicable to the project. In addition, the ESMF is prepared in line with the Environmental Risk Management (ERM) Guidelines of BB, which were issued in 2011 as a mandatory requirement for all scheduled financial institutions. The ERM Guidelines are being reviewed now; with support from IFC and BB is scheduled to issue the new ERM Guidelines by June 2015.

68. The ESMF has been prepared based on the following: (1) the environmental and social management system diagnostic report (prepared by IFC) of two leading banks; (2) the quick assessment of the environmental issues in the manufacturing sectors; (3) the stakeholder consultations during project preparation; and (4) identification of the institutional barriers and capacity building needs for environmental management. The Bangla version of the draft ESMF document has been disclosed both in the BB website (www.bangladesh-bank.org) and the Bank's Infoshop on March 18, 2015 and March 23, 2015 respectively. Hard copies of the document have also been made available in BB and potential PFIs. The disclosure notification has been published in one Bangla and one English daily newspaper. BB also organized a workshop on draft final ESMF on March 23, 2015. Final versions of the ESMF were disclosed in –country on BB website on April 2, 2015 and in Infoshop on April 6, 2015.

69. The ESMF will be the guiding document for the specifics of each subproject: (1) environmental screening of existing facilities and proposed investments; (2) assessment of proposed investments (for high-risk subprojects); (3) consultation and disclosure; (4) preparation of the environmental management plan (EMP) with budgeting; (4) implementation and supervision of EMP; and (v) reporting and quality control. The screening of the existing facilities will examine the current environmental conditions and practices of the industries. Apart from a safeguards specialist hired at BB, a consulting firm will be available for capacity building, guidance, and support to PFIs during implementation. In addition, independent third-party monitoring of the project will include the provision of the environmental specialist on the audit team and will monitor compliance of the environmental management issues in the project.

**Annex 1: Results Framework and Monitoring**
**BANGLADESH : Financial Sector Support Project**

## Results Framework

**Project Development Objectives**

**PDO Statement**

**The project development objective is to improve financial market infrastructure, regulatory and oversight capacity of Bangladesh Bank, and access to long-term financing for private firms in Bangladesh.**

| **These results are at** | Project Level |
|---|---|

**Project Development Objective Indicators**

| Indicator Name | Core | Unit of Measure | Baseline | Cumulative Target Values | | | | | Frequency | Data Source/ Methodology | Responsibility for Data Collection |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | YR1 | YR2 | YR3 | YR4 | End Target | | | |
| Percentage of Government Payments by value processed through electronic means (annual) | ☐ | % | 10% (September 30, 2014) | 10% | 15% | 25% | 30% | 40% | Annual | FSSP cell | FSSP cell |
| High level of operational reliability as measured by improved compliance of BB with the Principle 17 of the Committee of Payment and Settlement Systems (CPSS) – International Organization of Securities Commissions (IOSCO) Principles for Financial Markets Infrastructure ) | ☐ | Text | Not observed (September 30,2014) | Not observed | Partially observed | Partially observed | Broadly Observed | Observed | Annual | Peer reviewed self-assessment | FSSP cell |
| Certification of the BB against ISO270001 and COBIT | ☐ | Text | No | Stocktaking of current situation and capacity building | Self-assessment | Action plan to address gaps and implementation | Implementation of action plan | Final certification | Annual | FSSP cell and external assessment | FSSP cell |
| Performance on BCP assessment: Number of principles on which BB is judged as largely compliant and compliant. | ☐ | Number | 4 (2009) | 4 | 6 | 8 | 10 | 12 | Annual | Independent review | FSSP cell |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Outstanding FX Long term loans of PFIs | ☐ | US $ million | TBD (September 30,2014) | 75 | 150 | 240 | 400 | 550 | Annual | FSSP cell | FSSP cell |

**Intermediate Results Indicators**

| Indicator Name | Core | Unit of Measure | Baseline | Cumulative Target Values | | | | | Frequency | Data Source/ Methodology | Responsibility for Data Collection |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | YR1 | YR2 | YR3 | YR4 | End Target | | | |
| Observance the General Principles of Credit Reporting Systems. | ☐ | Text | To be assessed – Expected to be Partial Observance (September 30, 2014) | Partial Observance | Partial | Broadly Observed | Broadly Observed | Broadly Observed | Annual | Self-Assessment by the BB, using the Assessment Methodology for the General Principles. Peer Review of the self-assessment in year 2 and year 4. | FSSP cell |
| Uptime of the core systems of the BB: core banking, payment systems, credit reporting system, and MI module | ☐ | Percentage | 95% | 95% | 95% | 96% | 97% | 98% | Annual | FSSP Cell | FSSP Cell |
| Cumulative number of BB banking supervision officers trained on risk-based supervision | ☐ | Number | 0 (September 30, 2014) | 0 | 100 | 200 | 300 | 500 | Bi-annual | FSSP cell | FSSP cell |
| Circular on prompt corrective action issued by BB | ☐ | Text | No (September 30, 2014) | Analysis conducted | Draft prepared | Issued | NA | NA | Annual | FSSP cell | FSSP cell |
| Publication and dissemination of study on Warehouse receipt financing in Bangladesh | ☐ | Text | No (September 30, 2014) | Study initiated | Analysis conducted | Study Completed | Study Published and Disseminated | NA | Annual | FSSP cell | FSSP cell |
| Financial inclusion strategy drafted and approved | ☐ | Text | No (September 30, 2014) | Study initiated | Analysis conducted and strategy drafted | Strategy approved | Strategy Published and Disseminated | NA | Annual | FSSP cell | FSSP cell |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Direct project beneficiaries (firms) | ☒ | Number | 0 (September 30, 2014) | 50 | 114 | 178 | 238 | 250 | Annual | FSSP cell | FSSP cell |
| NPLs in project-funded in foreign-denominated long-term finance portfolio | ☐ | Percentage | 0 (September 30,2014) | 10 | 9 | 8 | 8 | 7 | Annual | FSSP cell | FSSP cell |
| Number of PFIs | ☐ | Number | 0 (September 30, 2014) | 3 | 4 | 6 | 8 | 10 | Annual | FSSP cell | FSSP cell |
| Publication and dissemination of two analytical and policy research papers on the development of long-term capital markets and on the pensions market | ☐ | Text | No (September 30, 2014) | Studies Initiated | Analyses conducted | Studies Completed | Studies Published and Disseminated | NA | Annual | FSSP cell | FSSP cell |
| Cumulative number of FI officers receiving training or attending workshops on risk management, safeguards, and commercial practices in procurement | ☐ | Number | 0 (September 30, 2014) | 9 | 18 | 30 | 36 | 45 | Bi-annual | BBTA, FSSP cell | FSSP cell |
| Cumulative number of Training Of Trainers (TOT), awareness campaigns and workshops delivered to industry associations on safeguards and health and safety | ☐ | Number | 0 (September 30, 2014) | 0 | 16 | 32 | 48 | 64 | Bi-annual | Industry associations/ FSSP cell | FSSP cell |
| Direct project beneficiaries (firms and PFIs) that feel project financing reflected their needs | ☐ | Percentage | 0 (September 30, 2014) | 75 | NA | 75 | NA | 75 | Annual | FSSP cell | FSSP cell |

## Description of the Indicators

| Project Development Objective Indicators | |
|---|---|
| **Indicator Name** | **Description (indicator definition, methodology for assessment etc.)** |
| 1. Percentage of Government Payments by value processed through electronic means | This indicator measures the percentage of the total Government payments - revenue collections, receipts for Government savings programs like *Sanchay Patra* and expenditures (including social benefit transfers) by value, made electronically. A Government payment is defined as being made electronically, where the payer and the payee both make and receive the payment from/to a bank account or an account at a regulated institution; and, the instruction is issued electronically. The data on the total value of Government payments is available with the Bangladesh Bank as it maintains the accounts of the Government. A Government payment is defined as being made electronically, where the payer and the payee both make and receive the payment from/to a bank account or an account at a regulated institution; and, the instruction is issued electronically. The Bangladesh Bank will establish a mechanism of collecting information from the National Revenue Board on the payment mechanisms used for the revenue receipts; collect information from the payment systems operated by the Bangladesh Bank on the value of Government payments processed by them; and, collect information from Sonali Bank which handles some Government payments. |
| 2. High level of operational reliability as measured by improved compliance of BB with the Principle 17 of the Committee of Payment and Settlement Systems (CPSS) – International Organization of Securities Commissions (IOSCO) Principles for Financial Markets Infrastructure (PFMI) | There is an established methodology for assessing against the CPSS-IOSCO PFMI. The assessment methodology establishes certain key requirements like: (i) development of a business continuity plan; (ii) periodic testing; (iii) participation of all stakeholders in the business continuity testing; (iv) achievement of a recovery time objective of 2 hours; (v) governance arrangements for monitoring and overseeing the overall business continuity planning and operational risk management framework; (vi) stress testing of the IT infrastructure etc. These are documents in the Assessment Methodology for the CPSS-IOSCO PFMI's publication and this is extensively used in Financial Sector Assessment programs (FSAPs).<br>The standard as a whole will be applied by the Bangladesh Bank Payment Systems department (PSD). The PSD is being trained on these standards, as part of ongoing TA program. The BB PSD will prepare a self-assessment against the standards and these will be reviewed both by the World Bank peer reviewers and peers from central banks in the SAARC region, as part of activities under the SAARC payments council. |
| 3. Certification of the BB against ISO270001 and COBIT | These are widely used international standards with established toolkits and methodologies for assessment and several IT consulting companies specializing in providing consultancy to conduct assessments and address gaps. There are also accredited institutions that can conduct assessments and provide certification. The Bangladesh Bank will engage a consulting company for providing guidance on implementing these standards and towards the end of the project – engage an accredited agency for conducting the assessment. |
| 4. Performance on BCP assessment: Number of principles | The Core Principles for Effective Banking Supervision, also referred to as the Basel Core Principles (BCPs) are the de facto standard for sound prudential regulation and supervision of banks and banking systems. The BCPs are used as a benchmark for assessing the quality of a country's banking legal, regulatory and supervisory frameworks and |

| | |
|---|---|
| on which BB is judged as largely compliant and compliant. | its day-to-day banking supervision. The BCPs are required to be assessed by experts with the appropriate knowledge, skills and experience. The BCPs are used by the IMF and the World Bank in the context of the FSAP. The assessment will be an independent review carried out by an international banking regulation and supervision specialist/s, such as a World Bank peer-reviewer who is well-versed in undertaking BCP assessments. The BCPs are assessed using a four-grade scale: compliant, largely compliant, materially non-compliant, and non-compliant. A not applicable grading can be used in certain circumstances. The description of the various possible gradings and their applicability is as follows:<br>- Compliant – A country will be considered compliant with a particular BCP when all essential criteria applicable to the country are met without any significant deficiencies. There may be instances where a country can demonstrate that the particular BCP has been achieved by other means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the particular BCP, and therefore other measures may also be needed in order for the particular aspect of banking supervision addressed by the particular BCP to be considered effective.<br>- Largely compliant – A country will be considered largely compliant with a particular BCP whenever only minor shortcomings are observed that do not raise any concerns about the authority's ability and clear intent to achieve full compliance with the particular BCP within a prescribed period of time. The assessment largely compliant can be used when the system does not meet all essential criteria, but the overall effectiveness is sufficiently good, and no material risks are left unaddressed.<br>- Materially non-compliant – A country will be considered materially non-compliant with a particular BCP whenever there are severe shortcomings, despite the existence of formal rules, regulations and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. It is acknowledged that the "gap" between largely compliant and materially non-compliant is wide, and that the choice may be difficult. On the other hand, the intention has been to force the BCP assessors to make a clear statement.<br>- Non-compliant – A country will be considered non-compliant with a particular BCP whenever there has been no substantive implementation of the particular BCP, several essential criteria are not complied with or supervision is manifestly ineffective.<br>- Not applicable – A particular BCP will be considered not applicable when, in the view of the assessor the particular BCP does not apply given the structural, legal and institutional features of a country. |
| 5. Outstanding FX Long term loans of PFIs | This indicator measures the total outstanding (i.e. not yet repaid or written off) amount of foreign exchange long term loans of PFIs portfolio. Long term loans are defined as loans with original maturity exceeding 3 years. |

| Intermediate Results Indicators | |
|---|---|
| **Indicator Name** | **Description (indicator definition, methodology for assessment etc.)** |
| 1. Observance the General Principles of Credit Reporting Systems. | These guidelines are managed by the World Bank with the support of an International Committee on Credit Reporting (ICCR). There is an existing publication on conducting assessments. The World Bank will provide TA to the Bangladesh Bank on applying the general principles and will leverage the ICCR to conduct a peer review of the self-assessment. |
| 2. Uptime of the core systems of the BB: core banking, payment systems, credit reporting system, and MI module | The aggregate downtime as a percentage of the total operating hours of the particular application is used to capture the uptime of a particular application. A simple average of all the uptimes of the critical applications is used to arrive at the consolidated uptime of all the critical business applications of the Bangladesh Bank. A downtime is defined as the period, when the business users of the application are unable to use the application or the system is unable to process its internal activities like end of day processing. The downtime is calculated at the overall infrastructure level for the particular business application – so even when the cause of the downtime is related to communications failure, it is to be included in the downtime.<br>The Bangladesh Bank would be required to maintain a record of duration of downtimes of the critical applications. This will also be cross-checked with logs from the system monitoring tools. |
| 3. Cumulative number of BB banking supervision officers trained on risk-based supervision | This indicator measures the cumulative number of BB banking supervision officers trained on risk-based supervision. One of the objectives of the project is to transition BB banking supervision officers fully from the current compliance- and rules-based system of banking supervision to a system of banking supervision which is based on the concept of risk-management. To this end, it is imperative that all banking supervision officers be trained over time on risk-based supervision. |
| 4. Circular on prompt corrective action issued by BB | Compliance with certain prudential requirements is, and in future will remain, an indispensable part of banking supervision. To ensure that banks comply with such prudential requirements, a system of enforcement and sanctioning must be encapsulated into the banking legal and regulatory frameworks, which system the supervisor thereupon is required to apply. An important component of this system is a prompt corrective regime, which consists of prescribed graduated indicators of increasing severity of non-compliance matched to graduated enforcement actions and/or sanctions of increasing severity which the banking supervisor is obliged to apply. Accordingly, the banking supervisor does not have discretion whether or not to apply the prompt corrective action regime. |
| 5. Publication and dissemination of study on Warehouse receipt financing in Bangladesh | This indicator tracks the progress of the study on Warehouse receipt financing in Bangladesh, including its publication and dissemination. |
| 6. Financial inclusion strategy drafted and approved | This indicator monitors the development of the comprehensive national financial inclusion strategy including its approval, publication and dissemination |
| 7. Direct project beneficiaries (firms) | This indicator measures the total number of private firms beneficiaries of FX long term loans under the Line of Credit |

| | |
|---|---|
| 8. NPLs in project-funded in foreign-denominated long-term finance portfolio | This indicator measures portfolio quality of the PFIs' sub-loans funded by the Line of Credit |
| 9. Number of PFIs | This indicator measures the total number of PFIs under the Line of Credit |
| 10. Publication and dissemination of two analytical and policy research papers on the development of long-term capital markets and on the pensions market | This indicator assesses the progress on the analytical and policy studies on the development of the long term capital markets and on the pensions market in Bangladesh, including their publications and disseminations. |
| 11. Cumulative number of FI officers receiving training or attending workshops on risk management, safeguards, and commercial practices in procurement | This indicator measures the total number of Financial Institutions' officers receiving training or attending workshops on risk management, safeguards, and commercial practices in procurement |
| 12. Cumulative number of Training Of Trainers (TOT), awareness campaigns and workshops delivered to industry associations on safeguards and health and safety | This indicator measures the total number of Training Of Trainers (TOT), awareness campaigns and workshops delivered to industry associations on safeguards and health and safety |
| 13. Direct project beneficiaries (firms and PFIs) that feel project financing reflected their needs | This indicator measures the percentage of project beneficiaries surveyed, including SIDBI and PFI officials that express that project financing reflected their needs. The beneficiary survey will be conducted three times during implementation: at the end of the first year of the project, to construct a baseline; at mid-term and at project's closing date. The main purpose will be to obtain regular feedback from beneficiaries on the project financing and also to capture data related to gender and employment. |

**Annex 2: Detailed Project Description**

**BANGLADESH: Financial Sector Support Project**

A2.1. The proposed project will have four components, and the costing details are presented in the Table 1 below.

**Table 1 - Costs by component**

| Sub-Component # | Description | Total Financing (US$) |
|---|---|---|
| Component 1: Strengthening Financial Market Infrastructure | | |
| | Total for Component 1 | 50,000,000 |
| Component 2: Strengthening Capacity of the Regulator | | |
| | Total for Component 2 | 5,000,000 |
| Component 3: Supporting Long-Term Finance | | |
| 3.1 | Refinance Facility for Long-Term Credit | 291,250,000 |
| 3.2 | TAs to Develop the Long-Term Finance Market | 1,250,000 |
| | Total for Component 3 | 292,500,000 |
| Component 4: Project Implementation and Monitoring | | |
| | Total for Component 4 | 2,500,000 |
| **Contingencies (physical and financial) are built in to the component cost** | | **-** |
| **Total Project Cost** | | **350,000,000** |

The following sections describe in detail the components and subcomponents of the project.

**Component 1: Strengthen Financial Market Infrastructure**

A2.2. Component 1 will build on previous efforts, including those under the Central Bank Strengthening Project (CBSP), and improve financial market infrastructure further, specifically focusing on the following four broad areas: (1) payment and settlement system development; (2) expansion and modernization of the Credit Information Bureau; (3) strengthening of the Bangladesh Financial Intelligence Unit's systems and their integration into systems of other stakeholders; and (4) improvements in BB's IT governance and management, optimization of BB's IT assets, and an emphasis on aspects of IT security for the financial industry. The project will support BB's investments to strengthen financial market infrastructure by: (1) enabling a large-scale shift to electronic payments in Bangladesh in general and of government payments in particular, thereby enhancing the efficiency of the financial system; (2) enhancing coverage of the Credit Information Bureau by including credit information on the microfinance sector and reliability of the credit reporting system thereby leading to better credit risk management; (3) increasing the effectiveness of the BFIU, thus leading to improved safety and integrity of the financial system;; (4) increasing the reliability and robustness of BB's IT systems; and (5) supporting capacity building of the BB staff in these and related areas.[28]

A2.3. The specific activities for which funding is proposed are listed below. BB has detailed the costing of the activities (procurement packages) based on available market information. BB

[28] Parallel technical assistance is provided by the World Bank on strengthening the Secured Transactions Registry. Discussions are ongoing with the Ministry of Finance and Bangladesh Bank.

has also prepared the technical design and bid documents for the different activities (procurement packages) as part of its project preparation.

A2.4. *Payment and Settlement System Development:* The project will support the following specific activities:

a. Enhancement of the Bangladesh Electronic Funds Transfer Network (BEFTN) component of the Bangladesh Automated Clearing House to support multiple clearing and settlement cycles from the current once a day cycle that would enable moving from T+2[29] settlement to T+0.
b. Implementation of a payment gateway to enable acceptance of electronic payments by BB for government collections and subscription to savings instruments – *Sanchay Patra*, Wage Earners Bond etc.
c. Enhancements to the National Payment Switch to support migration to Europay Mastercard Visa (EMV) and other relevant standards for chip cards and interoperability for mobile payments and ecommerce payments.
d. Automation of the processes related to development funds like the Exporters Development Fund and Equity Entrepreneurship Fund managed by the BB. This would also include automation of the processes relating to the proposed long-term credit facility proposed in component 3 of this project.
e. Upgrading of hardware and platform software to the most current versions for BB's various business applications to ensure continued warranty and support coverage by its suppliers.
f. Increasing hardware capacity for specific business applications like the Bangladesh Automated Cheque Processing System (BACPS).

A2.5. *Expanding and modernizing the Credit Information Bureau:* The project will support replacement of the CIB application with an in-house application under development to address very high annual maintenance expenses and charges for ad hoc changes related to business needs and also enhance the scope of the CIB to include credit information pertaining to the microfinance sector.

A2.6. *Strengthening the systems of the Bangladesh Financial Intelligence Unit and integration with systems of other stakeholders:* This activity will support implementation of specific applications related to operations of the BFIU like development of a Dash Board (central monitoring system) as a tool for monitoring the automated UN Sanctions List; GoAML (an Anti-money laundering system already in use in BB) customization and maintenance; procurement of necessary hardware and platform software, including procurement of supervisory software; a separate database for foreign currency transactions; monitoring software; a database for nongovernmental organization regulators; and software for audits of IT systems of banks and financial institutions.

