

PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: PIDC10930

Project Name	Financial Sector Support Project (P150938)
Region	SOUTH ASIA
Country	Bangladesh
Sector(s)	SME Finance (50%), Banking (35%), General finance sector (15%)
Theme(s)	Other Financial Sector Development (75%), International financial standards and systems (25%)
Lending Instrument	Investment Project Financing
Project ID	P150938
Borrower(s)	Government of Bangladesh
Implementing Agency	Bangladesh Bank
Environmental Category	F-Financial Intermediary Assessment
Date PID Prepared/ Updated	15-Aug-2014
Date PID Approved/ Disclosed	15-Aug-2014
Estimated Date of Appraisal Completion	18-Dec-2014
Estimated Date of Board Approval	26-Feb-2015
Concept Review Decision	Track II - The review did authorize the preparation to continue

I. Introduction and Context

Country Context

1. 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 last 20 years, overall annual growth of around 8 percent 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 GDP growth requires a range of initiatives including maintaining macro-economic stability, investing in transformative infrastructure, streamlining trade and investment regulations, strengthening the financial sector and furthering human development.
2. Building a strong financial sector that can cater to the needs of the growing economy is one of the essential ingredients in the path towards meeting its long term development goal, but also to support short to medium term growth. Bangladesh will need to develop a financial sector which is

stable, inclusive and capable of efficient financial intermediation to the productive sectors of the economy, allowing a boost to capital accumulation and investment to generate faster growth.

Sectoral and Institutional Context

3. To strengthen its financial sector, Bangladesh needs to address several key issues. One, improve stability by strengthening weak banks, particularly state owned banks but also others; there has been a steady rise in non-performing loans (NPLs) to 10.5 percent in March 2014, up from 6.1 percent in December 2011. Some of these banks may also require recapitalization and cleaning up of unrecognized loan losses from ever-greening of loans, weak/relaxed loan classification and provisioning requirements – especially true in state-owned commercial banks (SOCBs). Second, weak corporate governance in parts of the banking sector, especially state-owned banks, leads to sub-optimal loan decisions. Three, 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. Lastly, financial market infrastructure needs to be strengthened to improve efficiency and stability and enhance efficiency and effectiveness of transmission of policy measures.

4. Another critical issue is the low level of access to finance for SMEs and agriculture, as well as the high cost of finance. Although Bangladesh is rightly acknowledged for its thriving and innovative microfinance sector, financing to the market segments above microfinance, has lagged behind. Access to affordable finance is identified as one of the top four obstacles for doing business (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.

5. In particular, long term finance particularly for exporters and SMEs is limited, and the financial sector remains ineffective in its capacity to perform its term transformation functions. As a consequence private investment in Bangladesh, at 19 percent of GDP, is lower than countries such as India (at 23 percent of GDP in 2012) or those in East Asia, while a key challenge to raising growth to the targeted level of the country's Sixth Five Year Plan (SFYP) is to increase the investment rate to 32.5 percent by the end of the plan period. The scarcity of long-term financing (only 19 percent of total lending in June 2013) makes sectors in need of long-term credit, e.g. capital intensive export industry or labor intensive Ready Made Garments (RMG) or footwear industries, under-invest, constraining employment and growth. The inability to provide long term financing is particularly affecting entrepreneurial exporters who consequently face constraints in capturing emerging business opportunities and upgrading equipment and facilities. Such long term funding is needed to capture the opportunities for economic growth in Bangladesh spurred by relocation of labor-intensive production from fast-growing countries like China. This current economic opportunity underscores the time factor in addressing this access to finance gap, which is one of the factors constraining Bangladeshi firms from capitalizing on this opportunity. In addition, investment in energy efficient and environment friendly technologies, as well as investments in compliance with international safety standards, remain limited in Bangladesh in part constrained by this lack of access to long term funding. The initial preliminary results of a market survey (conducted by AC Nielsen – on-going) show that there is limited supply of long term financing. Several reasons explain this. One, banks lack access to long term sources of funds including Taka resources and foreign exchange resources which can be appropriate for exporting firms needing long term finance, for instance, to import machinery. Second, capital markets are under-developed as are long term pensions and savings markets. Third, lack of capacity and risk aversion amongst banks.

