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Growth Prospects of Banking Industry and Its Impact on Capital Market in the context of Mutual Funds

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Growth Prospects of Banking Industry and Its Impact on Capital Market in the context of Mutual Funds

by

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An internship report presented in partial fulfillment

of the requirements for the degree

Bachelor of business administration

INDEPENDENT UNIVERSITY, BANGLADESH

November 2008

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Table of Contents

1.0 Introduction ---------- **6**

2.0 Origin of the Report ---------- **8**

3.0 Problem Statement ---------- **9**

4.0 Objectives of the Study ---------- **10**

4.1 Broad objective ---------- *10*

4.2 Specific Objective ---------- *10*

5.0 Methodology ---------- **11**

5.1 Approach ---------- *11*

5.2 Sources of Data ---------- *11*

6.0 Mutual Fund ---------- **12**

6.1 What is a Mutual Fund and how does it work ---------- *12*

6.2 How Funds Can Earn Money for You ---------- *13*

6.3 The Origins of Mutual Funds ---------- *13*

7.0 Banking Industry and Capital Market ---------- **14**

7.1 Overview of Banking Industry ---------- *14*

7.1.1 Major Factors: Earnings and Profitability ---------- 14

8.0 Investment Potentialities ---------- **17**

8.1 Historically outperformed the overall market ---------- *17*

8.2 Low exposure to global Financial Turmoil ---------- *20*

8.3 Leveraged to positive Macro Environment ---- *21*

8.4 Financial Health of the sector ---- *23*

9.0 Positive Indicators ---- **26**

9.1 Deposits growing faster ---- *26*

9.2 Superior Asset Quality ---- *28*

9.3 Capitalization ---- *29*

9.4 Adoption of Modern Technology ---- *30*

9.5 Access to financial services is still low in the country ---- *30*

9.6 The competition in market is expected to intensify ---- *31*

9.7 Consolidation is expected to happen ---- *31*

9.8 Islamic Banking is growing faster ---- *31*

10.0 Possible Barriers ---- **32**

10.1 Investment ---- *32*

10.2 Export ---- *32*

10.3 Remittances ---- *33*

11.0 Regulations ---- **33**

11.1 Regulatory Environment ---- *33*

11.2 Corporate Governance ---- *34*

11.3 Liquidity and Interbank Market ---- *35*

12.0 Where to Invest ---- **36**

12.1 TOP 4 picks ---- *36*

12.1.1 Brac Bank----------36

12.1.2 Prime Bank----------37

12.1.3 Shahjalal Islami Bank Ltd. ----------39

12.1.4 Eastern Bank Ltd.----------40

13.0 Conclusion ----------41

References ----------42

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Equally I would also like to express my sincere gratitude and indebtedness to the authority of Independent University, Bangladesh for their kind co-operation

Executive Summary

Mutual Fund industry is known to be the fastest growing financial industry in the world's Financial Market. Bangladesh is going to have a rise in the numbers of mutual fund for the last couple of years. Mutual Funds pool money from the investors and then inject in the capital market under discretionary advises of experienced portfolio managers. Now the most important factor is the fund which will be pooled from potential investors. Any Fund manager needs to ensure the investors about the potential market return which is usually made through the help of the research wing. The Research Team of the fund do some in depth research of different industries and try to justify why the fund manager should invest in some particular industries rather than the rest. This report mainly consists of three main parts; Potentialities, Barriers and Positive indicators of the banking industry of Bangladesh in the context of Mutual Fund. This report is done for attracting the potential investors from mutual fund perspectives. This report maintains a Top down Approach, starting from the industry to the company, to find the investment potentialities of the top performers in the industry.

1.0 Introduction

This paper delves into the Bangladesh banking sector, taking a close look at financial health, growth prospects and historical performance of 24 listed banks in the DSE. We also look at the current regulatory environment that applies to these banks. Historically the banks have had good growth which we think will only be mildly affected by the global financial slowdown. The coverage banks have seen phenomenal growth in recent years, a trend that we expect will continue. Although it is only a matter of time before the global financial crisis reaches native shores, we contend that the effects will be somewhat subdued owing to the remarkable resilience of Bangladeshi exports. Furthermore the election of a democratic government is likely to further enhance an already blossoming economy. Solid fundamentals backing uptrend of share prices. Investor confidence in Bank shares have soared as banks prove their ability to generate windfall profits year after year. Government regulation has also been strong ensuring that all banks have a strong capital base thereby reassuring investors that banks are a" safe bet".

2.0 Origin of the Report

Internship report is the outcome of perfect coordination between theoretical and practical experience throughout the session of 12 weeks. This report includes some insights of the Bangladesh banking industry as an investment potential in respect of the capital market of Bangladesh. Now-a-days, education is not just limited to books and classrooms. In today's world, education is the tool to understand the real world and apply knowledge for the betterment of the society as well as business. From education, the theoretical knowledge is obtained from courses of study, which is only the half way of the subject matter. Practical knowledge has no alternative. The perfect coordination between theory and practice is of paramount importance in the context of

the modern business world in order to resolve the dichotomy between these two areas. Therefore, an opportunity is offered by School of Business, Independent University, for its potential business graduates to get three months practical experience, which is known, is as "Internship Program". For the competition of this internship program, the author of the study was placed in a mutual fund namely, "RACE Management PLC". Internship Program brings a student closer to the real life situation and thereby helps to launch a career with some prior experience.

The first part includes three potential investment themes which specify the reason why an investor should invest in banking sector for the next one year timeframe. Barriers include the different scenarios which may risks the investment in the coming future. The last part contains the positive indicators of the industry over other big industries of the capital market which actually helps to strengthen the potential investment themes to its core reason.

3.0 Problem Statement

As competition is increasing day by day in the Mutual Fund industry of Bangladesh, it has become a necessity for the mutual funds to maintain a very high level of research works before invest in potential industries. For ensuring perfect utilization of the investors' pool of money in respect of investment activities every mutual need to have a standard level of research done before the investment. Stock Exchange Commission is also stressing the current funds in the industry to have a sufficient level of research work done before investing in the capital market. From this point of view this report would be a cornerstone of the success for the mutual fund in their early inception

4.0 Objectives of the Study

4.1 Broad objective

The primary objective of the study is to meet the partial requirements to complete the BBA program from Independent University and to gain practical job experiences and view the application of theoretical knowledge in real life

4.2 Specific Objective

There are some specific objective which is directly related only with the project paper and the industry and company itself.

- To familiarize with practical job environment
- To have an in-depth understanding of the Bangladesh Banking Industry
- To gain experience on quantitative fundamental analysis and international research publishing.
- To develop knowledge about core banking system e.g. what are the key issues behind a good banking environment, how the banking industry will cope up with the current financial meltdown.
- How the top down industry research method fits in our country's context.

