Part II
Indicators
6

Compilation Guide for the Getting Finance Indicators for South Asia

As part of the World Bank's regional initiative to develop standardized indicators to measure the performance and soundness of the financial sector, this report, _Getting Finance in South Asia 2009: Indicators and Analysis of the Commercial Banking Sector_, uses indicators under six categories: (1) access to finance, (2) performance and efficiency, (3) financial stability, (4) capital market development, (5) market concentration and competitiveness, and (6) corporate governance. Initially, these indicators will be computed only for commercial banks.

Interpretation and analysis of these indicators is likely to vary unless banking supervisors adopt a common methodology for computing them. Because most of the indicators take the form of ratios, understanding the nature of the underlying data is imperative. This guide provides common definitions, data sources, and concepts for both compilers and users of the indicators. For indicators appearing in previous FPSI reports, the definitions are the same as those given in the compilation guide issued under those studies.

**Access to Finance**

In countries seeking to develop financial markets, it is important to monitor and measure the level of access to financial services. This knowledge provides a more balanced picture of financial sector development. It also enables policy makers and regulatory authorities to better target the development efforts. Initially it is expected that access to finance will be analyzed using data relating to providers of finance (supply-side data). Demographic as well as geographic market penetration will be analyzed.

1. **Demographic branch penetration**

   \[
   \text{Bank branches per 100,000 people} = \frac{\text{Number of bank branches}}{\text{Total population}} \times 100,000
   \]

   Number of bank branches: Number of commercial bank branches in the country at year-end.  
   Total population: Total population at year-end.
This indicator measures the demographic penetration of the banking sector in terms of access to banks’ physical outlets. Higher penetration means more branches and thus easier access.

2. **Demographic ATM penetration**

\[
\text{ATMs per 100,000 people} = \frac{\text{Number of ATMs}}{\text{Total population}} \times 100,000
\]

Number of automated teller machines (ATMs): Number of ATMs of commercial banks in the country at year-end.
Total population: As defined in eq. (1) above.

This indicator also measures the demographic penetration of the banking sector in terms of access to physical outlets. Higher penetration means more ATMs and thus easier access.

3. **Deposit accounts per 1,000 people**

\[
\text{Number of deposit accounts per 1,000 people} = \frac{\text{Number of deposit accounts}}{\text{Total population}} \times 1,000
\]

Number of deposit accounts: Number of deposit accounts in commercial banks in the country at year-end.
Total population: As defined in eq. (1) above.

This indicator measures the use of banking services. Higher values mean greater use of services.

4. **Loan accounts per 1,000 people**

\[
\text{Number of loan accounts per 1,000 people} = \frac{\text{Number of deposit accounts}}{\text{Total population}} \times 1,000
\]

Number of loan accounts: Number of loan accounts granted by commercial banks in the country at year-end.
Total population: As defined in eq. (1) above.

This indicator also measures the use of banking services, with higher values indicating greater use.

5. **Geographic branch penetration**

\[
\text{Bank branches per 1,000 km}^2 = \frac{\text{Number of bank branches}}{\text{Total surface area (km}^2)} \times 1,000
\]

Number of bank branches: As defined in eq. (1) above.
Total surface area (km\(^2\)): Total surface area of the country as measured by square kilometers.
This measures the geographic penetration of the banking sector in terms of access to the physical outlets of the bank. Higher penetration would indicate easier geographic access of branches.

6. Geographic ATM penetration

ATMs per 1,000 km² = \( \frac{\text{Number of ATMs}}{\text{Total surface area (km}^2\text{)}} \times 1,000 \)

Number of ATMs: As defined in eq. (2) above.
Total surface area (sq. km.): As defined in eq. (5) above.

This measures the geographic penetration of the banking sector in terms of access to the physical outlets of the bank. Higher penetration would indicate easier geographic access to ATMs.

**Performance and Efficiency**

Bank efficiency has become critically important in an environment of increasingly competitive international markets. Thus, comparative data on the efficiency of banks are important both to regulators and to banks, which can use the data to adjust their operating policies. For this study, two types of efficiencies are analyzed: returns efficiency and cost efficiency.

7. Profits to period-average equity (ROE)

Return on equity = \( \frac{\text{Net income}}{\text{Average value of total equity}} \)

Net income: Net profit before tax and other extraordinary adjustments.
Average value of total equity: Can be calculated by taking the beginning- and end-period values for total capital (total equity) and finding the average.
Total capital (total equity): Also called regulatory capital funds or own funds. Defined as Tier I (core) capital + Tier II (supplementary) capital.
Tier I capital: Equity capital and disclosed reserves that are freely available to meet claims against the bank. Tier I capital comprises paid-up shares, share premiums, retained earnings, statutory reserves, and general reserves. Goodwill should be deducted because its value may fall during crises. Tier I capital should be at least 50 percent of the total capital funds.
Tier II capital: Undisclosed reserves, revaluation reserves, general loan loss provisions, and hybrid instruments that combine the characteristics of debt and equity and are available to meet losses and unsecured subordinated debt. Tier II capital should be less than or equal to Tier I capital. Subordinated debt should not exceed 50 percent of Tier I capital. Loan-loss provisions should not exceed 1.25 percent of the total risk-weighted assets.

This ratio measures the efficiency with which a bank uses capital and, over time, the sustainability of its capital position.
8. **Profits to period-average assets (ROA)**

\[
\text{Return on assets} = \frac{\text{Net income}}{\text{Average value of total assets}}
\]

Net income: As defined in eq. (7) above.
Average value of total assets: Can be calculated by taking the beginning- and end-period values for total assets and finding the average.

This ratio measures the efficiency with which a bank uses assets.

9. **Staff cost ratio**

\[
\text{Staff cost ratio} = \frac{\text{Personnel expenses}}{\text{Operating expenses}}
\]

Personnel expenses: Total remuneration payable to employees.
Operating expenses: All expenses other than interest expenses and provisions.

This ratio measures personnel cost as a share of total administrative expenses and reflects cost efficiency.

10. **Operating cost ratio**

\[
\text{Operating cost ratio} = \frac{\text{Operating expenses}}{\text{Net interest earnings}}
\]

Operating expenses: As defined in eq. (9) above.
Net interest earnings (net interest income): Interest earned less interest expenses.

This ratio measures efficiency in controlling administrative and operating expenses in relation to net interest income.

11. **Net interest margin**

\[
\text{Net interest margin ratio} = \frac{\text{Net interest earnings}}{\text{Average value of total assets}}
\]

Net interest earnings (net interest income): As defined in eq. (10) above.
Average value of total assets: As defined in eq. (8) above.

This ratio measures the overall operating efficiency of the banking sector.

12. **Recurring earning power**

\[
\text{Recurring earning power ratio} = \frac{\text{Preprovision profits}}{\text{Average value of total assets}}
\]

Preprovision profits: Profits before tax and loan loss provisions.
Average value of total assets: As defined in eq. (8) above.
This ratio measures the recurring earning strength and efficiency of the banking sector.

**Financial Stability**

Financial stability means avoiding significant disruptions to the financial system and its functions. It is key to achieving both low inflation and sustainable economic growth. While different indicators measure different aspects of financial sector stability, this study uses capital adequacy, asset quality, and liquidity ratios. The capital adequacy ratios (CARs) measure the capacity of an institution to absorb losses and thus indicate its financial strength. The asset quality and liquidity ratios measure major vulnerabilities relating to credit risk and liquidity risk.

13. **Capital adequacy ratio (CAR)**

\[
\text{Capital adequacy ratio} = \frac{\text{Regulatory capital funds}}{\text{Risk-weighted assets}}
\]

Regulatory capital funds: Also called own funds or total capital funds, as defined in eq. (7) above.
Risk-weighted assets: Each class of assets and off-balance sheet exposures are weighted using weights related to the credit risk associated with each type of assets. The standard risk weights used as international best practices (Basel I) are as follows:

- Cash, gold, and government or treasury securities, 0 percent
- Government agencies, 20 percent
- Mortgage loans, 50 percent
- Others, 100 percent

The CAR provides an assessment of how well the capital cushions fluctuations in earnings and supports asset growth. The ratio should be calculated on a consolidated basis. Under international best practice, 8 percent of total risk-weighted assets on a consolidated basis is considered adequate capital.

14. **Leverage ratio**

\[
\text{Leverage ratio} = \frac{\text{Total equity}}{\text{Total on-balance sheet assets}}
\]

Total Equity: Total capital funds as defined in eq. (7) above.
Total on-balance sheet assets: Total assets in the balance sheet at the end of period without risk weighting.

This ratio measures the extent to which assets are financed by funds other than own funds; hence, it is a measure of capital adequacy.
15. **Gross nonperforming loans ratio**

Gross nonperforming loans ratio = \( \frac{\text{Gross nonperforming loans}}{\text{Total advances}} \)

Gross nonperforming loans (NPLs): The amount of NPLs before specific loan loss provisions are deducted. According to prudential norms, loans are classified as nonperforming when payments of principal and interest are past due by three months.

Total advances: Gross loans and advances, including NPLs before deducting specific loan-loss provisions.

This ratio is a measure of asset quality and indicates the credit quality of a bank’s loan portfolio.

16. **Provisions to nonperforming loans ratio**

Provisions to nonperforming loans ratio = \( \frac{\text{Loan-loss provisions}}{\text{Gross nonperforming loans}} \)

Loan loss provisions: Specific loan-loss provisions outstanding at the end of the period.

Gross NPLs: As defined in eq. (15) above.

This ratio is a measure of asset quality and identifies the adequacy/shortfall of the specific provisions made in respect of NPLs.

17. **Liquid assets ratio**

Liquid assets ratio = \( \frac{\text{Liquid assets}}{\text{Total assets}} \)

Liquid assets: Cash, demand deposits, and other financial assets that are available on demand or within three months or less.

Total assets: As defined in eq. (16) above.

This ratio measures stability. It indicates the liquidity available to meet expected and unexpected short-term demands for cash—and thus the vulnerability of the banking sector to loss of funding sources.

18. **Liquid assets to liquid liabilities ratio**

Liquid assets to liquid liabilities ratio = \( \frac{\text{Liquid assets}}{\text{Liquid liabilities}} \)

Liquid assets: As defined in eq. (17) above.

Liquid liabilities: Short-term debt liabilities and the net market value of financial derivatives positions (short term).

This ratio also measures stability. It captures the liquidity mismatch between short-term assets and liabilities and indicates the extent to which a bank can meet its short-term obligations without incurring liquidity problems.
**Capital Market Development**

The development of capital markets is a powerful indicator of the depth of the financial sector. By allocating funds for viable investment projects, healthy capital markets diversify the channels of financial intermediation. This study uses ratios to measure the size and structure of the stock and bond markets.

19. **Domestic bond to equity market capitalization ratio**

Bond to equity market capitalization ratio = \( \frac{\text{Domestic bonds outstanding}}{\text{Equity market capitalization}} \)

Domestic bonds outstanding: Total value of outstanding domestic debt securities issued by private entities as well as public entities, at the end of the period.
Equity (stock) market capitalization: Market value of all outstanding shares calculated by share price times the number of shares outstanding at the end of the period.

This ratio gives an indication of the size and structure of the capital markets. It also reflects financial depth and diversity.

20. **Domestic public bonds outstanding to GDP ratio**

Domestic public bonds to GDP ratio = \( \frac{\text{Domestic public bonds outstanding}}{\text{GDP}} \)

Domestic public bonds outstanding: Total outstanding value of domestic debt securities issued by public entities.
Gross domestic product (GDP): This is an aggregate measure of production in the economy equal to the total value added of all residential units engaged in production, for the given period.

This is another measure of the size of the bond market. It reflects the extent to which the public sector preempts resources that would otherwise be available to the private sector.

21. **Trading value of top 10 stocks to total trading value ratio**

Trading value of top 10 stocks ratio = \( \frac{\text{Trading value of top 10 stocks}}{\text{Total value of shares traded}} \)

Trading value of top 10 stocks: Total value of top 10 actively traded stocks in the stock exchange for the period under consideration, such as financial year or calendar year.
Total value of share traded: Total value of shares traded in the stock exchange for the period under consideration, such as financial year or calendar year.

The ratio measures the degree of concentration of the top 10 firms in the market and reflects the depth of the stock market.
22. Stock market capitalization to GDP ratio

Stock market capitalization to GDP ratio = \( \frac{\text{Stock market capitalization}}{\text{GDP}} \)

Stock market capitalization: As defined in eq. (19) above.
GDP: As defined in eq. (20) above.

This ratio measures the relative importance of the stock market to the size of the economy.

23. Stock trading value to GDP ratio

Stock trading value to GDP ratio = \( \frac{\text{Total value of shares traded}}{\text{GDP}} \)

Total value of share traded: As defined in eq. (21) above.
GDP: As defined in eq. (20) above.

This is a measure of activity or liquidity in the stock market and reflects the ease of trading.

24. Stock market turnover ratio

Stock market turnover ratio = \( \frac{\text{Total value of shares traded}}{\text{Average market capitalization}} \)

Total value of share traded: As defined in eq. (21) above.
Average market capitalization: Average of the end-period market capitalization values for the current period and the previous period.

This is a measure of efficiency in the stock market.

**Market Concentration and Competitiveness**

The study examines the market structure of the banking sector to evaluate the banking system’s proneness to instability and crises. A high level of concentration in the banking industry, by reducing competition and increasing cost, has a negative impact on efficiency. At the same time, a highly competitive banking sector might be more prone to crisis (due to increased fragility resulting from intense competition) than a more concentrated one.

25. Herfindahl-Hirschman Index (HHI)

HHI = \( \sum_{i=1}^{n} (\text{MS}_i)^2 \)

HHI is calculated as the sum of the squares of the market share (in terms of assets) of each bank in the geographic banking market.

This ratio measures the market concentration. A highly concentrated commercial banking sector may lead to lack of competitive pressure.
26. **K-bank concentration (assets) ratio**

K-bank concentration ratio (CR$_k$) assets = \[ \frac{\text{Three largest banks' total assets}}{\text{Total assets of commercial banks}} \]

(CR$_k$), where $k = \text{three largest banks}$.  
Three largest banks' total assets: Calculated as total assets of the three largest banks.  
Total assets of commercial banks: Total assets of the commercial banking sector.  
This ratio measures the banking concentration in terms of assets.

27. **K-bank concentration (deposits) ratio**

K-bank concentration ratio (CR$_k$) deposits = \[ \frac{\text{Three largest banks' total deposits}}{\text{Total deposits of commercial banks}} \]

(CR$_k$), where $k = \text{three largest banks}$.  
Three largest banks' total deposits: Calculated as total deposits of the three largest banks.  
Total deposits of commercial banks: Total deposits of the commercial banking sector.  
This ratio measures the banking concentration in terms of deposits.

28. **K-bank concentration (loans) ratio**

K-bank concentration ratio (CR$_k$) loans = \[ \frac{\text{Three largest banks' total loans}}{\text{Total loans of commercial banks}} \]

(CR$_k$), where $k = \text{three largest banks}$.  
Three largest banks' total loans: Calculated as total loans of the three largest banks.  
Total loans of commercial banks: Total loans of commercial banking sector.  
This ratio measures the banking concentration in terms of loans.

29. **Private credit extended by banks to GDP ratio**

Private credit to GDP ratio = \[ \frac{\text{Total value of private credit by commercial banks}}{\text{GDP}} \]

Total value of private credit by commercial banks: Claims on the private sector by commercial banks.  
GDP: As defined in eq. (20) above.  
This ratio measures the relative activity of banks as financial intermediaries in channeling savings to investors.
30. **Commercial banking assets to GDP ratio**

Private credit to GDP ratio = \( \frac{\text{Total value of private credit by commercial banks}}{\text{Total loans of commercial banks}} \)

Total commercial banking assets: As defined in eq. (26) above.

GDP: As defined in eq. (20) above.

This ratio measures the relative importance of commercial banking sector to the size of the economy.

**Corporate Governance**

Sound corporate governance creates an environment that promotes banking efficiency, mitigates financial risks, and increases the stability and, therefore, the credibility of financial institutions. Developing countries have much to gain by improving their corporate governance standards. The basic principles are the same everywhere: fairness, transparency, accountability, and responsibility are the minimum standards that give banks legitimacy, reduce vulnerability to financial crisis, and broaden and deepen access to capital.

Scoring performance on corporate governance is hugely challenging and must be done with care. Unlike other types of financial analysis, where quantitative measures can provide “hard” benchmarks to guide the more qualitative aspects of analysis, assessing corporate governance is a largely qualitative exercise. Because corporate governance is assessed in this study through a series of straightforward questions, no definitions or guidelines are provided here.
Methodology

Data Compilation

Annual data on the commercial banking sector in each of the five countries representing South Asia (in this study as well as in the phase I, II, and III studies)—Bangladesh, India, Nepal, Pakistan, and Sri Lanka—were compiled for the six years from 2001 to 2006. The data for the financial indicators were collected using a data collection template (for the results, see appendix 1), while the data on corporate governance were collected through a questionnaire (for the responses, see appendix 3.A). In completing this questionnaire, the supervisory agencies were asked to substantiate their responses with relevant legal references or sources.

The data available in this report (and the previous studies) are unique in that they are comparable data collected directly from the regulatory authorities or their published reports. To ensure the compatibility of the indicators across the region and aid consistent interpretation and analysis, a compilation guide (see chapter 6) was prepared, setting out definitions and underlying concepts for both the compilers and the users.

Choice of Indicators

To provide a more holistic perspective of Getting Finance in South Asia, and to improve the understanding of the financial systems in the regions’ countries, indicators under the six categories of access to finance, performance and efficiency, corporate governance, financial stability, capital market development, and market concentration and competitiveness were selected.

The financial indicators selected are based on internationally accepted measures and reflect the structure of financial systems in South Asia, just as in the previous reports. The corporate governance indicators are based primarily on the guidelines issued by the Basel Committee on Banking Supervision, which in turn rely on the principles of corporate governance published by the Organisation for Economic Co-operation and Development (OECD) (see chapter 9).

Although market-based indicators such as credit ratings and market volatility would serve better for macro prudential analysis, such indicators were not selected for this study. The effectiveness of such indicators depends on the quality

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and depth of the financial markets. In most South Asian countries, these characteristics are directly affected by the ownership structure of the commercial banking sector (with government-owned or government-controlled banks accounting for a large share of banking sector assets) and by the lack of stringent public disclosure requirements (for a detailed discussion of the advantages and disadvantages of macro prudential analysis, see World Bank and IMF 2005). It was therefore believed that micro prudential indicators would be better measures of the soundness of financial sectors in South Asia.

**Method for Country Rankings**

The ranking of countries by the financial and corporate governance indicators is based on a simple-average ranking system. Given the limited size of the sample, ranking based on percentile averages is not warranted. Simple-average ranking also appears to be appropriate given the lack of sufficiently detailed data to assess the impact of each variable on financial soundness and thus permit different weights to be assigned to the variables (see Djankov, Manraj, McLiesh, and Ramalto 2005). Thus, the use of simple-average ranking has made it possible to overcome some of the shortcomings associated with the type of analysis and indicators used in this report.

**Financial Indicator Scores**

For the rankings on each financial indicator, for each year each country is ranked relative to the others, with 1 representing the lowest ranking and 5 the highest. The lowest score of 1 is also given for any year for which no data are available (indicated in the data tables in appendix 1, by N/A). Except in instances in which no data are available for more than one country or in which more than one country reports the same ratio, each country receives a different score.

These scores are aggregated across the years to arrive at the score for the six-year period on each indicator—and the scores for the indicators within a category are added to arrive at the aggregate score for that category (access to finance, performance and efficiency, financial stability, capital market development, or market concentration and competitiveness). This aggregate score is then divided by the maximum “possible” total score for the category. That maximum score is 180, derived by multiplying the number of indicators in the category (6) by the highest possible score (5), then multiplying that by the number of years (6). Dividing the aggregate score by the maximum possible total score of 180 gives the composite score for each category. The composite scores range from zero to one. See table 7.1 for the composite scores received by the countries under each category. Also, the ranking of countries under each category is given in table 3.1.

**Corporate Governance Scores**

For corporate governance, each country is individually ranked on the two major sections of each of the four topics on a scale from 1 (not observed) to 5 (largely observed), based on the responses to the questionnaire (see appendix 3.A), the country’s corporate governance guidelines, and various reports. Here again a score of 1 is given if no data are available. Because the countries are not ranked comparatively, more than one country can receive the same score in a category.
### Table 7.1 Composite Scores on the Getting Finance Indicators for South Asian Countries

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Bangladesh</th>
<th>India</th>
<th>Nepal</th>
<th>Pakistan</th>
<th>Sri Lanka</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Access to finance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Demographic branch penetration (branches per 100,000 people)</td>
<td>15</td>
<td>25</td>
<td>6</td>
<td>15</td>
<td>29</td>
</tr>
<tr>
<td>2 Demographic ATM penetration (ATMs per 100,000 people)</td>
<td>17</td>
<td>12</td>
<td>13</td>
<td>16</td>
<td>30</td>
</tr>
<tr>
<td>3 Deposit accounts per 1,000 people</td>
<td>18</td>
<td>24</td>
<td>6</td>
<td>12</td>
<td>30</td>
</tr>
<tr>
<td>4 Loan accounts per 1,000 people</td>
<td>21</td>
<td>21</td>
<td>7</td>
<td>11</td>
<td>30</td>
</tr>
<tr>
<td>5 Geographic branch penetration (branches per 1,000 km²)</td>
<td>30</td>
<td>24</td>
<td>6</td>
<td>12</td>
<td>18</td>
</tr>
<tr>
<td>6 Geographic ATM penetration (ATMs per 1,000 km²)</td>
<td>22</td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total points</strong></td>
<td>123</td>
<td>118</td>
<td>50</td>
<td>78</td>
<td>167</td>
</tr>
<tr>
<td><strong>Composite score (total points/180)</strong></td>
<td>0.68</td>
<td>0.66</td>
<td>0.28</td>
<td>0.43</td>
<td>0.93</td>
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<tr>
<td><strong>Performance and efficiency</strong></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>1 Return on equity</td>
<td>18</td>
<td>16</td>
<td>6</td>
<td>27</td>
<td>23</td>
</tr>
<tr>
<td>2 Return on assets</td>
<td>12</td>
<td>20</td>
<td>14</td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>3 Staff cost ratio</td>
<td>15</td>
<td>17</td>
<td>6</td>
<td>23</td>
<td>29</td>
</tr>
<tr>
<td>4 Operating cost ratio</td>
<td>6</td>
<td>21</td>
<td>30</td>
<td>21</td>
<td>12</td>
</tr>
<tr>
<td>5 Net interest margin</td>
<td>8</td>
<td>19</td>
<td>10</td>
<td>25</td>
<td>28</td>
</tr>
<tr>
<td>6 Recurring earning power</td>
<td>17</td>
<td>21</td>
<td>10</td>
<td>23</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total points</strong></td>
<td>76</td>
<td>114</td>
<td>76</td>
<td>144</td>
<td>132</td>
</tr>
<tr>
<td><strong>Composite score (total points/180)</strong></td>
<td>0.42</td>
<td>0.63</td>
<td>0.42</td>
<td>0.80</td>
<td>0.73</td>
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<tr>
<td><strong>Financial stability</strong></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>1 Capital adequacy ratio</td>
<td>12</td>
<td>27</td>
<td>6</td>
<td>25</td>
<td>20</td>
</tr>
<tr>
<td>2 Leverage ratio</td>
<td>14</td>
<td>25</td>
<td>6</td>
<td>24</td>
<td>21</td>
</tr>
<tr>
<td>3 Gross nonperforming loans ratio</td>
<td>11</td>
<td>30</td>
<td>7</td>
<td>23</td>
<td>19</td>
</tr>
<tr>
<td>4 Provisions to nonperforming loans ratio</td>
<td>10</td>
<td>20</td>
<td>8</td>
<td>30</td>
<td>22</td>
</tr>
<tr>
<td>5 Liquid assets ratio</td>
<td>17</td>
<td>29</td>
<td>6</td>
<td>25</td>
<td>13</td>
</tr>
<tr>
<td>6 Liquid assets to liabilities ratio</td>
<td>24</td>
<td>30</td>
<td>10</td>
<td>18</td>
<td>8</td>
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<tr>
<td><strong>Total points</strong></td>
<td>88</td>
<td>161</td>
<td>43</td>
<td>145</td>
<td>103</td>
</tr>
<tr>
<td><strong>Composite score (total points/180)</strong></td>
<td>0.49</td>
<td>0.89</td>
<td>0.24</td>
<td>0.81</td>
<td>0.57</td>
</tr>
<tr>
<td><strong>Capital market development</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Domestic bond market to equity market capitalization</td>
<td>7</td>
<td>30</td>
<td>20</td>
<td>22</td>
<td>11</td>
</tr>
<tr>
<td>2 Domestic public bonds outstanding to GDP</td>
<td>10</td>
<td>26</td>
<td>8</td>
<td>25</td>
<td>21</td>
</tr>
<tr>
<td>3 Ratio of trading value of top 10 stocks to total trading value</td>
<td>19</td>
<td>18</td>
<td>7</td>
<td>30</td>
<td>16</td>
</tr>
<tr>
<td>4 Stock market capitalization to GDP</td>
<td>6</td>
<td>30</td>
<td>14</td>
<td>21</td>
<td>19</td>
</tr>
<tr>
<td>5 Market liquidity: Ratio of stock trading value to GDP</td>
<td>19</td>
<td>30</td>
<td>12</td>
<td>7</td>
<td>23</td>
</tr>
<tr>
<td>6 Stock market turnover ratio</td>
<td>21</td>
<td>29</td>
<td>6</td>
<td>19</td>
<td>15</td>
</tr>
<tr>
<td><strong>Total points</strong></td>
<td>82</td>
<td>163</td>
<td>67</td>
<td>124</td>
<td>105</td>
</tr>
<tr>
<td><strong>Composite score (total points/180)</strong></td>
<td>0.46</td>
<td>0.91</td>
<td>0.37</td>
<td>0.69</td>
<td>0.58</td>
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</table>

(Table continues on next page)
### Table 7.1 Composite Scores on the Getting Finance Indicators for South Asian Countries

(continued)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Bangladesh</th>
<th>India</th>
<th>Nepal</th>
<th>Pakistan</th>
<th>Sri Lanka</th>
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<tbody>
<tr>
<td><strong>Market concentration and competition</strong></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>1 Herfindahl-Hirschman index (HHI)</td>
<td>26</td>
<td>28</td>
<td>11</td>
<td>18</td>
<td>7</td>
</tr>
<tr>
<td>2 K-bank concentration ratio (K=3) – assets</td>
<td>24</td>
<td>30</td>
<td>12</td>
<td>18</td>
<td>6</td>
</tr>
<tr>
<td>3 K-bank concentration ratios (K=3) – deposits</td>
<td>24</td>
<td>30</td>
<td>17</td>
<td>13</td>
<td>6</td>
</tr>
<tr>
<td>4 K-bank concentration ratios (K=3) – loans</td>
<td>23</td>
<td>29</td>
<td>17</td>
<td>15</td>
<td>6</td>
</tr>
<tr>
<td>5 Private credit extended by banks to GDP</td>
<td>20</td>
<td>17</td>
<td>16</td>
<td>8</td>
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<tr>
<td>6 Commercial Banking assets to GDP</td>
<td>11</td>
<td>26</td>
<td>28</td>
<td>7</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total points</strong></td>
<td>128</td>
<td>160</td>
<td>101</td>
<td>79</td>
<td>72</td>
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<tr>
<td><strong>Composite score (total points/180)</strong></td>
<td>0.71</td>
<td>0.89</td>
<td>0.56</td>
<td>0.44</td>
<td>0.40</td>
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<td><strong>Corporate governance</strong></td>
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<tr>
<td>1 Ownership structure and influence of external stakeholders</td>
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<td></td>
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<tr>
<td>1.1 Identification of substantial majority holders</td>
<td>3</td>
<td>4</td>
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<tr>
<td>1.2 Indirect and beneficial ownership</td>
<td>1</td>
<td>4</td>
<td>1</td>
<td>4</td>
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<tr>
<td>2 Investor rights</td>
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<tr>
<td>2.1 Shareholder meetings and voting procedures</td>
<td>4</td>
<td>5</td>
<td>4</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>2.2 Basic ownership rights</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>3 Transparency and disclosure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.1 Adherence to internationally accepted accounting standards</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>3.2 Independent internal and external auditors and audit committee</td>
<td>3</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>4 Board structure and effectiveness</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.1 Role and effectiveness</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>4.2 Compensation</td>
<td>2</td>
<td>4</td>
<td>5</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total points</strong></td>
<td>26</td>
<td>32</td>
<td>26</td>
<td>34</td>
<td>27</td>
</tr>
<tr>
<td><strong>Composite score (total points/40)</strong></td>
<td>0.64</td>
<td>0.80</td>
<td>0.65</td>
<td>0.84</td>
<td>0.67</td>
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</table>

Source: Calculations based on appendixes 1 and 3. Underlying data from South Asian Central Banks, SECs and Boards, and stock exchanges; Indian Banks’ Association 2006a, and 2006b, and 2006c; Reserve Bank of India 2006a, 2006b, 2006c, and 2007.
With four topics and two major sections in each, and with the highest possible score being 5, the maximum “possible” score on corporate governance is 40. The information on corporate governance gathered in the 2005 study was revised in 2006; however, no significant changes are observed. Because comparable data are not available, the scores cannot be aggregated over the six-year period. Therefore, the total scores of 2006 are simply divided by the maximum possible score to arrive at the composite score for corporate governance. See table 7.1 for the composite scores received by the countries. Also, the ranking of countries under the category is given in table 3.1.

**Financial Soundness Ranking**

To ease comparison and interpretation, the composite scores range from 0 to 1. The composite scores for each of the six categories of indicators are then averaged for each country. These simple averages are then arranged from the highest to the lowest to identify the overall financial soundness ranking for each country (see table 3.1 for the overall ranking).
Bangladesh

Implementation of the New Capital Adequacy Framework (Basel II) in Bangladesh

Bangladesh adopted the 1988 Basel I accord in 1988, which required banks to maintain a minimum capital ratio of not less than 8 percent of the risk-weighted assets. Effective June 2003, all banks operating in Bangladesh had to maintain a minimum capital adequacy ratio (CAR) of not less than 9 percent of their risk-weighted assets with at least 4.5 percent in core capital (Tier I capital). In keeping with international practices, Bangladesh Bank (BB) has decided in principle to adopt the Basel II. Given the complexities involved, however, it has decided on a consultative approach. BB has decided to adopt a mix of Standardized and Foundation Internal Rating-Based (IRB) approaches to guide the minimum capital requirement. To study and guide the banking sector through this process, BB has established the following: a high-level steering committee with representations from the BB, banking industry, and accounting profession; and a mid-level coordination committee to study the risk-based grouping and a Basel II implementation cell. Once the process is identified and realistic timeframes are drawn, it is expected that the implementation of the new accord will take place in 2009. At present, BB is reviewing the existing capacities of the banking sector to undertake more stringent risk management processes that are required. BB is taking steps in this direction by issuing guidelines on managing core risks in banks.

Prudential Regulations

Prudential guidelines issued by Bangladesh Bank in 2005–06 include the following:

2005

• February: Accounting of the interest of classified loans: A continuous credit, a demand loan, or a term loan that will remain overdue for a period of 90 days or
more will be put into the “Special Mention Account,” and interest accrued on such loan will be credited to the Interest Suspense Account instead of crediting the same to the Income Account.

- **April:** In the circular in which qualitative judgment is used as the basis for loan classification, it is stated that if the inspection team of BB classifies any loan, the loan can be declassified with the approval of the board of directors of the bank. However, before placing such a case before the board, the chief executive officer (CEO) and branch manager shall certify that the conditions for declassification have been fulfilled.

- **April:** BB issued a circular revising the policy on single-borrower exposure. Among other things, it has been decided to reduce the single-borrower exposure limit from 50 percent to 35 percent. The total outstanding financing facilities by a bank to any single person or enterprise or organization of a group shall not, at any point in time, exceed 35 percent of the bank’s total capital subject to the condition that the maximum outstanding against fund-based financing facilities (funded facilities) does not exceed 15 percent of the total capital. Under the same guidelines, nonfunded credit facilities (for example, a letter of credit or guarantee) can be provided to a single large borrower. But under no circumstances shall the total amount of the funded and nonfunded credit facilities exceed 35 percent of a bank’s total capital.

- **April:** For the loans that have already been disbursed with the approval of BB, and that have exceeded the limit as stipulated, banks shall take necessary steps to bring down the loan amount within the specified limit. To meet this condition, banks may, if necessary, arrange partaking with other banks. However, for continuous loans, the limit has to be brought down per Section 02 by December 2005. December 2006 is the deadline for term loans.

- **July:** Banks and financial institutions (FIs) have been instructed to formulate and implement specific programs for performing Know-Your-Customer (KYC) procedures per the specified format supplied by the Anti-Money Laundering Department of BB keeping in line with the Guidance Notes on Prevention of Money Laundering.

- **August:** Some amendments have been made to the policy on loan classification and provisioning. Per the amendments, banks will be required to make General Provision at 5 percent on the outstanding amount of loans kept in the Special Mention Account (SMA) after netting off the amount of Interest Suspense and the status of the SMA loan should be reported to the Credit Information Bureau (CIB) of BB. This instruction will be effective from December 31, 2005.

- **October:** An information technology (IT) guideline of minimum security standards for scheduled banks and FIs has been prepared and forwarded to the banks on CD-ROM. Banks are advised to follow the guideline in their IT area and implement all the security standards by May 15, 2006.

- **December:** With the aim to fully implement a Risk Grading System, an Integrated Credit Risk Grading Manual has been developed and forwarded to the banks on CD-ROM. Banks are advised to implement Credit Risk Grading (as described in the manual) by March 31, 2006, for all exposures (irrespective of amount) other than those covered under Consumer and Small Enterprises Financing Prudential Guidelines and those under the Short-Term Agricultural and Micro-Credit. Banks are also advised to submit a compliance report by
April 15, 2006, to the effect that the Credit Risk Grading has been put in place. The Risk Grading Matrix provided in the manual will be the minimum standard of risk rating and banks may adopt and adapt more sophisticated risk grades in line with the size and complexity of their business. Arrangement will be made by BB, if necessary, to train trainers of the banks in this regard. The BB’s on-site inspection teams will monitor the progress of implementation of the manual and guideline during routine inspection.

2006

- **February/March:** Policy for rescheduling of loans has been reviewed and it has been decided that borrowers whose credit facility has been rescheduled will get a new loan facility subject to the fulfillment of the following conditions:
  - The defaulting borrower who has an interest waiver must settle at least 15 percent of the compromise amount (excluding the down payment on rescheduling per the present guidelines) to avail of any further credit facility from any bank. In case of borrowing from other banks, the same rule will be applicable (that is, the borrower will have to submit a no objection certificate [NOC] from the rescheduled bank).
  - Export borrowers may be granted further credit facility (after being identified as not a willful defaulter), if required, subject to at least 7.5 percent of the compromise amount (excluding the down payment on rescheduling as per present guidelines) being paid.
  - Prior approval of BB shall have to be obtained if the loan is related to the director or ex-directors of a Bank Company.
  - Information on the loan accounts rescheduled shall be reported to the CIB of Bangladesh Bank.
  - If any such issue is already there (such fresh facility has already been allowed after allowing for a waiver), the same will not fall under purview of this circular.

- **June:** To strengthen credit discipline and bring classification policy in line with international standards, BB has revised its prudential norms for loan classification and provisioning. As part of the process, a Master Circular was issued on June 5, 2006, to enable the banks to have all existing instructions on the subject at one place. This circular also includes a few new instructions as well as new formats for loan classification and provisioning. More concentration has been given on Short-term Micro-Credit by enhancing its limit from Tk 10,000 to Tk 25,000. Banks with Offshore Banking Units (OBUs) have been brought under the purview of loan classification and provisioning to aid transparency of OBU transactions of EPZ (Export Processing Zone) enterprises and report to the Banking Regulation and Policy Department (BRPD) and the CIB for cross-information purposes.

**Other Policy Developments**

As part of the restructuring of the nationalized commercial banks (NCBs), the Rupali Bank is under the process of being sold to a foreign buyer.

In March 2007, BB made it mandatory for all banks to get credit rated by a credit rating agency. Banks are advised to have credit ratings in all relevant areas as well as the bank management.
India

Implementation of the New Capital Adequacy Framework (Basel II) in India

The Reserve Bank of India (RBI) released draft guidelines on February 14, 2005, for implementation of Basel II in India. According to the draft guidelines, banks are required to adopt a standardized approach for credit risk and a basic indicator approach for operational risk. Banks would need the approval of RBI for migration to advanced approaches of risk measurement. The RBI is committed to the adoption of Basel II by the banks and had earlier indicated March 31, 2007, as the intended date for adoption by all commercial banks. Taking into account the state of preparedness of the banking system, however, banks were given more time to establish appropriate systems to ensure full compliance with Basel II. Foreign banks operating in India and Indian banks having presence outside India were to migrate to the standardized approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II, however, not later than March 31, 2009. The Steering Committee of the banks would continue to interact with banks and the RBI, and guide the smooth implementation of Basel II. The banks are required to follow the Standardized Approach for credit risk and the Basic Indicator approach for operational risk.

Under Basel II, the capital requirements are more sensitive to the level of credit risk; they are also applicable to operational risks. Thus, banks would need to raise additional capital for Basel II requirements, as well as to support the expansion of their balance sheets. To enable smooth transition to Basel II and to provide banks in India additional options for raising capital funds, banks were advised in January 2006 that they could augment their capital funds by issue of the following instruments: (1) innovative perpetual debt instruments (IPDI) eligible for inclusion as Tier I capital; (2) debt capital instruments eligible for inclusion as upper Tier II capital; (3) perpetual noncumulative preference shares eligible for inclusion as Tier I capital; and (4) redeemable cumulative preference shares eligible for inclusion as Tier II capital.

To move the banks to conform to Basel norms for explicit charge for market risk, banks were advised, in January 2002, to build up Investment Fluctuation Reserve (IFR) to a minimum of 5 percent of investment in Held for Trading (HFT) and Available for Sale (AFS) categories in the investment portfolio. Later, in 2004, banks were advised to maintain capital charge for market risk in a phased manner over a two-year period ended March 31, 2006. Banks were allowed to treat the entire balance held in IFR as Tier I capital, provided they maintained a capital of at least 9 percent of the risk-weighted assets for both credit and capital charge for market risk.

Prudential Regulations

The following are among the prudential guidelines issued by the Reserve Bank of India in 2005–06:

2005

• February: Detailed prudential guidelines were issued by the RBI to banks on capital adequacy for implementation of the new capital adequacy framework
under Basel II. To maintain consistency and harmony with international standards, banks were advised to adopt the Standardized Approach for credit risk and the Basic Indicator Approach effective from April 2006. Under the new approach for operational risk framework, banks adopting the Standardized Approach would use the ratings assigned only by those credit rating agencies that are identified by the RBI. Banks were also required to focus on formalizing and operationalizing their internal Capital Adequacy Assessment Process (CAAP), which would serve as a useful benchmark while undertaking a parallel run beginning April 2006.

- **March:** Draft guidelines on the implementation of the new capital adequacy framework were issued by the RBI for comments on management of operational risk.
- **April:** Banks were advised by the RBI to implement a Business Continuity Plan, including a robust information risk management system within a fixed timeframe.
- **April:** Banks with capital adequacy of 9 percent for both credit risk and market risk for both AFS and HFT may treat the balance in the IFR in excess of 5 percent as part of Tier I capital.
- **April:** A minimum framework was outlined, in respect of disclosures by FIs on their risk exposures in derivatives, to provide a clear picture of their exposure to risks in derivatives, risk management systems, objectives, and policies.
- **May:** Detailed guidelines were issued for merger and amalgamation of private sector banks, laying down the process of merger proposal, determination of swap ratios, disclosures, the stages at which the board will get involved in the merger process, and norms for buying and selling shares by the promoters before and during the process of merger.
- **June:** Banks were advised to have a board-mandated policy in respect of their real estate exposure covering exposure limits, collaterals to be considered, margins to be kept, sanctioning authority and level, and sector to be financed. Banks were directed to report their real estate exposure under certain heads and disclose their gross exposure to the real estate sector and provide details of the breakup in their annual report.
- **July:** The risk weight for credit risk on capital market and commercial real estate exposure increased from 100 percent to 125 percent.
- **July:** Banks were permitted to offer Internet-banking services without the prior approval of the RBI but subject to fulfillment of certain conditions.
- **October:** Banks that have maintained capital of at least 9 percent of the risk-weighted assets for both credit risks and market risks for both AFS and HFT categories as on March 31, 2006, were permitted to treat the entire balance in the IFR as Tier I capital. For this purpose, banks may transfer the entire balance in the IFR below the line in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve, or balance of the Profit and Loss Account.
- **October:** Revised guidance note on management of operational risk issued by the RBI to banks. The design of a risk management framework should be oriented toward a bank’s own requirements, and dictated by the size and complexity of business, risk philosophy, market perception, and the expected level of capital. The risk management systems in the bank should be adaptable to change in business, size, market dynamics, and introduction of innovative products.
• **November:** The general provisioning requirement for standard advances, with the exception of direct advances to agricultural and the small and medium enterprise (SME) sectors, is increased to 0.40 percent from 0.25 percent.