6. The project will support Bangladesh's efforts to develop the financial sector, by strengthening financial market infrastructure, improving regulatory, supervisory and sector developmental capacity of BB and building the market for and scaling up long term finance by exporters and SMEs to spur competitiveness, investment and growth (Financial Market Infrastructure is defined to encompass 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, and not just payment and settlement systems -as used in the CPSS-IOSCO principles). In doing so, it will address some of the key financial sector constraints identified above and complement other parallel ongoing efforts to address remaining constraints. By strengthening financial market infrastructure, the project will contribute towards 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 by supporting its developmental capacity, innovative new products for under-served market segments, as also initiatives on consumer protection, will be supported. By supporting long term finance and associated technical assistance, the project would serve as a catalyst for building a financial market in this market segment, a segment where no such funding currently exists nor is likely to organically develop in the near term.

7. The proposed project will factor in lessons learnt from previous and ongoing operational work in Bangladesh and elsewhere, in particular on supporting reforms in the financial sector, and will also support a deeper engagement on financial sector development in Bangladesh. On the choice of the central bank to wholesale the long term financing given that no other viable alternative exists in Bangladesh, the project will look at other Bank projects which used a similar channel (eg. recently in Jordan and Tunisia; but also the existing infrastructure finance project with BB) and ensure that adequate checks and balances are maintained and captured in the Operations Manual that will be developed (see also risks section). The project will also complement other parallel and independent efforts of the Government of Bangladesh (GoB) and BB, including those to strengthen SOCBs' governance, management and financial position. The project will also be complementary to the IMF's facility for Bangladesh and will coordinate with on-going IFC activities in the SME finance sector and the Bank's proposed policy loan which could include financial sector actions. Also, the project would complement other ongoing efforts in the real sector to address constraints that can unleash this growth potential, by focusing on financial sector development.

Relationship to CAS

8. The proposed operation is well grounded in the CAS and the CAS Progress Report's (CASPR, FY11-15) objective of accelerated, sustainable and inclusive growth, underpinned by increasing investments, enhancing the business environment and stronger governance. Specifically, the project contributes to the achievement of the second CASPR pillar, on accelerated growth, mainly through improved environment for private sector investment, by promoting the availability of long-term funds; and also by, strengthening the financial system to enable it to sustainably fund economic growth in future, and continued strengthening of regulation and supervision. The exporter and SME focus of the project directly contributes to higher growth, competitiveness, investment, and employment creation. The project will also contribute to skill enhancement of bankers, and industry on safeguards practices. The project also contributes to pillar four of the CASPR on strengthening governance through supporting enhanced transparency and accessibility of financial services, including Government payments (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) ; and improved security, governance and adoption of ICT infrastructure for digitization of processes, transactions and controls in government agencies (including BB). The project is in line with Bangladesh’s SFYP for FY11–FY15, which emphasizes private enterprise and particularly SME development for sustainable growth and employment creation.

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

9. The Proposed Development Objective of the project is: “to improve financial market infrastructure, regulatory capacity and access to long term financing”.

Key Results (From PCN)

10. The key results indicators will include:
- (i) Increase in annual per-capita electronic payment transactions from current levels of less than 1 to 5;
 - (ii) Observance of relevant standards for key payment systems infrastructure components - CPSS-IOSCO Principles of Financial Markets Infrastructure (PFMI); and World Bank General Principles for Credit Reporting Systems;
 - (iii) Enhanced supervisory capacity of BB through migration to risk based supervision;
 - (iv) Outstanding long term loan portfolio (growth) to exporters of all Partner Financial Institutions (PFIs) receiving World Bank support;
 - (v) Non-performing loans of PFI long term finance portfolio of less than 5%.

III. Preliminary Description

Concept Description

Component 1: Strengthening Financial Market Infrastructure

11. Financial market infrastructure is critical to facilitate a stable and efficient financial system and is an essential foundation of financial markets. It typically comprises the payments and remittance systems, securities settlement system, credit bureaus, etc. Strong financial market infrastructure is associated with financial soundness, enhanced efficiency and financial intermediation and lower transaction costs (see Figure 1 from a 2009 World Bank-IFC study in annex). Several studies also point to significant savings for countries by greater usage of electronic payments. For instance, a recent study by Central Bank of Brazil projected annual savings of around 0.7% of their GDP.