5.0 Methodology

5.1 Approach

As this is an Equity research project paper, we used a top down method from industry to company specific. The report is started using different macro components to gauge the industry performance and then went through sector dynamics, fundamental analysis, technical analysis lastly finished with ranking the companies of the industry. The first step of this project was problem identification and deciding on the topic. This was achieved through consulting with my faculty advisor and the external supervisor in RACE Management Ms. Sara Rauf, Head of Research, Mr. Hasan Imam Phd, CEO of RACE Management. . Basically the research paper will be used to draw funds from potential investors.

5.2 Sources of Data

To carry out this study, first the most recent published and audited income statement was taken. Only the secondary data was used for the analysis purpose. Annual Statements of the last three years of the 24 banks along with the statement of Bangladesh Bank have been used primarily to build the core structure of the overall project.

6.0 Mutual Fund

6.1 What is a Mutual Fund and how does it work

A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined holdings the mutual fund owns are known as its portfolio.

Some of the traditional, distinguishing characteristics of mutual funds include the following:

- Investors buy mutual fund shares from the fund itself (or through a broker for the fund) instead of from other investors on a secondary market,
- The price that investors pay for mutual fund shares is the fund's per share net asset value (NAV) plus any shareholder fees.
- Mutual fund shares are "redeemable," meaning investors can sell their shares back to the fund (or to a broker acting for the fund). It depends on whether the fund is closed or open ended.
- Mutual funds generally create and sell new shares to accommodate new investors. If the fund totally depends on individual investors for example,
- The investment portfolios of mutual funds typically are managed by separate entities known as "investment advisers" that are registered with the SEC.

  You can earn money from your investment in three ways:

6.2 How Funds Can Earn Money for You

- **Dividend Payments** — a fund may earn income in the form of dividends and interest on the securities in its portfolio. The fund then pays its shareholders nearly all of the income (minus disclosed expenses) it has earned in the form of dividends.

- **Capital Gains Distributions** — the price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (minus any capital losses) to investors.

- **Increased NAV** — if the market value of a fund's portfolio increases after deduction of expenses and liabilities, then the value (NAV) of the fund and its shares increases. The higher NAV reflects the higher value of your investment.

With respect to dividend payments and capital gains distributions, funds usually will give you a choice: the fund can send you a check or other form of payment, or you can have your dividends or distributions *reinvested* in the fund to buy more shares (often without paying an additional sales load).

6.3 The Origins of Mutual Funds

The mutual fund industry traces its roots to England in the mid-1800s. The british law first time liberalized investors to share their profits to different institutions as further investments. In 1861

Foreign and Colonial Government Trust formed in London. This trust created a mutual fund in basic structure, providing "the investor of moderate means the same advantages as the large capitalists by spreading the investment over a number of different stocks. This concept first established the idea of mutual funds in the world.

7.0 Banking Industry and Capital Market

7.1 Overview of Banking Industry

7.1.1 Major Factors: Earnings and Profitability

Interest Income and Assets

For banks, one of the major sources of income is interest income. The main source of interest Income for banks is loans and advances. A comparison of total interest income and total assets by bank groups shows that, in December 2007, PCBs had the highest interest income-asset ratio followed by FCBs, SCBs, and SBs (Table:1). However, at the end of June 2007, performance of SBs was better compared with other groups in the banking industry.

Table 1 Total Interest Income by Total Assets

Bank Grou	Dec-07	Jun-07	Dec-06	Jun-06
SCBs	4.3	2.3	5.2	2.2
SBs	3.5	4.6	3.2	3.9
PCBs	8.3	4.4	8.2	3.4
FCBs	7.6	4.1	7.5	3.2

Source: Bangladesh Bank

Interest Expenditure and Assets:

A similar picture is seen for interest expenses of the banks. In December 2007, interest expenditure-asset ratio of PCBs was highest followed by the SCBs, FCBs, and SBs. At the end of

June 2007, the ratio was highest for SBs. The major expenditure category of banks is expenditure on deposits.

Table 2 Total Interest Expenditure to Total Assets

Bank Grou	Dec-07	Jun-07	Dec-06	Jun-06
SCBs	3.5	1.9	4.0	1.9
SBs	2.8	3.7	2.3	3.1
PCBs	5.8	3.2	6.0	2.4
FCBs	3.3	1.8	3.0	1.2

Source: Bangladesh Bank

Non Interest Income and Assets:

A changed scenario is observed in the case of non-interest income as a share of total assets. In December 2007, the ratio was highest for FCBs compared with other groups showing greater importance of non-interest income as income source for FCBs. The ratio was also higher for PCBs than SCBs and SBs.

Table 3 Non Interest Income by Total Assets

Bank Grou	Dec-07	Jun-07	Dec-06	Jun-06
SCBs	2.4	1.1	2.0	0.9
SBs	0.8	0.8	0.6	0.7
PCBs	3.1	1.5	2.8	1.1
FCBs	3.8	2.0	4.1	1.8

Source: Bangladesh Bank

Non Interest Expenditure and Assets:

In case of non-interest expenditure to total asset ratio, PCBs and FCBs had the highest ratio in December 2007 (Table 3.2.4). In June 2007, the ratio was highest for SBs followed by FCBs, PCBs, and SCBs.

Table 4 Non Interest Expenditure and Total Assets

Bank Grou	Dec-07	Jun-07	Dec-06	Jun-06
SCBs	1.6	0.8	1.8	0.7
SBs	1.3	2.0	1.2	1.9
PCBs	2.1	1.0	2.1	0.8
FCBs	2.1	1.2	2.2	1.0

Source: Bangladesh Bank

Return on Assets:

For earning profit, the banks add value to inputs and deliver outputs. A straightforward measure of bank profitability is the net after-tax profit per unit of assets, or return on assets (ROA). This measure shows how well a bank is being managed by conveying how much profit the bank earns per unit of assets. Table 3.2.5 shows that ROA for FCBs is much higher than those of PCBs, SCBs, and SBs. The ROA for PCBs was, however, better than those of SBs and SCBs.