A2.7. *Strengthening the IT governance and management of BB:* The following activities will be supported:

a. Outfitting of a new data center at another location. This would have a different risk profile from the current data centers in Mirpur and Dhaka, both of which have similar risk profiles due to their close proximity. This new data center would serve as a disaster recovery center for mission-critical applications like the core banking system, BACPS, BEFTN, National Payment Switch and the upcoming Real-Time Gross Settlement (RTGS) system.

[29] The funds settlement between banks occur on T+1, but funds are credited to recipients account on T+2.

b. Reorganization of the deployment of applications to leverage all the data center facilities—Dhaka, Mirpur, and the proposed one in the other location. The Dhaka and Mirpur data centers would serve as a primary and near-site “hot” backup site for mission-critical applications to allow for a very short recovery time and zero data loss in case of a localized failure in the Dhaka data center. Other non-mission-critical applications would be deployed across the three data center facilities. This would involve implementation of additional data replication, system management, network management applications, and hardware.
c. Deployment of a new dedicated network—FinNet—to connect all the banks, financial institutions, BB, and other stakeholders. FinNet would allow secure and reliable data exchange among these institutions for participation in the various business applications operated by the BB—BACPS, BEFTN, National Payment Switch, CIB, core banking, BFIU data reporting, the market infrastructure module, and the Enterprise Data Warehouse.
d. Implementation of IT governance and risk management best practices and certification of IT operations according to prevailing international standards.
e. Skills upgrades of the BB staff on information security, IT management, IT audits, and specific application domains.
f. Industrywide initiatives to spread awareness of aspects of information security.
g. Funding for hiring individuals and firms to provide technical advisory services for specific areas related to the above activities.

A2.8. Capacity building of BB staff in financial infrastructure covered in component 1 and related areas would include financing the engagement of consultants to assist in implementing the component and the provision of training and guidance to the BB staff on relevant international standards and best practices. Staff would also receive internationally recognized certifications and accreditations in these areas. A detailed technical study on assessing the automation and modernization needs of state-owned banks would also be undertaken.

**Component 2: Strengthening the Capacity of the Regulator**

A2.9. Bangladesh Bank would like to review its current system of banking supervision and consolidate and streamline its eight supervisory departments. It has determined that it is ready to migrate to a risk-based approach to regulation and supervision in the discharge of its responsibility to ensure a safe and sound banking system and enable BB to pursue its mandate more effectively and efficiently.[30] Risk based Integrated Supervisory System (RISS) would involve changing bank governance, ensuring accuracy of financial statements, improving internal audits, enhancing supervisory capacity and resources and conducting high-level banking sector analysis (see note of risk based supervision in Box 1).

A2.10. The project will provide technical assistance toward developing and adopting of the comprehensive risk-based integrated approach to banking regulation and supervision, which would include related documentation and training.

[30] The risk-based approach was also recommended under the Bangladesh Contingency Planning Project in its final report of March 2, 2011.

**Box- 1 –Risk Based Approach to Regulation and Supervision**

The risk-based approach to supervision is used in a number of supervisory agencies and focuses on the supervisory perspective and its implications for the banks and their operations. Recognizing that a rigid, rules-based approach to supervision can result in a reactive response to events that have already taken place, the risk-based approach moves the supervisory process toward one that is more anticipatory. It encourages banks to develop efficient risk management and control processes that identify and measure risk exposures and trigger management and board responses before the risk develops into a loss event. Thus, under the risk-based approach, the bank boards and management are required to be fully aware of the risks that their banks are taking and are held responsible and accountable for ensuring that the operations of their banks are safe and sound. It requires the banks to establish systems for ensuring that adequate capital is held against their individual risk profiles. When fully engaged, the risk-based approach allows the supervisor to monitor individual banks and systemic risks, assign required capital on a bank-by-bank basis, and react accordingly, thereby allocating supervisory resources to areas of greatest concern. It also allows the supervisor to better anticipate risk events on a specific bank basis and on a systemic basis before a crisis mode is triggered.

A2.11. The RISS places special importance on corrective and remedial powers, which are indispensable to a banking regulatory and supervisory authority in pursuit of financial stability and a safe and sound banking sector. The project will in that light provide technical assistance to BB to develop a corrective and remedial action policy, including a prompt corrective action policy. Such policy would contain a graduated approach with the severity of the supervisory response correlated to the gravity of the situation. Accordingly, the supervisory authority would take into account a bank's risk-based ratings, capitalization, liquidity position, asset quality, earnings, governance, risk management, internal controls, and compliance with legal, regulatory, and supervisory prescriptions. Support will also be provided to review and strengthen prudential regulations.

A2.12. The migration to a risk-based approach to regulation and supervision is a major reform that involves not only substantive changes in policies, procedures, and practices but also a major change in the behavior, culture, and mindsets of the regulator and the regulated. It is, therefore, a long-drawn-out process that involves all stakeholders and requires a combination of several dedicated initiatives, innovations, lasting efforts, and substantial resources. This project will act as the catalyst to initiate the required reforms and provide the expertise and resources for implementation. However, it should not be assumed either that the full and complete migration to RISS will be achieved by the closing date of this project or that the work begun under the project will end by that date. For the most effective and efficient results, the work must continue as the behaviors and procedural changes adapt to changing circumstances.

A2.13. *Strengthening of the Financial Intelligence Unit:* The BFIU, as the central agency on AML/CFT in Bangladesh run by BB, will anchor the development and implementation of the AML/CFT regime in Bangladesh. To comply with FATF (Financial Action Task Force) recommendation, Bangladesh has already taken measures to ensure BFIU's operational autonomy. Accordingly, BFIU has been vested with increased responsibilities under the new laws relating to prevention of money laundering and terrorist financing. To support the ongoing reform activities in this area, the project will provide: (1) an AML/CFT mentor at BFIU for its capacity building and assistance with the development and strengthening of a policy framework for AML/CFT regulation; and (2) human resource development in support of AML certification of BFIU officials such as the Certified Anti-Money Laundering Specialist Examination; (3) capacity building on strategic, tactical, and operational analysis**;** (4)

conducting risk assessments of trade-based money laundering, alternative remittance systems, and virtual currencies; (5) software development training to integrate with other databases..

A2.14. *Human Resources Development*: Human resource development will be an integral part of regulatory and supervisory capacity building. Banking legislation, regulation, and supervision constitute specialist areas that require specialist knowledge. The project will provide technical assistance to conduct a review of the human resource policy on banking regulation and supervision to ensure that these functions are being effectively carried out in fulfillment of its mandate. This component of the project will also support BB in developing a comprehensive program that covers induction training, on-going training and development, and career path planning.

A2.15. To assist and support BB in implementing the supervisory and regulatory capacity of BB, two consulting firms, one focusing on supervision and the other on regulation, will be hired through single-stage international competitive bidding based on quality and cost. The firms will be required to base two resident experts in BB for a minimum of three years in addition to sourcing short-term individual experts to work on the various activities specified in the terms of reference. The consultants will work closely with the relevant departments under the general guidance and supervision of the FSSP Cell. In addition, for human resources capacity building, an HR adviser will be hired to support the human resources development's activities and the FSSP Cell.

A2.16. *Development capacity:* In addition, to support the regulator's developmental capacity, technical support for a comprehensive market assessment, countrywide dissemination, and market awareness of new and innovative products will be provided. The following are the areas identified by the GOB and BB for support:

(a) **Warehouse Receipt Financing: Market assessment, countrywide dissemination, and market awareness.** This project's activity will support the development of a related study on warehouse receipt financing, which will aim to enable BB to: (1) identify impediments in the policy and regulatory framework and official control mechanisms to establish warehouse receipt financing as a tradable and negotiable system; (2) identify the operational gaps in warehouse processes and in best practices and international standards, the processes of financial institutions that need to be enhanced, what collateral managers need to be able to operate in Bangladesh so that the entire sector can rely on warehouse receipt financing; and (3) identify the current impediments and benefits from warehouse receipt financing for the farmers in the context of Bangladesh. The study outcomes and recommendations will be disseminated countrywide, and regular market awareness activities will be conducted among different stakeholders on the opportunities arising from establishing an enabling environment and an adequate regulatory, licensing, monitoring framework, and trustable and tradable receipts to bring about a viable and scalable warehouse receipt financing system in Bangladesh (see Box 2 on the current status of warehouse receipt financing in Bangladesh)**.**

(b) **Developing a National Financial Inclusion Strategy for Bangladesh.** In addition to maintaining monetary and financial stability, boosting financial inclusion is also an important component of BB's financial sector development strategy for accelerated economic growth. In Bangladesh there has been overall a lack of a National Financial Inclusion Strategy document to guide and monitor progress on various financial inclusion initiatives (see Box 2 for a summary). A financial inclusion strategy provides a framework for prioritizing reforms and actions, including those for a country's priorities. Key initiatives have been undertaken so far; however, there have not been any comprehensive stock taking or analysis of the achievements of these reforms, which may therefore appear uncoordinated. These efforts, while important, would be more effective if implemented within the context of a comprehensive financial inclusion strategy that would be based on a thorough analysis of the existing obstacles to access to finance. This project's activity will support the formulation of a National Financial Inclusion Strategy for Bangladesh, under the leadership of BB.[31] Through proposed parallel technical assistance provided by World Bank experts and short-term consultants, this component will include a comprehensive assessment of the current status of financial inclusion and a formulation of a financial inclusion strategy with a roadmap, an implementation plan, and a dissemination plan. This activity will also seek to support implementation of selected actions and reforms of the National Financial Inclusion Strategy, which are the responsibilities of BB.

**Box 2- Bangladesh Initiatives on Warehouse Receipt Financing and on Financial Inclusion.**

*Warehouse Receipt Financing in Bangladesh*

Warehouse receipt financing as a tradable and negotiable system is not available yet in Bangladesh due to several impediments including: (1) the regulatory environment, regulatory authorities, licensing procedures and standards, inspection policies and control mechanism, and insurance; (2) the storage capacity of warehouses and operational standards, lack of trust between financial institutions and warehouses/cold storages, market knowledge; and (3) market awareness among farmers on use of crop stocks as trusted and reliable collateral to access formal credit.

*Financial Inclusion in Bangladesh.*

Recent initiatives to improve financial inclusion in Bangladesh include encouraging the banks to embrace innovative financial products; developing ten-taka (BDT 10 minimum deposit) bank accounts for farmers, bank-led mobile banking, school banking; issuing guidelines on agent banking; and promoting SME loans, including those for women entrepreneurs, and green banking, among others. In 2014, BB received the Alliance for Financial Inclusion Policy Award for promoting mobile banking with its Guidelines on Mobile Financial Services introduced in 2011. In addition, along with the formal banking sector, several nonbanking financial institutions such as cooperatives, microfinance institutions, and mobile financial services providers, also provide various financial services in Bangladesh, contributing to the improvement of financial inclusion. With diverse lenders, from both government and the private sector and numerous initiatives to broaden the base of financial access, Global Findex[32] ranks Bangladesh second after Sri Lanka on the financial inclusion index of South Asian countries. It was estimated that in 2011, 40 percent of adults (15 years and older) had an account at a formal institution in Bangladesh, compared to about 69 percent in Sri Lanka but ahead of India, where 35 percent of adults had a formal bank account. Furthermore, 23 percent of adults had a loan from a financial institution, the highest in South Asia, where the average stood at 9 percent. Access to insurance, including crop insurance, is minuscule, and despite Bangladesh's performance on credit and deposits, there are large gaps that exist in other product segments.

**(c) TA to Develop the Foundation for Long-Term Capital, Pension and Banking Markets.** As a complement to the long term credit line provided under component 3, the

[31] Central banks are well positioned to take a leadership and coordination role to develop a National Financial Inclusion Strategy as demonstrated by studies by the Alliance for Financial Inclusion, the Consultative Group to Assist the Poor, and also by international experience. When central banks are responsible for implementing a financial inclusion strategy, more financial inclusion topics under their purview are likely to be covered and more resources and staff are likely to be dedicated to these matters. Private sector response is also more effectively catalyzed.

[32] World Bank financial inclusion database.

project will support BB in *developing a foundation for long-term capital markets (particularly secondary bond markets) and in building the pension market*, which is critical for building a long-term financing market in Bangladesh. This activity will revolve around identifying the regulatory impetus and roadmap required to develop the long-term capital and pensions markets. In order to assist BB with this TA, a consulting firm with long-standing experience and demonstrated expertise in developing secondary bond and pension markets will be hired.[33]This work will contribute to the separate request made by the GOB for support for an insurance and pension support program that will be initiated shortly.

A2.17. In addition, this TA will support BB and financial institutions in *designing and developing the use of long-term deposit instruments in local currency* (i.e., in Bangladeshi taka). Activities under this TA are expected to include support to design long-term deposit instrument in local currency, roadshows to facilitate adoption of the instrument by financial institutions and workshops to train sector participants on managing the deposit product. Indeed, due to the current absence of long-term deposit instruments in the PFIs, the introduction of long-term financing will inevitably lead to persistent short positions in long-term liquidity, resulting in a maturity mismatch between assets and liabilities for the PFIs. In particular, this TA will delve deeper into how local banks could be encouraged to develop longer-term savings instruments (e.g., inflation-indexed time deposits targeted at migrant workers, people saving for their retirement, worker provident funds and the like) to address the current term-mismatch problem, notably by taking lessons from other developing countries that have overcome this problem (e.g., commitment savings accounts and time deposits in the Philippines) and from recent advances in behavioral economics (e.g., on incentives or nudges designed to encourage people to take actions better aligned with their long-term interests), . To assist BB in implementing these activities, a consulting firm—with relevant knowledge and demonstrated expertise in developing long-term deposit instruments in other emerging financial sectors—will be hired based on quality and cost. [34]

**Component 3: Supporting Long-Term Finance**

A2.18. *Long-Term Refinance Facility:* This component will support long-term financing (expected average of five years financing or more) through PFIs[35] to firms, including some SMEs, and particularly manufacturing firms and exporters[36] in Bangladesh (see figure 3 below). The funding will be accompanied by technical assistance to support capacity building of PFIs and industry associations as well as to develop long-term financial markets. The long-term finance line will be channeled by BB to PFIs and through a demonstration effect, and the above-mentioned technical assistance will serve to build long-term finance markets. In

[33] The consulting firm is required to mobilize resources to engage in direct consultations with Bangladesh Bank and other relevant entities (including the Securities and Exchange Commission) to lay down the structure of a implementable, near-term development program for the secondary bond market and pension market. The recommendations proposed by the firm must be supported by tried-and-tested case examples in other developing countries but must have a strong rationale with respect to the local context as well. The consulting must source short-term, specialized individual experts as needed for the various activities (as defined under the terms of reference). The consulting firm is expected to mobilize resources to extend full support to Bangladesh Bank in conducting the pilot(s) envisaged under the activities.

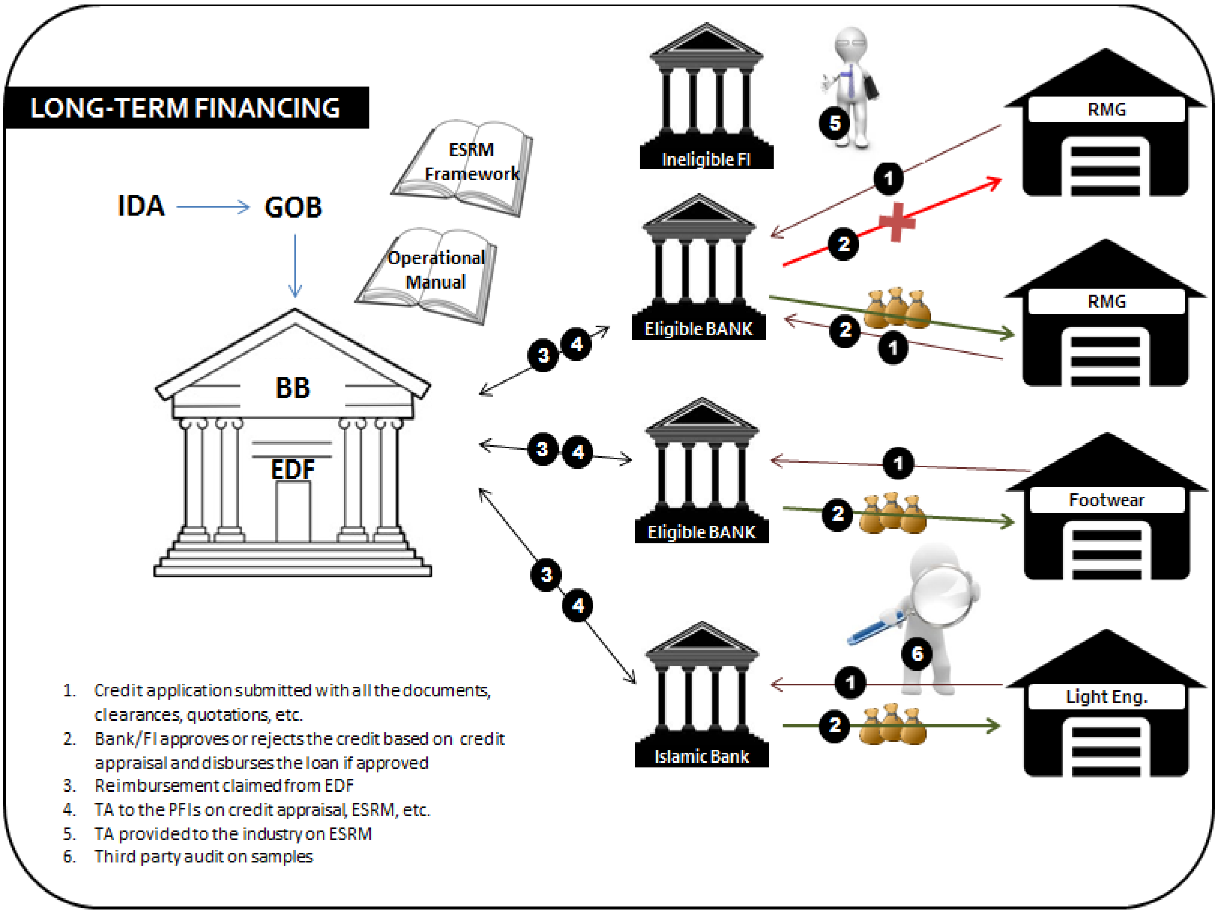
[34] The consulting firm will be required to work in close collaboration with the FSSP cell and will be required to mobilize experts in the country to scope out the potential for long-term deposit instruments particularly suitable in the context of Bangladesh's financial sector. The consulting firm will also be expected to mobilize resources in the country to deliver the roadshows and workshops, and the structure of these programs must be customized to meet the specific capacity gaps among the local financial institutions (including PFIs).

[35] PFIs could include Islamic finance banks.

[36] Long-term financing is becoming increasingly critical to the export sector for remaining competitive and contributing to job creation and growth.

addition, through the implementation arrangements the project will contribute to the improvement of health and safety standards in the industry and thereby reduce credit risk.

*Figure 3: Long-term finance*




A2.19. With regard to the long-term finance credit line, the market study commissioned by the World Bank confirms the lack of a long-term finance market in Bangladesh (see Box 3 for a summary of the report).[37] Less than 3 percent of foreign currency–denominated loans to exporters was greater than a three-year tenor, and none of the banks and financial institutions surveyed extended any loans of five years or more. On the demand side, the market survey and mission discussions with industry associations and firms clearly reaffirmed the need for an increased supply of funds to purchase capital equipment, for upgrades (including improving health and safety compliance), and for expansion, which are expected to be the most significant purposes.

[37] This has been shared with BB for comments and feedback.

**Box 3: The Landscape of the Long-Term Credit Market in Bangladesh: Report Summary**

The key objective of this study, commissioned by the World Bank and undertaken by Nielsen, was to estimate the demand for and supply of long-term finance to export-oriented and other domestic enterprises and prepare a landscape report on the long-term credit market. For this, six banks and three nonbank financial institutions were studied from the supply side. These financial institutions collectively have about 20 percent of the total financial sector assets of Bangladesh. These financial institutions were given structured questionnaires to collect the required information. On the demand side, a total of 32 firms were covered. Among these 32 firms, there were eight ready-made garment firms, six leather factories, six pharmaceuticals industries, six textiles firms, and six footwear companies.