12. The proposed component will build on previous efforts, including those under the Central Bank Strengthening Project (CBSP), and improve financial infrastructure further. It will focus on the improvement of the payment and settlement systems but also on other critical financial market infrastructure, such as that related to credit information. This would be done through information technology investments that improve digitization of internal BB systems (for example: core banking, Bangladesh Automated Clearing House and central securities depository) and better integration with external systems like the Government payment systems (including the National Board of Revenue (NBR) and the Ministry of Finance Public Financial Management System, PFMS) and effective oversight of the national payments system. It would also include the strengthening of the Credit Information Bureau (CIB) to improve data reliability and coverage; and; strengthening the systems of the Bangladesh Financial Intelligence Unit (BFIU). The proposed

component would also strengthen the core underlying IT infrastructure supporting the financial market infrastructure.

Component 2: Strengthening Regulatory Capacity

13. A strong regulatory and supervisory capacity is essential for maintaining the stability and efficiency of the financial system. For the banking sector, the capacity of BB, must continue to be strengthened further and updated to meet the ever growing complexity and evolution of financial markets and the growing stresses in Bangladesh's financial sector (reflected in growing NPLs, capital shortage, etc). Enhanced capacity will support BB's compliance with the international standards and Basel accords for regulation. The capacity enhancement of BB will support reforms by strengthening prudential regulations and will also help BB better supervise and monitor banks, including the SOCBs, mitigating the risk of that part of the financial system posing a threat to the stability of the entire system. The proposed component will continue to also strengthen the capacity of the Bank and Financial Institutions Division (BFID) which monitors SOCBs. The project will focus on the migration to Risk Based Supervision as well as support strengthening prudential regulations and completing preparations for BASEL III.

14. In addition, in support of BB's developmental role, the project will also support innovative and inclusive financial market development activities, focusing on select areas where there has been little by way of financial sector development/activities. These would include: (i) initiating and facilitating reforms in and the development of warehouse (and cold storage) receipt system and financing as a demonstration pilot, and possibly, also on agriculture insurance; and (ii) the development and implementation of innovative programs for financial literacy and consumer protection.

Component 3: Supporting Long Term Finance

15. This component will provide Bangladesh's firms, including exporters and SMEs with access to long term finance and also provide technical assistance to banks in credit appraisal skills and to banks and industry in improving safeguards practices. Preliminary initial findings confirm the acute lack of supply of long term finance in Bangladesh's credit market. For instance, of the four surveyed lending institutions, the vast majority of export finance is short term in nature (no trade finance would be provided), and none of it is five years or longer – a factor that clearly inhibits competitiveness and investment amongst exporters. The demand side survey validates this finding as well.

16. By providing long term financing to exporters/SMEs via PFIs (which will be selected through an appraisal conducted by BB and based on eligibility criteria which will be developed and reflected in the Operations Manual and could include Islamic financing banks and financial institutions) and through technical assistance to PFIs and industry associations, the project will demonstrate the potential of this product and market segment to financial institutions. In addition, through the implementation arrangements promoting good practices on safeguards amongst lenders and funded firms, the project will contribute to the improvement of health and safety standards, including for women workers in the industry. Such support can leveragethe momentum that is slowly but steadily gathering amongst firms – as captured in the demand side market survey – to improve safeguards performance. Also, technical assistance to develop the secondary bond market and explore the development of new instruments to facilitate long term financing, which are both critical for building a long term financing market in Bangladesh, will be included. The component will be designed in line with Bank policy OP/BP 10.0 and the accompanying Guidance Note on

financial intermediary lending.

Component 4: Project implementation and monitoring

17. This component will support BB's capacity in project implementation and in developing a strong monitoring and evaluation mechanism.

IV. Safeguard Policies that might apply

Safeguard Policies Triggered by the Project	Yes	No	TBD
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	

V. Financing (in USD Million)

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

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