Table 5 ROA in Selected Asian Countries

Year	Bangladesh	India	Pakistan
2002	0.5	0.8	0.9
2003	0.5	1	1.8
2004	0.7	1.1	1.9
2005	0.8	0.9	2.8
2006	0.8	0.9	3.1
2007	0.9	0.9	3

Source: Bangladesh Bank

Return on Equity:

It is important for the shareholders to know the return on their invested equity in a bank. A useful summery of this information is provided by net after tax profit per unit of bank equity capital known as return on equity (ROE). During December 2007, ROE for FCBs was highest followed by PCBs, while it was zero for SCBs and negative for DFIs (Table 3.2.6) The recent

trend shows that ROA of the banking sector in Pakistan is higher than that of India and Bangladesh. The trend is similar for ROE. 49

8.0 Investment Potentialities

8.1 Historically outperformed the overall market

Banking sector has historically outperformed the overall market, offering seasonal trading opportunities

- ABI has outperformed the broader market indexes, namely the DSI and DGEN. Our analysis suggests that over a 5-year period (2002-2007), the ABI has achieved a CAGR of 34.33%, handily outperforming DGEN with 20.67 % and DSI 18% over the same period.

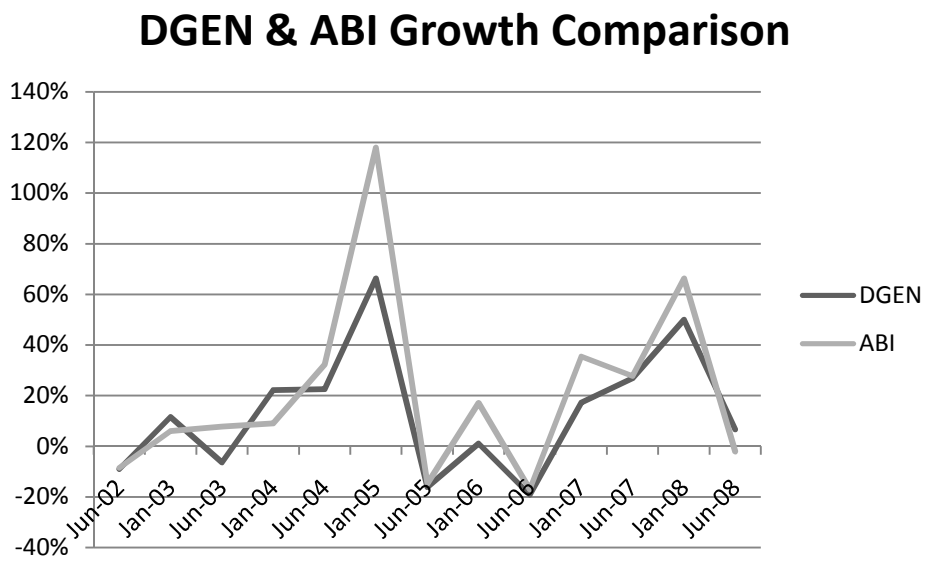
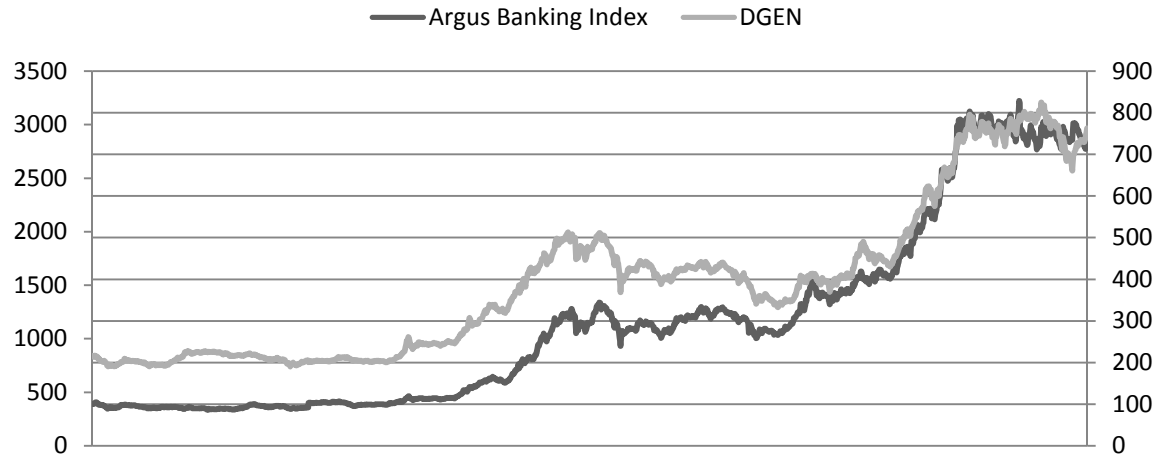
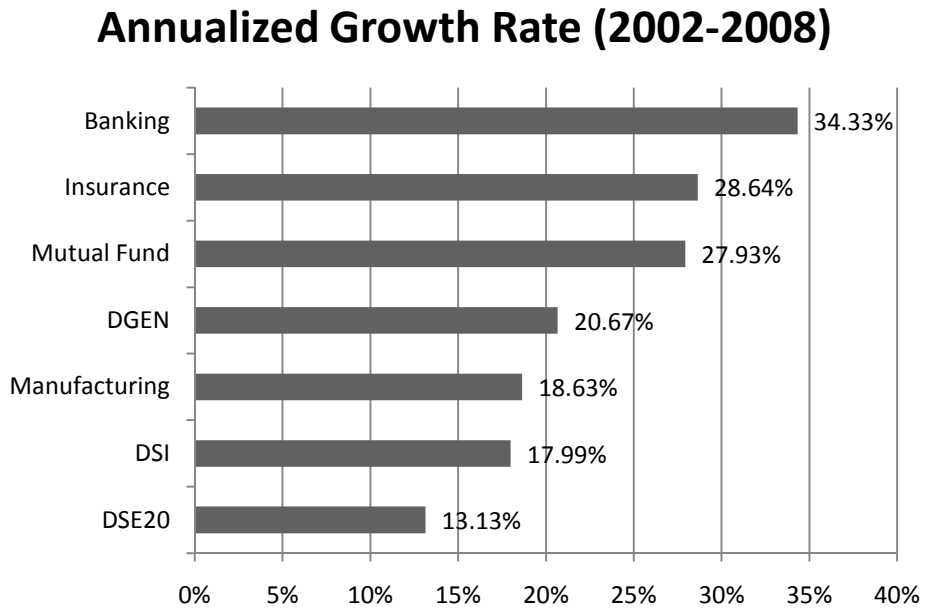


Figure 1: Daily Index Trend: ABI vs. DGEN (2002-2008)





- During periods of recapitalization, the ABI enjoys especially high returns. This is due to the fact that the Banks, in order to boost paid-up capital, offers extraordinary numbers of bonus shares. On average, we can account this effect by calculating the difference between the adjusted and the unadjusted ABI, which over the 2002-2007 periods.