***Supply side***

- Long-term loans represented 21 percent of surveyed banks' portfolios and 44 percent of those of nonbank financial institutions, and the maturity of long-term loans was around five years.
- Banks largely (68 percent) provide short-term loans with maturity of less than a year (90 days to 180 days), and their loans are mostly (74 percent) provided to large businesses and corporates with very limited lending (only 15 percent) to the SMEs.
- 94 percent of bank loans denominated in foreign currencies were short-term loans and granted almost exclusively (99 percent) to large businesses and corporates.
- Banks mainly provided loans to the ready-made garments, agro-based industries, and pharmaceuticals, and they held 56 percent, 26 percent, and 7 percent, respectively, of their lending portfolio. But only 12 percent of these loans had a long-term maturity of five years.
- Banks mostly used term deposits of over three years as the major source of long-term loans. Only a few used core deposits. Thus there is a maturity mismatch between their source of funds and the use of funds for long-term lending.
- Banks charged interest rates based on loan duration and volume of collateral, and thus long-term loans carry higher interest rates, especially for the exporters.

*Demand side*

- The demand for long-term credit arises mainly from the exporters and manufacturers for capital machinery imports, for capacity expansion, and for competitiveness upgrades.
- The bulk of financing obtained by firms in 2013 consisted of trade finance and cash credit.
- The demand for long-term credit is high in the pharmaceuticals, footwear and leather sectors.
- About 90 percent firms feel that the main obstacle to getting long-term credit from banks is high interest rates.

A2.20. Under this component, PFIs will also be encouraged to offer Shariah-compliant financial products, which are based on the principles of risk sharing and asset backing rather than risk-transfer (see annex 7 for more details). The proposed design will enable Islamic banks to offer Shariah compliant products at longer maturities and therefore provide new opportunities for growth to firms that are seeking Shariah compliant products.

A2.21. In addition to offering longer term financing, Islamic banks will be able to offer Shariah compliant products that - sidestep collateral constraints since the asset backing endogenous to this class of transactions (particularly Ijarah (operating lease) and Murabahah (markup financing). hence providing firms with financial breathing space to maintain healthy and sustainable growth.[38]

[38] Islamic finance is inherently directly or indirectly asset backed such that the issue of collateral is minimized particularly in case of *Murabahah* (sale financing) and *Ijarah (leasing)*. Currently, there is WB-IFC collaboration on identifying issues and resolutions concerning movable collateral which could lead to paving the way for robust *Shariah*-compliant firm financing.

A2.22. Detailed implementation arrangements of the credit line are provided in Annex 4.

*A2.23. Technical Assistance to the Financial Sector:* Even though the availability of long-term financing from BB (through the line of credit) will increase PFIs' appetite for channeling these funds to export-oriented companies, there are several impediments to the sustainable development of the long-term financing market which the project will address through the TA on developing the foundation for long-term capital, pension and banking markets described in component 2 above. Moreover, as the inability to address safeguards issues may lead to nonperforming loans, financial institutions will be supported to develop their capacity in safeguards risk assessment, due diligence, and management, thereby leading to the sustainable scaling up of their long-term financing portfolio.

A2.24. In particular, the TA will provide support to Bangladeshi financial institutions in the following areas:

**(a) Capacity Building on Safeguard Management**: training on how different environmental and social risks come into play for export-oriented firms and their loan projects will be supported. The training will seek to build a strong foundation for knowledge on relevant environmental and social risks among financial institutions and emphasize that ignoring such risks in their lending operations can adversely affect their business. The training will also help them relate to the principles outlined in the World Bank Environmental, Health, and Safety Guidelines for different sectors. PFIs training on the ESMF to ensure that they can integrate this into their appraisal and monitoring of long-term financing projects will also be supported as needed. Such training on the framework will turn the safeguards-related knowledge into practice, allowing individual projects to be screened for relevant environmental and social risks.

**(b) Capacity Building on Aspects of Long-Term Financing**: sector wide training for banks on credit risk management for longer financing tenors will be provided. Such training will revolve around helping banks develop tailored credit risk appraisal and monitoring processes and equip them with knowledge regarding best practices in this arena. PFIs' training on fiduciary aspects as described in the OM (to ensure that they can exercise their best judgment when monitoring borrowers' use of funds for long-term projects) will also be available as needed.

*A2.25. Technical Assistance to Industry Associations.* Partnerships with industry associations will be forged to raise awareness and improve safeguards practices across the private sector.[39] This activity will aim to build the capacity of different industry associations (such as BGMEA and BKMEA) on safeguards management. Activities expected under this assistance include: developing trainers for industry associations and equip them with practical sector-specific knowledge on safeguards principles and procedures[40]; workshops for different industry associations to build general understanding on safeguards and how firms' operations may be affected by current or emerging environmental and social risks and pilot firm-level trainings—in collaboration with the industry associations—to create industrywide awareness and

[39] This will help the industry to improve occupational health and safety by structured training programs, sharing good practice experience, developing awareness-raising tools, and the like and will be operated through the industry associations.

[40] Currently, firms remain unaware of the types and degrees of different environmental and social risks inherent in their operations and interactions with different stakeholders (workers, suppliers, customers, and such). Hence, sector-specific training modules and trainers will be developed through which the industry associations can train their member firms on safeguards for their respective sectors.

understanding of effective safeguards management.

***Component 4: Project Management and Monitoring***

A2.26. Management of project implementation will be assumed by the Financial Sector Support Project (FSSP) cell in BB. The component will include costs for project management,[41] monitoring and evaluation (M&E), and the GAAP implementation. This component will provide support to the project implementation unit—the FSSP cell—to build up its capacity in the areas of project implementation, monitoring, and evaluation. This would include two broad activities:

- *Project Management and Capacity Building*: Implementation support will be provided to the FSSP cell for the day-to-day management and coordination of project activities. Technical assistance will be provided to increase the cell's expertise in managing the procurement, financial management, and safeguards aspects of the project but also in performing core central bank functions (under component 2), in part to ensure that staff develop technical skills for the future but also to oversee the technical quality aspects of project implementation under the other three components. This component will also support the project audit to review on-lending by PFIs to end-beneficiaries (firms).

- *Monitoring and Evaluation:* The FSSP cell's capacity to collect and analyze data for project monitoring and evaluation and project impact analysis will be strengthened through technical assistance. A monitoring and evaluation specialist will support the cell in the initial phase of project implementation to help plan and develop a strong M&E mechanism (including third party monitoring) and a credible baseline (including the beneficiary feedback mechanism). The consultant will also build capacity within the FSSP cell.

[41] Project management costs include all expenditures incurred by the FSSP cell in coordinating and implementing the project. It has been agreed that, out of these FSSP cell operating costs, BB staff salaries, GOB civil servant salaries, sitting allowances, honoraria, and cash per diem would be ineligible for IDA financing and would be financed by the Government contribution.

**Annex 3: Lessons Learned from IPFF and CBSP**

**BANGLADESH: Financial Sector Support Project**

A3.1. The project's design fully incorporates lessons from ongoing and completed Bank Group and donor projects, from international best practices in the long-term finance area, and from current and past experiences with (1) refinancing operations involving credit lines, (2) TA programs, and (3) implementation of financial sector infrastructure development projects. In summary, these lessons include the following:

- To ensure sustainability of project outcomes, the project design needs to adopt a comprehensive approach that covers key supply-and-demand-side issues, as well as short-term financing needs and longer-term needs related to policy and institutional development.
- Project institutional arrangements are best coordinated by a single intermediary (rather than multiple arrangements with PFIs), and institutional arrangements should establish enduring capacity in the financial intermediary to monitor the project after completion.
- Technical assistance is crucial to building capacity in project implementation.
- Clear and transparent project eligibility criteria should be established for the PFIs.
- Critical to success are the need to identify quantifiable financial indicators to monitor the progress achieved by each of the PFIs and regular project monitoring through these indicators.
- The project should include indicators for tracking the performance of PFIs onlending portfolios (e.g., NPLs, profitability, pricing, and the like), as well as other key financial ratios for monitoring the overall performance of the PFIs (e.g., overall NPLs, loan-loss provisioning, adequacy of equity, and profitability, among others).

A3.2. Maximum transparency in project implementation arrangements through frequent dissemination of project monitoring reports will help ensure that the results monitoring is incorporated into continuous implementation adjustments. Transparency will also enhance ownership and reduce the potential for elite groups to capture of decision making and prioritization processes.

A3.3. *The proposed credit line of the FSSP will build mainly on the achievements of the Export Development Fund (EDF)*, although the EDF has developed customized implementation arrangements and eligibility criteria based on BB's prior and existing experiences with the IPFF. The EDF was set up in BB to refinance back-to-back sight Letter of Credits (L/Cs) opened by exporters and meet their raw material import requirements. The fund has a strong track record with a total amount of US$1.2 billion available as of June 2013 from what started with an initial seed funding of about US$27.16 million (SDR25 million) from IDA and US$2.84 million from the GOB in 1988. However, EDF provides only a short-term window in foreign currency with a tenor of 180 days from dates of disbursement extendable by BB to a maximum of 270 days, which is not suitable for imports of capital machinery, for instance. The FSSP will now create a second widow under the EDF—this time to provide long-term finance in foreign and local currency with a typical tenor of five to seven years. Project funds provided to the long-term fund will be passed onto eligible financial institutions for on-lending for longer tenure to exporters/ other firms, according to the same implementation and management arrangements that have been followed by EDF. The Foreign Reserve and Treasury Management Department will be responsible for managing and operating both windows of the EDF, and the Foreign Exchange Policy Department will be responsible for formulating the necessary policy circulars affecting the functioning of both credit lines (see details in Annex 4).

A3.4. *The Investment Promotion and Financing Facility Project* or IPFF was a five-year term (January 2007–December 2011) on-lending–based technical assistance project, which consisted a credit line of US$47.50 million for partial debt financing through private sector financial intermediaries for eligible and government-endorsed infrastructure projects and a TA component of US$2.50 million to promote the role of private sector entrepreneurs in the development of infrastructure. BB was the implementing agency of the project, and it showed outstanding competency in project implementation, specifically in structuring public-private partnerships according to high environmental and procurement standards and in playing a catalytic role in deepening the financial sector and rallying domestic funds for infrastructure investment. Even as early as the third year of the project, BB supported IPFF in attaining the Project Development Objectives in full by disbursing 100 percent of the credit line. The project was then topped up by the Bank in 2010 with an additional IDA credit in the amount of US$257 million, and since then BB has continued to build on the positive impacts made through implementation of the IPFF project.

A3.5. *The IPFF project, including the project implementation team and the lessons learned, has contributed significantly to the design of the proposed credit line under the FSSP*. It not only supported BB in developing the OM (including the eligibility criteria for PFIs) and the ESRM Framework by providing ready and tested reference materials and experience for citing, but also set the stage for BB to play an effective catalyst role in deepening the Bangladesh financial sector through a demonstration effect. Significantly, the FSSP project preparation team of the Bank and BB specifically kept the following lessons from the IPFF in mind while designing the proposed credit line under the FSSP:

- First, it is important, in the context of Bangladesh, to stimulate a particular segment of the market without creating a complex overhead institutional structure. IPFF created minimal institutional overhead and was designed to be maximally compatible with market conditions and incentives.
- Second, involvement of local private financial and entrepreneurial institutions from the outset was intended to ensure a design that suits the needs and capacity of the Bangladesh economy.
- Third, IPFF is market based to the greatest extent possible, as multiple participants promote competition for the funds that generate market-based pricing.
- Fourth, the design has emphasized transparency, protected by clear contractual arrangements through the separation of resource control and resource allocation.
- Fifth, the structure is flexible, as contractual arrangements with PFIs allow the facility to easily respond to changing circumstances or failure of any participant to perform without institutional reform or retrenchment of incumbent staff. The open architecture allows for innovation, evolution, and easy entry and exit of parties. Such flexibility and market orientation could function only with adequate checks and balances, as was ensured by effective regulatory oversight from BB and the application of strict criteria for financial institution participation.

A3.6. The *Central Bank Strengthening Project (Cr. No 3792) is the other project that has provided significant inputs into the design of and implementation arrangements of the first two components of the proposed FSSP.* CBSP, the first automation project of Bangladesh, was implemented by BB; it faced initial hurdles in implementation but in the end achieved significant results that are highly regarded by the BB management, staff, and stakeholders. The key issues identified by the Bank ICR team and IEG Evaluation, which have been taken into account in the preparation of the FSSP project led to the risk mitigation measures listed in table 7.

**Table 7: Lessons Learned from CBSP and FSSP Mitigation Measures**

| *Areas* | *Lessons Learned from CBSP* | *FSSP Mitigation Measures* |
|---|---|---|
| *Efficacy* | The PDO was too broad, and there were not sufficient and appropriate indicators to measure the achievement of the PDO. | The PDO is specific, supported by quantifiable results indicators to measure the achievement of the PDO. |
| | There was a mismatch/disconnect between the PDO and the scope and scale of investments being financed. | There is no such mismatch. |
| *Efficiency* | The lengthy procurement process of the IT packages to automate the central bank and the staff resistance caused by fear of job losses due to automation resulted in substantial implementation delays. | The bidding documents for the procurement of the major IT packages are prepared during project preparation, and major procurement activities will start before the approval of the project. In addition, BB has developed significant competency in procuring IT goods and services. |
| *Quality at Entry* | The risks relating to the automation component were relatively high, as BB's capacity was extremely limited. | Risk assessment is conducted and the proposed mitigation measures will receive due attention during implementation.<br><br>BB now has adequate capacity to implement major automation projects. |
| | There were shortcomings in the design of the results framework. | The results framework is designed carefully, and this has been agreed upon with the client. |
| *Quality at Supervision* | There were delayed corrective action and staff changes in managing the tasks. | The project team has key staff members in place with the relevant competencies. |
| | The delineation of control between the CBSP cell and line departments of implementation were not appropriately defined in the initial phase of project implementation | The FSSP cell, as the project implementation unit, is responsible for all aspects of project's implementation while working in close coordination with line departments of BB |
| *Implementing Agency Performance* | | |
| | The project went for period without a full-time director, and this neglect may have reflected staff apprehension over automation. | The PD, DPD, and component leaders of the project have been identified and were placed in the PCU/FSSP cell during the identification and preparation phase of the project. |

| | | |
|---|---|---|
| *M&E Design, Implementation, and Utilization* | Some of the indicators were qualitative, broadly defined, or subjective. | Indicators will be quantitative and specific. |
| | Short-comings in the M&E system did not always allow for adequately measuring progress toward achievement of objectives. | A carefully developed and effective M&E system will be in place from the inception of the project; it will allow for adequately measuring progress toward achievement of objectives. |
| | The M&E system was not well utilized. | The M&E system is expected to be established at the beginning so that the senior management of BB can regularly use the data as an input to decision making at the institutional level. |

A3.7. BB has also developed critical financial sector infrastructure like the Credit Information Bureau, the Bangladesh Automated Clearing House, and the Bangladesh Financial Intelligence Unit through different projects financed by other donors (DFID, IFC, IDA). This has provided BB adequate exposure in successfully implementing IT and financial infrastructure projects.

A3.8. The satisfactory implementation of the ongoing IPFF project and the lessons learned from the previous financing, infrastructure development and automation projects demonstrate BB's capacity to implement the proposed operation. BB benefited throughout the preparation and implementation of previous Bank-financed operations from an improved internal control procedures, including updating its *Financial Management Manual* and the internal audit risk-based approach strategy. On procurement, it gained commendable experience evident in the procurement practices of the project beneficiaries that are in line with operational practices mandated by the Bank. An OM for the ongoing project prepared in line with Bank guidelines and procedures has been useful in laying the groundwork for the proposed operation.

## Annex 4: Implementation Arrangements

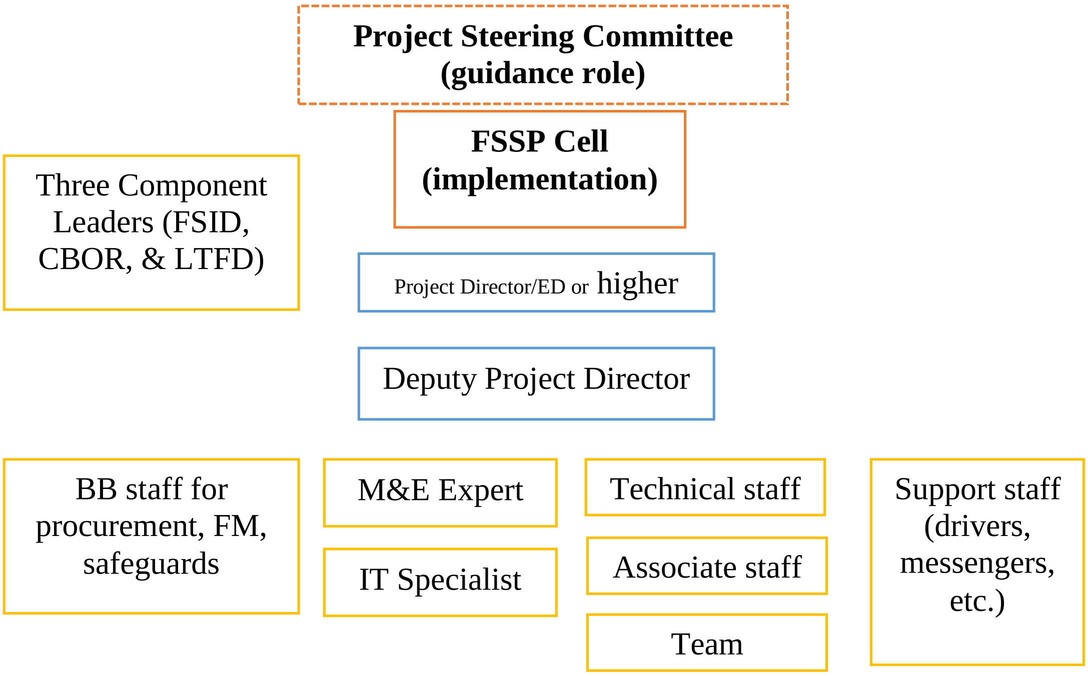
## BANGLADESH: Financial Sector Support Project

A4.1 *Organization Responsible for the Project*: The Bank and Financial Institutions Division of the Ministry of Finance will be the executive division for the project. BB will be the implementing agency and will be responsible for overall project implementation, and all funds flow will be through BB. In terms of legal arrangements, in addition to the credit agreement between IDA and the Government of Bangladesh, a project agreement is proposed to reflect the agreement between IDA and BB. A Subsidiary Loan agreement will be signed between BB and Finance Division of MOF.

A4.2 *Policy and Overall Guidance:* A project steering committee will provide the project with overall guidance, monitoring functions, and attention to inter-ministerial issues. The PSC will be chaired by the governor of BB, and it will include all deputy governors of BB and senior representatives (joint secretary or above) from Finance Division, BFID and Economic Relations Division of the MOF, and Implementation Monitoring and Evaluation Division and Socio-Economic Infrastructure Division of the Planning Commission, and such other entities as the PSC may decide. The PSC will meet half-yearly (the first meeting will be within two months of the project commencement or effectiveness) to decide on policy and major implementation aspects of the project. The project director, appointed at the level of executive director or above by BB, will act as the member secretary to the committee, and a deputy project director, appointed at the level of a deputy general manager by BB, will support him in the committee with project details.

A4.3 Implementation: Responsibility for project management will be entrusted to an executive director of BB or equivalent or higher, who will be seconded to act as the Project Director (PD). This PD will lead the project coordination unit located at BB. The former PIU for the Central Bank Strengthening Project, which has continued performing project management duties since the CBSP closed in 2012, will now be designated as the FSSP cell. Each component will be managed by a Component Leader (CL) who is at Deputy Governor rank: It is proposed that under current Deputy Governor configurations, CL for Component 1 will be the Deputy Governor in charge of BB's ICT, CL for Component 2 will be the Deputy Governor in charge of bank regulation and supervision and CL for Component 3 will be the Deputy Governor in charge of Forex Reserve and Treasury Management Department. The CLs will be responsible for the implementation of his/her respective component (the OM carries a summary description of their roles) and will coordinate closely with other concerned departments of BB in the implementation of the project. There will be component coordinators in the FSSP Cell for each component who will be responsible for coordinating the activities under each components. The FSSP Cell will also include a monitoring and evaluation expert to be hired under the project. The FSSP Cell will also hire necessary support staff as needed. The PD and CLs will be supported by the DPD, who will coordinate and monitor the activities of the various implementing departments and teams of BB and their technical consultants. The consultants will work under the direct supervision of the PD, CLs, and DPD. The FSSP Cell will also coordinate with the other regulators in the financial sector like Microcredit Regulatory Authority, Insurance Development and Regulatory Authority, Bangladesh Securities and Exchange Commission to implement specific project activities and the industry associations for implementation of the TA.

