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Slowing Private Sector Credit & Rising NPL: Foggy Outlook

Bangladesh Bank Sector Report
December 08, 2019

Key Takeaways

- Private sector credit growth fell to its 9-year low and expected to remain subdued next year.
- Amount of Non-Performing Loans (NPL) continues to rise. The central bank's relaxed policies are not helping.
- Bank sector capital shortfall persists but we expect Basel III implementation next year.
- High yielding NSC sales are low due to stricter monitoring which is bringing liquidity to the Private Banks. The government is borrowing more from the bank sector to cover fiscal deficit amid poor revenue collection.
- An Asset Management Company (AMC) might be formed next year to buy troubled loans from banks and focus on collecting default loans.
- We expect satisfactory loan and deposit growth next year for our coverage banks and a slight improvement in spread in 2020 due to an increase in CASA ratio.
- We like BRAC Bank, City Bank & EBL at this price while we wait to see Prime Bank's turnaround story in numbers.

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Major Events in Banking Sector to Look out for in 2020

IMPROVEMENT IN PRIVATE SECTOR CREDIT GROWTH

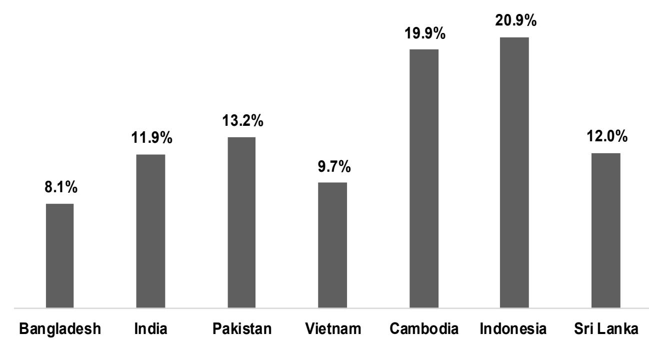
CREATION OF ASSET MANAGEMENT COMPAMY

Important Numbers

USD 317 Bn GDP (CURRENT PRICE, IMF)	**USD 118 Bn** LOAN SIZE	**USD 127 Bn** DEPOSIT SIZE
USD 14 Bn NPL (OFFICIAL)	**12.0%** NPL RATIO (OFFICIAL)	**4.4%** NPL (% OF GDP)
USD 25 Bn NPL (INCL. RESCHEDULED LOAN & COURT STAY ORDER)	**8.0%** NPL (% OF GDP, INCL. RESCHED-ULED LOAN & STAY ORDER)	**59** NO. OF BANKS

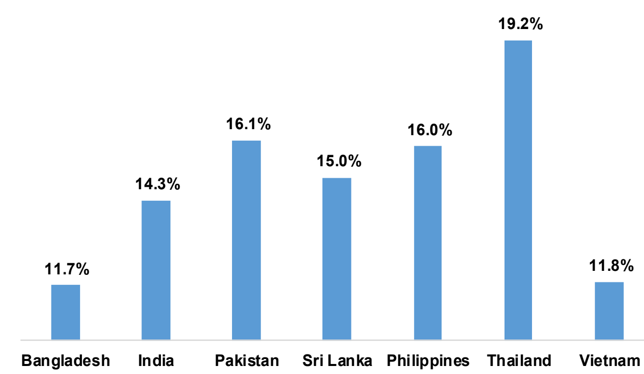
Major Indicators

Chart: Tier-1 Ratio, Latest Available



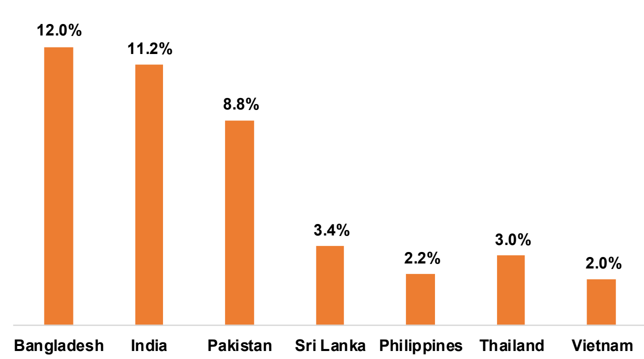
Source: IMF

Chart: Capital Adequacy Ratio (CAR), Latest Available



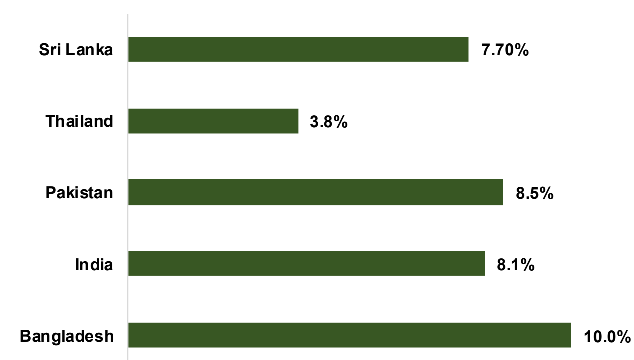
Source: CEIC DATA, Newspapers

Chart: Non-Performing Loans (NPL) Ratio , Latest Available



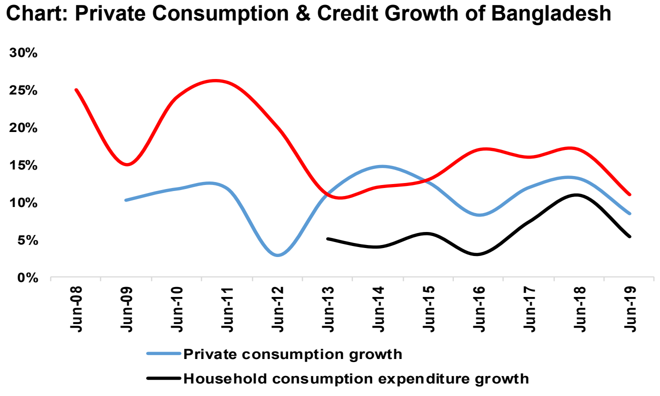
Source: CEIC Data, Newspapers, Bangladesh Bank

Chart: Private Sector Credit Growth , Latest Available



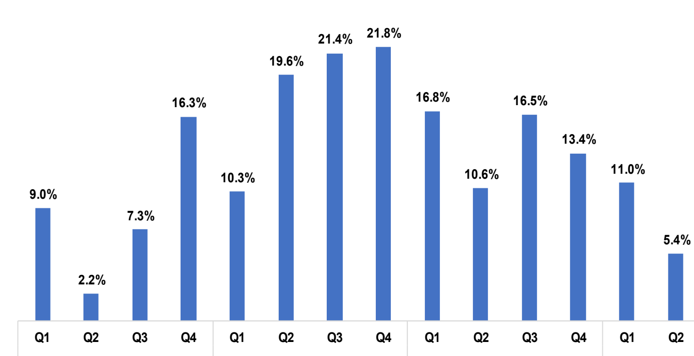
Source: The Global Economy

Chart: Private Consumption & Credit Growth of Bangladesh



Source: Bangladesh Bank

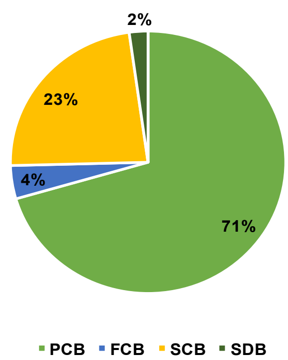
Chart: Industrial Production Growth of Bangladesh



Source: The Global Economy

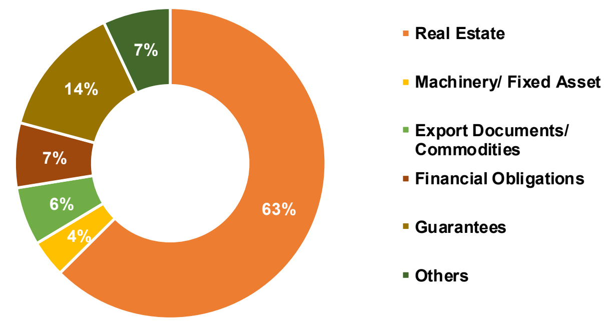
Major Indicators

Chart: Share of Earning Assets in Bangladesh Bank Sector



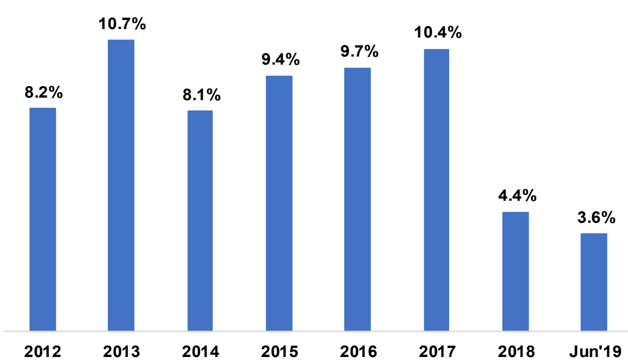
Source: Bangladesh Bank
PCB = Private Commercial Bank, FCB = Foreign Commercial Bank,
SCB = State-owned Commercial Bank, SDB = Specialized Development Bank

Chart: Security Type as Collaterals against Advances in Bangladesh



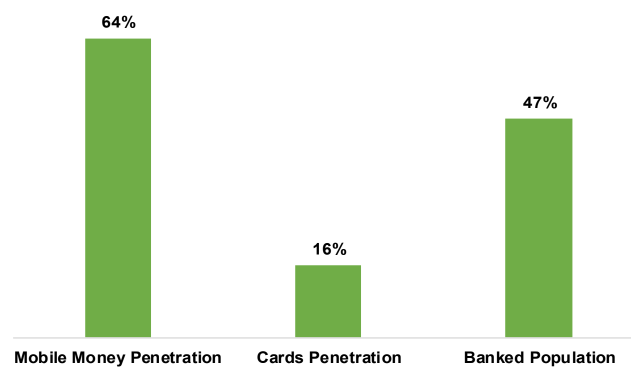
Source: Bangladesh Bank

Chart: Banking Sector Return on Equity (ROE)