- Adjusted vs. Unadjusted ABI

Year	% Change in ABI Unadjusted (A)	% Change in ABI Adjusted (B)	Difference (A-B)
2002	3.57%	-2.30%	5.87%
2003	29.15%	17.00%	12.15%
2004	213.44%	184.33%	29.11%
2005	8.18%	0.36%	7.81%
2006	23.65%	14.74%	8.91%
2007	121.99%	112.97%	9.02%
2008	-1.87%	-8.34%	6.46%
		Average Difference	11.33%

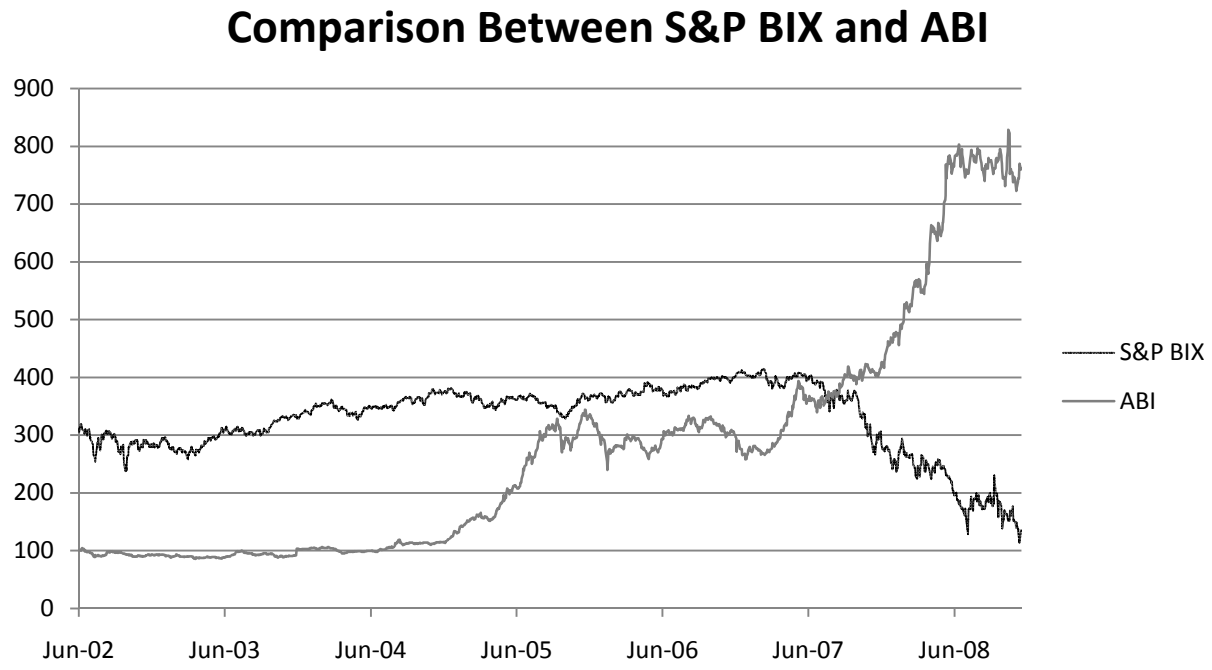
Source: ARGUS Research

Seasonal Trends: from a portfolio management perspective, banks offer seasonal trading opportunities. Our analysis suggests that between 2002 and 2007, banks have had a "June (or some other period) boost" – ahead of the AGMs. [NEED CHART for ABI that shows this effect. Graph ABI on Y axis and Time by months (Jan, Feb, Mar, etc) on the X axis. Then plot the peaks and valleys.

8.2 Low exposure to global Financial Turmoil

Historically, the banking sector has been uncorrelated with the global banking sector. While Banks around the world are in dire straits, Bangladesh banking sector is enjoying a period of high returns.

Table 6 S&P banking Index Vs Argus Banking Index



Source: Company Reports

Overall DSE has low exposure to foreign capital, of the "fast kind. From our analysis, overall capital inflow from foreign institutions is around $500mn, accounting for less than 10% of annual turnover this is much smaller than the exposure of other emerging markets (x% for India and Y% for China, for example); Therefore, DSE and the ABI is not exposed to the flight of fast money that has laid to waste stock markets in other emerging markets like India (down 23.4% YTD) and China (down 62.7%% YTD).

At a fundamental level, Bangladesh banks are restricted from investing capital in FX denominated assets. This has shielded Bangladesh banks from direct exposure to the USA sub-prime and other mortgage backed structured instruments.

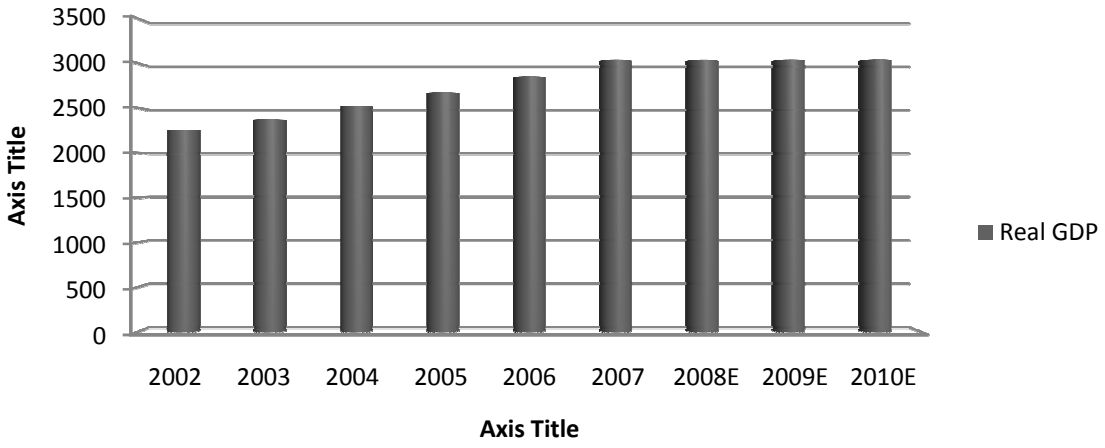
However, we should not minimize the negative impact on Bangladesh banks due to a slowdown in the global economy – contagion remains a significant risk. Bangladesh has already experienced a slowdown in GDP growth due to the dual price shocks of rising oil and food prices, with its origins in the weakening dollar. While this abates, a slowdown in global consumer spending and its associated effects are likely to impact the Bangladesh economy through slowing demand for export goods and remittance – two of the largest drivers of GDP growth for Bangladesh.

8.3 Leveraged to positive Macro Environment

Leveraged to positive macro environment, even as global demand slowdown curtails growth somewhat; we project deposit growth of x% over the next 3 years.