*Figure 1: Project Implementation Arrangement*




A4.4 The FSSP cell, headed by a general manager of BB, will be in charge of overall project coordination as well as overseeing the financial management, procurement, reporting, M&E, audit, public information, and related functions. The key responsibilities of the cell will be as follows:

a. Overall monitoring and supervision of the project.
b. Overall procurement and contract management under components 1, 2, 3, and 4.
c. Overall M&E and reporting based on key project development indicators.
d. Overall coordination among participating departments of BB.
e. Reviewing effective functioning of the on-lending facility to final borrowers through PFIs.
f. Oversight of capacity building activities for industry associations.
g. Facilitation of the provision of capacity building to financial institutions and of other technical assistance for capital market and pensions development.
h. Procurement and disbursement with responsibility for adherence to all fiduciary and safeguard requirements of the World Bank.
*i.* Any other functions needed under all project's components, including providing public information services for the project.

A4.5 The FSSP Cell will hire part-time technical specialists as required to support the BB in the implementation of the main components. The FSSP cell will be staffed adequately to support implementation of the four components of the project.

A4.6 *Implementation Arrangement for Components 1 and 2:* The FSSP cell will be responsible for the overall procurement and contract management under components 1 and 2. For the effective implementation of the components, the cell will coordinate among participating and implementing departments and make sure of facilitating appropriate regulatory and policy interventions, if required, through appropriate channel(s) during implementation. The concerned departments or units of BB will take the responsibility for related project's activities.

A4.7 *Implementation Arrangement for Component 3:* BB through its Forex Reserve and Treasury Management Department will be responsible for managing the long-term finance credit line, and the Foreign Exchange Policy Department will be responsible for formulating necessary policy circulars and finalizing and endorsing the OM. For eligibility, detailed criteria are defined in the OM (see box 1 for a summary of eligibility criteria for PFIs- detailed description and full list of criteria are in the OM)[42]; and based on an appraisal of the PFIs' management and financial performance, BB will select the PFIs . The FSSP Cell will be responsible for ensuring that sub-project activities comply with the fiduciary and safeguards arrangements for the project. Project funds for the credit line will be channelled through BB, which will then on-lend to eligible financial institutions that will ultimately reach the end-beneficiaries, namely, manufacturing firms and exporters, which may include some SMEs. Given its financial capacity and track record, BB is well placed and has the capacity to implement the project and ensure compliance during implementation. Arrangements are in place to ensure adequate project implementation support, covering fiduciary and safeguards aspects, with an annual audit of the processes and activities supported under the component.

**Box 1 - Eligibility criteria for PFIs [43]– Details are provided in the project's OM.**

(1) The PFI must hold a valid license from BB to operate as a bank or NBFI (nonbank financial institution) and have a demonstrated track record of providing long-term lending for at least two years;
(2) The PFIs must have qualified and experienced management, adequate organization, and institutional capacity for its specific risk profile;
(3) The PFIs must have appropriate capacity, including staffing, for carrying out appraisal (including environmental assessment) of loans to borrowers and for supervising implementation thereof;
(4) The PFIs must have well-defined credit and loan policies and procedures for management of financial risks (liquidity, credit, foreign exchange, interest rate, and market risk, including risks associated with balance sheets and income statements);
(5) The PFI must have a minimum rating of 3 (three) or better on the CAMELS[44] (a banking supervisory rating system to measure soundness of a bank measured on a scale of 1-strongest to 5-weakest) -based assessment undertaken by the BB;
(6) The PFIs must have an acceptable level of nonperforming loans of no more than the banking sector's average and no provisioning shortfall;
(7) The PFIs must meet the minimum level of regulatory capital adequacy requirement as instructed by BB;
(8) The PFIs must have adequate and functional internal audits and controls;
(9) The PFIs have to have at least three years' of audited financial accounts with no significant unresolved observations; and
(10) Banks and financial institutions with large financial scams or those with an observer placed by BB, will become ineligible for participation in the facility.

A4.8 The component is designed in line with World Bank policy OP/BP 10.0 and the accompanying guidance note on financial intermediary lending. Selected PFIs will appraise

[42] Based on experience and changing circumstances, criteria may evolve during implementation and any revisions will be captured in the OM which will be agreed between the World Bank and Bangladesh Bank.
[43] As per the provisions in the OM, if a bank meets most but not all eligibility criteria, and provided that there is a strong development rationale for including the bank in the project and there is a credible plan to meet the remaining criteria, on an exception basis this bank may be considered in agreement with the World Bank (this approach is consistent with the World Bank OP 10 guidance note on financial intermediary financing).
[44] Soundness of a bank measured on a scale of 1 (strongest) to 5 (weakest). Bank examiners (trained and employed by the country's central bank) award these ratings on the basis of the adequacy and quality of a bank's Capital, Assets (loans and investments), Management, Earnings, Liquidity, and Sensitivity (to systemic-risk). Banks with a rating of 1 are considered most stable; banks with a rating of 2 or 3 are considered average, and those with rating of 4 or 5 are considered below average, and are closely monitored to ensure their viability. These ratings are disclosed only to the bank's management and not to other banks or the general public. CAMELS rating is an advanced version of the older MACRO rating.

firms. Financing of firms will be in accordance with the project implementation framework, which will be defined in the OM, including requirements on reporting and fiduciary and safeguards dimensions. BB will monitor overall progress and compliance throughout project implementation. This is executed as part of the participation agreement between PFIs and BB and the Sub-Loan agreement between PFIs and firms (templates of these agreements will be included in the OM). The project audit will also undertake a sample review of the on-lending by PFIs to end-beneficiaries (firms).

A4.9 The implementation arrangement is consistent with international good practice for wholesale long-term lending facilities and standards for lines of credit. The proposed line of credit would be on-lent on market terms, without creating market distortion. BB sets on-lending rates to cover the cost of funds, operating costs, and currency risk and also to be competitive with market rates. Pricing of the credit line will be determined according to market principles and is expected to vary according to risks and tenors. An indicative pricing range of LIBOR+300-400 basis points has been discussed based on available market data/benchmarks. Interest rates can be revised by BB depending on market developments/conditions. Pricing to firms will be determined by the PFIs based on an appraisal of the credit risk of the borrower and the underlying activities being financed (typically expected to be in the range of 200-400 basis points above the cost of funds, which is fully in line with market rates for the few long term financing transactions that exist.[45] Interest rates are due to be revised accordingly by the FEPD.

A4.10 *Operations Manual:* The OM includes, among other topics, the agreed FM and disbursement arrangements; procurement arrangements; the Environmental and Social Risk Management Framework; Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD; Loans and IDA Credits and Grants, dated October 15, 2006, and revised in January 2011; and a detailed M&E framework and Project performance indicators for the continuous measurement and monitoring of outcomes, a key element in ensuring effective implementation. It also includes detailed eligibility criteria for financial institutions that could access the funds. The eligibility criteria ensure that financially sound institutions are selected. Also, it ensures proper governance, monitoring, and reporting standards for these institutions.

***Fiduciary Capacity***

A4.11 Based on the assessment of BB's fiduciary capacity, the procurement risk of the project is substantial. Though BB has adequate experienced procurement staffs with national and international training to conduct the procurement under component 1 and component 2, the procurement risks are mainly due to implementation of a significant number of IT contracts following ICB methods in a timely manner. Internal control, documentation, information dissemination, contract administration including delivery follow-up, payments, complaints handling, and the like also need to be strengthened for IT procurements. However, a large portion of the project funds will be used under component 3: PFIs will follow commercial practices in which the private sector has already gained reasonable experience over time. In addition, BB has been operating similar type of projects (credit lines) of different donors. However, for this particular operation, PFIs will require adequate skilled staff to manage procurement according to the OM and will need additional training on commercial best

[45] Lending has been undertaken in the range of LIBOR+400-450 basis points from banks to firms. Under the project, the financing is expected to be smaller in size and to smaller firms compared to the financing currently being undertaken; the higher end price expected to firms under the project factors in the higher transaction and credit risk costs.

practices following the Bank's guidelines. Several measures will need to be introduced to minimize procurement risks during project implementation.

A4.12 BB's financial management capacity is satisfactory,[46] given its position as Bangladesh's central bank and that it has adequate numbers of skilled staff, including those in the area of financial management. They have sufficient experience in working on projects financed by the World Bank. Both from procurement and financial management point of view, BB has successfully implemented similar Bank-funded central bank strengthening projects.

### *Planning and Budgeting*

A4.13 *Planning:* A draft procurement plan covering all major procurement has been prepared for the entire duration of the project. This plan will be agreed upon between the borrower and the Bank during negotiations and be made available on the Bank's external website. The procurement plan will be updated by BB, at least annually, to reflect actual implementation needs in consultation with the Bank.

A4.14 *Budgeting:* The proposed project team has experience in planning and budgeting as it has had the experience of preparing the plan and budgeting for other World Bank–financed projects including CBSP and IPFF. Thus, the overall planning and budgeting process at the implementing-agency level is considered *satisfactory,* and the assessed associated risk is *low*. However, staff may need further training to sharpen their monitoring skills.

A4.15 A budget will be maintained for the entire term of the project, and detailed budgets for each *fiscal* year will also be produced to provide a framework for financial management purposes. The annual budget will be prepared on the basis of the procurement plan and any other relevant annual work plans. These budgets will be monitored periodically to ensure that actual expenditures are in line with the budgets and to provide input for necessary revisions.

### *Internal Control*

A4.16 *Filing and Record Keeping*: BB and PFIs will preserve all procurement records and documents in accordance with provisions of the Public Procurement Act 2006 (PPA 2006) and the OM as applicable. These records must be made readily available on request for audit, investigation, or review by the government and the World Bank. All project-related documents must be filed separately to facilitate internal and external audits, as well as reviews by the World Bank.

A4.17 *Controls:* BB has a relatively strong Internal Audit Department, which is fully independent of executive control. The head of internal audit reports to the Board Audit Committee, which comprised four independent members and an adviser, who joins the meeting on call, as and when required. BB's Internal Audit Department carries out audits of World Bank–funded projects at least once in a year.

### *Oversight Arrangements*

A4.18 *External Audit:* The Foreign Aided Projects Audit Directorate (FAPAD) of the Office of the Controller and Auditor General will conduct an audit of the project's annual financial statements within six months from the end of the fiscal year. The PD will be responsible for

[46] For the past and current projects, there are no overdue project audit reports.

audit follow-up and for taking remedial actions. Meetings to resolve audit objections must be held within three months of the receipt of the external audit report from FAPAD.

A4.19 *Procurement Complaints:* In addition to the grievance redressal mechanism which is in place, for procurement related aspects BB will establish a system for managing complaints, including a database for recording, monitoring, and following up on all procurement activities. The World Bank must be notified of any complaints to ensure transparency in the resolution process.

***Procurement Considerations in the Fiduciary Assessment***

A4.20 Total procurement under component 1 and component 2 of the project will be around US$47 million, out of which goods of US$39.25 million and consulting services of individuals and firms are about US$7.75 million. Procurement would be carried out in accordance with the World Bank's "Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants" dated January 2011 and revised July 2014 (Procurement Guidelines) and "Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by World Bank Borrowers" dated January 2011 revised July 2014 (Consultant Guidelines), as well as the specific provisions stipulated in the financing agreement. Component 3 is around US$284 million, and procurement will carried out following commercial practice. A general procurement notice (GPN) for all major procurement to be financed by the proposed project will be published on the Bank's external website and the United Nations Development Business (UNDB).

**Procurement under Component 1 and Component 2:**

A4.21 *Procurement of Goods and Works:* Except as otherwise agreed in the procurement plan, procurement of goods and works would follow ICB procedures. Procurement of goods and works with an estimated value that is less than the ceiling stipulated in the procurement plan may follow National Competitive Bidding (NCB) and Shopping procedures. Direct Contracting (DC) may be allowed under special circumstances with prior approval of the Bank. NCB contracting would be carried out under the Bank's Procurement Guidelines, following procedures for the Open Tendering Method (OTM) of the Public Procurement Act, 2006 (PPA 2006) (including the first amendment to the PPA, 2009) and the Public Procurement Rules, 2008 (PPR 2008) (as amended in 2009), using standard bidding documents satisfactory to the Bank. For the purpose of NCB contracting, the following shall apply: (1) post bidding negotiations shall not be allowed with the lowest evaluated or any other bidder; (2) bids should be submitted and opened in public in one location immediately after the deadline for submission; (3) lottery in the award of contracts shall not be allowed; (4) bidders' qualifications and experience requirements shall be mandatory; (5) bids shall not be invited on the basis of percentage above or below the estimated cost and contract award shall be based on the lowest evaluated bid price of compliant bid from eligible and qualified bidder; and (6) single-stage two-envelope procurement shall not be allowed.

A4.22 *Procurement of Non-consulting Services:* Except as otherwise agreed in the procurement plan, procurement of non-consulting services would follow ICB procedures. Procurement of non-consulting services having an estimated value less than the ceiling stipulated in the procurement plan may follow NCB procedures.

A4.23 *Selection and Employment of Consultants:* The following methods will apply for selection of consultants: Quality and Cost-Based Selection (QCBS), Quality-Based selection (QBS), Fixed Budget Selection (FBS), Consultants' Qualification (CQ), Least-Cost Selection

(LCS), and Single-Source Selection (SSS). Single Source Selection (consultants) may be allowed under special circumstances with prior approval of the Bank. Shortlists of consultants for services estimated to cost less than US$500,000 equivalent per contract may be composed entirely of national consultants. The procurement plan will specify the circumstances and threshold under which specific methods will be applicable.

A4.24 *Staffing:* (1) *Procurement focal person*: BB shall nominate a procurement focal point for the project. The appointed focal point must have sound knowledge in procurement and have formal training, both on the Bank's Guidelines as well as on the PPA and PPR. The focal point will support BB in day-to-day procurement follow-up and preparation of periodic procurement reporting. This focal person will be a mandatory member of all evaluation committees for procurement implemented by BB. (2) *Technical Focal Person:* BB shall nominate an IT focal point for the project. The appointed focal point must have sound knowledge in IT systems and reasonable experience in international IT procurement. This technical focal point will take necessary IT procurement training on World Bank guidelines. The IT focal point will support BB in day-to-day technical support related to IT procurement. This focal person will be a mandatory member of all evaluation committees for IT procurement implemented by BB.

A4.25 *Webpage for Procurement Information:* All information pertaining to bidding and procurement above the specified thresholds, per PPR, must be published on the Central Procurement Technical Unit (CPTU) website. In addition, BB will publish procurement information on its own website. This information must include invitations to bid, bid documents, and requests for proposals (wherever applicable); latest information on procurement plans and contracts; status of evaluations once completed; contract award information; and information covering the poor performance of contractors, suppliers, and consultants, including a list of debarred firms. The website would be accessible to all bidders and interested persons equally and free of charge.

A4.26 *Technical Expert:* Most of the goods procurements are complex IT. BB will hire an experienced international IT expert to develop robust technical specifications and the bidding document.

A4.27 *Publication of Award of Contract*: BB will publish contract award information within two weeks of contract award on its own website, as well as on the UNDB Online and CPTU websites. The following information must be included: contract package number, advertisement date, number of bid documents sold, number of bids submitted along with names of bidders, bid prices as read out at bid opening, name and evaluated price of each bid, number of responsive bids along with name of bidder, name of bidders whose bids were rejected and brief reasons for rejection of bids, name of the winning bidder and the price it offered, and proposed completion of date of contract, as well as a brief description of the contract awarded.

**Procurement under Component 3:**

A4.28 All procurements under this component undertaken by beneficiaries or Sub Borrowers using the proceeds of IDA or a financial intermediary under the credit facility shall follow procedures in accordance with prevailing commercial practices which are acceptable to the Bank and in line with~~,~~ the provisions of clause 3.13 of the Bank's Procurement Guidelines and clause 3.13 of Bank Consultant Guidelines

A4.29 *Project Operations Manual*: An OM will be developed acceptable to the World Bank, which includes detailed processes of established commercial practices for the procurement of goods, services, and works financed under the facility. The OM will clearly describe different methods of commercial practices and the corresponding step-by-step processes. Beneficiaries and Sub-Borrowers will follow this manual. The manual also defines the main responsibilities of PFIs such as: (1) assessing the capacity of the beneficiaries to carry out procurement efficiently; (2) approving acceptable plans for the procurement of goods, works, and non-consulting services and the selection of consultants as may be applicable; (3) agreeing to supervision and oversight arrangements under each sub-loan (consistently with the provisions under the World Bank loan) for the procurement to be carried out by the beneficiaries to ensure compliance with the agreed private sector methods and commercial practices under the sub-loans; (4) maintaining all relevant records for the World Bank's post review and audits when requested; and (5) satisfying itself with the reasonableness of the price of contracts awarded by the beneficiaries in the particular market through the hiring of an independent entity or auditors, if necessary.

A4.30 *Procurement Check List:* The PFIs will develop and follow a procurement checklist as a part of the OM while carrying out procurement under the project.

A4.31 *Credit Rating Certification by Independent Organization*s: For international bidder, PFI will check the credit rating of the recommended bidder by an independent organization as part of its loan approval process.

A4.32 *Procurement Capacity Development*: BB will hire a firm for financial capacity building for long term credit activities of PFIs. As part of this support, the firm will carry out procurement capacity development within the PFIs. PFIs may take advisory support from the firm on general and specific procurement cases as required.

A4.33 *Review by BB*: On a sampling basis, BB will do periodic spot checking using its own resources to verify the actual implementation of a contract. In addition, every year BB will hire an independent firm to review the procurement and contract implementation process by the beneficiaries and sub-borrowers on a sample basis (sample size will depend on risk). BB will share that report with the World Bank.

A4.34 *Prior Review of Procurement Decisions*: IDA's prior review of procurement decisions will be governed by appendix 1 of the Bank's Guidelines. For each contract to be financed by the credit, the monetary threshold for prior review and post review will be identified in the procurement plan. During the first 18 months of the project, IDA will carry out a prior review of the following contracts (to be updated based on the procurement performance of BB): (1) all contracts for goods and non-consulting services following international competitive bidding and direct contracting procedures irrespective of estimated cost; (2) all contracts for goods and non- consulting services following national competitive bidding procedures estimated to cost US$1,000,000 or above; (3) all contracts for consultant services following single-source selection procedures irrespective of estimated cost; (4) all contracts for firms estimated to cost US$500,000 or above; and (5) all contracts for individuals estimated to cost US$200,000 or above. In addition, all terms of reference for consultants will be subject to the Bank's review, irrespective of the prior review status of the contract. *(6) Procurement by the Beneficiaries and Sub-borrowers Following Commercial Practice:* All contracts estimated cost US$5,000,000 or above.

A4.35 *Post Review by the Bank:* The World Bank will conduct a fiduciary post review (procurement and financial management) on a sample basis. The sample size will depend on risk and efficiency. This review will be on an annual basis and will cover the contracts implemented by BB and the contracts implemented by beneficiaries and sub-borrowers following commercial practice.

***Financial Management Considerations in the Fiduciary Assessment***

A4.36 *Staffing:* BB has adequate and experienced staff with previous experience in IDA projects. BB shall ensure that the required FM staff will be in place once the project becomes effective. In case of staff turnover, BB will ensure placement of new staff from BB so that financial management activities continue without interruption.

A4.37 *Fund Flow:* For use of IDA's share of eligible expenditure, BB will open a dollar special deposit account under terms and conditions acceptable to IDA. The Project Director and, in his or her absence, an alternative official will be the authorized persons for issuing checks or payment advices and replenishment requests to IDA. In respect of claims on category 2 (sub-loans), utilization of funds as reported by the firms would be included as expenses in the Financial Management reports (FMRs).[47]

A4.38 BB will be responsible for transferring IDA funds to eligible PFIs that will lend the funds to approved private investors. For payments relating to goods, works and services under the project, BB will pay directly per the terms and conditions of the approved signed contracts. Report-based disbursement procedures will be applicable for withdrawal of funds from the credit. The IDA ceiling will be mentioned in the disbursement letter based on the forecast for two quarters.

A4.39 *Accounting Policies and Procedures:* The accounting policies and procedures of the project will be governed by the existing BB Accounting Policy. All project-related transactions—i.e., all sources (IDA and GOB/BB)—will be accounted for separately by BB following double-entry bookkeeping principles and on a cash basis. The existing software will be customized to meet project-specific needs and will be installed in the project once the credit becomes effective.

A4.40 The key project accounting functions for which BB will be responsible are as follows: (1) budget preparation and monitoring; (2) payments for eligible project expenditure; (3) maintenance of books and bank accounts; (4) cash flow management; (5) financial reporting to the GOB, the World Bank, and other stakeholders; (6) preparation of withdrawal applications to claim funds from the World Bank; and (7) assistance to external auditor and ensuring appropriate follow up of audit.

A4.41 BB will be responsible for consolidating financial information, maintaining supporting papers, and preparing financial statements on a monthly basis.

A4.42 The Financial Management reports (FMRs) will include: (1) financial statements (sources and uses of funds, uses of funds by project activity, and the special account reconciliation statement); the FMR will be submitted to IDA no later than 45 days after the end of each calendar quarter. By complying with the GOB Policy, BB will ensure that all project financial information is provided periodically to the CAO of the MOF. This is to ensure that project funds routed through the special account is reflected in the government accounts as well as in the consolidated financial management reports.

[47] Sub-loans for expenses incurred at or before the closing date will be eligible for disbursements up to a period of 4 months after the closing date.

A4.43 *Disbursement:* The following disbursement categories are proposed for the IDA Credit:

| **Category** | **Amount of the Financing Allocated (in SDR)** | **Percentage of Expenditures to be Financed (inclusive of Taxes)** |
|---|---|---|
| (1) Goods, works, non-consulting services, consultants' services, Operating Costs, and training for the Project (other than for Sub-loans) | 33,500,000 | 80% |
| (2) Sub-loans | 179,900,000 | 86.9% of the amounts disbursed for a Sub-loan |
| **TOTAL AMOUNT** | 213,400,000 | 85.7 |

*Environmental and Social (including safeguards)*

**Environmental Safeguards**

A4.44 Applicable Environmental Category and Safeguard Polices. The project is classified as a Category FI project since the financing to the existing firms (mainly manufacturing industries) will be channelled through PFIs. The policy on environmental assessment (OP/BP 4.01) has been triggered for the proposed operation to ensure that the project design and implementation will be focused on reducing adverse impacts and enhancing positive impacts. The environmental safeguard policies Natural Habitats (OP/BP 4.04), Forests (OP/BP 4.36), and Physical Cultural Resources (OP/BP 4.11) have not been triggered since most of the investment will be on the current premises of the industries.

A4.45 The occupational health and safety has become a concern in Bangladesh in recent years. The loss of 1,136 lives when *Rana Plaza* collapsed on 24 April 2013 sent shockwaves worldwide. Coming just months after the fatal fire at *Tazreen Fashions* in which 112 died it was clear that the Bangladesh Ready Made Garment (RMG) sector had reached a crucial juncture. Business could not continue as usual. Fundamental changes relating to safety, inspection and compliance had to be made if the lives of over four million workers were to be safeguarded and the confidence of global buyers retained. It has been now realized that improved occupational safety and health enhances productivity by reducing the number of interruptions in the manufacturing process, reducing absences, decreasing the number of accidents and improving work efficiency. Two initiatives representing international brands and retailers: the Bangladesh Accord on Fire and Building Safety and the Alliance for Bangladesh Worker Safety have carried out inspections of the 1,687 factories which their member companies source from. During 2014 the Bangladesh University of Engineering and Technology (BUET) undertook inspections of 471 RMG factories under the national initiative. In January 2015, two private sector companies were engaged to carry out structural, fire and electrical safety inspections of the remaining national initiative factories. The project will create opportunity to the factory owners to implement the recommendations to improve the factory level occupational health and safety condition by accessing the long-term financing.

A4.46 Approach to Addressing Environmental Safeguard Issues. The proposed project will be implemented over a period of five years. BB intends to ensure that the proposed investments take environmental concerns into account and that PFIs improve their institutional capacity on environmental management. Details of the subprojects to be implemented under FSSP will be finalized during the project implementation phase and therefore the exact locations, size, and extent of the subprojects will remain unknown at the project appraisal stage. Instead, an Environmental and Social Management Framework has been prepared for the project describing the procedure of environmental screening, assessment, management plan preparation and implementation, monitoring, and reporting. The screening of the existing facilities will examine the current environmental conditions and practices of the industries.

A4.47 The ESMF has been prepared based on the following: (1) the environmental and social management system diagnostic report (prepared by IFC) of two leading banks; (2) a quick assessment of the environmental issues in the manufacturing sectors; (3) stakeholders' consultations during project preparation; (4) identification of the institutional barriers and capacity building needs for environmental management and (5) the Environment Conservation Rules (ECR) 1997 and the Environmental Conservation Act 1995 of GOB.

A4.48 The ESMF prepared for the project meets the requirements of Department of Environment of Bangladesh and the World Bank Environmental Safeguard Policy. The ESMF will be the guiding document for subproject-specific: (1) environmental screening of existing facilities and proposed investments; (2) assessment of proposed investments (for high-risk subprojects); (3) consultation and disclosure; (4) preparation of an environmental management plan with budgeting; (iv) implementation and supervision of EMP; and (v) reporting and quality control, among others.

A4.49 Further to the ESMF, the relevant Environmental, Health, and Safety Guidelines of the World Bank Group will be applicable to the project.

A4.50 ESMF also takes into account the Environmental Risk Management (ERM) Guidelines of BB, which were issued in 2011 as mandatory requirements for all scheduled financial institutions. The ERM Guidelines are being reviewed now; supported by IFC, BB is scheduled to issue the new ERM Guidelines by June 2015. The new ERM Guidelines are expected to address the environmental impact mitigation measures in detail and to cover the social aspects. The guidelines will also integrate credit risk with the environmental and social risks in the overall decision-making process. In addition, it will spell out the organizational requirements for effectively following the guidelines.

A4.51 Borrower's Capacity on Environmental Safeguards. The BB is familiar with the World Bank safeguard policies through implementing the Investment Promotion and Financing Facility (IPFF) Project. IPFF has provided the opportunity to BB and participating PFIs to learn the bank safeguard policies and its application. BB is also monitoring the implementation of the environmental management plan with the support of a national firm. BB has established the Green Banking and Corporate Social Responsibility (CSR) Department on April 4, 2013, with a view toward developing a sustainable banking (i.e., green banking, CSR, and financial inclusion) framework and integrating it into the core business operations of banks and FIs through efficient and effective implementation of green banking, CSR, and financial inclusion. The PCU (FSSP cell) will be the focal unit for the environmental management work of FSSP which will be done in coordination with the Green Banking and CSR department. The project will provide the opportunity to strengthen BB's own institutional structure and capacity on environmental management.

A4.52 To build further capacity of PFIs, it has been agreed that the PFIs selected for the project will have a dedicated desk and regular qualified staff or consultant on environmental management before participating in FSSP. In addition, the project has a TA provision that will help PFIs build their own capacity on safeguard management. The TA consultant for environmental and social management will be on board from the inception of the project.

A4.53 Environmental Assessment and Review. The ESMF also provides guidelines on subproject environment and social risk categories. These are: (i) high risk transaction; (ii) substantial risk transaction; (iii) moderate risk transaction; and (iv) low risk transaction. Although PFIs have not yet been identified, the prospective PFIs will be required to use the procedures outlined in the ESMF in reviewing and appraising sub-borrowers/sub-projects, and to inform firms of the environmental requirements for subprojects appraisal, so that sub-projects can be implemented in an environmentally sound manner. The firms will be responsible for carrying out any environmental analysis and for confirming that the proposed sub-projects comply with national environmental legislation and for obtaining the necessary environmental clearance from the Department of Environment (DoE). The environmental documents will also confirm the World Bank safeguard policies requirement.

A4.54 Green Banking and CSR Department of BB will post review on sample basis the ‘low’ risk and ‘moderate’[48] risks subprojects environmental documents. However, in the initial year they will prior review all ‘substantial’ and ‘high’ risk subprojects and thereafter on a sample basis depending on the experience of the first year for such cases. The ToR for EIA of these types of subprojects needs to be cleared earlier by Green Banking and CSR Department.

A4.55 All high risk transactions will require prior review and clearance of the World Bank. A detailed capacity assessment will be carried out during the Mid-term review or a suitable time to assess the capacity development of PFIs and BB. Depending on the capacity development, the clearance role can be delegated to BB. The World Bank will prior review first three substantial risk transactions to ensure the template/expectations are understood and thereafter applied.

A4.56 Environmental Safeguard Supervision and Monitoring. The PFIs will be responsible for regular supervision and monitoring of the EMP implementation. The PFIs will submit quarterly reports to BB on the implementation of the EMP at the industrial level. In addition, the independent third-party monitoring of the project will include the provision of an environmental specialist on the team to monitor the compliance of the environmental management issues of the project. The terms of reference for the environmental consultant have been included in the OM/ ESMF.

A4.57 Consultation and Disclosure. The ESMF was prepared in consultation with the key stakeholders, including the BB, PFIs, IFC, industry sectors, and communities. A consultation workshop was undertaken by BB on March 23, 2015 to share the draft ESMF with all the stakeholders and take their opinions before finalizing the ESMF. Consultation with labor and nearby communities has been made mandatory for environmental screening and assessment of each subproject as relevant. The draft ESMF document has been disclosed on the BB website (www.bangladesh-bank.org) on March 18, 2015, and the Bank’s Infoshop on March 25, 2015, for public comments. The final version of the ESMF were disclosed on the BB website and the Bank’s Infoshop on April 2, 2015 and April 6, 2015 respectively. Hard copies of the document have also been made available in BB and potential PFIs. The disclosure notification was published in one Bangla and one English daily newspaper on April 2, 2015.

**Social Safeguards**

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[48] Risk based categorization has been explained in Chapter-5.

A4.58 Applicable Safeguards Category and Social Safeguard Polices: The project is classified as a Category FI project since the financing to the existing firms (mainly manufacturing industries) will be channelled through PFIs. The project will finance factories' upgrading of equipment and health and safety standards, as well as expansion of existing factories. However, all expansion activities will be limited to the owner's own existing property or located in designated industrial zones or commercial areas/buildings. No land acquisition or displacement of people (physical or economic) will be permitted under the project.

A4.59 OP 4.12 Involuntary Resettlement is not triggered for the project. Since all project activities will be restricted to factory compounds or within industrial zones there is no possibility of affecting indigenous people or their lands, lifestyles, norms, or cultures. Hence OP 4.10 Indigenous People is also not triggered for the project.

A4.60 Approach to Addressing Social Issues. The proposed project will be implemented over a period of five years. BB will ensure that the proposed investments take social concerns into account and that PFIs improve their institutional capacity on social management. Details of the subprojects to be implemented under FSSP will be finalized during the project implementation phase and therefore the exact locations, size, and extent of the subprojects will remain unknown at the project appraisal stage. Instead, as discussed above, an Environmental and Social Management Framework has been prepared for the project describing the procedure of environmental screening, assessment, management plan preparation and implementation, monitoring, and reporting.

A4.61 The project aims to enhance efficiency in manufacturing and management by allowing investment in new technologies. Any adverse impacts on livelihoods (for example, rendering labor redundant due to new technologies) will be mitigated through the implementation of tailored mitigation measures incorporated in the Environmental and Social Management Framework. The project may provide new equipment and technologies to leather factories that have been instructed to relocate by the government; such cases will be treated as high risk, and the ESMF will provide guidance on how to screen these cases to assess whether the relocation procedures took appropriate and sufficient measures to handle laborers who worked in those factories. If appropriate rehabilitation or compensatory measures were not undertaken, the project will not fund those factories.

A4.62 The ESMF will be the basis for conducting all social screenings, assessments, and management plans as appropriate. The focus of the social framework for this project will be those related to the labor standards. It will essentially include guidance on (1) social screening of existing facilities and proposed investments; (2) assessment of the social risks of proposed investments (for high-risk subprojects); (3) stakeholder analysis, consultation, and communication and disclosure; (4) labor and working conditions; (5) gender; (6) grievance and complaint handling mechanisms; (7) preparation of social management plan (SMP) with budgeting; (8) implementation and supervision of the SMP; and (9) reporting and quality control, among others. The screening of the existing facilities will examine the current labor and working conditions and practices of the firm.

A4.63 Borrower's Capacity to Handle Social Issues. The BB is familiar with World Bank safeguard policies through implementing the Central Bank Strengthening Project and the Investment Promotion and Financing Facility project. It established the Green Banking and CSR Department on April 4, 2013, to develop sustainable banking (i.e., green banking, CSR, and financial inclusion) framework and to integrate it into the core business operations of banks and FIs through efficient and effective implementation of green banking, CSR, and financial inclusion.

A4.64 BB will be responsible for the management of the social issues that pertain to this project. The department will be a useful support to other projects and activities that BB undertakes in the future. The department may be staffed with consultants who are knowledgeable in the relevant fields alongside internal staff who can develop capacity and lend their expertise on the internal organizational context required to create the implementation arrangements for social plans and mitigation measures. In addition, the project has a TA provision to help PFIs build their capacity on safeguard management. The TA consultant for environmental and social management will be on board from the inception of the project.

A4.65 Social Safeguard Supervision and Monitoring. The PFIs will be responsible for regular supervision and monitoring of the implementation of any social plans or mitigation measures under all subprojects. The PFIs will submit six monthly reports to BB on the implementation of such plans. The terms of reference for a third-party monitoring firm that will review a sample of cases financed by the project has been included in the OM/ESMF.

**Monitoring and Evaluation**

A4.66 The monitoring and evaluation of the proposed project will be integrated into the various project components. The implementation of an efficient M&E framework is essential to ensuring that the activities undertaken will consistently contribute to achieving the Project Development Objectives. The FSSP cell of BB will bear primary responsibility for project monitoring and evaluation. Project performance monitoring will be based on key performance indicators and intermediate outcome indicators as included in annex 1.

A4.67 The FSSP cell will establish standard formats with baseline information and data, guidelines for data collection, and report updates of M&E to the PSC. For the long-term credit line (component 3), the data on project outcomes and results will be generated as an integral part of the day-to-day business of the PFIs. The data will be provided to the FSSP cell by the PFIs on a regular basis, in an agreed format; this will also include periodic performance reports covering both credit information on firms and progress on specific TA to commercial banks, wherever applicable. The FSSP cell will take responsibility for compiling, analyzing, and reporting this information to the PSC, the World Bank, and other relevant stakeholders. Financial performance of the PFIs will be monitored through independent auditors' reports. The PSC will provide strategic policy guidance and oversight of the project implementation. In addition, the project will finance an M&E consultant to support BB on monitoring and evaluating results.

A4.68 BB will monitor the implementation of the project through quarterly financial management reports, annual audits, and other reports on a semi-annual basis. A midterm review will be conducted within 30-36 months of project effectiveness to assess implementation progress. This will provide an in-depth assessment of progress toward project outcomes and will recommend measures to reorient the project if needed to ensure that it will achieve its objectives. The midterm review of the project will also entail an update of an institutional assessment of the BB and PFIs, including an assessment of management, appraisal standards, and portfolio quality.

A4.69 At project closing, BB will prepare a completion report documenting the projects' achievements, results, cost, and current and future benefits to be derived from it. In addition, a beneficiary feedback mechanism has been integrated into the project.

**Role of Partners**

A4.70 IDA is the sole external financier of the project.

**Annex 5: Governance and Accountability Action Plan**

**BANGLADESH: Financial Sector Support Project**

## Introduction and Background

A5.1 The overall objective of the Governance and Accountability Action Plan (GAAP) is to outline approaches to strengthening management control over the Financial Sector Support Project by reducing potential risks to ensure complete realization of project objectives. It will outline the specific responsibilities of BB to facilitate effective and appropriate use of the funds for the project and maintain good governance in the management and implementation of project activities.

A5.2 The GAAP is based on an assessment of probable governance risks, particularly fraud and corruption, in the context of Bangladesh and specifically for the entities involved with the FSSP. It is also based on the experience and lessons learned from the previous Bank-funded project—Central Bank Strengthening Project—with the same implementing agency. Based on any major change in the policy environment, the GAAP is expected to be reviewed and adjusted as and when necessary during the project implementation period to reflect any emerging governance issues or to reinforce existing actions and add new ones. The action plan will be monitored regularly through the measures agreed upon with the implementing agency, as well as during the World Bank implementation support missions.

## Country Context

A5.3 Bangladesh has undertaken a number of initiatives to improve the quality of governance and has managed to make progress on governance indicators. Considering the global indicators, it is deemed essential to continue the effort of improving governance as a key priority to achieve the country's development aspirations. The core governance systems are targeted for improvement through strengthening of core governance institutions. To combat corruption, the legal framework under the Anti-Corruption Commission has been put in place. Aiming to increase transparency, the Right to Information Act 2009 was enacted with a view toward facilitating greater access of citizens to public documents. Massive automation initiatives have been taken to reduce the number of person-to person interactions needed to get public services. A National Integrity Strategy was adopted in 2014 to improve the morals and ethics of public servants in the country. Although Bangladesh has improved its governance culture to a great extent, there is still scope for improvement in public sector governance. Ensuring good governance in the implementation of this project would require an action plan to mitigate the probable corruption and governance risks relevant to the project.

## Governance in Financial Sector

A5.4 Financial institutions play vital role of intermediation and serve the diverse financial needs of the growing economy. The magnitude of their role underscores the importance of governance in the financial sector. A number of initiatives have been taken by BB to ensure good governance with particular focus on the accountability and transparency of management in the financial sector. The legislative framework related to the financial industry has been revised with a view toward helping improve governance and strengthening discipline in the financial system. Automation of the financial sector was a major step for the central bank in ensuring financial discipline. BB has introduced the Integrated Supervision System and the Foreign Exchange Monitoring Dashboard. In addition, the Integrated Export Monitoring System has put in place with the National Board of Revenue to intensify financial sector supervision. However, governance is an issue needing continuous scrutiny and is addressed regularly and whenever required.

A5.5 The project outcomes are designed to be realized through three main components: (1) strengthening financial market infrastructure; (2) strengthening the regulatory capacity of BB; and (3) supporting long-term financing. Strengthening financial market infrastructure will be based on the achievement of the Central Bank Strengthening Project and designed to improve the infrastructure further. This component is expected to leverage the existing infrastructure established under the earlier project and take the benefits of automation to the next level of excellence. This component will ensure good governance by enhancing the integrity and transparency of the financial system and the greater reliability of the credit reporting system. Some of the activities under this component are linked with other organizations like banks, nonbank financial institutions, government agencies, and the like. All-out support from these external organizations during the implementation and linking up their systems will be a challenge for project management.

A5.6 Under component 2, strengthening regulatory capacity will reinforce the supervisory framework and consequently mitigate inherent risks of the financial sector, thereby ensuring improvement of the governance and accountability of bank management. Supporting long-term financing under component 4 is designed to facilitate the improvement of domestic output. This will be an on-lending activity where PFIs will select prospective manufacturing firms needing long-term financing support and will use FSSP fund to finance them. Major governance risks in this component lie with the PFIs. Eligibility criteria for PFIs have been identified in the Operational Manual. In order to qualify as a PFI and to access the facility's funds for long-term financing, the PFI must meet the defined list of eligibility criteria outlined in the OM. To be an eligible PFI, financial institutions will be required to improve their overall performance, maintain regulatory provisions, and enhance their internal control and compliance. The PFIs must have well-defined policies and procedures for managing financial risks (liquidity, credit, foreign exchange, interest rate, and market risk, including risks associated with balance sheets and income statements). These efforts will in turn ensure overall governance in the respective institutions.

**Description of Governance Risks and Mitigation Actions**

A5.7 The following five areas of governance and accountability risks have been identified under the FSSP: (1) project formulation and design; (2) project implementation and oversight; (3) procurement capacity, including contract management; (4) financial management capacity and systems; and (5) environmental risk management.

A5.8 A number of governance risks and issues are associated with the implementation of the project. These risks are categorized under the areas mentioned above. The GAAP matrix delineates mitigation actions for each of these issues, shows a timeline for each action, and indicates the official or agency responsible for implementation. The GAAP matrix appears in annex 1.

**Disclosure of Project Information**

A5.9 BB will upload all project-related information to its official website. It will also be updated regularly. A member of the Project Implementation Unit will be designated as information officer. In addition, BB and the FSSP CELL will ensure due diligence on all other information disclosure in the light of the Right to Information Act 2009.

