PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: PIDA62169

Project Name	Modernization of State-Owned Financial Institutions Project (P155363)
Region	SOUTH ASIA
Country	Bangladesh
Sector(s)	Banking (100%)
Theme(s)	State-owned enterprise restructuring and privatization (50%), Corporate governance (30%), Other Financial Sector Development (20%)
Lending Instrument	Investment Project Financing
Project ID	P155363
Borrower(s)	Peoples Republic of Bangladesh
Implementing Agency	BFID
Environmental Category	C-Not Required
Date PID Prepared/Updated	06-Jun-2016
Date PID Approved/Disclosed	06-Jun-2016
Estimated Date of Appraisal Completion	29-Apr-2016
Estimated Date of Board Approval	30-Jun-2016
Appraisal Review Decision (from Decision Note)	

I. Project Context

Country Context

Generally prudent management of fiscal and monetary policy, and the resultant macroeconomic stability Bangladesh has enjoyed over the past decade, has served it well in its quest for higher growth . Bangladesh?s per capita gross national income (GNI) grew more than tenfold from around US$100 in 1972 to US$1,314 in 2015. Average annual gross domestic product (GDP) growth has been rising over the last three decades, and grew by more than 6 percent a year on average during the past five years despite the adverse impacts of the global recession, and natural disasters. Inflation was contained well below double-digits most of the time. Bangladesh is the only country in South Asia with positive public savings. In addition, the overall budget deficit has been financed through prudent external borrowing that has kept the effective interest rate on public debt at less than 5 percent. Recourse to monetary financing of deficit has been used as a very short-term measure that has typically been quickly reversed. The public debt-to-GDP ratio declined throughout the last decade. Since adopting the floating exchange rate regime in 2003, the Bangladesh Bank has followed a market-based exchange-rate policy that ensured smoothing out exchange-rate volatility and building up foreign exchange reserves. Monetary policy allowed monetary aggregates to expand in line with growth in demand for credit in the private sector and price stability.

The country has achieved very good progress since 2000 in reducing extreme poverty and boosting shared prosperity. Based on PPP$1.25 global poverty measure, the number of poor in Bangladesh fell from around 77 to 65 million ?a drop of 12 million ?at a rate that was 60 percent faster than in the rest of the developing world, excluding China. Increases in the share of the working population along with rising labor incomes were the two most important contributors to the decline in poverty over the past decade. Nevertheless, despite Bangladesh?s remarkable development achievements, significant challenges remain in its quest to eliminate extreme poverty and boosting shared prosperity. It remains one of the poorest countries in the region, with constrained public services and comparatively weak institutions, and though it has done fairly well in recent years, many others, e.g. China, Sri Lanka, and Vietnam, have done much better .

One challenge for Bangladesh is preserving its good macroeconomic and fiscal management which has been one of the key enablers for Bangladesh to enjoy strong sustained economic growth and poverty reduction over the past decade. The balance sheets of SOBs are still weak, a consequence of the enduring impact of a series of financial scams and resultant loan defaults in the SOBs. SOBs are under the Government recapitalization program which provided fresh capital in 2014-2015 and should continue in the medium term. Private banks are not immune to corporate governance failures either. Ease of access to finance in Bangladesh is constrained in part due to the inefficiencies of SOBs which own about 56 percent of total bank branches and have the deepest branch penetration across Bangladesh, including remote areas/villages.

Building a strong and diverse 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 goals as well as supporting short- to medium-term growth. 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 and ensuring these developments can benefit citizens through better pensions and improved insurance products.

Sectoral and institutional Context

Banks dominate the financial system in Bangladesh with 57 percent of total assets as of June 30, 2014. The capital market has a 34 percent share, and the insurance sector has 3 percent of total financial system assets. Among the 56 scheduled (licensed) banks operating in Bangladesh, there are 6 state-owned commercial banks (SOCBs), 2 state-owned specialized developmental banks (SODBs), 9 foreign commercial banks, and 39 domestic private commercial banks including eight Islamic banks.