Source: Bangladesh Bank
**Jun'19 ROE figure is annualized*

Chart: Financial Inclusion in Bangladesh, Latest Available



Source: Kantar—Finclusion, Bangladesh Bank

Table: Macro Economic Indicators of Bangladesh

Parameter	Date	Amount	YoY Change
Remittance	2019-20 Jul-Nov	USD 7,710 Mn	22.5%
Foreign Exchange Reserve	Nov 27, 2019	USD 31,728 Mn	2.4%
NBR Tax Revenue	2019-20 Jul-Oct	BDT 651 Bn	4.3%
Net Sales of NSC	2019-20 Jul-Oct	BDT 55 Bn	-69.1%
Broad Money	Sep 2019	BDT 12,519 Bn	11.9%
Domestic Credit	Sep 2019	BDT 11,832 Bn	14.4%
Private Sector Credit	Oct 2019	BDT 10,260 Bn	10.0%
Budget Deficit	2019-20	BDT 1,454 Bn *(5% of GDP)*	15.4%
Foreign Exchange Reserve to Monthly Import	FY Reserve: 27 Nov 2019 Import: LTM Avg.		6.91

Source: Bangladesh Bank, BRAC EPL Research

Table: Balance of Payment

In USD million	Jul-Sep FY20	Jul-Sep FY19	% Change
Export	9,535	9,747	-2.18%
Import	13,252	13,599	-1.64%
Trade Balance	-3,717	-3,852	N/A
Current Account Balance	-678	-1,316	N/A
Current Account Balance as % of GDP (Annualized)	-0.8%	-1.8%	N/A

Source: Bangladesh Bank, BRAC EPL Research

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Executive Summary

Private sector credit growth has slumped to its 9-year low. High interest rate due to liquidity crunch is shrinking loan demand. Key factors causing liquidity strain include high NSC rates mopping liquidity out of the banking sector, government's increased bank borrowing, worsening of the Balance of Payment condition, and overall sluggish manufacturing sector activities. As a result, banks are becoming more risk averse.

Amount of Non-Performing Loans (NPL) continues to rise. Official data shows the amount to be about USD 14 billion out of about USD 118 billion loans outstanding (~12% NPL ratio, 4.4% of GDP). However, the NPL amount jumps to about USD 25 billion if rescheduled loans and loans with court injunctions are included (~21% NPL ratio, 8.0% of GDP).

The central bank recently relaxed the way Non-Performing Loans are classified, allowing banks to charge lower provisions than before. The central bank also relaxed its policy for rescheduling loans to reduce the NPL ratio, and we expect this to impact financials by the year-end of 2019. Moral hazard caused by recent relaxation of Rescheduled Loans policy means even the good borrowers are incentivized to default. To make matter worse, a few leading indicators show a slowdown in economic activities. Both factors probably explain why even our favorite banks saw their NPL ratios rise in 2019.

The government's recent move to raise restrictions on purchasing NSCs is bringing liquidity to the Private Banks, while the government is borrowing more from the bank sector. However, rising deficit funding through increased bank sector borrowing implies crowding out effect. As such, although we forecast an improvement in industry credit growth in 2020, we expect it to be moderate. Current deposit base of the sector (~USD 127 billion) is also expected to grow moderately.

By the end of 2018, many banks, including some good banks voluntarily failed to comply with Basel III compliance as required by Bangladesh Bank. However, we expect this to be strictly enforced from next year. Banks have recently started issuing subordinate bonds aggressively. BRAC Bank is the most capitalized bank in our coverage and even without any subordinate bond, its Capital Adequacy Ratio (CAR) is exceptionally high. In the long-term, if provisions are taken to reflect true asset quality, assuming average asset growth, many banks will be under-capitalized.

The government is addressing long-term capitalization and solvency by forming an Asset Management Company (AMC), a government-sponsored entity — which will buy troubled assets from banks and focus on collecting default loans by targeting specific borrowers. We like this idea as it has worked in other markets, but considering our strength in legal enforcement, we are skeptical. Other options like M&A and rights issuance seem lengthy and less probable solutions to be accepted by bank owners.

While loan-deposit spreads have been falling since 2018, we think that much of this is inflated owing to some poorly managed banks offering very high deposit rates to channel their unhealthy lending activities. We expect spreads to improve for our coverage banks in the near to medium term as liquidity condition improves and commercial banks start to pass on high NPL costs to borrowers. To improve long-term spreads, well-managed banks are strategically directing towards i) improvement in CASA ratio — via improving customer experience & investing in agent banking, and ii) diversifying away from large corporate lending. While competition is increasing from one or two institutions in the SME segment, lack of expertise, experience and proper policy imply BRAC bank will continue to uphold a leading position in the SME segment.

Bangladesh has seen a tremendous improvement in Financial Inclusion in recent years. Financial inclusion has increased from 20% in 2013 to 47% in 2018. There were primarily two factors for Bangladesh that worked towards improvement in financial inclusion - Agent Banking & Mobile Financial Services (MFS). With the growth of bKash, mobile money penetration has increased from 17.8% in 2014 to 64.2% in Oct'19. The MFS industry is expected to grow significantly with a focus towards merchant payment. A solid number of banks have started to focus on agent banking recently, including BRAC Bank and City Bank. Agent banking seems to be the most effective step to acquire rural customers and tap into the deposit base while maintaining cost efficiency and thus working towards improvement of financial inclusion in Bangladesh.

Our valuation highlights with target price for Dec'20 are given below:

Company	DSE Ticker	Bloomberg Ticker	Current Price* (BDT Per Share)	Target Price (BDT Per Share)	Total Return	Dividend Yield	BEPL Research Call	Current Mcap (USD MN)	2019 ADTV (USD '000)
BRAC Bank**	BRACBANK	BRAC:BD	58.5	N/A	N/A	N/A	N/A	848.9	821.2
City Bank	CITYBANK	CITYBA:BD	22.3	25.1	15.1%	2.6%	BUY	266.7	397.6
Eastern Bank	EBL	EBL:BD	34.5	39.1	15.4%	2.1%	BUY	329.5	78.8
Prime Bank	PRIMEBANK	PB:BD	18.9	17.9	1.2%	6.6%	HOLD	251.8	131.8

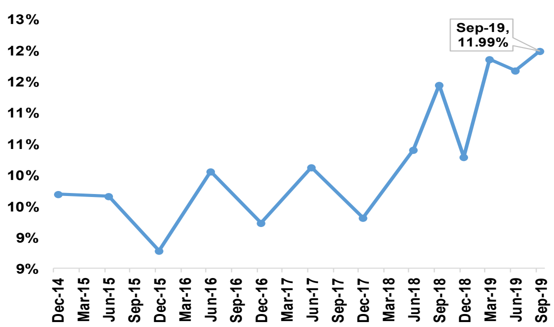
**as of December 05, 2019*

***We don't put a target price on BRAC Bank as it is our parent organization*

Asset quality & governance

Asset quality condition worsens

Chart: NPL Ratio



Source: Bangladesh Bank

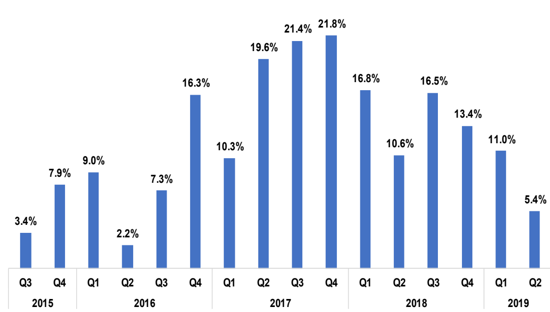
While spike in the interest rates following tight liquidity constraints and AD ratio changes hurt the private commercial banks in 2018, the spillover effect of lending crunch has led to a private segment slowdown in the overall economy. This is complemented by the regulatory ease of rescheduling loans incentivizing borrowers to default even more. All of the facts are prompting NPLs to rise even for the well-managed banks. Asset Quality continued to deteriorate since 2017 while the numbers being reported by the sector paints an overly optimistic picture, and given recent regulatory changes, the situation is showing no sign of improvement. Our coverage banks also witnessed a rise in NPL ratio by the end of Q3'19, while some of these got their credit ratings downgraded by Moody's.

Table 1: Gross NPL Ratio & Stressed Loan Ratio

	Q3 2019	2018	2017	2016
Gross NPL Ratio	12.0%	10.3%	9.3%	9.2%
Stressed Loan Ratio	N/A	20.5%	19.0%	17.2%

Source: Bangladesh Bank, BRAC EPL Research
**Stressed Loan Ratio includes official NPL plus Restructured and Rescheduled loans as a percentage of Total Loans Outstanding*

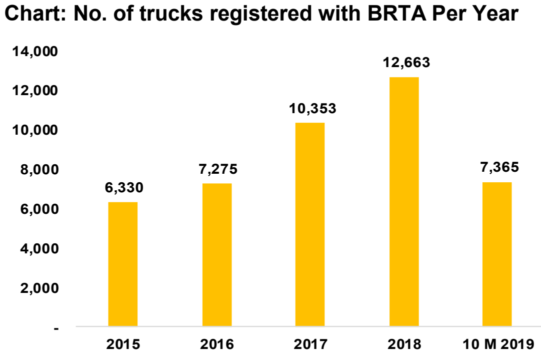
Chart: Industrial Production Growth



Source: The Global Economy

Restructured and Rescheduled loans continued to rise in 2018, while loans under high court stay order of roughly BDT 800 billion is equivalent of 8-9% of total loans in 2018 – both obscure the degree of toxin present in the balance sheets of the bank sector. Governance issues have not been adequately addressed either, as evident by the lack of any mention of large business groups that were expected to be defaulters when the government published a list of defaulters in the parliament.

Chart: No. of trucks registered with BRTA Per Year



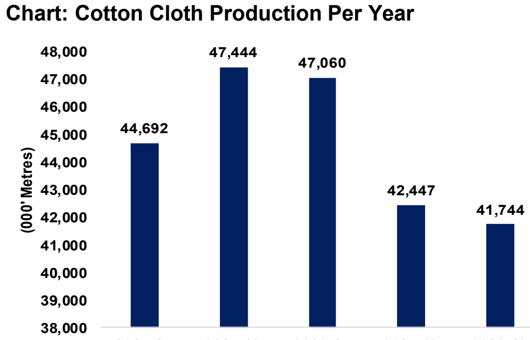
Source: Bangladesh Road Transport Authority (BRTA)

While most of this NPL growth came from State Owned Banks – with NPL rising from 26.5% in 2017 to 30.0% in 2018, Private Commercial Banks (PCB) comprising 70.5% of total banking industry assets also contributed to rising NPL – growing from 4.9% to 5.5% in 2018. Restructured and Rescheduled loans combined with NPL forms Stressed loans – which continued to rise.