**GAAP Monitoring, Remedies, and Sanctions**

A5.10 The Bank will apply sanctions per its guidelines if it determines incidence of fraud, corruption, collusion, or coercive practices. These sanctions may include fines, blacklisting, suspension of disbursements, or, ultimately, cancellation of the contract. The Bank will seek first to remedy cases of corruption through cooperation with BB. Information on such cases, where lessons are learned and funds are retrieved, will be widely disseminated.

A5.11 GAAP will be monitored regularly through indicators and reflected in progress reports by the implementing agency, as well as in World Bank implementation supervision reports and aide memoires for supervision missions. The GAAP matrix will be used widely for monitoring purposes (see table 6). Any "early warning" indicators of governance and accountability risks will be monitored regularly so that corrective measures can be carried out promptly. A governance specialist will also be included in the Bank supervision team to strengthen the dialogue on the governance and accountability issues with the implementing agency.

A5.12 The project will require intensive supervision by Bank staff. Supervision arrangements for this project, particularly for procurement and financial management, are extensive. Bank supervision missions will be more frequent at the start of the project and will involve qualified staff in all disciplines, including procurement and financial management. The Bank will also conduct regular monitoring between supervision missions.

A5.13 The GAAP will be adjusted as necessary during implementation to reflect governance issues that may emerge or to add actions. Considering the project design, fund flow, and oversight arrangements—and subject to meeting the agreed GAAP—the implementing agency will have adequate systems for accurately accounting for and reporting on project resources and expenditures and for ensuring that the project funds are used for their intended purpose.

**Table 6: Governance and Accountability Action Plan Matrix**

| Issues/Risks | Mitigation Actions | Timeline | Responsibility |
|---|---|---|---|
| **A. Project implementation and supervision** | | | |
| Delays resulting from lack of coordination between BB and GOB | • A Project Steering Committee will be formed chaired by the governor of BB, including deputy governors, Finance Division, Economic Relations Division, Implementation Monitoring and Evaluation Division, and Planning Commission. Project director will act as the member secretary to the PSC.<br>• Implementation of each component will be assigned to a component leader who will give the overall guidance to the implementation team. | • Meeting of the PSC will usually be convened half yearly. However, the PSC may meet anytime if required.<br>• Will be assigned at the start of project implementation. | • Project director (FSSP), BB Management. |
| Inadequate leadership or delegation within the Project Implementation Unit. | • A full time project director and a deputy project director will be appointed to carry out the project activities. An implementation unit is already in place with experienced officials from the CBSP project. The implementation unit can fill the gaps in the absence of any project personnel. | • Already in place. | • FSSP cell. |
| Delays in obtaining approvals from concerned government agencies. | • As the Project Steering Committee consists of senior members from all the concerned government agencies, if any approval needs special attention, it will be raised in PSC meeting and intervention by the PSC members will help get timely approvals. | • As and when required. | • FSSP cell. |

| Issues/Risks | Mitigation Actions | Timeline | Responsibility |
|---|---|---|---|
| Lack of monitoring and evaluation skills hamper tracking of project progress. | • Employ a monitoring and evaluation specialist to support the FSSP Cell in the initial phase of implementation.<br>• Develop a strong M&E framework with the help of monitoring and evaluation specialist. | • Hiring expert: At the beginning of the project.<br>• Reporting: All required reports will be prepared in a timely manner. | • Project Implementation Unit, project director. |
| Inadequate coordination across functional units of BB. | • Regular coordination meetings will be arranged with the concerned departments. Special meetings will be held as and when necessary.<br>• Senior executives of BB will be engaged as component lead for each of the components and will be responsible for ensuring implementation of the related components. A component coordinator from the FSSP cell will be assigned to work with the component lead to ensure proper coordination among different functional units of BB. | • Throughout the project life. | • FSSP cell and project director will play the coordination role. |
| Inadequate representation from BB's various departments in project implementation. | • Two IT departments will be engaged in implementation of component 1, and the component lead will monitor their implementation progress<br>• Relevant departments will be engaged and a team will be created with the officials of those relevant departments to implement component 2.<br>• The existing Export Development Fund unit of FRTMD will be strengthened, or a separate unit will be created to implement component 3. | • At the start of implementation. | • Component lead and project director. |

| Issues/Risks | Mitigation Actions | Timeline | Responsibility |
|---|---|---|---|
| | • The FSSP cell will be responsible for component 4. | | |
| Inadequate resource allocation to each component. | • A component coordinator will be appointed for each component in the Project Implementation Unit.<br>• The component coordinator and his or her team will help the component lead of each component.<br>• The component lead will use the resources from the relevant functional areas to achieve the project goal.<br>• Consultants and experts in the related areas will be hired to help the component leads.<br>• The project director will sit regularly with project implementation unit to review and steer the implementation of each component and activity. | • As and when required. | • Deputy project director and component coordinators. |
| Lack of appropriate guidance on long-term financing facility. | • Consult with the bank and FIs before finalizing the OM and policy circulars.<br>• Arrange meetings with banks, FIs, and other stakeholders to review the Operational Manual and circulars for updating. | • Policy guidelines will be circulated before the project commencement. | • Foreign Exchange Policy Department will be responsible for formulating necessary policy circulars and reviewing the Operational Manual from time to time. Coordination will be done by the Project Implementation Unit. |
| Risk that PFIs do not follow project guidelines | • PFIs will be selected on the basis of overall performance. | • Throughout the project life. | • Foreign Reserve and Treasury Management |

| Issues/Risks | Mitigation Actions | Timeline | Responsibility |
|---|---|---|---|
| | • A series of workshops will be conducted for officials of banks and FIs to inform them about the procedures to be followed.<br>• Routine and surprise inspections and checks will be conducted by FSSP Cell /FRTMD.<br>• The credit risk of the investment will be on the PFIs' shoulders, and hence they have to bear the consequences of selecting inappropriate borrowers. | | Department of BB and Project Implementation Unit. |
| Risk that there will be improper selection of PFIs | • PFIs will be selected strictly according to the eligibility criteria specified in the OM.<br>• PFIs will select borrowers and projects based on current best practices and any relevant terms and conditions specified in the OM.<br>• If the PFIs fail to maintain the quality of loans, BB can immediately realize the whole loan by debiting the FC clearing account of the PFI. Necessary debit authority will be obtained from the PFIs at the time of disbursement of the refinance. | • Throughout the project life. | • PFIs and Forex Reserve and Treasury Management Department. |
| Risk of improper use of the fund for the designated purpose. | • The FSSP Cell will conduct regular offsite and onsite inspection jointly with other relevant departments of BB both at the PFIs and at the ultimate borrowers to ensure the effective use of the facility for the designated purpose. If any fraudulent act is detected, the entire refinanced amount will be canceled and realized from the PFI. | • Throughout the project life. | • FSSP Cell and other related departments of BB. |
| **B. Procurement management** | | | |

| Issues/Risks | Mitigation Actions | Timeline | Responsibility |
|---|---|---|---|
| 1. Incorrect specifications of goods for the IT systems based on the requirements.<br>2. Unavailability of procurement-related information and all documents in a timely way in accordance with procurement regulations.<br>3. Procurement processes not completed on time.<br>4. Delays in recruitment and availability of suitable consultants during the implementation of specified components.<br>5. Inadequate transparency, accuracy, and efficiency in procurement process. | • The FSSP Cell has comprised personnel with prior experience of complex procurements of goods and services under the previous project, the Central Bank Strengthening Project. In addition, the FSSP Cell officials should have an adequate understanding of IDA procurement procedures, rules, and regulations and a good understanding of IDA's Procurement Guidelines.<br>• A detailed procurement plan and work schedule have been prepared to ensure a smooth flow of procurement under project components 1, 2, and 4. Procurement processes will be carried out per the procurement plan.<br>• One designated procurement focal person will be nominated in the FSSP Cell for effective design and implementation of the project by taking care of procurement-related issues.<br>• A general procurement notice and specific procurement notices will be published in a timely way in relevant media in accordance with the procurement provisions.<br>• All documents will be made publicly available upon finalization of procurement plans through the website of BB and Central Procurement Technical Unit of the GOB. | • Throughout the project life. | • Project director and FSSP Cell. |
| **C. Safeguards management** | | | |

| Issues/Risks | Mitigation Actions | Timeline | Responsibility |
|---|---|---|---|
| Inadequate formulation of proper environmental safeguard framework. | • Prepare an Environmental and Social Risk Management Framework for the project in line with BB's ERM Guidelines, National Environmental Regulations, and IDA Environmental Policy Guidelines with the help of an international expert.<br>• PFIs' compliance with the project's safeguards and fiduciary framework will be monitored by the FSSP Cell in collaboration with the Green Banking Department of BB. | • The Environmental and Social Risk Management Framework will be finalized before commencement of the project. | • Project director. |
| Risk of non- compliance of environmental and social risk management framework. | • PFI will ensure that each of its proposed projects and undertakings is in full compliance with the Environmental and Social Risk Management Framework of the project.<br>• BB has already made it mandatory that environmental risk be incorporated in the Credit Risk Management Framework of all banks.<br>• A Green Banking Unit has been created in all banks to formulate necessary operational policy frameworks to comply with the regulatory requirements to preserve the environment.<br>• A post review of a sample of loan applications will be done to ensure that proper safeguard procedures are followed.<br>• Technical assistance to the PFIs and the potential borrowers will be provided to equip them with the understanding of the environmental risks associated with the loan | • Throughout the project life. | • FSSP Cell and Green Banking and CSR Department. |

| Issues/Risks | Mitigation Actions | Timeline | Responsibility |
|---|---|---|---|
| | projects in the context of long-term financing and the safeguard frameworks. | | |

**Annex 6: Economic and Financial Analysis**

**BANGLADESH: Financial Sector Support Project**

## I. Introduction and Overview of the Analysis

A6.1 An economic and financial analysis of the project was undertaken to assess and answer the following three questions related to the project design and expected outcomes:

- *What is the project's expected economic development impact?* A standard quantitative assessment of costs and benefits of the credit line (in component 3), a quick review of business benefits under component 1, and a qualitative analysis of component 2 and other projects activities (including TA) are used to assess this impact.
- *Is public funding needed and what levels of financing are appropriate?* This part of the analysis explains why public financing is justified and necessary to achieving the desired development impact.
- *What is the World Bank's value added in the project?* This part of the analysis discusses the value added derived from Bank experience and the commitment of Bank staff time and implementation support.

## II. The Project's Expected Development Impact

*Project Benefits*

A6.2 The project would invest US$350 million in improving financial markets, enlarging the capacity of the regulator, and expanding access to long-term finance for the manufacturing sector. The project supports Bangladesh's efforts to develop the financial sector by strengthening financial market infrastructure; improving the regulatory, supervisory, and sector developmental capacity of BB; and building the market for and scaling up long-term finance by exporters and manufacturing firms to spur competitiveness, investment, and growth. In doing so, it addresses some of the key financial sector constraints identified earlier and complements other parallel ongoing efforts to remove the remaining constraints. By strengthening financial market infrastructure, the project contributes to a key public good for the smooth, stable, and efficient functioning of financial markets. By strengthening the regulator's capacity building, including in its supervisory and oversight functions, it would contribute to financial sector stability and mitigation of financial sector risks; and building the regulator's developmental capacity will catalyze financial sector innovations and allow the development of new and innovative products to reach underserved market segments. Through long-term finance and associated technical assistance, the project would help build for LT where currently none exists and is not likely to develop organically in the near future.

**<u>Component 1: Strengthening Financial Market Infrastructure</u>**

A6.3 The proposed activities in component 1 are critical to ensuring the reliability, efficiency, and effectiveness of the financial infrastructure as demonstrated below:

- The systems of the BB are currently operating at 95 percent uptime, translating roughly into 13 days of downtime or degraded performance in a year. This level of downtime will not be tenable once the BB systems become fully computerized. In addition, international standards require that systems like the Real Time Gross Settlement System, the National Payments Switch, the Credit Information Bureau, and the ACH perform at levels of 99.6 percent up time and also provide round-the-clock availability throughout the year.

- Achieving this higher level of uptime will require state-of-the-art hardware and software systems: an extremely robust business continuity plan supported by a robust data replication between the main data center and the near site and the disaster recovery site, which component 1's activities seek to achieve.

- In addition, the current clearing and settlement of T+2 hampers widespread use of the BEFTN system, which has processed around 7 million transactions amounting to BDT 22 billion. This alone has the potential to expand by over 20 times in a period of 10 years. It has been indeed widely acknowledged that a higher use of electronic payments translates into savings for society of about 0.5–2 percent of the GDP. The savings are a result of increased efficiency due to lower indirect costs like wait times at queues, lower leakages, faster reconciliation, reduced losses through fraud and thefts, and reduced float costs.

- This project would also enable greater shifts of cash-based and paper-based payments to electronic means, in particular for government payments. According to a recent study by the World Bank Group, the total cost to society of processing a check in Bangladesh is BDT 125 and that for an electronic funds transaction is BDT 43. Shifting one check payment to EFT would result in a total saving of BDT 82 (about US$1). This would mean that if around 15 million additional transactions are processed by EFT instead of checks, it will result in a saving of around US$15 million annually to society.

**Component 2: *Strengthening the Financial Sector Regulator***

A6.4 Sound legal, regulatory, and supervisory frameworks and effective and efficient supervision are essential for maintaining financial stability and ensuring a safe and sound banking system. As experience from around the world shows, the costs of financial crises can be heavy, running into several percentage points of GDP. The gains from an efficient and stable system that supports productive economic activities through efficient financial intermediation are significant. This component of the project will support reforms by strengthening prudential regulations and will also help BB better supervise and monitor banks, including the SOCBs, and mitigate the risk that that part of the financial system poses to the stability of the entire system. The project will focus on the migration to risk-based supervision as well as support the strengthening of prudential regulations and the completion of preparations for Basel III. When fully operational, the risk-based approach allows the supervisor to monitor individual banks and systemic risks, assign required capital on a bank-by-bank basis, and react accordingly, thereby allocating supervisory resources to areas of greatest concern. It also enables the supervisor to better anticipate risk events, on a specific-bank basis and on a systemic basis before a crisis mode is triggered.

**Component 3: Supporting Long-Term Finance**

A6.5 The proposed project aims to increase long-term bank financing to the manufacturing sector, specifically to the export firms including some SMEs, while also improving the quality of banks' long term lending. Through a combination of financing instruments and technical assistance to financial institutions, manufacturing or other firms, the project seeks to address both the supply- and the demand-side issues that limit firms' access to long-term finance. This activity is expected to have a positive impact on the overall growth of firms particularly in the manufacturing and export sector, economic growth, employment, and poverty reduction.

A6.6 Discussions with banks and other stakeholders have indicated high levels of interest and demand for this project component, including the TA activities. Significant economic benefit is expected to be derived from the project. Broadly, the project will help improve long-term credit market efficiency, strengthen banks' long-term loan appraisal systems and practices, and improve risk management of their loan portfolios (long-term). This should enhance profitable bank lending to viable firms and reduce banks' NPLs. Ultimately, through its economy-wide demonstration effect, the project is likely to generate benefits for a much larger number of banks and manufacturing firms, with wider implications for export growth, job creation, and poverty reduction. Expected project benefits are as follows:

- The credit line will provide banks with access to longer-term resources for on-lending to firms. This will help firms access the term lending (expected average of five years) that is required for capital formation and technological upgrade, thereby facilitating the growth, productivity, and competitiveness of firms.

- The TA interventions targeted at banks are expected to lead to improved efficiencies in loan appraisal quality and processes, better-designed products for firms, improved quality of lending, and higher profitability growth and margins for banks from lending to firms and exporters.

- TA activities are also expected to develop the long-term finance market in Bangladesh by supporting BB in developing long-term capital markets (particularly the secondary bond markets) and in building the pensions market, which is critical for building a long-term financing market in Bangladesh. In addition, the TA activity seeking to develop the use of longer-term savings instruments (e.g., inflation-indexed time deposits targeted at migrant workers, people saving for their retirement, worker provident funds, and the like) will also help address the current term-mismatch problem.

- This component will also build capacity of the PFIs on safeguards management (in conformity with the World Bank Environmental, Health, and Safety Guidelines) and implementation aspects of long-term financing (to ensure proper adherence to fiduciary duties and the Environmental and Social Risk Management Framework).

- This component is also expected to build capacity of different industry associations (such as BGMEA and BKMEA) on safeguards (with particular emphasis on ensuring proper management and mitigation of environmental and social risks in line with World Bank Environmental, Health, and Safety Guidelines).

*Quantification of Project Benefits: Line of Credit (Component 3)*

A6.7 The economic feasibility of the credit line in component 3 of the FSSP is examined through calculating the net present value and internal rate of return of the proposed US$291.3 million credit line to be provided to exporters and manufacturing firms. The NPV and IRR are calculated from the net cash flow of the manufacturing firms, based on several assumptions and simulated over a variety of scenarios. Since more than 80 percent of the total export of Bangladesh is from the ready-made garment sector and data on other manufacturing sectors are not readily available, this analysis assumes the whole amount of the credit line will be absorbed by the RMG sector. In fact, the market survey shows that among banks' loans of 5 years or more, 80 percent were granted to the RMG sector. The economic analysis therefore develops an export sales profile of the manufacturing firms (RMG) that will access the credit and estimates profits from sales proceeds to estimate the net cash flow for calculating NPV and IRR.

A6.8 **Assumptions:** The NPV and IRR calculations are based on the following data, assumptions, and scenarios:

- According to the Bangladesh Garment Manufacturing Exporters Association (BGMEA), there are currently 5,600 manufacturers in Bangladesh. With a total RMG export of US$24.5 billion in FY14, the current export of RMG per firm per year is US$4.4 million.
- The survey on the long-term credit market estimates that the demand for capital investment of one RMG manufacturer is on average US$1.8 million. As the project seeks to focus on mid-size and smaller firms, average loan size of US$ 1.2 million is assumed. Based on this estimate, the project credit line (including recipient's contribution) would be able to provide long-term financing to about 250 firms.
- The credit line will be exhausted in five years (project's duration).
- Garment exports have grown just over 15 percent over the past 10 years. With the *Rana Plaza* disaster in April 2013, Bangladesh's garment export growth in the long term remains challenging. However, with the project implementation requirements (for instance on safeguards) and all the due diligence and credit appraisal process done by the PFIs, firms that benefit from the project are expected to be efficient. Therefore, their growth rate is estimated at 14 percent, for the base case, which is close to the growth rate of the industry for the past 10 years. Results considering a lower sales growth of 12 percent and a higher growth of 16 percent have also been presented.
- The firms will reap benefits of the capital investment two years after accessing the first line of credit, and the growth will continue for five years. After that, growth will become stagnant if no new investment is made.
- Anecdotal evidence and personal interviews with a few industry insiders suggest that the profit margin in the RMG industry varies between 5 and 10 percent. It is therefore assumed that the profit margin of a firm is 7.5 percent, which is the average of the profit margin range.
- A manufacturing unit's lifespan is conservatively estimated as 10 years as the base case. In the sensitivity analysis, operating life spans of 8 years and 12 years have also been considered.
- A discount rate of 12 percent, which is the prevailing rate on government bonds, is assumed to calculate the NPV as the base case. The sensitivity analysis also considers different discount rates of 10 percent and 13 percent.
- It is assumed that 100 percent of the firms that use the credit will be successfully exporting at the 14 percent level.[49] The sensitivity analysis also calculates the NPV and IRR of the project if 75 percent, 85 percent, and 95 percent of the firms are able to use the credit under the base case scenario.

[49] This is expected for the project beneficiaries as PFIs are likely to support the firms that minimize the credit risk and that are potentially successful exporters. At lower levels of sales growth, 10% and 8%, the project remain viable with respectively NPV= $243.28 million and IRR=44% at 10% and NPV= $214.4 million, IRR=41% at 8%.

**A6.9 Results:** Table 1 presents NPV and IRR of the proposed credit line at varying rates of sales growth. In the base case of 14 percent export sales growth and a 7.5 percent profit margin, the NPV of the project is positive at US$306.36 million; at a 12 percent discount rate with an IRR of 49 percent, indicating that the project is viable. In addition, even with a lower export sales growth of 12 percent, the project remains viable.