A number of positive developments have taken place in the banking sector over the past two decades, yet many constraints remain in its provision of finance and access to financial intermediation. A regional comparison indicates that Bangladesh is still behind most peers, except Pakistan (Table 2). Bangladesh lags behind India in terms of financial deepening and well behind countries like China and Vietnam. Capacity constraints, lack of diversity of products including long term finance instruments, as well as underdeveloped insurance, pensions and capital markets limit access to finance to households and enterprises. Financial intermediation remains modest, with a credit to GDP (banks and NBFIs) ratio of 43 percent in March 2015. The constraints nevertheless present substantial systemic development opportunities where SOBs are posed to play an important lead role.

SOBs ? primarily the commercial banks but also to a lesser extent the developmental banks ? remain an important group of banks in the system. They hold close to 30 percent of the total banking assets and play a significant role in the system by channeling funds to the government?s priority areas for development and providing banking services (access to finance) across the country using their large branch network. There are six SOCBs which are fully or majority owned by the Government of Bangladesh, and two specialized developmental banks (SODBs) which were established for specific objectives like agricultural or industrial development. There are also two non-scheduled banks which the government intends to modernize alongside the SOCBs and SODBs.

SOBs have not been performing to their full potential and present substantial opportunities for their institutional strengthening and development The Government of Bangladesh is fully intent to continue addressing the deficiencies which have led to the ongoing underperformance of the SOBs. Some of the core reasons for the underperformance are listed below.

? Governance: The governance of the SOBs exhibits a number of weaknesses relative to accepted good practices. The tradition and practice of appointing directors to the boards of the SOBs is reportedly often based on the political loyalty and affiliation, rather than experience and competence. Boards should include independent, qualified, and socially reputable professionals with unquestionable integrity. BB Guidelines 2010 for bank directors include ?Fit and Proper Test Criteria? for the nomination of directors along with their responsibilities and power, but these criteria are yet to be implemented fully.

? Supervisory Oversight: BB still lacks full authority over SOBs, although its powers have recently been increased by amendments of the Bank Companies Act. Specialized development (non-scheduled) banks are outside the purview of the Bank Companies Act and BB?s regulatory perimeter.

? Unsustainable pricing of some financial products: As part of the implementation of the government?s development policies and program, the SOBs provide some services/products to their clients without margin or at ?no cost?, without mechanisms for loss/cost recovery.

? Risk management: The absence of a comprehensive risk management policy in the SOBs makes it difficult to detect and handle fraud and other extraordinary cases. The implementation of respective BB guidelines is in early stages in the SOBs.

? Automation and management information system: Automation and management information system (MIS) in the banks needs to be upgraded. In spite of the previous reform initiatives, the SOBs have been slow towards adopting IT-based banking services and MIS. There have been comprehensive programs for the last several years to establish the RTGS and the National Payments Switch in the SOBs, computerization of the head offices and branches of all banks, electronic banking services, online corporate banking service, electronic fund transfer, automated teller machine (ATM), and internet banking. Nevertheless SOBs are behind other banks in adopting the programs. This is not only affecting their efficiency and profitability, but also their internal controls, giving rise to opportunities for fraud, e.g., through delayed or incomplete data aggregation and submission for managerial control and decisions.

? Internal control: Absence of information technology (IT) adds challenges to the internal control function. The SOB internal control departments are weak. This is mainly due to the incentive structure which prevents hiring of qualified professionals for this function, also to deficient data.

? Transparency and accountability: Most of the SOBs have weak business processes, inadequate accounting and auditing practices, and weak compliance procedures, with low levels of financial and nonfinancial disclosure. Many of these problems stem from the lack of a clear performance monitoring system to ensure accountability and responsibility for performance, particularly of the board and the CEO/MD.

? Human resource policy: Human resource (HR) development has been a neglected issue in the SOBs. The HR departments of the SOBs remain weak and powerless to take decisions on recruitment and promotion, including due to a lack of capacity.

II. Proposed Development Objectives

The proposed project development objective is to contribute to the modernization, transparency and efficiency of state-owned banks.

III. Project Description

Component Name

Supporting SOB Business Process Reengineering

Comments (optional)

This Component will provide consultancy support to the SOBs for a comprehensive Business Process Reengineering (BPR) ? from internal control and accounting to credit appraisal system, risk management and transaction processing ? that will be a pre-requisite for an automated modern banking environment. BPR will strengthen and modernize the banks? internal processes and workflows and will precede development and implementation of new IT solutions in SOBs. The new IT solutions would then be adapted to the updated processes and workflows. For those SOBs which require addition capitalization by the Government, the BPR exercise will add an additional module which would make assessments of the banks? recapitalization requirements and provide options on capital allocations.