Overall GDP growth in positive territory, even after adjusting for global slowdown. GDP has been growing with a CAGR of X% since 2002 as shown in figure 4, and we expect it to be stable in the future. Although the possible ebbing of remittances may take its toll on GDP, its effects will be somewhat countered by the country's stable RMG export. Plunging oil prices should further help prop up GDP. Overall we expect GDP growth to stay somewhat stable even after adjusting for the global slowdown.

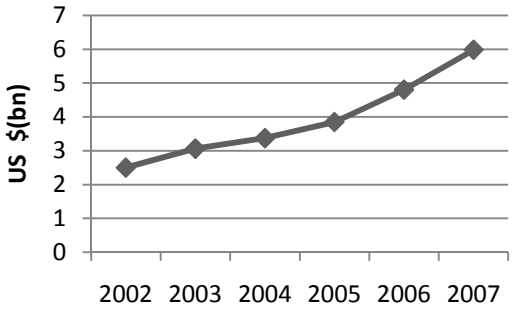
Figure 2: GDP of Bangladesh



Source: Bangladesh Bank and ARGUS Research

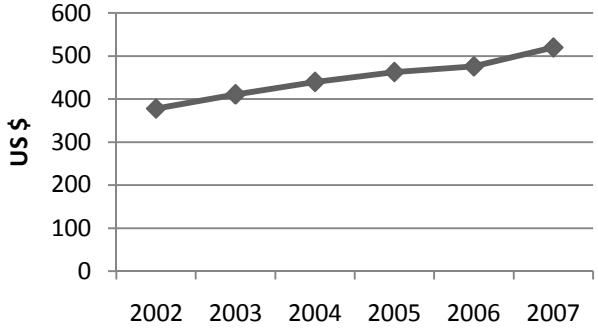
Consumption accelerating, led by dual effects of increasing remittance and rising per capita income. Rising per capita income and an ever increasing remittance inflow has enabled the masses to increase consumption for both durable and nondurable goods.

Figure 3: Remittance by NRB



Source: Bangladesh Bank

Figure 4: Per Capita GNI of Bangladesh

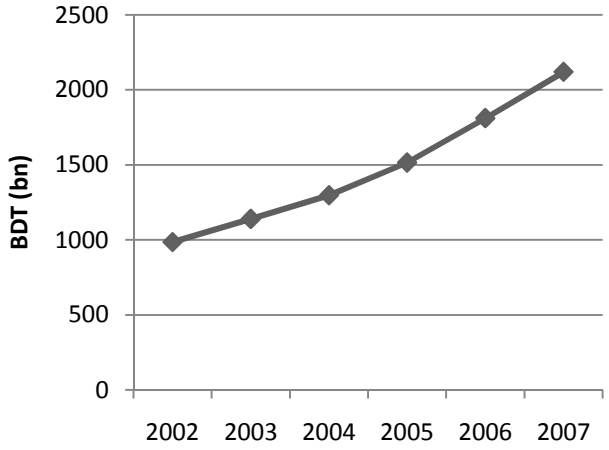


Source: Bangladesh Bank

Moderate monetary policy; Bangladesh has been enjoying a period of benign monetary policy with money supply growing. Monetary policy has maintained a contractionary

trend overall since 2005; however it has failed to curb demand which has run rampant as shown by the increase in M2 (figure 7).

Figure 5: Broad money

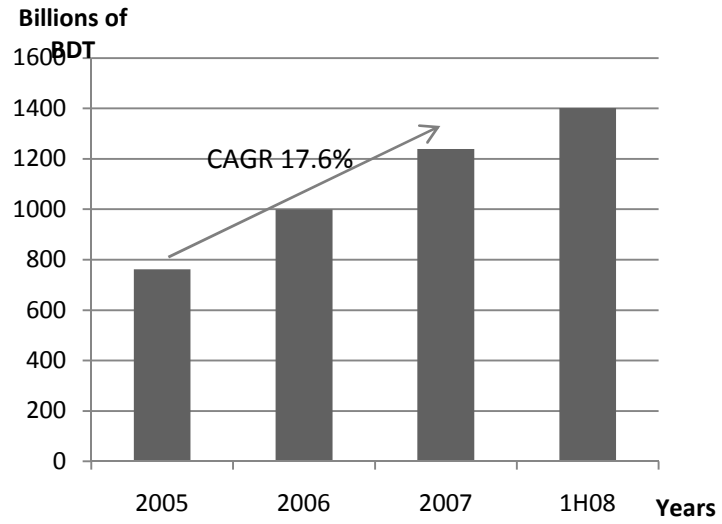


Source: Bangladesh Bank

8.4 Financial Health of the sector

Assets have seen steady growth boosted by steady increases in loans and investments. Assets have seen tremendous growth in the last three years owing to the phenomenal increase in loans and investments in recent years.

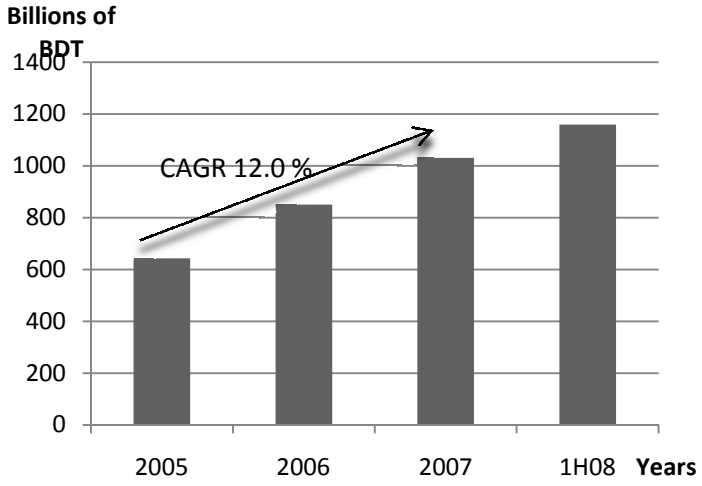
Table 7 Assets Of coverage Bangladesh banks



Source Company Reports

Deposit growth has been steady and is expected to grow annually at a rate of 14-17% annually. Healthy economic growth and a blossoming healthy business climate have helped Bangladesh reach healthy deposit growth. We expect this trend to continue in the future.

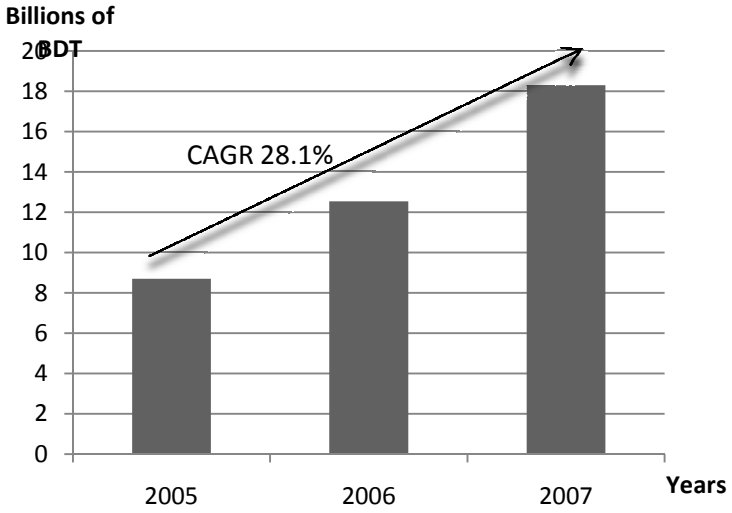
Table 8 Deposits of Coverage Bangladesh Banks



Source Company Reports

- **Profits have seen tremendous growth spurred on by large returns from interest and non interest sources.** In recent years large spreads as well as massive gains realized in investments have helped the Banks realize healthy profits.

Table 9 Profits of coverage Bangladesh banks



Source Company Reports

Costs have also seen growth; however revenues growth has outpaced growth in operational expenses. Expansion, hiring of skilled workforce and improving IT infrastructure have all contributed to increasing costs; however massive gains in revenue has outshined growth in costs accounting for an improving efficiency ratio.

9.0 Positive Indicators

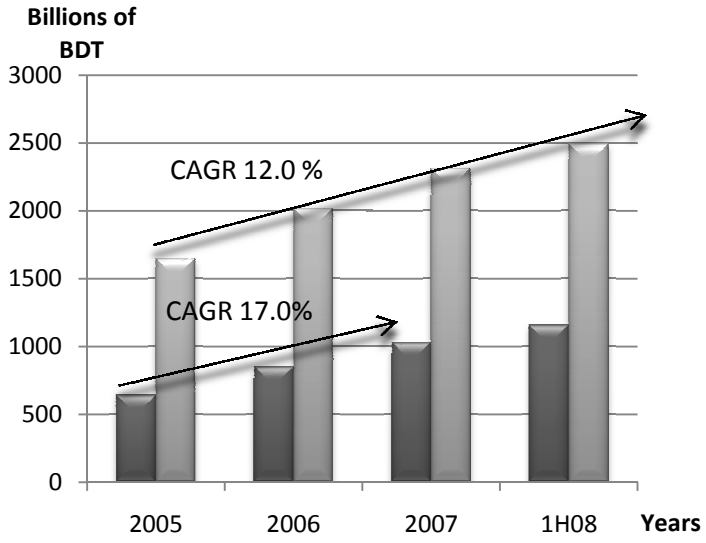
9.1 Deposits growing faster

There has also been high growth in non-funded activities. Non-interest income in 2006 was 1.8% of total assets employed, which increased to 2.6% in 2007. This is due to expansion in trade and remittances, the main sources of non-funded income for the banks. Non-interest income accounts for a larger share of total income among foreign banks than local banks.

Deposits are the main source of funding liabilities for coverage Bangladesh banks. Deposits account for 88.4% of funding liabilities and have been increasing the last 3 years while at the same time a large retail customer base has contributed to a low cost of funds.

Increasing deposits over last three years with CAGR of 17.0%; expected to increase 14-17% annually in the future. As Chart shows Aggregate deposits have gone from 642.8 billion Tk. in 2005 to 1030.7 billion Tk. in 2007 with a 3 year CAGR of 17.0%. Strong economic growth and a blossoming business sector have lead to a growth in deposits. Chart also shows that deposit growth has tracked M2 growth. According to table, deposits in fixed/term deposits have increased from 53.5% to 55.7% while savings deposits have decreased from 20.8% to 17.9%. High interest rates on fixed deposits are leading customers to it as an investment avenue, away from savings deposits.

Figure 6: Aggregate deposits of coverage Bangladesh banks VS M2 of Bangladesh economy



Source: Company reports

Table 10 Composition of deposits of coverage Bangladesh banks from 2005 to 1H08

Component	2005	2006	2007	1H08
Current	14.3%	12.6%	13.4%	15.1%
Savings	20.8%	19.0%	18.5%	17.9%
Fixed/Term	53.5%	57.9%	56.4%	55.7%
Others	11.4%	10.5%	11.7%	11.4%

Source: Company reports

9.2 Superior Asset Quality

This figure was 26.9% and 31.8% respectively for NCBs and SBs. The PCBs and FCBs had classified loans of 6.11% and 1.5% of assets respectively. The reduction in NPLs in recent years is partly due to writing off some NPLs but due to the implementation of more effective credit control processes and systems. The development of a credit information bureau, the money loan

court, and improved risk management have facilitated greater efficiency. Credit Information Bureaus help lenders identify clients who have defaulted on their obligations to other financial institutions and Money Loan Court plays an important role in the fast settlement of default cases.

Table 11 Non Performing Loans of different categories of banks

Different Cattegories of Banks	NPL
NCB	26.9%
PCB	6.1%
FCB	1.5%
SB	30.1%

Source: Bangladesh Bank

9.3 Capitalization

However, the NCBs and SBs suffer from capital shortfalls and some have negative capital. As per Bangladesh Bank (BB), the total capital of banks stood at BDT 100bn in June 2007 representing 6.2% of bank loans. Capital position of NCBs stood at BDT (-) 30.9bn, SBs BDT 14.8bn, PCBs BDT 84.5bn, and FCBs BDT 31.6bn. NCBs are suffering from negative capital due to their sustained operating losses. Most of the PCBs and all the FCBs have adequate capital. The capital of the banks is in the form of equity, paid up capital, statutory reserves, and general provisions. Tier II capital in the form of preferred stock or subordinated debts are almost non-existent

Table 12 Outstanding Loans and Capital positions of Bangladeshi Banks

Different Cattegories of Banks	Loans	Capital
NCBs	499.4	30.9
PCBs	854.1	84.5
FCBs	118.5	31.6
SBs	125.1	14.8
Total	1,597.10	100

Source: Bangladesh Bank

9.4 Adoption of Modern Technology

ATM services are gaining popularity very fast. Customers' use of online banking (the ability of the customers to execute transactions in any of the bank's branches, not in the branch where the account was opened) is also expanding rapidly. Internet banking and Tele-banking services are also growing fast. According to the Financial Sector Review by BB, between June and December 2007, the monthly volume of credit card transactions grew by 124%, debit cards increased by 112% and transaction through ATMs increased by 114%. During the same period, transaction through POS and SWIFT grew by 111% and 61% respectively. While FCBs and PCBs are introducing technology driven products in Bangladesh state owned banks are lagging in adoption of new technology and associated efficiencies.