Macroeconomic hurdles and regulatory changes probably drove NPL ratios higher in most recent times

Rise in NPL ratios till Q3'19 so far — despite considering seasonal impact — seems high. We are of the opinion that slowdown in investment activities and consumption might be weighing down on the sharp rise in NPL ratios this year — and this can explain rise in NPL ratio this year even for our coverage banks. Slowdown in growth of consumption, private sector credit, import, domestic truck sales and some industrial production are indicating moderating economic activity.

Chart: Cotton Cloth Production Per Year



Source: Bangladesh Bank

Another possible reason driving NPL ratios higher most recently is the moral hazard issue among good or able borrowers to deliberately default their loans to take get their loans rescheduled at better terms. This is a result of recent regulatory change made by the government and we will discuss it further.

Regulatory changes provide no actual solution

Bangladesh Bank made regulatory changes that can further sugar-coat deteriorating asset quality conditions. The most important changes include central bank a) relaxing NPL reporting standards b) incentivizing borrowers to reschedule loans and c) making writing-off of bad loans easier. We will discuss these briefly.

Change in loan classification policy won't solve NPL issue

NPL recognition was changed through two specific policy revision–

Policy Change 1: As per the new policy, the overdue period for Sub-Standard loans has been extended to 3-9 months period from the previous 3-6 months period and that for Doubtful has been shifted to 9-12 months period. This also implies that loans classified as Bad/Loss have been extended to an overdue period of 12+ months. The minimum number of days of overdue for a loan to be classified as NPL remains unchanged at 3 months. The overall NPL numbers will not change, but owing to changes in how default loans are classified, debt provision charges will be lower.

Table 2: Loan Classification Policy Change 1— Continuous, Demand

Loan Classification		Overdue period under previous rules (2012)	Overdue period under new rules (2019)	Specific Provision Required
Standard	SMA	2 - 3 months	2 - 3 months	0%
NPL	Sub-Standard	3 - 6 months	3 - 9 months	20%
	Doubtful	6 - 9 months	9 - 12 months	50%
	Bad/Loss	9 + months	12 + months	100%

Source: Bangladesh Bank, BRAC EPL Research

Policy Change 2: Under this policy, the definition of "Overdue" has been changed exclusively for Fixed Term Loans. In case an installment or part of an installment of a fixed-term loan is not repaid within the fixed time frame; the amount of unpaid installment will be treated as "Overdue" after six months of default. This implies that the meaning of "Overdue" for Fixed Term loan payments has been extended from 0 to 6 months, and the implications are highlighted in the table below.

Table 3: Loan Classification Policy Change 2 — Fixed Term Loan

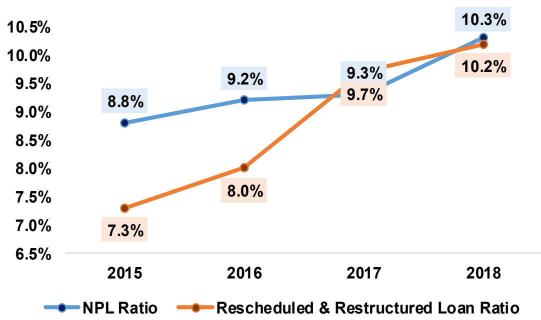
Loan Classification		Required due period under previous rules (2012)	Required due period under new rules (2019)	Specific Provision Required
Standard	SMA	2 - 3 months	8 - 9 months	0%
NPL	Sub-Standard	3 - 6 months	9 - 15 months	20%
	Doubtful	6 - 9 months	15 - 18 months	50%
	Bad/Loss	9 + months	18 + months	100%

Source: Bangladesh Bank, BRAC EPL Research

The change in NPL classifications would have no effect on the NPL amount for continuous and demand loans. For fixed term loans, the NPL amount would reduce drastically as loans unpaid till six months would not be considered 'Overdue' anymore. The greatest advantage that the banks had from this regulation is the release of provision which was expected to increase the profitability of the banks in Q2-Q3 2019. But even after this advantage, the third quarter earnings for many banks saw YOY decline.

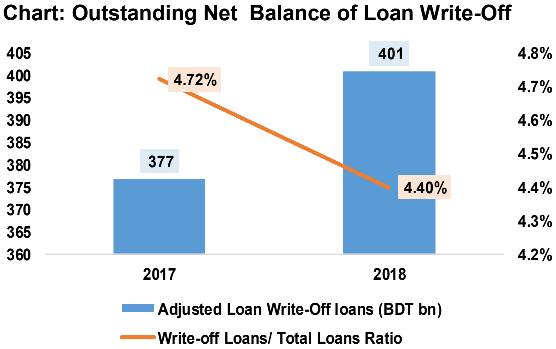
The central bank's policy to reduce reported NPL and decrease the overall debt charges on banks does not solve the underlying problem that has gripped the bank sector of Bangladesh. These policy changes would rather encourage lenders to lend with less caution. A moral hazard issue is that it would facilitate habitual defaulters, as many of them would specifically apply to get Fixed Term loans in the name of project implementation. On the other hand, asset quality is directly impacted as the numbers reflected in NPL and NPL coverage reported by banks would underscore the true picture of default loans in the sector.

Chart: NPL Ratio & Restructured Loan Ratio



Source: Bangladesh Bank, BRAC EPL Research

Chart: Outstanding Net Balance of Loan Write-Off



Source: Bangladesh Bank, BRAC EPL Research

Special policy for defaulters regarding loan rescheduling

Bangladesh Bank changed its policy regarding loan rescheduling and created a way for defaulters to clear their "defaulted" status by availing rescheduling facility at a low cost. The key points of the policy are:

Loan Rescheduling:
This policy allows the application with a down payment of only 2% whereas previously the down payment ranged from 10% to 50% depending on the frequency of rescheduling. The grace period under this policy would be one to ten years whereas previously loan was rescheduled from 0.5-2 years depending on the frequency of rescheduling. Moreover, the interest rate will be lower between "cost of fund +3%" and 9%. The accumulated interest amount which was not paid can even be forgiven by the bank. After taking the facility, if a certain number of payments get overdue, then the facility will be cancelled and the loan will be classified as bad/loss.

One Time Exit:
Defaulters will have the option to ask for a one time exit from the defaulted status by paying back the defaulted loan. Even in this case, applicants need to pay a 2% down payment and the interest rate will be only the cost of fund, but full outstanding balance has to be paid within 360 days. If the loan cannot be paid within 360 days of taking the facility, the facility will be cancelled. The loan will be classified as bad/loss. After the one-time exit facility is taken, the loans will be considered as SMA. But the banks will have to keep the previous provision charge against these loans.

Adverse implications of the policy changes:

The rescheduling policy is a beneficial policy for the loan defaulters. It appears that the policy offers a solution for cleaner balance sheets than a remedy to improve risk management. The target of the government was to influence the defaulters to pay back the loans as most of the defaulters in Bangladesh are habitual, but the policy saw backlash from bankers and economists. The basis of the backlash were:

a) Due to an opportunity to reschedule loans at a much lower rate than the existing rate, moral hazard may prompt even the good borrowers to willfully default. Then they can apply for rescheduling at a lower rate, at much lower down payment, and with a higher grace period. This is matter of concern for the asset quality and profitability for banks. Until 20th October 2019, 5 state owned banks have received 30,000 applications for loan rescheduling.

b) The loan rescheduling facility will increase the income inequality prevailing in the economy. The majority of the defaulted loans are taken by large borrowers and most of them are willful defaulters. So, they are going to take the rescheduling facility which would cost them less whereas the good small borrowers will pay back the loan at a higher rate.

To make the situation worse, some defaulters applied for a rescheduled loan for their written-off loans even though the rescheduling of written off loans was not included in the circular. If a defaulter could not or was unwilling to pay back the loan before, it is highly unlikely he would pay back the loan after taking the rescheduling facility. So, it can be assumed that most of the defaulters applied for rescheduling of their written-off loan to remove the defaulted status from their Credit Information Bureau (CIB) report — which is a barrier against securing new loans. Bangladesh Bank has turned down the proposal by few banks for providing a special facility to reschedule written-off loans.

Writing off loans made easier

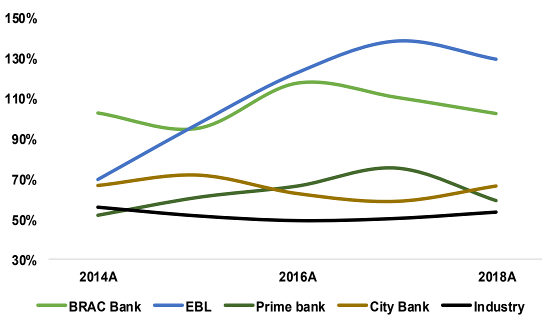
There are two major changes with regards to write-off policies in the 2019 circular. Writing off loans is not necessarily a bad thing as it requires banks to take full provision against the defaulted loans, clean the balance sheets and earn tax benefits. However, some banks might want to compromise on recovery attempts after writing loans off aggressively. Bangladesh Bank has provided additional regulation so that banks continue to make adequate recovery attempts through the creation of a special 'debt collection unit' for recovery of written-off loans.

The first change allows banks to write off a loan worth below BDT 200,000 without filing a lawsuit; in the previous policy, the limit was BDT 50,000. This can particularly benefit banks to write off their retail and small loans by saving court related expenses.

The second major change allows banks to write off bad loans after 3 years of having classified status instead of 5.

Overall, apart from increased costs to form a new 'debt collection unit' team we do not see a major improvement in debt recovery process owing to these changes.

Chart: NPL Coverage



Source: Bangladesh Bank, BEPL Research, Financial Statements

Banks under our coverage improved in 2018, but 2019 speaks otherwise

Despite industry-wide worsening of NPL ratio, most of our coverage banks showed positive improvements in 2018 with NPL ratio coming down for all our banks under coverage. This came in line with what we expected. However, 2019 turned out to be bad for our coverage banks. BRAC bank, City Bank, EBL and Prime Bank's NPL ratio worsened despite regulatory support while debt charges saw significant rise.

In response to deteriorating asset quality and increasing risk factors, Credit rating agency Moody's has downgraded BCA and Long-term deposit ratings of both City Bank and EBL in 2019, while keeping that of BRAC bank unchanged. Moody's sighted less exposure to corporates and lower concentration risk as the primary reasons why had it kept BRAC bank's ratings unchanged. However, BRAC bank's outlook has been revised to "negative" from "stable" condition.

Table 4: Credit Rating

Types of Ratings and Outlook	Dec-18			Nov-19		
	BRACBANK	*CITYBANK*	*EBL*	*BRACBANK*	*CITYBANK*	*EBL*
Long-term deposit ratings	ba3	ba3	ba3	ba3	b1	b1
Baseline credit assessment (BCA)	b1	b1	b1	b1	b2	b2
Outlook	Stable	Stable	Stable	Negative	Negative	Stable

Source: Moody's Credit Rating

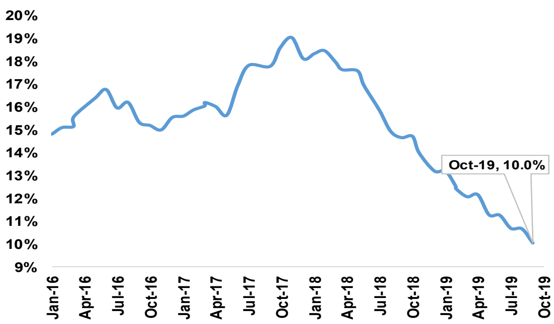
On a positive note, the government has recently made some changes which is improving the liquidity condition while the problem of ailing asset quality condition is being addressed on a long-term basis — by announcing to form an Asset Management Company to buy back toxic loans. We will discuss about this concept later in this report.

Loan growth & Liquidity

Private sector credit growth is sluggish

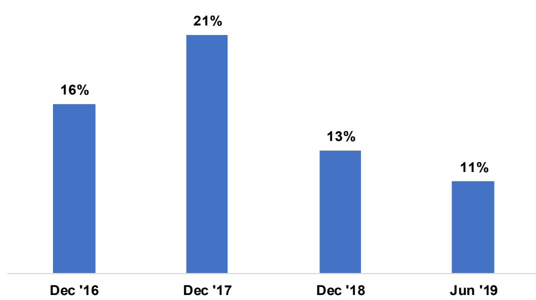
Industry-wide loan growth continues its sluggish run. Private sector credit growth came to a 9-year low this year. Slowdown in private sector credit started from 2018. While the central bank made some expansionary changes – lowering Cash Reserve Requirement (CRR) from 6.5% to 5.5%, repo rates from 6.75% to 6.0% and deferring the AD ratio reduction rule twice before finally scrapping it — monetary mechanism transmission has not proven to be very effective in Bangladesh. Weak private sector growth continued till Q3' 2019.

Chart: Private Sector Credit Growth



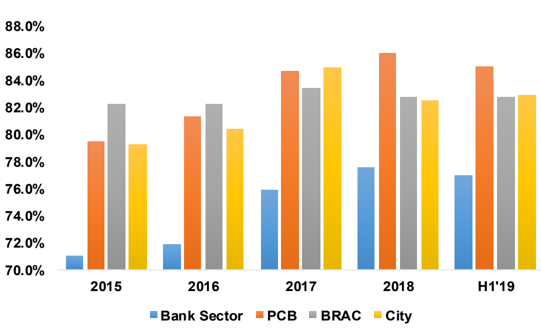
Source: Bangladesh Bank, BRAC EPL Research

Chart: Growth of Banks' loans to Non-Financial Corporation



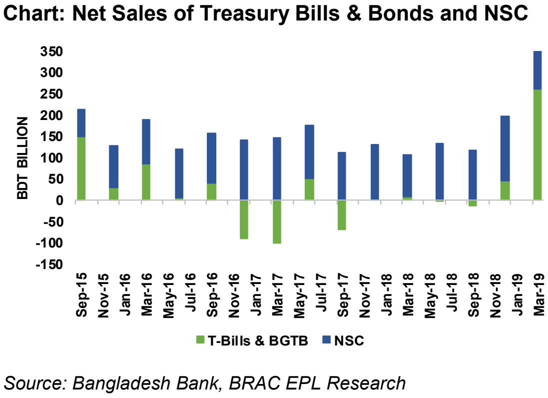
Source: Bangladesh Bank, Financial Statements, BEPL Research
**Jun'19 figure is annualized*

Chart: Advance to Deposit Ratio (ADR)



Source: Bangladesh Bank, Financial Statements, BEPL Research

Chart: Net Sales of Treasury Bills & Bonds and NSC



Source: Bangladesh Bank, BRAC EPL Research

Slack private sector growth can be explained by a combination of related factors:

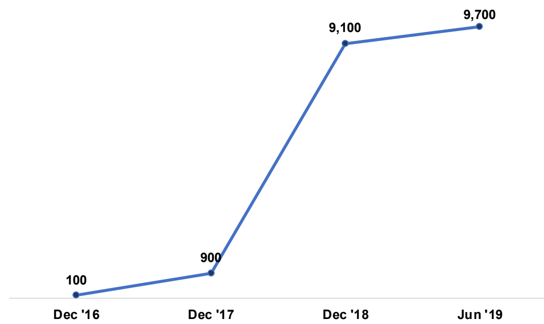
a) Liquidity crunch in the Private Commercial Banks (PCB) at the start of 2018 due to aggressive lending and deposit funds being channeled towards the National Savings Certificate (NSC) – which continues to offer higher interest rates.
b) Weak investment opportunities in 2019 – particularly the lack of big projects undertaken by the private sector has also been emphasized by a few experts, possibly due to high interest rates and a slowdown in economic activities.
c) Considerably higher AD ratio by PCBs relative to the entire banking industry is the result of State-Owned Banks (SOB) hoarding up too much cash reserves that they were not lending. This was amplifying the liquidity crunch and hurting the overall business community. The government tried to address this issue by asking large government-owned entities to deposit a minimum of 50% of their deposits in the PCBs from the minimum requirement of 25% earlier – but failed to yield effective results as government agencies did not mobilize funds to the PCBs as they were supposed to.
d) Ballooning current account deficit prompting Balance of Payments into negative territory in 2018 – driven by a combination of expensive currency, heavy infrastructural import payments, possible pre-election over-invoicing of imports and under-invoicing of exports.
e) Central bank's intervention in the FX market to stabilize the BDT was mopping bank funds available for circulation.
f) Increasing default loans as explained earlier.
g) Lowering of the Advances-to-Deposit (AD ratio) by the central bank at the start of 2018 that was announced but scrapped later.
h) Bangladesh Association of bankers (BAB), a forum of bank owners suggested fixing loan-deposit spread within 9-6% range in 2018 – which, although not followed in 2019 — did worsen the liquidity condition in the PCBs to a certain extent.

Government's restrictions on purchasing Savings Certificates is positive for liquidity condition

We appreciate the government's recent move of imposing strict rules and regulations imposed for purchasing National Saving tools despite not reducing the nominal interest rates – which is further complemented by increasing the tax rates on specific interest income. According to new rules, all investors purchasing saving tools must submit Tax Identification Number (TIN) certificate and the National identity card. These changes have already prompted NSC sales to drop by the 3rd quarter of 2019. We believe that liquidity conditions are improving owing to these changes. The central bank, on the other hand, has scrapped the regulatory requirement for conventional banks to bring down Advances to Deposit ratio (AD ratio) from 85.0% to 83.5%, which was expected to be enforced in September 2019.

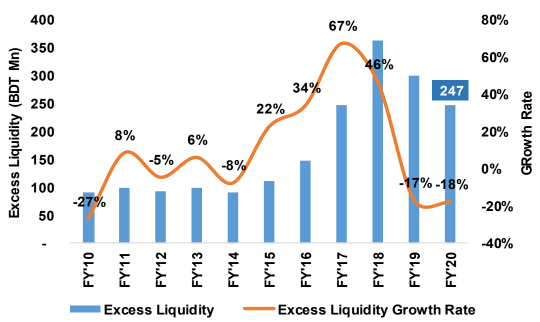
While private sector credit growth has dipped to 9 years low, we expect this to turnaround in 2020, given improving liquidity prospects from its trough. Although interest rates are expected to come down by the end of 2019, we do not see long-term interest rates witnessing drastic movements either. The government will continue to increase its deficit financing and focus more of its borrowing from the bank sector and this should put upward pressure on treasury yields — as interest rates on NSC still remain unchanged. This can prompt private sector banks to be crowded out of the deposit base. It is more likely that liquidity stress and interest rate pressure will continue at least for the 2020-21 periods, despite funds mobilizing away from the NSCs — and as such, private sector growth might not see its robust growth level witnessed in the 2016- 17 periods.

Chart: BB's Liquidity Support to Banks (BDT Million)



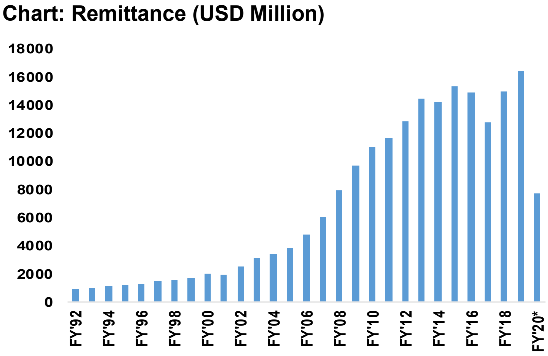
Source: Bangladesh Bank

Chart: Excess Liquidity



Source: Bangladesh Bank, BRAC EPL Research
**Excess liquidity is calculated as a sum of currency in tills of banks and cash reserve in BB excess of CRR*
*** FY'20 growth is YTD*

Chart: Remittance (USD Million)



Source: Bangladesh Bank
**Jul-Nov FY'20*

Table 5: Selected Macro indicators

Parameter	Date	USD Bn	YoY Change
Remittance	2019-20 Jul-Nov	7.71	22.5%
Foreign Exchange Reserve	Dec 04, 2019	32.0	2.7%
Monthly Import Coverage	Reserve: 04 Dec 2019 Import: LTM Avg.	6.97	

Source: Bangladesh Bank, BRAC EPL Research

Hurdles to growth still remain

Weak overall investment scenario, as discussed earlier and rising NPL ratios are current hurdles and can continue to weigh on loan growth in 2020— despite liquidity improving in the overall industry. As a result, risk remains that banks might continue to be risk averse going forward.

Corporations now have new horizons to borrow funds from abroad

Of noteworthy development is the first taka-denominated IFC bond that was just floated in the London Stock Exchange, called the Bangla Bond — similar to Masala bond issued by the Indian government — that will be used to disburse loans for local corporations. Although only small amount USD 9.5 million was issued, the response was good according to IFC, and it expects a USD 1 billion Bangla Bond issuance in the future. Successful implementation of this bond issuance will signal confidence amongst offshore investors and reduce liquidity stress.

BB is providing short-term liquidity support to the highly stressed banks

Through repo windows, cash-strapped banks secured short-term funding this year using repo provided by Bangladesh Bank — particularly during the Eid-Ul-Fitr festival. In the short-term, the central bank is expected to remain upbeat with liquidity support.

Government's plan to bring the idle money of government agencies to national exchequer is going to tighten liquidity condition

The government approved a draft law allowing the government to bring the surplus money of different autonomous, semi-autonomous and statutory agencies, including non-financial corporations, to the national exchequer. 68 self-governed agencies had BDT 2.0 trillion idle money in different banks as of Mar'19, which is 19.2% of total deposits of the banking sector. Of the idle money, the surplus amount will be deposited to the national exchequer after keeping aside the operational cost — an additional 25% of operational cost as emergency fund, money for general provident fund (GPF) and pension.

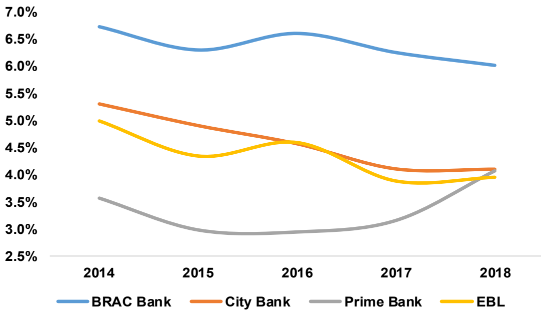
If the government starts to withdraw this money from the banking sector, this will cause a liquidity stress in the sector. Moreover, this will ultimately hamper private sector credit growth. The government is already prioritizing public sector over private sector; this step will emphasize the priority and deteriorate the credit scarcity of the private sector further.

In the long-term strong fiscal policy and macro dynamics are key elements for improvement

Increased foreign borrowing by the government can help ease liquidity stress in the medium term. The government's debt remains sound, with total debt comprising of 34.0% of GDP and a credit rating that is good at Ba3 by Moody's. The government is expected to borrow more from overseas, which will cool off the crowding out effect of private sector borrowing and decrease interest rates.

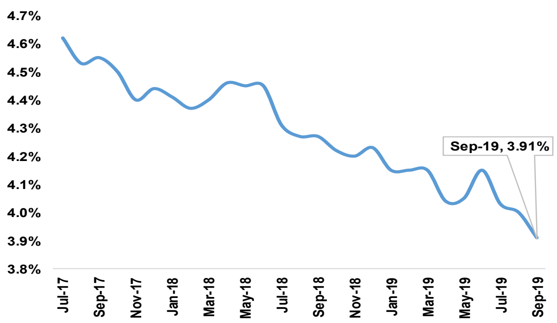
In the long-term, however, the government must complete its undertaken infrastructure projects and improve its fiscal condition to curb not just macroeconomic but also banking problems. On the other hand, macroeconomic stress marked by rising Current Account deficit in 2018 has cooled down in 2019, driven by strong remittance inflow, thereby alleviating liquidity stress. The central bank incentivized inward remittance to encourage repatriation through the legal channel – which signals a sustainable strong remittance growth.

Chart: Net Interest Margin (NIM)



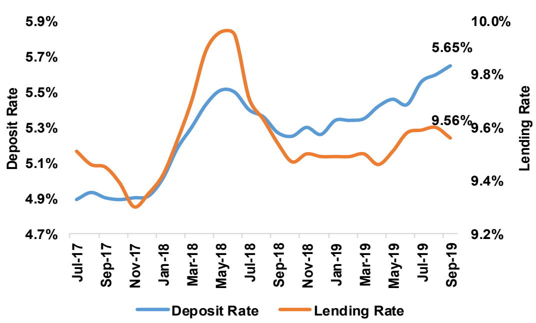
Source: Financial Statements, BRAC EPL Research

Chart: Sector Interest Rate Spread



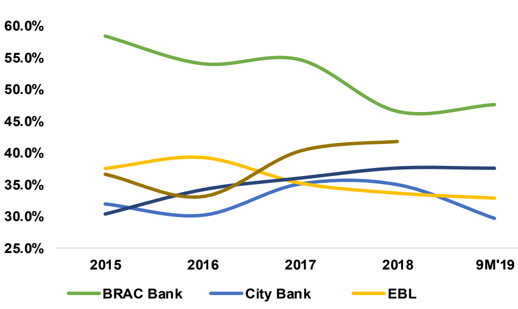
Source: Bangladesh Bank, BRAC EPL Research

Chart: Deposit Rate & Lending Rate



Source: Bangladesh Bank, BRAC EPL Research

Chart: CASA Ratio



Source: Financial Statements, BRAC EPL Research

Spreads & Margins

While banks in 2017 compromised their spreads to accelerate their loan portfolio, this changed after the announcement of AD ratio reduction at the start of 2018, when the liquidity base of private banks started to rapidly deteriorate. In contrast to our earlier forecast of significant shrinkage of spreads in the previous bank sector report, it turned out that our coverage banks did well to defend their spreads, despite their downward trajectory. As of now, it appears that despite political pressure to reduce lending rates, most private banks under our coverage are not willing to penalize themselves.

Falling spreads to reverse its course in the short-term to reflect worsening asset quality

Stabilization of falling loan-deposit spreads are not reflected in the overall sector spread because we believe that some banks in the industry are not profit-maximizing – as these poorly governed banks are rather offering very high fixed deposit rates to fund their lending activities to related parties.

We are of the opinion that loan-deposit spreads are likely to reverse in the short to medium term as liquidity condition improves and commercial banks start to realize that the NPL costs associated with high asset growth weigh more than intense competition for corporate clients, which was driving down spreads. Particularly, those banks that are focused on improving profitability and capitalization will want to pass on high NPL costs in the form of high loan-deposit spreads.

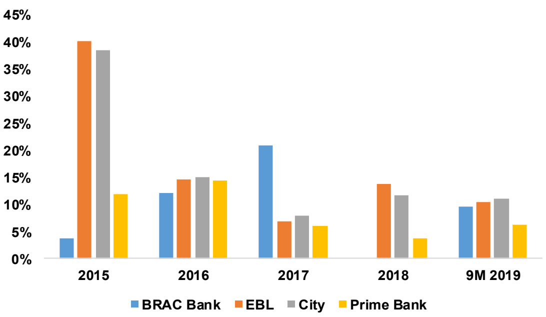
Improvement in CASA via Agent Banking and IT investment is positive for the long-term

The PCB's CASA ratio slumped in 2018 – as funds channeled out to the NSC instruments. However, the worst seems to have passed as we have seen improvement in CASA for our coverage banks in Q3'19. BRAC Bank's CASA ratio improved to 47.5%. Both CBL's and EBL's CASA amount has been accelerating since the end of 2017 (chart on next page). On the other hand, the government's recent inclination to borrow from the banks has been driving treasury rates up, and this should improve Net Interest Margins (NIM). As such, for our coverage banks, we expect overall loan-deposit spread as well as NIM to improve in 2020, while that of 2019 is likely to show slight improvement.

One route many banks are undertaking is investing in agent banking. Among our coverage banks, BRAC bank and City bank have become aggressive in increasing agent banking outlets to tap low cost deposit from rural and semi-rural areas in Bangladesh instead of opening expensive branches. This strategy has already worked for Dutch Bangla bank, Bank Asia and Al-Arafah; which have improved their respective CASA ratios when most banks in the industry have been losing CASA. Agent banking is still in its nascent stage with total deposits of only BDT 61.7 billion, but showing robust growth in deposits at 139.4%. Both BRAC bank and City bank are late to the party — but their managements are heavily investing in it and expect to gain significant benefits.

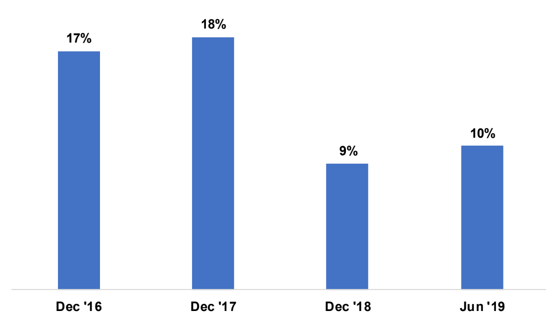
Offering superior customer experience is a key competitive advantage that few banks realized earlier than others. Most banks have yet to launch proper banking apps and this opened opportunities for competitive advantage, particularly for those banks that are focused on building long-term younger generation client base. City Bank is leading in this area, known for its trademark City-Touch app, which was the first to offer features like integrating deposits, loans and credit cards, instantaneous account transfers and later interbank transfers and bKash transfers. Integrating app with retail loan products will allow banks to grow their retail loan products at a cheaper cost of funding.

Chart: CASA Growth



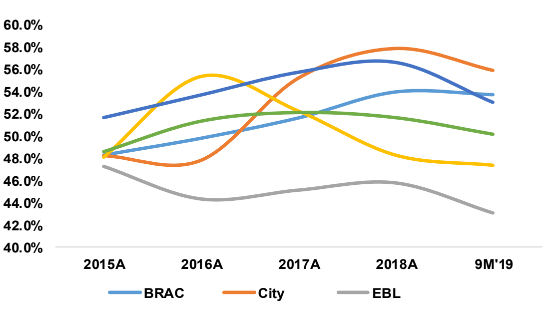
Source: Financial Statements, BRAC EPL Research
**for Q3'19 we have taken YTD growth*

Chart: Growth of Banks' Loans to Households



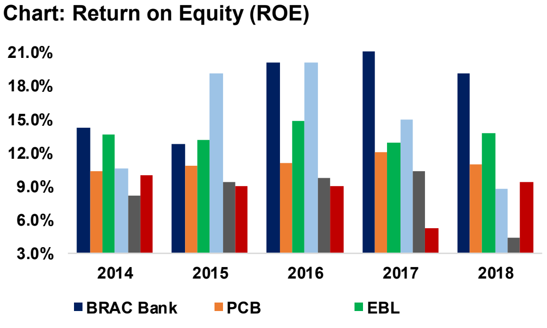
Source: Bangladesh Bank

Chart: Cost to Income Ratio (CIR)



Source: Financial Statements, BRAC EPL Research

Chart: Return on Equity (ROE)



Source: Financial Statements, Bangladesh Bank, BEPL Research

Credit card sales are growing for our favorite banks

Cross-sales to credit card customers have worked for banks to bring in new deposit customers. Banks doing well on credit cards, including City Bank, EBL, and BRAC bank are branding themselves and improving the customer experience. Few other banks are investing in the payment system. Mutual Trust bank has already launched a QR code-based product. Both City Bank and EBL have grown their CASA deposits by a 2-year CAGR of ~13.0%, which is higher than that achieved by most PCBs.

Banks that offer superior customer experience and diversify away from corporates will grow faster

In the long-term, as banking problems improve, competitive and political pressure imply spreads will remain subdued. But those banks that offer superior customer experience and branding to customers will still be able to grow cheap deposits. Eastern Bank and City Bank are among the few corporate-heavy banks that we see as CASA winners for the future. At the same time, lending to corporates have become increasingly risky and unprofitable for the overwhelming banks. Banks that can do well in SME and Retail can increase their asset yields.

Despite strong industrywide interest, barriers to entry in SME lending remain strong

To diversify away from default risk associated with corporate loans and earn higher yields, several banks had earlier shown interest in the SME segment. City Bank is one institution that has already invested in the SME infrastructure and has started to disburse SME-Small loans. Although growth is strong as of Q3'2019, the total loan size in this segment is very small to threaten the leader, BRAC bank. On the other hand, IDLC is currently focusing on small ticket size loans. From BRAC bank's perspective, there is no other institution that currently possesses a serous threat to its SME-Small business. In our view, the SME segment continues to uphold high barriers to entry.

Despite increasing competition, lack of expertise, experience and an excess of investible capital in the overall bank industry imply BRAC bank will continue to uphold a leading edge in the SME-Small segment, despite increasing competition. BRAC bank plans to further their investment in the SME. As such, in the long-run, we are positive about loan-deposit spread improvement for both BRAC bank and City Bank.

Banks are starting to focus on efficiency

Unnecessary hiring to compete and grow is fading away as banks are investing more to attain automation, skillful training, and productivity gains — while also improving customer services that reduces the need to visit bank branches. The move to invest in agent banking is a positive attitude among bank managers who have ushered to slow down or stop increasing more bank branches.

The risk of political pressure on interest rates remains

Political pressure of restraining interest rates, especially on corporate loan rates, is not likely to go away although market forces will eventually win. Such pressure might pose hurdles to regular banking activities – translating to short-term impact on profitability, as witnessed in 2018.

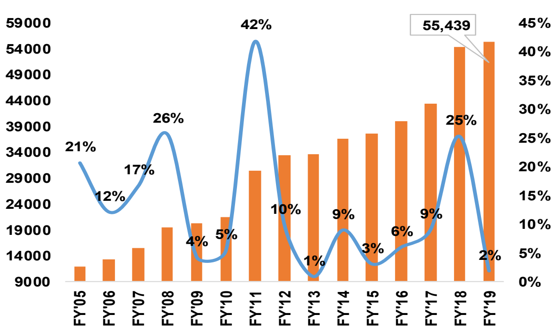
Combining higher default risk associated with corporate lending with short-term political pressure on rates, we believe that banks that stray away from their reliance on corporate interest income are likely to be winners in the long-term. As such, we think diversified banks like BRAC bank and City bank will come out strong in the long-term.

Table 6: Balance of Payment in FY'20

In USD million	Jul-Sep FY20	Jul-Sep FY19	% Change
Export	9,535	9,747	-2.18%
Import	13,252	13,599	-1.64%
Trade Balance	-3,717	-3,852	N/A
Current Account Balance	-678	-1,316	N/A

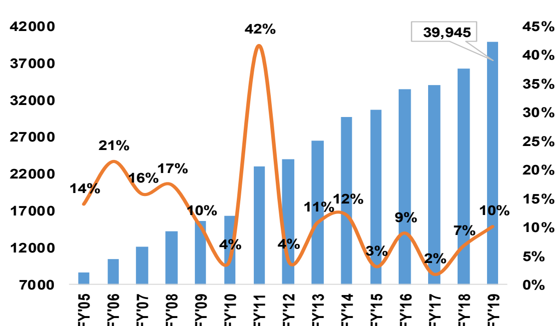
Source: Bangladesh Bank

Chart: Import (USD Million)



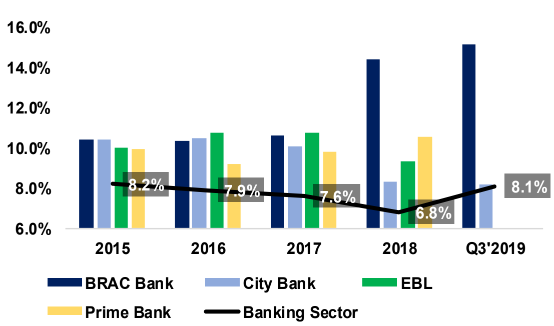
Source: Bangladesh Bank, BEPL Research

Chart: Export (USD Million)



Source: Bangladesh Bank, BEPL Research

Chart: Tier-1 Capital Ratio



Source: Financial Statements, Bangladesh Bank, BEPL Research

Offshore Banking Operations (OBO) policy changes are going to have small impact on spreads

Bangladesh Banks issued a policy this year by which Offshore Banking Units (OBUs) of the banks were brought under the Banking regulation. Previously, the OBUs were exempted from the purview of certain provisions of the Banking regulations, but now the OBUs will be considered a general branch of the banks and will come under all the regulations that the general branches have to follow. OBUs are now required to maintain Cash Reserve Ratio (CRR) and Statutory Reserve Requirements (SLR), which they previously did not. This may increase the cost of funds for the banks, which may hamper the spreads. But OBUs for most banks are relatively small in size, so the spread is not likely to be significantly impacted. Moreover, banks can control the loan-deposit spread by passing on the cost to the customers. City bank has followed this strategy of passing on their additional cost of OBUs to the customers to maintain spread.

Slowdown in Export & Import may have affected the income of the banks

Both import & export have seen negative growth in Q3'19. The possible reasons could be global economic slowdown, Brexit causing lower demand from EU, and central bank restricting depreciation of the currency. Banks earn fee income from their clients who provide them with trade commission. Moreover, slowdown in business of the export-oriented industries will cause a lower demand for large loans from those industries and also create risk of non-payment of loans. If export and import show no improvement, that will continue to hamper the profitability of the banks. But Bangladesh Bank let a small devaluation of taka in October 2019 to boost up exports. We are yet to see the result of that step. Apart from that, the global economy shows no sign of improving with no solution of US-China trade war & Brexit. So, the export & import outlook doesn't seem too positive.

Capitalization & Solvency

Most of our coverage banks are well capitalized

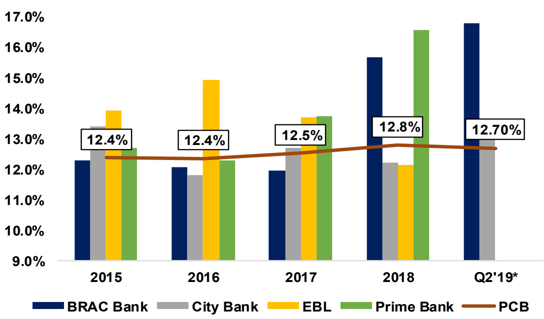
While Bangladesh Bank's commitment to Basel III required banks to meet capital ratio targets by January 2019 – Capital Adequacy Ratio (CAR) at 12.5% and Tier I ratio at 6.0% — many banks failed to meet the former ratio, and some did it voluntarily by redeeming costly Tier II subordinate bonds from its balance sheets – City Bank being one of them. Bangladesh Bank unofficially extended this deadline and it expects banks to comply by the start of 2020 before it starts penalizing for non-compliance.

We think that by 2020, few banks, except our favorite ones -- BRAC bank, Eastern Bank, City Bank, and Prime Bank — will fail to meet the Basel III requirement of keeping the minimum Capital Adequacy Ratio (CAR) of 12.5% or Tier I ratio of 6%. Our favorite banks in the coverage already have very strong capitalization – all above or near 12.5% as of September 2019 and all of them are expected to show improvements in CAR through the issuance of subordinate bonds and strict dividend disbursements.

We think most banks will be able to maintain the target by reducing provisions through rescheduling loans (which is expected to peak in Q4'2019), restricting cash dividend and loan disbursement (which is ongoing), earning higher income on treasury assets, and issuing subordinate bonds (a component of Tier II capital).

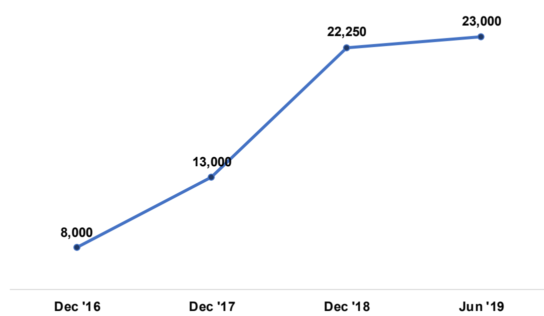
Many of those banks that do manage to capitalize, if they continue to disburse loans and start provisioning their rescheduled/restructured/under-provisioned loans, will most likely see their capital base eroded in the medium to long-term. We know that both rescheduled and restructured loans can convert to NPL and require provisions once miss payments start again. Until corporate

Chart: Capital Adequacy Ratio



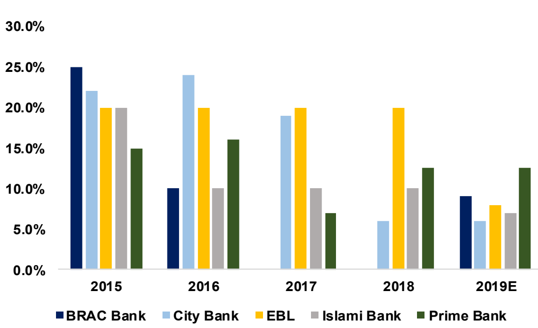
Source: Financial Statements, Bangladesh Bank, BEPL Research
**Q2'19 CAR of Prime Bank, Islami Bank, EBL are not available*

Chart: Outstanding Subordinate Bond (BDT Million)



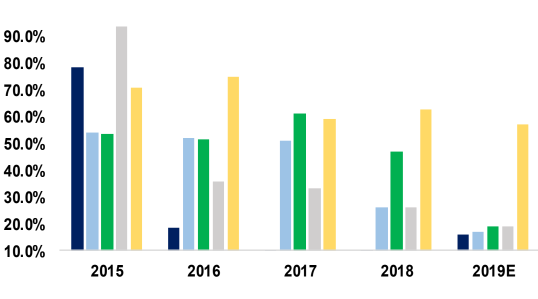
Source: Bangladesh Bank

Chart: Cash Dividend Rate



Source: Financial Statements, BEPL Research

Chart: Dividend Payout Ratio



Source: Financial Statements, BEPL Research

governance issues significantly improve, it is unlikely that the poorly managed banks will want to reduce their payout ratio either and recent budgetary tax provision to maintain a minimum cash dividend disbursement means that the capitalization prospect is further worsened.

BRAC bank is one of the most capitalized banks in the industry

When it comes to capitalization, BRAC bank is very impressive as it currently has one of the highest Tier I ratios amongst PCBs in 2018 at both Consolidated and Solo levels, at 14.4% and 12.3% – as well as very high CAR at solo and consolidated levels of 15.7% and 13.7% — all without the issuance of any subordinated debt. This means BRAC bank has deep pockets to invest in technology & SME and grow its business.

On the other hand, weakening profitability and aggressive dividend policy over the years have compromised City Bank's capital – with a Tier I ratio of 8.2% by September 2019, which is the lowest in our coverage. The bank is meeting its minimum CAR this year, mostly by issuing subordinate bonds. To improve CAR, it declared reduced dividend in 2018. Given its aggressive growth strategy, should CBL's OPEX and debt charges go up significantly, it will have less of excess capital — which might compromise its long-term growth. Falling capital was one of the reasons sighted by Moody's that caused CBL's long-term deposit rating to be down-graded.

Government borrowing from the bank sector is positive

The government's recent inclination to borrow from the banks should provide strong tailwinds to the sector troubled by deteriorating economic conditions by i) reducing Risk Weighted Assets (RWA) and ii) Earn risk-free profits for the banks instead of depleting equity by costs associated with NPL and OPEX. However, in the long-term, borrowing from banks should be done at a controllable level so that it does not crowd out private credit growth.

Issuance of Subordinate bonds is in demand

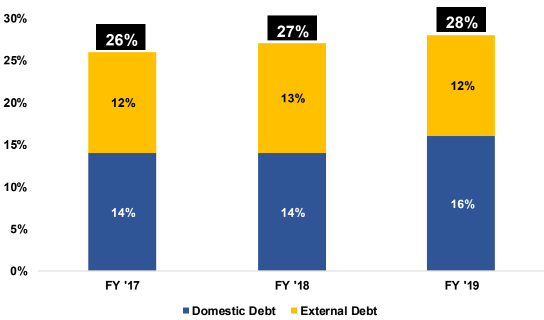
Banks are not issuing rights as current capital market condition make it unviable to take that route. Relying on subordinate bonds to meet Tier 2 capital is not a long-term solution. Deteriorating trust amongst investors, the closure of PLFS and lack of credit ratings from trusted agencies mean the worst hit banks will fail to issue enough through subordinate bonds. On top of that, Bangladesh Bank fixes a range for interest rates to be charged on these subordinate bonds, unique for every bank -- making subordinate bonds difficult to issue even for the well managed banks. We have seen The City Bank and Eastern Bank both missing out on CAR requirement by the end of 2018 and one of the reasons sighted was the difficulty to raise enough bond capital at a capped interest rate – when the market interest rates were high. However, it appears that a bigger underlying issue is the moral hazard of the better banks to not raise enough Tier II capital because 'other banks' are also not complying, and this is a problem that might repeat.

Conservative Dividend Policy is expected to improve capitalization

On the bright side, we have seen some of our coverage banks reduce their payout ratios in 2018 in order to improve capital condition. Although conservative dividend policies should have been implemented earlier, it is a good sign that the board realizes the importance of capital and we think this trend will continue at least for the next two years amongst the well managed banks. BRAC Bank's superior corporate governance is reflected by a lack of cash dividend since 2016 – helping it become one of the strongest capitalized banks in the industry.

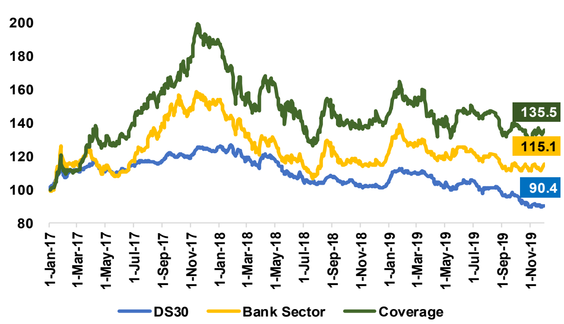
Well capitalized banks have a major competitive advantage and will be able to grow faster than the industry and be able to invest in technology and newer markets. These banks are also likely to perform better during a crisis.

Chart: Government Total Debt-to-GDP Ratio



Source: Bangladesh Bank

Chart: Index (Bank Sector & Market)



Source: DSE, BRAC EPL Research

Government bailed out Farmer's Bank but did not rescue an NBFI

Following excess irregularities and an NPL ratio in excess of around 58% by a 4th generation bank, Farmer's Bank, recently changed to Padma Bank, the government bailed it out in 2018 by injecting BDT 7.2 billion (~ 0.3% of NBR Total Revenue) in equity and issuing bonds worth BDT 10.0 billion through four State-Owned Banks (SOB) and one government owned FI – which did create chaos in the capital markets, but not very much in the banking sector.

In 2019, PLFS became the first insolvent NBFI in the country and government allowed it to liquidate. Considering the total assets of the banking and NBFI sectors, PLFS had a market share of roughly 0.1% — small from the government's perspective to allow it to fail.

NBFIs, comprising of roughly 6.2% of total assets in the financial sector is small and of lesser priority for the government. Bangladesh Bank had also assured depositors and creditors (other Banks and NBFIs) of their exposure at PLFS and none of our coverage banks have significant exposure either. However, further development regarding PLFS liquidation needs to unfold to confirm if these parties are secured.

Current stock market conditions make capitalization via rights issue unlikely

Bank stocks have suffered substantially since the start of 2018. Interestingly, this slump resulted in a situation when asset quality, profitability and capitalization for the broad industry are at challenging states, making rights issue a very unlikely option that can work in the near term.

Addressing solvency in the short-term is not very difficult for the Government

We think there might be some banks and NBFIs like Farmer's bank that might become insolvent in the next one or two years. Should that happen, we think the government would probably opt to bail out or restructure those financial institutions. It is important to note that the government had been recapitalizing the SOBs for long-time, averaging ~ 1% of its annual fiscal expenditure in the last 6 years. Given how fragmented the industry is, bailing out 3-5 NBFIs should not be difficult for the government.

There already is a negative perception among stakeholders about the ailing condition of the NBFI industry, so a case of serious panic or banking contagion due to further bail-outs is highly unlikely, given strong long-term economic prospects and manageable public debt levels.

On the other hand, the SOBs might lend through bond purchase — to support struggling banks while the central bank will be expected to provide a lot of liquidity support.

Forming an Asset Management Company to recover default loans is a long-term solution planned by the Government

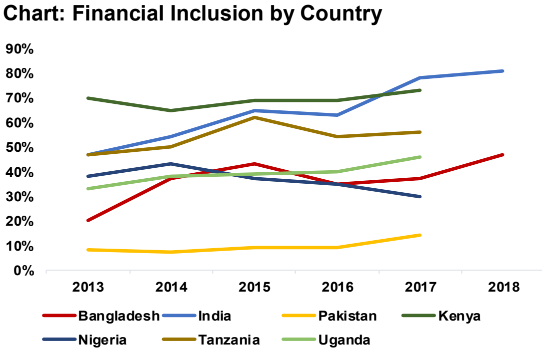
Bangladesh Govt is considering setting up an Asset Management Company (AMC) to reduce high NPL of the financial sector (not to be confused with existing Asset Management Companies who manage Mutual Funds and Alternative Investment Funds). The law will empower the PAMC to purchase non-performing loans (NPLs) from banks and sell them off to individuals or corporate entities. The PAMC will acquire defaulted loans from banks after completing due diligence and then restructure the loan. This allows the PAMC to focus on recovering loans from specific corporations or business groups that defaulted multiple banks. The government is going to draw up a separate law for this purpose within FY'20. Moreover, a secondary market for NPL is proposed by the concerned committee as well. The Asian Development Bank (ADB) showed interest in providing technical and financial support to the gov-

Table 7: AMCs Around the World

Country	Period	AMC Type	Comment
Sweden	1990s	Public	AMC had the authority to change defaulter's structure, replace management, cut cost and sell asset.
Korea	1998-99	Public	Organized international bidding of the structured NPLs where global giants like Deutsche Bank and Goldman Sachs participated.
Japan	1999	Public	Very high recovery rate
Ireland	2009	51% private, 49% public	
Spain	2012	55% private, 45% public	
Vietnam	2013	Public	Low recovery rate

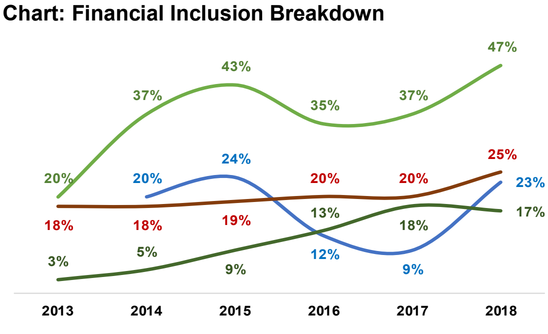
Source: EPL Research

Chart: Financial Inclusion by Country



Source: Kantar-Finclusion

Chart: Financial Inclusion Breakdown



Source: Kantar—Finclusion

ernment for the creation of the PAMC. ADB provided similar support to a few countries which helped banks in those countries to clean up their balance sheets.

This tool has been "successful" in many countries including Sweden, Korea, Japan, Ireland, Spain, Vietnam etc. Primary functions of a typical AMC include - purchase bad debts from banks, collect bad debts, sell bad debt and collaterals and restructure the debt. The advantage of using AMC to reduce NPL includes the following — AMCs use their specialized skills in debt collection and restructuring. It lets banks to focus on lending properly while concentrating on bad debt recovery itself. Disadvantages include low incentives for banks to consider recoverability of loans and improving loan approval and monitoring process.

AMCs buy bad loans from banks in exchange for special purpose bonds. The problem is that the major part of NPLs still remain in the AMC's balance sheets and there is no effective solution to deal with such debts. If the AMC cannot recover bad debts, they are returned to the commercial banks and become the responsibility of the bank to handle the loans again.

Using such tool as an AMC to handle NPL situation may not yield the desired result; there are a few things to consider in the context of our country-

- bankruptcy and other laws are weak compared to other countries
- loans taken by politically linked people/organization are high
- Central Bank has weak oversight of the banks whereas the Ministry of Finance exerts influence on the watchdog.

Other possible solutions of the Government

Mergers and acquisition is not something impossible in the future. However, we restrict that possibility among i) SOBs— SOBs and ii) SOBs - PCBs, but not between two PCBs. However, we doubt there would be synergy benefits or improvement in risk management practices as it will be very difficult politically — with taxpayers not winning much as a result. Among industry experts, the consensus is that it is highly unlikely that there would be any merger or acquisition among the PCBs. On the other hand, SOBs might continue to lend to the troubled banks by purchasing bonds as they did for Farmer's Bank.

Overall, out of all the long-term plans discussed, the idea of forming AMC seems to be most effective in our opinion. However, the formation of such a company and its functions, should it happen at all — will require a lot of time and effort.

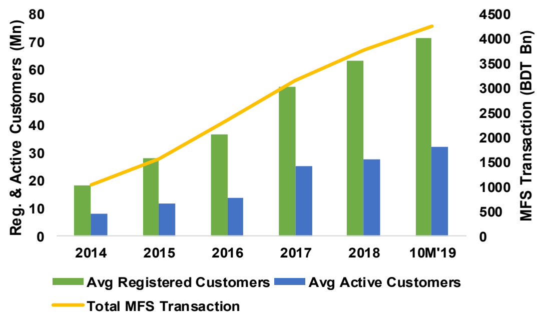
Financial Inclusion

Bangladesh has seen a tremendous improvement in Financial Inclusion in recent years. Financial inclusion has increased from 20% in 2013 to 47% in 2018. Among the six peers of Bangladesh, only India has outperformed Bangladesh in terms of improvement in financial inclusion. Most of the peers have higher financial inclusion than Bangladesh due to inclusion of mobile money system in their payment ecosystem before Bangladesh. But Bangladesh is catching up with the rest of the countries pretty fast. There were primarily two factors for Bangladesh which worked towards improvement in financial inclusion - Agent Banking & Mobile Financial Services.

Mobile Financial Services (MFS) has significant contribution towards financial inclusion

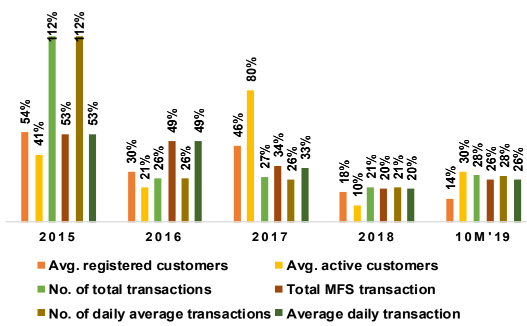
Mobile Financial Services (MFS) has been the cornerstone of financial inclusion in Bangladesh. Rural people with no concept of banking are now using MFS for their day to day usage. At first MFS was used as a means to send money to family member of individuals who lived in cities leaving their family in villages. Due to this reason, it was more popular to the lower income group who had no other means to transfer money to their family members. A lot of

Chart: Mobile Financial Services (MFS) Industry



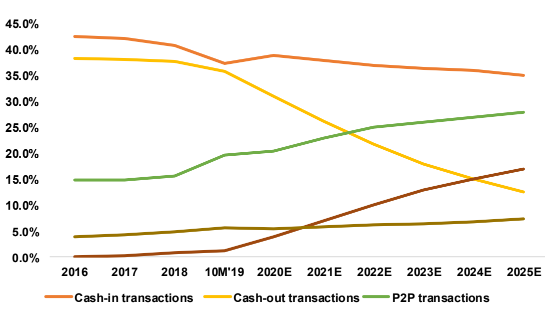
Source: Bangladesh Bank, BRAC EPL Research
**10M'19 value of Total MFS Transaction is annualized*

Chart: MFS Industry Growth



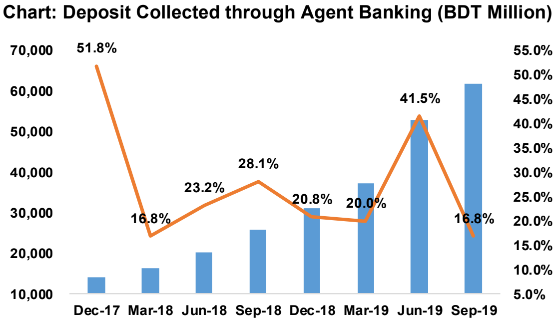
Source: Bangladesh Bank, BRAC EPL Research

Chart: MFS — Percentage of Total Transaction



Source: Bangladesh Bank, BRAC EPL Research

Chart: Deposit Collected through Agent Banking (BDT Million)



Source: DSE, BRAC EPL Research

people used to go to agents to transfer money through MFS rather than opening up their own accounts. Previously MFS providers used USSD service of the mobile network operators (MNO) to provide their services. But the introduction of mobile app has extended the reach of the MFS providers to middle to upper middle-income segment as well. Over time the MFS services, mainly bKash, has instilled the importance of its usage within the people of the country which can be seen from the improvement in mobile money penetration from 11.8% in 2014 to 41.5% in 2018. bKash, the leading MFS provider, is focusing on acquiring more customers rather than aiming to increase the transaction frequency or value per transaction which can be seen by the rather stagnant value over the years. But this phenomenon may change in the coming years due to focus on merchant payment and introduction of other services like utility bill payment and bank to bKash transfer.

Even though MFS transactions and no of customers has shown a high growth trajectory over the past years it has slowed down in the recent year. One reason could be stricter KYC required while opening an MFS account. Moreover, there were many occurrences of fraud where people found their wallet emptied. But the MFS providers are conducting awareness promotions which are helping in reduction of these occurrences. So, the growth might pick up due to convenience of merchant payment and bank to bKash transfer.

Table 8: Mobile Financial Services (MFS) Industry

	2014	2015	2016	2017	2018	10M'19
Population	155.8	157.9	159.9	161.8	164.6	168.3
Adult Population (~66%)	102.9	104.3	105.6	106.8	108.7	111.1
Mobile Money Penetration	17.8%	27.1%	34.8%	50.3%	58.2%	64.2%
No of transactions per reg. customer	30.0	41.3	40.1	34.9	35.9	36.0
Avg Value per Transaction	1,877	1,353	1,593	1,678	1,667	1,649

Source: Bangladesh Bank, BRAC EPL Research

Merchant payment is the primary focus of bKash

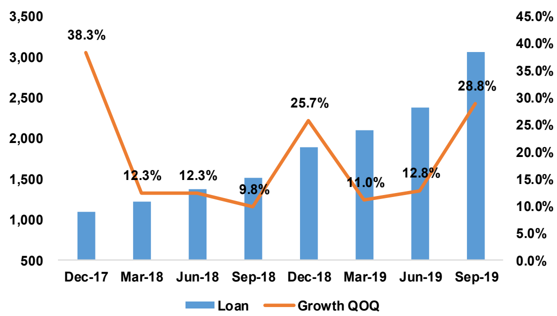
Merchant payment is the primary focus of bKash at this moment, and rightly so. If not for merchant payment, bKash users would just be using the cash in and cash out services which would not be the complete use of MFS services. Merchant payment allows the users to use the money in their bKash wallet for purchasing goods and services rather than paying a fee while cashing out. A user can now complete a transaction cycle without paying any charge to bKash as both cash in and merchant payment are free for customers. This is allowing a greater value generation for the customers rather than the previous cash out model.

Moreover, merchant payment gives a better margin to bKash as it doesn't have to share their commission from the merchants with agents or MNOs. So, a focus on this segment is going to be valuable for bKash in future as merchant payment gains more popularity. Collaborating with bKash is beneficial for the merchants as well because merchants have to pay 2%-3% charge for card transaction while the charge for a transaction through bKash is ~1.2%. Moreover, merchants have to purchase POS machines worth BDT 40K-50K if they want to facilitate card transaction. bKash has ~80,000 agents currently, of which 50K-55K are active. bKash has target of ~100K active merchants by the end of 2019. We expect merchant payment's market share in total MFS transaction to increase from 2% in 2019 to 17% in 2025.

Agent Banking is the most recent focus of the banks

Agent banking has played an exceptional part in improving financial inclusion of the country. Financial inclusion through banks has increased from 20% in 2017 to 25% in 2018 primarily because of the focus on agent banking. Till Q3'17, banks only used to collect deposit through agent banking. But after

Chart: Loans Disbursed through Agent Banking (BDT Million)



Source: DSE, BRAC EPL Research

that, loan disbursements through agent banking has also seen light. Most of the deposits collected through agent banking are current and savings account, which help the banks to improve their CASA. Ratio. Moreover, agent banking is cheaper than opening up a branch. So, banks don't need to incur high costs of opening branches in rural areas where banks might not get enough deposit and loan disbursement opportunities to generate sufficient revenue to make that branch cost effective. Agents can reach such parts of rural area to acquire customers where the reach of branches wouldn't have been possible. These advantages have been influencing more banks to initiate agent banking services and speed up the process of financial inclusion as well.

Table 9: Agent Banking Outlets & Agents

	Sep-17		**Sep-18**		**Sep-19**	
	No. of Agents	**No. of Outlets**	***No. of Agents***	**No. of Outlets**	***No. of Agents***	**No. of Outlets**
Bank Asia	1,223	1,272	2,296	2,370	3,094	3,195
Dutch Bangla Bank	445	1,487	619	1,686	753	3,123
Al-Arafah Bank	71	99	114	168		
Islami Bank Bangladesh	3	3	148	148	646	646
City Bank	5	5	50	75	56	180
BRAC Bank	-	-	1	1	145	160
Eastern Bank	-	-	-	-	8	8
NRB Commercial Bank	3	360	3	563	556	569
Total	**2,015**	**3,565**	**3,902**	**5,791**	**6,531**	**9,391**

Source: Bangladesh Bank

The number of banks providing the service has increased from 10 banks in 2016 to 19 banks in 2019, with Bank Asia being in the lead. The number of agents and outlets have also increased ~3 times from 2017 to 2019.

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