Component Name

Supporting IT Modernization of SOBs

Comments (optional)

The Component will support purchase and implementation of the modernized IT architecture with relevant software and hardware solutions in the SOBs and will also support SOBs in improving their basic IT infrastructure in parallel with the implementation of key systems (such as CBS, ERP, and AML). Although all banks have embarked on a centralized CBS implementation, there is a lack of basic technical infrastructure to sustainably support this initiative and provide uninterrupted business process. Furthermore, exposure to basic automation will help prepare the current workforce for automated business processes down the road. IT training programs to retool existing workforce and prepare them for a fully automated business environment will be developed and implemented under the Component.

Component Name

Supporting institutional development of SOBs and MOF in enhancing ownership oversight and corporate governance framework

Comments (optional)

Under this component, the project will provide advisory support to all the banks participating in the project and the MOF as the agency exercising ownership rights of the banks on improving the framework within which the ownership rights are exercised and banks are governed. The adoption of international good practices in the corporate governance of SOBs will increase accountability and transparency, leading to improved performance and the achievement of social goals and mandates. The project will involve various consultancy and training activities and will strengthen 5 key pillars - (i) policy and legal framework for SOB governance; (ii) ownership capacity of BFID, (iii) capacity of the SOB Boards to oversee the banks; (iv) bank transparency, (v) internal control, audit and compliance.

Component Name

Project Implementation and Monitoring

Comments (optional)

This component will provide support for the monitoring and coordination of Project activities undertaken by various beneficiary institutions. It will also help develop a strong monitoring and evaluation system to be used by the Project Implementation Unit (PIU) and other stakeholders to assess implementation progress.

IV. Financing *(in USD Million)*

Total Project Cost:	200.00	Total Bank Financing:	150.00
Financing Gap:	0.00		

For Loans/Credits/Others	**Amount**
BORROWER/RECIPIENT	50.00
International Development Association (IDA)	150.00
Total	200.00

V. Implementation

The project intends to provide funding for long-term investments by state-owned banks towards their modernization through improved governance, better IT systems, business process reengineering (BPR) and better decision making and operational processes. Advisory assistance to the banks and the MOF as the representative of the owner ? on the decision making and operational processes, improved governance, change management - would complement the investments in physical IT infrastructure.

The project will follow a sequenced approach. First, SOBs will undergo business process reengineering (BPR) whereby consultancy services will be provided to them to review and improve internal processes and workflows. Concurrently with the BPR, the consultants will assess recapitalization plans for those SOBs which require additional capital and will recommend options to BFID. This phase is expected to be done during the first 12 months of the project. IT investments will follow starting in the second year of the project once the important IT diagnostic exercise (implemented under a parallel FSSP project during CY2016) will result in bank-specific strategies, implementation plans, and procurement packages ready for bidding. The investments will continue throughout years 2-5 of the project. The SOB governance improvement activities ? assessments and implementation of recommended reforms - will start at the outset of the project and continue throughout its duration, in parallel with the BPR and IT modernization activities.

The proposed project will include the following four components: (i) supporting SOB business process reengineering; (ii) supporting IT modernization of state-owned commercial and development banks; (iii) supporting institutional development of banks and MOF by enhancing ownership oversight and the corporate governance framework; and (iv) supporting project coordination, implementation and monitoring. 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 of US$150 million, and a government contribution in the amount of US$50 million.

VI. Safeguard Policies (including public consultation)

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

Comments (optional)

Public Disclosure Copy

VII. Contact point

World Bank
Contact: Marius Vismantas
Title: Lead Financial Sector Speciali
Tel: 473-5591
Email: mvismantas@worldbank.org

Contact: Shah Nur Quayyum
Title: Financial Sector Specialist
Tel: 5764+4239 /
Email: squayyum@worldbank.org

Borrower/Client/Recipient
Name: Peoples Republic of Bangladesh
Contact: Mr. Md. Eunusur Rahman
Title: Secretary
Tel: 88029576013
Email: secretary.bfid@gmail.com

Implementing Agencies

Name: BFID
Contact: Mr. Md. Eunusur Rahman
Title: Secretary
Tel: 88029576013
Email: secretary.bfid@gmail.com

VIII. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop