

# PROJECT INFORMATION DOCUMENT (PID) CONCEPT STAGE

Report No.: PIDC28574

<b>Project Name</b>	Modernization of State-Owned Financial Institutions Project (P155363)
<b>Region</b>	SOUTH ASIA
<b>Country</b>	Bangladesh
<b>Sector(s)</b>	Banking (100%)
<b>Theme(s)</b>	State-owned enterprise restructuring and privatization (50%), Corporate governance (30%), Other Financial Sector Development (20%)
<b>Lending Instrument</b>	Investment Project Financing
<b>Project ID</b>	P155363
<b>Borrower(s)</b>	Peoples Republic of Bangladesh
<b>Implementing Agency</b>	BFID
<b>Environmental Category</b>	C-Not Required
<b>Date PID Prepared/ Updated</b>	02-Feb-2016
<b>Date PID Approved/ Disclosed</b>	15-Mar-2016
<b>Estimated Date of Appraisal Completion</b>	08-Apr-2016
<b>Estimated Date of Board Approval</b>	01-Jun-2016
<b>Concept Review Decision</b>	Track II - The review did authorize the preparation to continue

## I. Introduction and Context

### Country Context

Over the past 20 years, Bangladesh has made significant gains in economic growth, development and poverty reduction. 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 risen steadily over the last three decades, and grew by more than 6 percent a year on average during the past decade despite the adverse impacts of the global recession, and natural disasters.

2. Despite this progress, growth remains below potential and Bangladesh will need overall annual growth of around 8 percent 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 macroeconomic stability, investing in transformative infrastructure, streamlining trade and

investment regulations, strengthening and diversifying the financial sector, and furthering human development.

3. 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 63 percent of total assets, the capital market has 34 percent and the insurance sector has only 3 percent of total financial system assets. Of the 56 scheduled (licensed) banks operating in Bangladesh, there are 5 state-owned commercial banks (SOCBs), 3 government-owned development banks, 9 foreign commercial banks, and 39 domestic private commercial banks including 8 Islamic banks.

5. Positive developments in the banking sector over the past two decades have been somewhat overshadowed by a steady rise in nonperforming loans (NPLs) from 6.1 percent in December 2011 to 11.6 percent in September 2014, especially from the state-owned banks. Improving the health of the financial sector and enhancing financial intermediation remain a key challenge in Bangladesh. Capacity constraints, lack of diversity of products including long term finance instruments limit access to finance to households and enterprises. Access to credit has been identified as one of the top barriers for doing business in Bangladesh (Doing Business 2015). Only 31 percent of adults in Bangladesh have access to a bank account (Findex, 2014). In addition, financial inclusion remains particularly daunting for certain groups including women, small and medium enterprises (SMEs), and farmers. Sources of long term financing – so critical to meet the country's enterprise growth and infrastructure needs – are limited and constitute severe impediments to creating jobs, increasing shared prosperity, managing financial and macroeconomic risks and vulnerabilities.

6. State-Owned Commercial Banks (SOCBs) and State Owned Development Banks (SODBs) account for around 30 percent of the banking system and are systemically important. Furthermore, they have a deep branch penetration across Bangladesh including in rural areas making them well poised to play an important role in promoting financial access. At the same time, poor management and governance, weak credit underwriting systems and internal controls and limited capacity have meant that their financial performance has been weak, capital levels have suffered, and asset quality has been a persisting concern. While non-performing loans (NPLs) had fallen from 29.0 percent in 2007 to 11.3 percent in 2011, they subsequently increased, reaching well over 20% in some State Owned Banks in 2015. Capital adequacy ratios slightly increased during the same period but remained inadequate for the State Owned Banks as a group, below the prudential requirement of 10 percent minimum capital adequacy ratio.

7. To strengthen its financial sector, Bangladesh needs to improve stability by enhancing the performance of financial institutions, particularly state-owned commercial and development banks - which are systemically important in terms of assets but also retail presence so crucial for financial inclusion. Governance and management systems—including risk management, internal controls, and credit appraisal of state owned banks need to be enhanced to mitigate the risk of suboptimal

loan and investment decisions, and overall operations need to be automated to enhance data integrity, efficiency and competitiveness. Governance of the public banks needs significant strengthening, too.

8. The project intends to provide funding for long-term investments by state-owned banks towards their modernization through better IT systems 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 support the government's ongoing state owned bank restructuring efforts, and help the authorities by providing a foundation for advancing the bank development and consolidation/divestment strategy. The GOB will perform a viability analysis of the SOBs and will select only those banks to participate in and benefit from the project which will demonstrate a medium to long term viability.

### **Relationship to CAS**

9. 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 (CASPR, FY11–15 - IDA/R2013-0299; IFC/R2013-0388) endorsed by the Board on January 14, 2014. The CAS focuses 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 a diverse set of financial products and instruments and the strengthened capacity of the financial system to fund sustainable economic growth in the future and continued strengthening of regulation and supervision. The project will also contribute to the fourth pillar of the CASPR: strengthening governance through better transparency and accessibility of financial services, including improved security, governance and adoption of information, communication and telecom (ICT) infrastructure for digitization of processes, transactions and controls in government agencies.

10. The project is in line with Bangladesh's 7th Five-Year Plan for FY16–FY21. The plan emphasizes private enterprise development for sustainable growth and job creation. The Strategic Country Diagnostic also focuses on sectors that require long term financing and notes financial sector as a critical constraint for overall growth and development in the country.

11. Overall, the project will support building a stronger financial sector. The latter will contribute to macro-financial stability and facilitate improved financial intermediation, thus promoting inclusive growth and contributing to the World Bank Group's twin goals. State-owned commercial and development banks have a deep branch penetration across Bangladesh, including in rural areas, making them well poised to intensify financial deepening and inclusion, expand outreach of banking services, and offer financial services to all, especially the unbanked population of the country.

## **II. Proposed Development Objective(s)**

### **Proposed Development Objective(s) (From PCN)**

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

### **Key Results (From PCN)**

13. The key results indicators are as follows:
- i. Automation -- The transaction and business processes of all SOBs participating in the project, including all their branches, are automated (Core Banking Systems (CBS) and Enterprise Resource Planning (ERP) implementation by number of branches and user accounts over five years, also percentage of automated transactions);
  - ii. Transparency -- Participating SOBs are fully compliant with BB's (a) Risk Management Guideline, (b) Credit Management Guideline, and (c) Internal Audit requirements; Participating SOCBs improve compliance with the requirements of BASEL III and risk-based supervision;
  - iii. Efficiency -- Cost efficiency of the banks is improved (share of operating costs over revenues)

### **III. Preliminary Description**

#### **Concept Description**

14. The proposed project will include the following three broad components: (i) support to modernize and improve the performance of state-owned commercial and development banks; (ii) support to the banks, MOF, and BB in enhancing ownership oversight and corporate governance framework, and (iii) Support for Project Coordination, implementation and monitoring.

Component 1 - Support to Modernize State-Owned Commercial and Development Banks (tentative amount US\$107-118 million)

15. Project activities will focus on the following: (a) review and redesign of internal tools, processes, reporting lines and overall structure for risk management, credit process (including internal rating systems and internal scoring systems as necessary), internal controls; (b) automation – introduction of automated tools and systems for risk management; loan origination, monitoring and collection; internal audit, compliance and internal controls; and (c) capacity building - staff training (e.g. training of trainers) on the new tools and practices, as well as core competencies (e.g. credit underwriting).

16. Support under the project is planned for a total of up to eight state-owned banks. However, the final decision of the number of institutions and extent of support will hinge on further project preparation work including assessment of the banks' viability and detailing an IT strategy for each institution and a detailed systems implementation plan with costing of software, hardware, resources and training. Considerable synergies are expected given the common nature of the business and background of the institutions, which can enable aggregation of benefits and create efficiencies in implementation.. The banks would, at the minimum, have to meet BB's prudential criteria or a similar set of indicators in order to be eligible for the support under the project.

Component 2 - Support for institutional development of banks, MOF, and BB in enhancing ownership oversight and corporate governance framework (tentative amount US\$30-40 million)

17. Under this component, the project will provide advisory support to the banks participating in the project, the MOF as the agency exercising ownership rights of the banks, and BB as the regulator and supervisor of the commercial banks on improving the framework within which the ownership rights are exercised and banks are governed. Enhancement to laws on negligence and fraud/insider abuse and improvement in audit standards are two critical areas for improvement. The project will also support developing bank directors' continuous education and training program which all bank directors would be required to attend regularly and confirm this in their annual

statement to the bank. This component would provide advisory assistance for developing a Bank Director's Manual, detailing laws, standards, and guidelines applicable to directors in the corporate governance area.

18. An important feature which could be funded under the component is an international advisory panel which would (i) consist of a few/several experienced senior international public officials and bankers with expertise relevant to Bangladesh's case, (ii) stay in place throughout the life of the project, with at least one visit per year to Bangladesh, and (iii) serve as a sounding board and impartial professional advisor to the BFID, BB, SOB directors, and management on a wide range of SOB issues, including corporate governance, social mandates, IT infrastructure/core banking systems, risk management, public reporting, personnel management and others.

19. Component 2 is proposed to be designed using results-based financing mechanism in the form of disbursement-linked indicators (DLIs). Such approach would establish interim and ultimate targets for improving SOB governance and the overall ownership function of the government, and provide strong disbursement incentives for the authorities to achieve tangible and measureable results against the targets, While Component 1 would lead to stronger operational and decision-making framework in the banks, Component 2 for institutional development would lead to stronger boards, more management accountability, and streamlining of mandates of the state-owned banks.

Component 3 - Support for Project Coordination, Implementation and Monitoring (tentative amount US\$2-3 million)

20. 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. 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:	200.00	Total Bank Financing:	150.00
Financing Gap:	0.00		

<b>Financing Source</b>	<b>Amount</b>
BORROWER/RECIPIENT	50.00
International Development Association (IDA)	150.00
Total	200.00

## **VI. Contact point**

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