**Table 1: NPV and IRR at Different Level of Sales Growth**

| Sales growth (%) | 12 | 14 | 16 |
|---|---|---|---|
| NPV(US$ millions) | 273.9 | 306.36 | 340.75 |
| IRR (%) | 46 | 49 | 52 |

*Sensitivity Analysis*

A6.10 **Success Rate of the Firms:** Table 2 provides comparisons of the NPVs and IRRs considering failure of some firms to export after receiving the credit. The table reports these estimations using a discount rate of 12 percent. If 75 percent firms are able to grow in the base-case scenario, NPV remains positive at US$177.28 million and the IRR is 35 percent. If we consider that 85 percent firms will be able to export successfully at the base case, the NPV is US$228.91 million with an IRR of 41 percent. Similarly, for 95 percent successful firms, the NPV is US$280.55 million and IRR increases to 46 percent. Therefore, the results remain robust to changes in the success rate of the firms supported under the project.

**Table 2: Base Case With Different Firm Success Rates**

| Firm success rate (%) | 75 | 85 | 95 |
|---|---|---|---|
| NPV (US$ million) | 177.28 | 228.91 | 280.55 |
| IRR (%) | 35 | 41 | 46 |

A6.11 Given the track record of the RMG sector, it is reasonable to assume that the success rate of the RMG firms will be at least 85 percent. For the rest of the sensitivity analysis, the scenarios are based on the assumption that 85 percent of the firms will be successful.

A6.12 **Different Discount Rates:** Table 3 depicts NPVs at different discount rates of 10 percent and 13 percent. A discount rate of 10 percent increases the NPV of the project to US$271.47 million while at a discount rate of 13 percent NPV reduces to US$210.09 million.

**Table 3: Base Case With Different Discount Rates**

| Discount rates (%) | 10 | 12 | 13 |
|---|---|---|---|
| NPV (US$ millions) | 271.47 | 228.91 | 210.09 |
| IRR (%) | 41 | 41 | 41 |

A6.13 **Different Scenarios in Firm Lifespan:** Table 4 describes the results when the factories operate at a shorter lifespan of 8 years and a longer span of 12 years. As previously described, with 85 percent of firms being successful, the NPV of the project is US$228.91 million and the IRR is 41 percent. If the factories operate for 8 years, the project will still be feasible at an NPV of US$137.31 million and an IRR of 36 percent. The result is also robust to lifespans of factories operating for 12 years.

**Table 4: Base Case with Different Factory Lifespans**

| Years | 8 | 10 | 12 |
|---|---|---|---|
| NPV(US$ millions) | 137.31 | 228.91 | 301.94 |
| IRR (%) | 36 | 41 | 41 |

A6.14 **Conclusion:** The above analysis suggests that at the base scenario of 14 percent sales growth, 7.5 percent profit margin, and 10-year operating life, the project will be feasible with an NPV of US$306.36 million and an IRR of 49 percent. Even if only 85 percent of firms that use the credit are successful in exporting, the project remains feasible with an NPV of US$228.91 million and an IRR of 41 percent. These results are also robust to changes in firms' lifespan and the use of various discount rates.

## III. Justification of Public Funding and Levels of Financial Support

A6.15 Bangladesh's financial sector needs strengthening. Public intervention is needed to ensure that the sector is able to support the GOB's 2021 vision for growth and poverty reduction. Past experiences suggest that the costs of financial crisis can be high—the 2008 global crisis pushed 120 million people back into poverty and created 22 million unemployed persons. Financial instability disrupts financial intermediation and stifles growth of the real economy. The project contributes toward achieving a key public good—the smooth, stable, and efficient functioning of financial markets—by strengthening financial market infrastructure, which to keep up with the growing economy. The project would also contribute to financial sector stability and mitigation of risks by strengthening the regulator's capacity for supervisory and oversight functions. Better supervision and more resilient and efficient public financial institutions are indeed critical.

A6.16 In addition, as demonstrated in section I, there is a long-term financing gap in Bangladesh due to information asymmetries as well as to insufficient capacity and perceived risk by private financial institutions. In addition, banks lack access to sources of long-term funds and capital markets, partly because of underdeveloped long-term pensions and savings markets. This market failure needs to be addressed as it is critical to investment, employment, and growth as well as to Bangladesh's objective of moving toward middle-income status. By supporting long-term finance through the provision of a long-term credit line and associated technical assistance to banks (and industry associations), the project would serve as a catalyst for building a financial market in the long-term financing segment of the market. The use of public funds for the credit line under the project is an integrated part of the project's catalytic role. Through demonstration effects, it will build financial market experience in long-term funding and "crowd in" private provision of long-term finance to meet the investment needs of firms. The demonstration effect, combined with the technical assistance to develop long-term bond markets, can support the creation of new financial instruments.

## IV. World Bank Value Added to the Project

A6.17 The Bank has significant global and regional experience with similar projects. These projects have created a pool of knowledge and experience within the Bank and its staff as well as in its partnering countries. The World Bank will leverage this broad and deep international experience on the four components of the project, including its expertise on credit lines, regulatory and supervisory capacity building, and financial market infrastructure. The Bank team will draw on multiple Global Practices—including Finance and Markets, Trade and

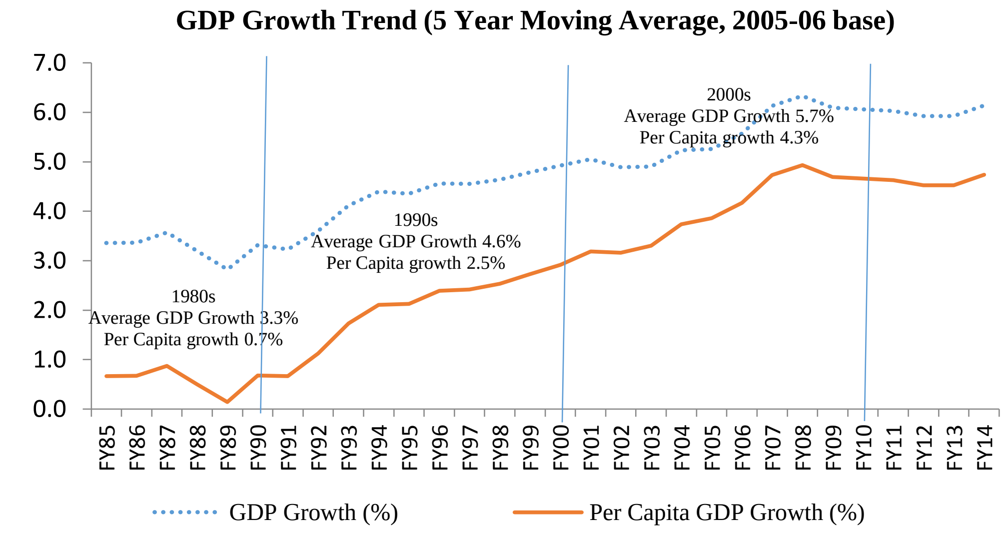
Competiveness, Environment and Natural Resources—and also maintain technical collaboration and coordination with IFC. These shared experiences would help in both design and implementation. In addition to funding assistance, the implementation support, technical oversight, and inputs from the Bank would also benefit the country's own capacity to implement projects.

A6.18 The World Bank has played a leading role in the development of the financial sector in Bangladesh. The Bank has been a long-term partner to the authorities on financial sector policy dialogue and to all the relevant stakeholders (including bankers, bank association leaders, and others). The CBSP, which closed in December 2012, achieved noteworthy results, and the Bank has also provided four technical assistance projects to BB over time, including AML/CFT capacity building, payment system development, contingency plan development, and financial projection model. The Bank has also supported one similar project (IPFF), which focuses on developing the market for infrastructure financing through public-private partnerships. Financing, knowledge, and implementation support are essential to BB's ability to design and implement such a project.

## V. Financial Intermediaries under the Line of Credit (component 3)

***<u>Macroeconomic environment:</u>***

A6.19 **Over the past twenty years, Bangladesh has made significant gains in economic growth, development and poverty reduction**. Average annual GDP growth has risen steadily over the past three decades (see figure below), and grew by more than 6 percent a year on average during the past 5 years despite the adverse impacts of the global recession, oil price rise, and unrest in the Middle East (an important destination for migrants) and natural disasters. As indicated in section I, several factors explain its resilience to global and domestic shocks so far, including good macroeconomic fundamentals, resilience of exports and remittances, relatively under-developed and insulated financial markets, and a pre-emptive policy posture.



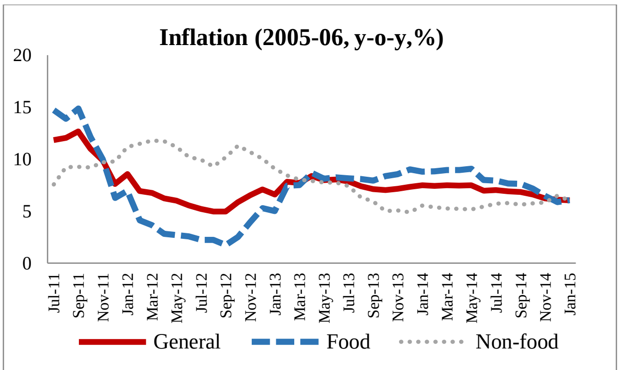

*Source: Bangladesh Bureau of Statistics and WB Staff*

A6.20 **Growth however remains below potential.** It remains below what is needed for Bangladesh to comfortably achieve middle-income status by 2021 (see section I for details).

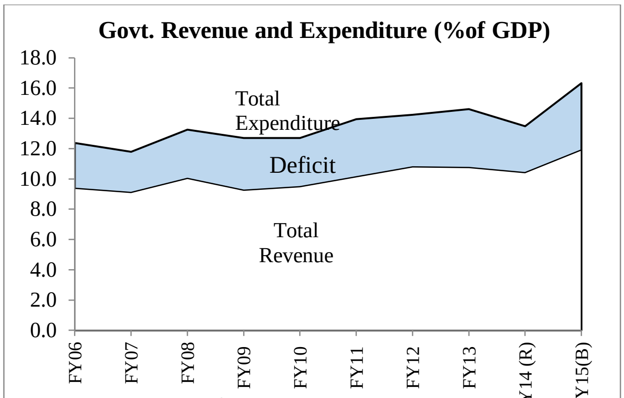
A6.21 **FY15 growth is expected to inch up to 6.2 percent.** Bangladesh's growth resilience in recent years has been tested by political turmoil in the last half of 2013 and its recurrence since early January 2015. Stagnating private investment, remittances slowdown in FY14 and export slowdown in the first half of FY15 contributed further to diffuse the growth momentum. The ongoing political unrest is taking a heavy toll on economic activity, in particular the services sector, agriculture, exports, and non-formal sector businesses. Inter-district transportation has been disrupted, affecting domestic supply chains. Private investment has stagnated since FY12 due to growing political uncertainty and inadequate progress in addressing the structural constraints, particularly in providing land, transport, and energy.

A6.22 **External balances remain comfortable despite weak export growth and strong imports.** Rebound in remittance growth partially offset the impact of increased trade and services account deficit on the current account, which moved to a $1.3 billion deficit during July-November 2014 compared to a $1.13 billion surplus during the same period of the preceding year. This deterioration is the result of 0.9 percent export decline along with 16.6 percent import growth. Growth in import payments is likely to slow down because of the sustained decline in international oil prices and the ongoing political turmoil. Foreign exchange reserves continued to set records, surpassing the $22 billion level by end-January 2015, equivalent to 6.4 months of prospective FY15 merchandise imports.

A6.23 **Favorable international commodity price trends, a stable nominal exchange rate and prudent monetary policy have helped contain inflation.** Inflation has been under control, reaching 6.04 percent in January 2015, partly because of favorable international price trends. But credit is also due to the monetary policy framework which pursued price and external stability. A sizable surplus in the overall balance of payment continued to boost official foreign exchange reserves as the BB (BB) intervened to smoothen volatility in the nominal exchange rate. The conduct of monetary policy continued to be a source of strength for the economy, notwithstanding shortfalls in financial regulation. BB's Monetary Policy Statement for January-June 2015 has kept policy rates unchanged. BB plans to limit broad money growth to 16.5 percent, has set a private credit growth target of 15.5 percent (sufficient to accommodate any substantial rise in investment and trade-financing), and has maintained government borrowing from the banking system within the FY15 budget target of Tk 312 billion (≈ $4 billion).




*Source: Bangladesh Bureau of Statistics*




*Source : Ministry of Finance*

A6.24 **Fiscal policy has remained consistent with macroeconomic stability**. Fiscal deficit was held in check at 3.1 percent of GDP in FY14. The shortfall in tax revenue collection due to the adverse impact of political turmoil on the economy was offset by better control of recurrent expenditures, particularly subsidies. The FY14 subsidy bill was budgeted to decline to 2.2 percent of GDP, compared with 3.2 percent in FY13, while actual expenditure was even lower (1.7 percent). The FY15 budget target for subsidies is 1.9 percent of GDP, but is likely to be much lower because of lower domestic demand for petroleum products due to political turmoil and related transport disruptions and lower international prices of petroleum products, fertilizers, and other hydro-carbon based products. While implementation of the Annual Development Plan has improved in recent years, progress to-date in FY15 is off-target. Past implementation record shows that more than 40-50 percent of the ADP implementation happens in the final quarter of the fiscal year, so it seems there may still be enough time to regain the momentum.

**A6.25 The financial health of state-owned commercial banks remains fragile.** The financial sector in Bangladesh has been adversely affected by a series of financial scams and resultant loan defaults in the state owned commercial banks (SOCBs) over the past 2-3 years, when the staff collaborated with some unscrupulous borrowers to swindle large amounts of money under different instruments. While the authorities have taken some disciplinary actions against a severely mismanaged SOCB, in most cases neither the management nor the Boards of these banks have been held accountable for frauds.

***Financial sector framework:***

*Banking Sector Indicators*

A6.26 The banking sector has demonstrated a strong resilience in the face of political and economic turmoil in the past fiscal year.

A6.27 **Banking Sector Stability:** The capital position of the private commercial banks, which hold more than 70 percent of banking sector assets in Bangladesh, is fairly good, as their average capital adequacy ratio (CAR) is above the regulatory requirement of 10 percent of risk-weighted assets. As of March 2013, only one private commercial bank out of 38 had a negative CAR. All 10 foreign commercial banks were also well capitalized, with an average CAR of 22.40 percent. But the CAR of the two out of four state-owned commercial banks and three out of four specialized development banks, representing more than 26 percent of the banking sector (in terms of assets) still remain below the minimum capital requirement.

A6.28 **Banking Sector Asset Quality:** Nonperforming loans increased in recent times (last five quarters), even in the private and foreign commercial banks. The gross NPL of the banking sector reached 10.45 percent in March 2014, up from 8.93 percent in December 2013. NPLs of all categories of banks—especially of state-owned banks (state-owned commercial banks and specialized development banks)—increased substantially. Defaults on bank loans have been increasing over the past two years because of the sluggish business situation following a political turmoil, bank scams, implementation of tighter loan classifications, and provisioning. Foreign commercial banks are well provisioned (averaging 94.41 percent), followed by state-owned commercial banks (64.37 percent) and private commercial banks (58.91 percent).

A6.29 **Liquidity Position and Fund Management*:*** The advance deposit ratio in the banking sector has decreased to 69.62 percent as of March 2014, down from 71.18 percent in December 2013. The credit or advance-deposit ratio is an important signal of the demand for local currency funding, which has been on a declining trend for the past year as credit demand in the private sector continued to drop due to uncertain investment conditions and high bank rates. As mentioned above, private sector credit growth hit a 13-year low in FY2012–13, and this declining trend has created stagnation in local investment; imports of capital machinery have also been sliding for the past few months. It was feared that this situation would hamper continued economic growth.

A6.30 **Banking Sector Performance and Efficiency:** Profits of most of the listed financial institutions fell over the past year, most likely because political uncertainty has hurt private sector credit growth, income from export-import business has decreased, and loan defaults have risen. Moreover, banks have had to meet higher provisioning requirements under the new provisioning rule, which partly explains their weaker performance. Out of the 30 listed banks, 18 posted significantly lower earnings in 2013. Infrastructural constraints, economic slowdown, and higher rates of interest dimmed enthusiasm for private investment, causing a declining demand for bank loans. The banking sector average return on assets fell farther, to 0.61 percent in March 2014, down from 0.91 percent in December 2013.

***<u>Potential Candidate Banks for the Proposed Project and Their Performance</u>***

A6.31 The broad eligibility criteria are as follows (see more details in annex 4):

- Adequate profitability, capital adequacy, and asset quality and liquidity in accordance with accounting and auditing principles acceptable to the Bank.
- Acceptable levels of loan collections.
- Appropriate capacity, including staffing for subproject appraisal and implementation.
- Adequate managerial autonomy and commercially oriented governance.
- Capacity to mobilize domestic resources.
- Appropriate prudential policies, administrative structure, and business procedures.

A6.32 The result of the review of representative candidate PFIs showed that all institutions reviewed meet the basic eligibility criteria. Selected key financial parameters are displayed in table 5.

A6.33 As seen in table 5, the returns on assets for most of the representative PFIs stood in excess of 0.9 percent, while their capital adequacy position is strong and typically well above the 10 percent prudential requirement. While overall asset quality is within acceptable limits, the public sector banks' portfolios need improvement (they do not qualify as PFIs); however, by and large, banks have undertaken adequate provisioning cover for this portfolio. Liquidity positions for all banks are sustained by a steady growth in short-term deposits and high levels of term deposit renewals; thus, banks are effectively borrowing short to lend longer term.

A6.34 Given the very stable growth in bank deposits over a long period, banks see deposits as long-term and dependable sources of funds for them. Adequate liquidity, the ability to raise resources in the short-term money markets, and strong balance sheets provide a level of comfort for the banks on liquidity aspects. Nonetheless, given the present strategy of borrowing short to lend longer term (with a significant portion at fixed rates), banks will need to reconsider their financing strategy and move toward raising longer-term debt to sustain the longer-term asset deployment objectives in the event of a hardening of interest rates.

A6.35 Overall, the financial review showed that, prima facie, despite challenges facing all the institutions reviewed and the scope for improvement, all these institutions meet the basic eligibility parameters specified in OP10.0.

A6.36 During implementation, BB will assess candidate PFIs using the criteria to determine eligibility, and PFIs' compliance with these eligibility criteria will be closely monitored by BB and tracked on an on-going basis.

A6.37 As indicated in the M&E section, the PFIs will also be required to report to BB on their sub-loan portfolio and on key financial and performance indicators on a quarterly or annual basis, as relevant, and in line with the results framework (annex 1). The financial performance of the PFIs will be monitored through independent auditors' reports.

***Interest rates***

A6.38 The project is consistent with international good practice for wholesale lending facilities and with Bank guidelines and policies on financial intermediary financing (OP10.00) and standards for credit lines. The proposed credit line would be on-lent on market terms, without creating market distortion. BB's proposed on-lending rate is similar to or more expensive than the cost of alternative sources of funds (such as foreign currency) for the commercial banks and NBFIs. As indicated in annex 4, BB will set on-lending rates to cover the cost of funds, operating costs, and currency risk and to be competitive with market rates. The OM contains a detailed pricing matrix based on risks and tenors. An indicative pricing of LIBOR+300bps to LIBOR+400bps has been discussed based on available market benchmarks. Interest rates can be revised by BB depending on market conditions and proposals for revisions would be captured in the OM, which will be agreed with the World Bank. The loan interest rates charged to the ultimate borrowers will also be driven by market conditions and banks and NBFIs will determine rates based on their cost of funds and on credit and currency risks.

In fact, interest rates to firms under the project are expected to be above the rates witnessed in the limited transactions currently evidenced in the market (only 30-35 firms received long term foreign resource denominated financing in 2014; 28 in the last six months). The price from BB to banks - plus an average conservative expected spread for banks takes the end rate to the firms consistent with the limited transactions in the market to a rate a level comparable with above the market reference rates for end rate to firms (relative to the few transactions that were made and indicated above). In part this is since the comparison being made with market transactions is with respect to larger firms with larger loan sizes, whereas the Bank project will focus on mid-sized firms with much smaller transactions (a tenth of current market transactions) – the expectation, confirmed through industry discussions, is that price offered as above, would be of interest to potential beneficiary firms. In terms of comparisons of BB's lending rates to banks and market benchmarks, there are very limited transactions (only two[50], one which was somewhat higher and one that was much lower than the proposed rate under the project) to make any meaningful comparison. Most foreign currency denominated loans to banks in Bangladesh are of short term duration and at rates lower than what is proposed under the project, as expected. Pricing may be adjusted based on market factors and evolving conditions and the intention is that through the demonstration effect and supply of long term financing, market interest and transactions in this segment will build over time.

[50] Further analysis is being conducted and data is being sought to update the description of market data as well as inform discussions with BB on the matter.

**Table 5: Monitoring Indicators of Banks (percent)**

| Banks | Deposit Growth (%) | | Credit Growth (%) | | Credit Deposit Ratio (%) | | CAR (10% of Risk Weighted Assets) | | % of NPL | | Profitability (return on assets) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Mar. 2014 | Dec. 2013 | Mar. 2014 | Dec. 2013 | Mar. 2014 | Dec. 2013 | Mar. 2014 | Dec 2013 | Mar. 2014 | Dec. 2013 | Mar. 2014 | Dec 2013 |
| **Total state-owned commercial banks (avg.)** | **14.63** | **18.38** | **-3.39** | **-4.64** | **56.58** | **55.64** | **9.77** | **10.81** | **21.98** | **19.76** | **-0.09** | **0.60** |
| SONALI | 14.28 | 14.43 | -10.30 | -8.24 | 51.28 | 51.89 | 9.22 | 10.67 | 34.80 | 32.11 | -1.19 | 0.22 |
| JANATA | 12.38 | 17.18 | -2.18 | -7.89 | 61.86 | 59.01 | 10.51 | 11.22 | 12.73 | 10.18 | 0.69 | 1.33 |
| **Total Private Commercial Banks (avg.)** | **16.34** | **14.82** | **12.85** | **11.52** | **75.62** | **77.72** | **12.39** | **12.52** | **5.77** | **4.54** | **0.78** | **0.96** |
| UCBL | 6.57 | 8.57 | 11.74 | 9.06 | 82.26 | 80.21 | 11.61 | 11.52 | 5.68 | 3.83 | 1.60 | 1.35 |
| EBL | 13.14 | 26.80 | -0.84 | 6.60 | 75.09 | 71.53 | 12.27 | 11.98 | 4.91 | 4.02 | 1.30 | 1.63 |
| DHAKA | 5.79 | 8.26 | 8.08 | 11.81 | 80.47 | 80.89 | 11.06 | 12.13 | 5.65 | 3.80 | 0.60 | 1.29 |
| SOUTHEAST | 19.88 | 14.58 | 13.80 | 7.21 | 71.44 | 78.52 | 11.05 | 11.00 | 3.94 | 3.97 | 1.37 | 1.48 |
| DUTCH BANGLA | 11.45 | 15.93 | 3.66 | 15.65 | 66.44 | 68.59 | 13.28 | 13.72 | 4.80 | 3.81 | 0.94 | 1.08 |
| AL-ARAFAH | 23.14 | 15.85 | 25.91 | 19.11 | 88.58 | 89.30 | 13.68 | 13.51 | 3.19 | 2.78 | 1.04 | 1.20 |
| ISLAMI | 20.95 | 13.72 | 9.23 | 7.67 | 79.23 | 82.50 | 13.50 | 13.95 | 4.96 | 3.35 | 0.36 | 0.85 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| SOCIAL Islami | 9.34 | 18.56 | 11.86 | 10.49 | 88.05 | 86.78 | 11.29 | 11.74 | 5.37 | 4.10 | 0.85 | 1.12 |
| ONE BANK | 21.76 | 18.57 | 18.11 | 27.76 | 82.03 | 84.63 | 12.21 | 11.87 | 6.67 | 4.95 | 1.48 | 1.11 |
| EXIM | 23.92 | 21.98 | 16.68 | 20.53 | 86.98 | 87.21 | 12.84 | 13.30 | 4.61 | 3.67 | 0.76 | 1.03 |
| **Total foreign commercial banks (avg.)** | **15.60** | **15.47** | **-0.13** | **-0.62** | **58.63** | **64.49** | **22.40** | **20.27** | **5.32** | **5.46** | **3.48** | **2.98** |
| STD. CHARTERED | 16.64 | 11.49 | -1.35 | 2.10 | 60.03 | 65.17 | 15.02 | 13.32 | 4.61 | 4.83 | 5.26 | 3.67 |
| CITIBANK | 10.45 | 5.28 | -16.93 | -14.48 | 35.60 | 45.70 | 28.94 | 28.68 | 2.81 | 1.91 | 2.13 | 2.43 |
| HSBC | 10.76 | 8.47 | 7.20 | -5.62 | 54.85 | 59.88 | 23.25 | 22.07 | 1.98 | 2.13 | 4.21 | 4.48 |
| **Total banking sector** | **16.06** | **16.25** | **8.47** | **7.41** | **69.92** | **71.18** | **11.32** | **11.52** | **10.45** | **8.93** | **0.61** | **0.91** |

## Annex 7: Implementation Support Plan

## BANGLADESH: Financial Sector Support Project

### Strategy and Approach for Implementation Support

A7.1. The World Bank will support the implementation of the project and provide the technical advice necessary to facilitate the achievement of the PDO.

A7.2. BB already has a strong track record in implementing Bank-financed operations, consistent with the Bank's policies and procedures. The satisfactory implementation of an ongoing project demonstrates BB's capacity to implement the proposed operation. BB benefited throughout the preparation and implementation of previous Bank-financed operations in improving its internal control procedures, including updating the Financial Management (FM) Manual and the internal audit risk-based approach strategy. On procurement, it gained commendable experience evident in its internal procurement practices as well as in its advisory role in other automation projects of the GOB.

A7.3. The project has less than seven high-value contracts for which advance preparatory activities have already taken place. The bidding documents of all major contracts have already been prepared by the FSSP cell with the help of an international technical specialist(s) hired by BB and a number of staff assigned from the concerned departments or units for assessing the business needs of the activities and then preparing the required technical specifications. All the bidding documents of the project are expected to be completed before the project gets approved by the World Bank Board. The World Bank Task Team for Project Preparation has provided necessary inputs and advice—both technical and fiduciary—to BB in this important project preparatory exercise, completion of which is one of the readiness filters of projects for Board submission.

A7.4. Throughout the project duration, the World Bank team will closely monitor the project on semi-annual implementation support missions. During the implementation support missions, the World Bank will ensure that the financial arrangements agreed on are respected and will assess if any additional training or support is needed. The World Bank team will review and clear the audit terms of reference, review the audit reports and Interim Financial Reports (IFRs) received, and provide its feedback in a timely manner. The project team will also be responsible for reviewing all prior review procurement contracts.

A7.5. Technical assistance support under the project will largely be provided by consultants, and the World Bank team will review their terms of reference and the deliverables and engage in reviewing the TA performance during implementation support missions.

A7.6. The World Bank's implementation support will follow a risk-based approach. At least two missions will be carried out annually in addition to follow-up visits as deemed necessary. The audit reports and the interim and annual financial statements, respectively, in addition to the management letter, will be reviewed on a regular basis by the World Bank FM specialist, and the results or any issues will be followed up during implementation support missions. Also, during the World Bank's implementation support missions, the project's financial management and disbursement arrangements will be reviewed to ensure compliance with the World Bank requirements and to assess the financial management performance for the Implementation Status and Results Report (ISR).

A7.7. The World Bank's fiduciary team, which is currently based in Dhaka, will advise and support BB in financial management and procurement. FRTMD, the department that will be in charge of the long-term credit line, will be supported by the FSSP cell under the project, and its staff will receive training and capacity building support under other core public financial management and procurement programs financed by the Bank. Both the FSSP cell and FRTMD staff will be provided specific training on issues such as World Bank procurement and strengthening financial controls, including internal audit.

A7.8. The World Bank will work toward building BB's capacity on environmental and social risk management and ensure that the Environmental and Social Management Framework abides by the World Bank policies and is included in the Operational Manual. The World Bank is also supporting BB in upgrading its Environmental Management Policy 2011 applicable to the banks and NBFIs in line with the international best practice policies.

**Implementation Support Plan**

A7.9. The World Bank implementation support team will consist of technical specialists from its Finance and Markets Global Practice and Private Sector Development Vice Presidency, as well as specialists in operations, procurement, financial management, safeguards, and monitoring and evaluation. The external communications specialist will advise on the project's communications strategy.

A7.10. Technical specialists will review project documents, including terms of reference, bidding documents, and consultant reports. They will also conduct site visits to assess progress in the field and consult with the financial sector stakeholders, including think tanks, on project implementation progress. The safeguards specialists will review environmental assessments for the project in line with the ESMF.

A7.11. During project implementation, support will be provided as indicated in table 1 and table 2 below:

**Table 1- Implementation Support Plan**

| Time | Focus | Skills Needed | Resource Estimate (US$) | Partner Role |
|---|---|---|---|---|
| First 12 months | Fiduciary and safeguards management; operationalizing the long-term component; M&E baseline communications; strategy and awareness building | Please refer to the table below. | 160,000 | |
| 12–60 months | Project management and implementation support | Please refer to the table below. | 160,000 per year | |

**Table 2- Skills Mix Required over Project Period**[51]

| Skills Needed | Number of Staff Weeks | Number of Trips | Comments |
|---|---|---|---|
| Financial market infrastructure, including AML/CFT systems | 25 | Minimum of 2 a year | Will provide technical support in the implementation of component 1 |
| Bank supervision and regulation | 20 | Minimum of 2 a year | Overall supervision and implementation support |
| Functional reorganization and Human Resources Development | 5 | Dhaka based | Will provide technical support in the implementation |
| Warehouse receipt financing | 10 | Dhaka based | Will support the designing and implementation of the pilot |
| Financial literacy and awareness | 15 | Minimum of 1 a year | Will provide support in the implementation. |
| Long-term financing | 40 | Minimum of 2 a year and Dhaka-based staff as well | Overall supervision and implementation support |
| Islamic finance | 15 | Minimum of 1 a year | Will oversee the Islamic line of credit |
| Capital market and pension development | 15 | Minimum of 1 a year | Will support the development of long-term finance market in the country |
| Credit appraisal and project supervision | 20 | Dhaka based | Will support supervising the TA activities to strengthen the capacity of the PFIs |
| Governance specialist | 10 | Dhaka based | Will support supervision of GAAP implementation |
| Safeguards specialist | 20 | Dhaka based | Will support supervision |
| Fiduciary specialists | 20 | Dhaka based | Will support supervision |

[51] Staff costs of several experts (including Islamic finance, financial literacy and awareness capital market and pension development etc.) are expected to be also covered through trust fund resources.

## Annex 8: Background of Islamic Finance

## BANGLADESH: Financial Sector Support Project

A8.1 Islamic finance operates according to Shariah, the Islamic law. Just like conventional financial systems, Islamic finance features banks, capital markets, fund managers, investment firms, and insurance companies. These entities are governed by Islamic law and the finance industry rules and regulations that apply to their conventional counterparts. The concept of Islamic or Shariah-compliant finance is based on core tenets of Islam concerning property rights, social and economic justice, wealth distribution, and governance. One of the key features of the system is the prohibition of riba (interest) and gharar (ambiguous contracts or deals). There is consensus among scholars that the prohibition of riba is not limited to usury but refers to interest on debt in any form. The prohibition of gharar is to discourage uncertainty in contracts, enhance disclosure, and proscribe all forms of deception.

A8.2 Globally, Islamic finance has registered remarkable growth in the past two decades, with Shariah-compliant financial assets expanding at about 10 percent annually, reaching about US$2 trillion at end-2014. Although banks dominate the sector, the Islamic bond market (Sukuk) has also grown rapidly at a compounded annual growth rate of 30 percent during the past decade to an estimated US$70 billion in 2014 up from US$2.5 billion in 2001. Countries with sizable Islamic finance industries include Bahrain, Brunei, Indonesia, the Islamic Republic of Iran, Malaysia, Pakistan, Sudan, and the United Arab Emirates. There is also a growing interest in Islamic finance from non-Muslim countries, for example, Luxembourg and the United Kingdom. Such rapid growth is driven by several factors, including high liquidity and limited investment alternatives in the Middle East and North Africa Region, increased interest from non-Muslims in the wake of the global financial crisis, the search for asset diversification by institutional investors, and a large and expanding global Muslim population.

A8.3 The expansion of Islamic finance has the potential to enhance economic growth, financial sector development, inclusion, and stability (see box 3). The use of profit-and-loss sharing arrangements encourages a direct link between finance and production, while the emphasis on tangible assets directly supports real economy transactions. The development of Islamic financial services promotes financial access and diversification, widening the range of products and services available to enterprises and households. Notably, Islamic finance can help meet the needs of those excluded because of religious reasons, while remaining open to non-Muslims that are not prohibited from using Islamic financial services. Finally, there is growing empirical evidence that Islamic financial institutions may be more resilient to unforeseen shocks, thereby contributing to overall financial stability.[52] During the global financial crisis, Islamic financial institutions were relatively unscathed, protected by their fundamental operating principles of risk sharing and avoidance of leverage and speculative financial products.

[52] Cihak and Hese 2008, Askari et. al. 2010, Demirguc Kunt et. al. 2010 and Tabash and Dhankar 2014.

**Box 3: Characteristics of Islamic Finance**

In addition to the prohibition of *riba* and *gharar*, Islamic finance has several key precepts. Implemented fully, Islamic finance:

- Eliminates pure debt securities from the financial system, replacing interest with the rate of return earned ex post on contracts of exchange or risk sharing.
- Calls for bank deposits to be collected on a profit-loss-sharing basis rather than fixed, predetermined liabilities. All profits and losses on the asset side are to be passed through to the investors (depositors) on the liability side.
- Finances trade and the exchange of goods and services to ensure a close link between the real economy and the financial sector, because all financial contracts should be backed by assets or transactions and activities in the real economic sector.
- Upholds property rights for the individual and society and clarifies the sources of individual ownership.
- Mandates the fulfillment and sanctity of contracts that deal with trade in goods and services, as well as the transfer of ownership and the honoring of debt obligations.
- Emphasizes principles of morality and ethics in business conduct, proscribing illicit activities according to *Shariah* and mandating that all economic activities be governed by rules of fair dealing and justice.
- Advocates the sharing of risk and reward between the rich and the poor through specific instruments of redistribution.
- Subjects Islamic financial institutions to two sets of corporate governance issues: *Shariah* compliance and business performance. The first requirement of *Shariah* compliance arises from the need to reassure stakeholders that the institution's activities fully comply with the precepts of Islamic jurisprudence. There must, therefore, be corporate governance mechanisms to assure them that the necessary safeguards are in place. The second requirement of business performance arises from the need for the same stakeholders to be assured that the firm will nonetheless actively promote their financial interests and prove to be an efficient, stable, and trustworthy provider of financial services.

A8.4 **Islamic financial products can be divided into two basic categories:** (1) non-profit-and-loss sharing products, which involve the purchase and hire of goods or assets and services on a fixed-return basis (i.e., *wakalah*, *kafalah*, *ijarah*, and *murabahah*); and (2) profit-and-loss sharing products, also referred to as participatory modes (i.e., *mudarabah* and *musharakah*).

- *Wakalah* (agency contract): *Wakalah* is an agency contract between two counterparties, an agent (*wakeel*) and a principal (*muwakkel*). The agent undertakes to render a service to the principal for a predetermined fee (known as *ujrah*).

- *Kafalah* (financial guarantee): *Kafalah* is a financial guarantee contract whereby the guarantor agrees to discharge the liability of the debtor in the case of default by the debtor. This includes the debtor's debt, fine, or any other personal liability.

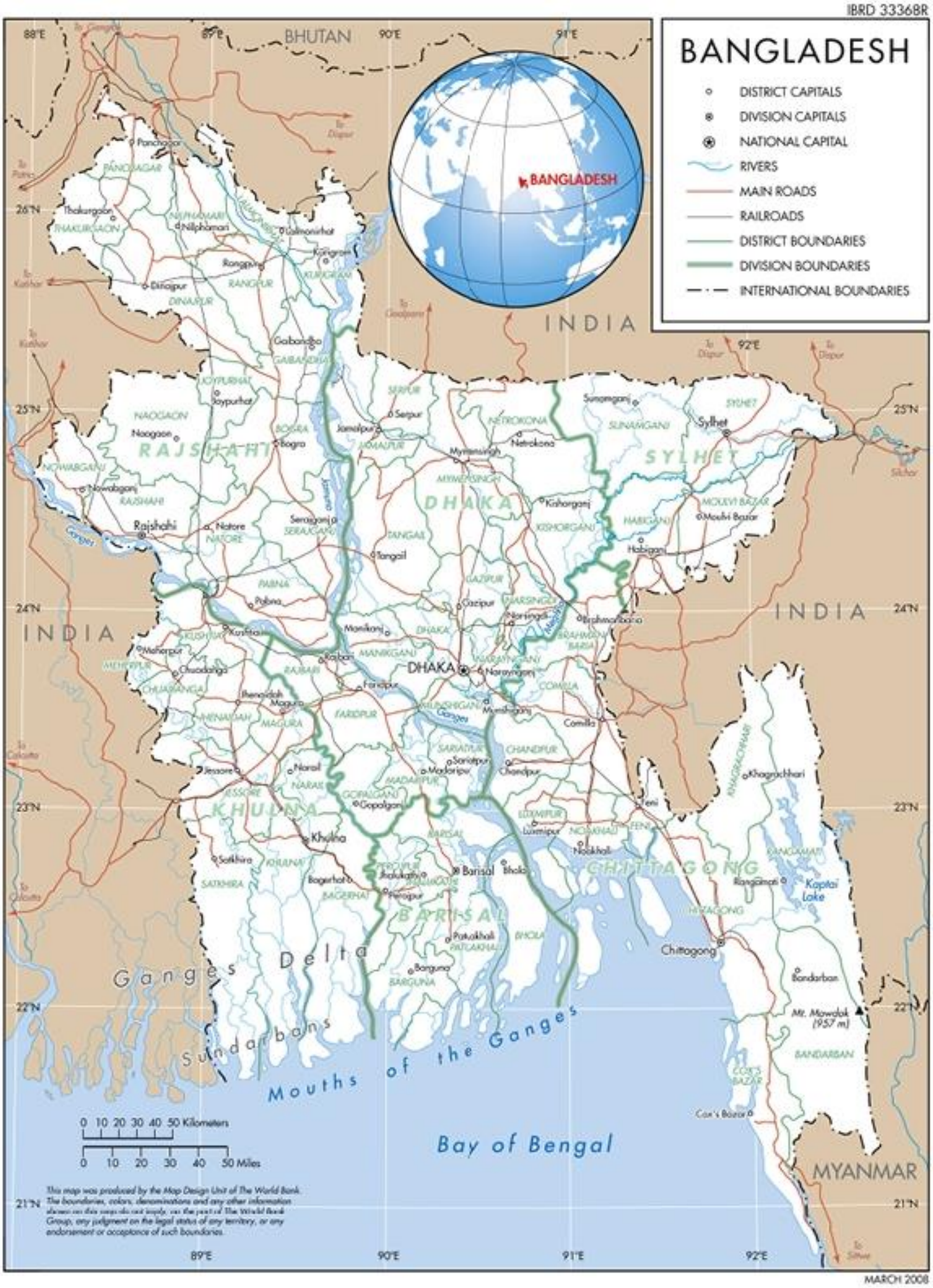
- *Ijarah* (operational and finance leasing): *Ijarah* is a leasing contract whereby the usufruct generated over time by an asset is sold to the lessee at a predetermined price. It can be classified into "operating *ijarah*," which does not include a promise to transfer the legal title of the leased asset to the lessee at the end of the lease, and "*ijara wa iqtina*," which is concluded by passing the legal title of the leased asset to the lessee. *Ijara* literally means *rent*, and the process can be used for equipment as well as property.

- *Murabahah* (commodity sale with an agreed upon markup): *Murabahah* is a contract whereby the seller purchases goods desired by the buyer and transfers ownership to the buyer upon full payment within an agreed upon time frame (including an agreed upon markup, with payments either in installments or in a lump sum). The seller bears the risk for the goods until they have been delivered to the buyer. Under a diminishing *murabahah*, ownership is transferred gradually upon the receipt of installments.

- *Mudarabah* (trustee finance contract): *Mudarabah* is a contract between two or more individuals whereby some provide finance while others provide entrepreneurship and management to carry out a business venture with the objective of sharing the profits in accordance to agreed-upon ratios. The loss borne by the financiers is in proportion to the equity share. The loss for the entrepreneurs is missed rewards for the services provided.

- *Musharakah* (partnership or equity participation contract): *Musharakah* is a contract whereby all partners share in equity as well as management. The profits are distributed in accordance to agreed-upon ratios. Losses must be shared according to the equity share.

**MAP**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