9.5 Access to financial services is still low in the country

There are tremendous growth and investment opportunities in financial services. As the economy modernizes, the banking sector may grow even faster. In addition, banks are expected to increase their diversification towards capital market related activities

9.6 The competition in market is expected to intensify

International and regional players are expected to increase or expand their operations when the sector is opened up. However, banks with technological and managerial superiority are expected to continue to enjoy a high level of profitability in the medium term.

9.7 Consolidation is expected to happen

Players with automated, country-wide operations are expected to enjoy a competitive advantage with foreign remittances and internal money transfer a high growth business. Therefore, there should be consolidation within the banking sector, especially among smaller, new generation PCBs. anticipating consolidation in the industry; BB has published guidelines for bank mergers and acquisitions. It has been argued that uneconomic factors, like a sponsors' prestige associated with being a bank director, may be an obstacle to consolidation in the near-term. However, we believe some smaller players will be forced to consolidate if Basel II capital regulations are applied stringently.

9.8 Islamic Banking is growing faster

Currently 6 commercial banks are operating as full-fledged Islamic bank. Ten other conventional banks including two foreign banks offer Islamic banking products.

10.0 Possible Barriers

The ADB projects the US economy to grow by 1.5 per cent in 2008 and 2 per cent in 2009. This is much stronger than the 0.5 and 0.6 per cent growth forecast by the IMF. The financial meltdown would make a bitter experience for the Bangladeshi banking industry as a whole.

There are three major channels through which a worse-than-expected global slowdown could affect Bangladesh: investment, exports, and remittances.

10.1 Investment

Let's consider investment first. The financial meltdown will stress the banks to charge the interest rate high. Further, at times like this, lenders seek the relatively less risky borrowers. As a result, credit spreads will widen, and Bangladeshi businesses will find it harder to borrow. This, in turn, will hurt investment. The flight to quality will also mean foreign direct investment might dry up.

In the near term, sharp slowdown in investment will hurt employment and household income, with flow on effects on consumption. In the medium term, slowdown in investment, particularly foreign direct investment, will hurt industrialization, technology transfer, and productivity growth -- all very important factors for poverty alleviation through sustained economic growth.

10.2 Export

The second channel through which a worse-than-expected slowdown could affect Bangladesh is exports. About a quarter of Bangladesh's exports are to the US, with Germany, the United Kingdom, France, and Italy accounting for another third.

If the US recession is worse than anticipated, or if one or more of the major European countries enter a recession, exports will suffer. A sharp slowdown in exports will have additional impacts on investment, employment, and household income. A sharp slowdown in export will result in low volume of LCs, which will eventually hurt the loan growth of the banking industry as well create a liquidity problem.

10.3 Remittances

Remittances will also suffer, especially if the credit squeeze worsens. This is because most non-resident Bangladeshis, particularly those living in the developed economies, will have to pay higher interest payments in their house mortgage, credit card debt, or personal loans. Remittances have shored up household income and boosted consumption in recent years. If remittances were to start drying up, consumption will hurt, and the service sectors such as Banking, property, and telecommunications will suffer.

11.0 Regulations

11.1 Regulatory Environment

The overall health of the banking sector, especially capital adequacy and asset quality, has improved significantly in recent years. However regulatory vigilance needs to be increased to avoid the recurrence of events like the failure of Oriental Bank. BB has been successful at improving corporate governance in banks. Financial standards have improved. Bank directors are no longer allowed to get in operational decisions of the banks. Lending to directors directly as

well as the companies they own has been stopped. BB has also promoted and implemented Anti-Money Laundering rules.

In addition to its own ratings based on capital adequacy, asset quality, management efficiency and liquidity, BB has made it mandatory for the banks to be rated by independent rating agencies. BB has also made publication and public disclosure of bank financial statements mandatory.

BB has issued a number of prudential guidelines regarding capital adequacy, corporate governance and legal issues recently. These include strengthening a bank's capital base and making them better prepared for adopting Basel II standards. In the near future, the banks will be required to maintain capital to risk-weighted assets ratio of 10% as a minimum with core capital not less than 5%. Currently banks need to maintain 9% capital on risk weighted assets. As tier II capital is almost non-existent, bank capital is mainly in the form of equity. The paid up capital and the statutory reserve of all bank companies has been raised to a minimum floor of BDT 2bn Basel II standards will be implemented from early 2009. Implementation of these regulations will help strengthen the financial system and will help bring greater discipline in the activities of the banks and financial institutions.

11.2 Corporate Governance

Professionalism in management is more evident in banking than any other sector in the country. BB has taken some corporate governance initiatives recently. The number of members in the board of directors has been restricted to thirteen. The role of the and role of chairman of the board have also been defined. As per BB directives, the chairman of the board of directors or chairman of any committee formed by the board or any director does not have jurisdiction for

taking decisions in executive matters. BB has also made the CEO responsible for implementing the policies taken by the board and looking after all administration. BB has also directed the banks to establish audit committees formed by the board of directors. Several other reforms have also been introduced by BB to ensure good governance in all institutions operating in the financial sector

11.3 Liquidity and Interbank Market

Banks in Bangladesh need to maintain 5% of their liabilities as cash reserves in BDT clearing account (non interest bearing) with Bangladesh Bank. In addition, commercial banks need to invest 13% of their liabilities in government treasury bills. Traditionally the overnight interbank call money market was the source of liquidity for banks in Bangladesh. The repo facility with the central bank was introduced in 2002. Subsequently the interbank repo market has also evolved. However, the trading volume of government treasury bills/bonds is still low. The interbank term lending market is thin. Therefore, banks need to depend on the call money market and repo window for liquidity management. Due to the absence of an interbank money market and a secondary market of government treasury bills, market liquidity and overnight interbank rates fluctuate abruptly. Overnight interbank borrowing rates sometimes shoot up to 20%.

12.0 Where to Invest

12.1 TOP 4 picks

12.1.1 Brac Bank

Investment Positives

- Consistency in CAR: Brac Bank's one and three year CAR is 12.3% and 11.7% respectively. The three year average is pretty consistent with the industry average of 12.1%.
- Massive Asset and Deposit Growth**:** From its early inception Brac Bank is growing very fast in respect of assets and deposits. Three year average of asset growth is 67% which cleanly outperforms any other bank in Bangladesh. Deposits have been growing simultaneously with the assets part as well. Its three year average deposit growth rate is 66% which is far above the industry average of only 28.2%.
- Dynamic NIM growth**:** Despite of growing cost of funds, the NIM has increased substantially year over year. Three year average NIM outperforms the industry by almost 2.7%.
- Specialization: BRAC Bank focuses on pursuing unexplored market niches in the Small and Medium Enterprise (SME) Business, which has remained untapped within the country. SME Sector, the main concentrated area for the bank, comprises of 50.81% of the total loans and advances.
- A healthy Equity Return: An overall ROE of 32% greater than the industry average of 24% depicts more successful capital allocation within the institution than the industry overall.

Barriers of Improvement

- NPL/Loans well above industry average: The Asset Quality of the bank is not among the best in its class. Brac banks one year average of NPL/Loans is 4.5% which is way higher than the industry average of 2.4%.
- P/E is way Higher: Brac bank's P/E is 31.28 where as the industry average is 18.25 and the overall DSE P/E average is 12.1 in December 2007. This clearly states that the investors are paying 71.4% premium for the banks share.

  Catalysts
- Loan provision is likely to go down: Brac Bank has increased the loan recovery rate of SME loans to 98% which is a corner stone of the bank's success in managing the overall loan portfolio. And this will help the bank to curb down the loan provisions from its current unacceptable level of 97.4%.
- Increased Paid-Up Capital will ensure overall growth: Fulfillment of the Basel 2 compliance will strengthen the bank's asset base to maintain the current loan/deposit ratio or increase it to a level better than the current standing.
- Growth of revenue is higher than Opex: A higher growth rate of 71.1% in revenue than the growth rate of 55.89% of operating expense over year to year will help the company to have untapped potentialities to invest more and make greater return.

12.1.2 Prime Bank

Investment Positives

- Robust Asset Quality: Prime Bank's one year average of NPL/Loan is 1.3% where as the industry average is 3.9%. The three year industry average of NPL/Loans is 1% in the contrary to 4% of industry average.

- A very consistent Asset Growth: Prime Bank's Asset growth remains consistent for the last three years. We have found standard deviation of 10% on year over year asset growth rate of Prime Bank.
- Healthy NIM Growth: The bank has been maintaining a NIM growth rate of 3.7% which is exactly at par with the industry. The one year average of NIM of Prime Bank is 3.5% which is again very close to the industry average of 3.7%.
- Consistent Return: For the last five years Prime bank's rate of return has been very consistent and resulted a higher than average industry rate of return of 32.17%. The industry return was 34%.
- Strong Corporate Governance: Prime Bank is run by a group of very talented professionals.
- Prime Focus: Prime Bank Ltd., since its beginning has attached more importance in technology integration. In order to retain competitive edge, investment in technology is always a top agenda and under constant focus.

Barriers to Improvement

- Interest Expense out runs the Interest Income: The one year average of interest expense is higher than the average of interest income.

Catalysts

- Undervalued: P/E of 13.53 is undervalued in respect of the industry average of 18.25 and very close to DSE average of 12.1 at the end of 2007.
- Higher Than Average ROE: Bank's Earnings has been increasing considerably from year to year as an average of 28.2%, where as the industry average is 24% for three year.
- Loan Syndication results in improved Profitability and Branding: Prime Bank's Loan Syndication programs are helping to improve the profitability and also providing

"Branding" for the bank. Prime Bank has alone increased Tk 300 crore in the syndication market for the year 2008.

12.1.3 Shahjalal Islami Bank Ltd.

Investment Positives

- SIBL's CAR surpassing the industry average: One year CAR of the Bank is clearly implying that it maintains the CAR very well. CAR of one year of the bank is surpassing the industry rate of 12.1% by 4.3%.
- Asset Quality is best in its class: One year and Three year average of NPL/Loans are respectively 0.6% and 0.4%, which clearly states SIBL's dominant presence in this regard in the overall industry. Whereas the industry average for one year and three year average are 3.9% and 4% respectively.
- Outstanding Asset Growth: Asset growth has been tremendously consistent over a three year period since its inception. One year asset growth of the bank is way over than the industry average of 25.5%. For the year ended 2007, the Asset growth was 32.8%.
- Specialization: Shahjalal Bank has already completed seven years of service with a special focus on small and medium enterprises (SMEs) and development of rural economy.

Barriers to Improvement

- Deposits growth is shrinking: From the year 06 to 07 Prime Banks deposit growth drastically falls from 48.2% to 25% where as the industry average was 22.1% and 28.2% respectively for the one year and three year average.

- Low Expected Rate of Return: SIBL's rate of return is below the industry average, which is 30.08%. Its Beta of 0.85 with the banking industry as a whole depicts that the rate of return will be lower than the industry.
- High Dependency on Mudaraba Term Deposits: SJIBL deposit composition has a greater dependency on mudaraba term deposits which comprises of 50.14% of the total deposit portfolio, which can be a constraint for the near future.

Catalysts

- Expansion in the horizon: SJIBL will open minimum 20 SME booths in near future in compliance with a recent central bank directive and this will contribute to a large extent to create new employment opportunities
- SJIBL to buy ICB Islamic Bank shares: Shahjalal Islami Bank Limited will acquire a total of 118,916 shares worth Tk 118.91 million (face value Tk 1000) of ICB Islamic Bank (formerly Oriental Bank Ltd) against a partial payment of deposit liability just after the trading of ICB Islamic Bank will resume on the stock exchanges.

12.1.4 Eastern Bank Ltd.

Investment Positives

- Superior Capital Adequacy: EBL has been maintaining an outstanding level of Capital Adequacy of 15.3% clearly outperforms any other banks in the industry. The three year average of the industry in this regard is 11.3%.
- Healthy NIM: Eastern Bank has an average three year growth of 3.7% which is greater than the industry average clearly depicts the increase in interest income for the last three years.

- Eastern bank signs MOU with SEDF: It is envisaged that the partnership between SEDF and Eastern Bank will significantly contribute towards increasing access to finance by the SMEs.
- Most Diversified loan and deposit portfolio: EBL's loan and deposit portfolio comprises of more than 13 different schemes which give the bank an edge from any other banks in the country.

Barriers of Improvement

- Substandard Asset Quality: EBL's three year average NPL/Loan is 4.5% in the contrary to the industry average of 4%.
- High Loan to Deposit Ratio: The Banks loan to deposit ratio is excessively high. For the last 3 three years the average rate.

13.0 Conclusion

Banking Industry in Bangladesh is going to have a prosperous future in the coming years in respect of the economies macro economic factor, Deposit growths, Loan growth, Diversified Consumer products ensure more penetration. Though the financial sector is dominated by banks, the vast majority of the people do not have access to banking services. The banking system asset ase is USD 30 bn, roughly 42% of the country's GDP. By comparison, this ratio is more than 57% in Pakistan. This information not only symbolizes that a prosperous future is coming on but also ensures Bangladesh economy to be emerged as a giant in the world economy.

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