• **November:** With a view toward achieving the objective of greater financial inclusion, all banks were advised to initiate steps within one month, to make available a basic banking no-frills account either with nil or low minimum balances and to report to the RBI on a quarterly basis. Banks were advised to give wide publicity, including on their Web sites, to the facility of such no-frills account, indicating the charges in a transparent manner.

• **November:** Banks were advised to have a well-documented policy and a Fair Practices Code for credit card operations. Guidelines include norms relating to issue of cards; interest rate and other charges; wrongful billing; use of direct selling agents (DSAs), direct marketing agents (DMAs), and other agents; protection of customer rights; right to privacy; customer confidentiality; fair practices in debt collection; redress of grievances; internal control and monitoring system; and right to impose penalty.

2006

• **January:** Banks were advised to augment their capital funds by issue of the following additional instruments:
  - IPDI eligible for inclusion as Tier I capital
  - Debt capital instruments eligible for inclusion as upper Tier II capital
  - Perpetual noncumulative preference shares eligible for inclusion as Tier I capital
  - Redeemable cumulative preference shares eligible for inclusion as Tier II capital

• **February:** The Union Budget, 2006–07, proposed the following measures:
  - Increase in foreign institutional investor (FII) investment limit in government securities to US$2 billion from US$1.75 billion
  - Increase in FII investment limit in corporate debt to US$1.5 billion from US$0.5 billion
  - Increase in ceiling on aggregate investment by mutual funds in overseas instruments to US$2 billion from US$1 billion and removal of requirement of 10 percent reciprocal share holding
  - Limited number of qualified Indian Mutual Funds (MFs) allowed to invest, cumulatively, up to US$1 billion in overseas exchange traded funds
  - Steps to create a single, unified exchange-traded market for corporate bonds
  - An investor protection fund under the aegis of the Securities and Exchange Board of India (SEBI)

• **March:** SEBI amended the SEBI Disclosure and Investment Protection Guidelines, 2000, with respect to rationalization of disclosure requirements, abridged letter of offer, disclosure of issue price, further issue of shares, and lock-in provisions for listed companies making rights or public issue.

• **April:** SEBI amended the SEBI Discloser and Investment Protection Guidelines, 2000, to permit unlisted companies to opt for grading of initial public offerings (IPOs) from credit rating agencies and to ensure disclosure of all grades, including unaccepted grades.
• **May:** The risk weight on exposure of banks to commercial real estate increased to 150 percent from 125 percent. Furthermore, total exposure of banks to venture capital funds will form a part of its capital market exposure and, henceforth, a higher risk weight of 150 percent will be assigned to these exposures.

• **May:** The general provisioning requirement for banks on standard advances in specific sectors (that is, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs 20 lakh, and commercial real estate loans) increased to 1 percent from the present level of 0.40 percent.

• **May:** Banks (excluding Regional Rural Banks [RRBs]) were advised to disclose in the Notes on Account the information providing details of the breakup of provisions and contingencies shown under the head Expenditure in Profit and Loss Account as follows: (1) provisions for depreciation on investment; (2) provision toward nonperforming assets (NPAs); (3) provision toward standard asset; (4) provision made toward income tax; and (5) other provision and contingencies (with details).

**Other Policy Developments**

In February 2005, the RBI laid down a comprehensive policy framework for ownership and governance in private sector banks. The broad principles underlying the framework were to ensure that ultimate ownership and control of commercial banks is well-diversified, key shareholders and directors and CEO pass the “fit-and-proper” test (FPT), and the board observes sound corporate governance principles.

In March 2005, the RBI set up the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS), as a committee of the Central Board of the Reserve Bank. BPSS is the apex body for giving policy direction in the area of payment and settlement systems.

At present, foreign banks operate in India through only one of the three channels: branches, wholly owned subsidiaries (WOS), or a subsidiary with an aggregate foreign investment up to 74 percent. With a view of delineating the direction and pace of the reform process in the area of foreign ownership in domestic banks, in February 2005, the RBI laid down a road map for the presence of foreign banks in India in two phases. During the first phase, covering the period from 2005 to 2009, foreign banks, existing and new, may be permitted to open branches in excess of the World Trade Organization (WTO) commitment of 12 branches in a year. The existing and new foreign banks may choose either the branch or WOS route. The RBI may prescribe market access and national treatment limitation consistent with WTO and international practices. During this phase, permission for acquisition of shareholdings in Indian private sector banks by eligible foreign banks will be limited to banks identified by the RBI for restructuring.

In the second phase, commencing April 2009, RBI will address the issues of removing limitations on the operations of the WOS and according them treatment on par with domestic banks. This phase will begin after reviewing the experience in Phase I and after due consultations with all stakeholders in the banking sector.

The RBI has been issuing instructions and guidance notes on various risks for the benefit of the banks and to sensitize the banks in regard to the growing need for establishing proper risk management systems. RBI issued a set of instructions to banks on June 29, 2005, for risk management of exposures arising from advance against real estate. In terms of these guidelines, banks must have a board-mandated policy in respect of their real estate exposure and the policy must set
limits, establish a risk management system, monitor the exposure to this sensitive sector, and disclose the exposure in their annual report. In November 2005, as a major step toward setting up and operating a national-level payment system, the National Electronic Fund Transfer (NEFT) was operationalized.


The implementation of a Cheque Truncation System (CTS) basis in the national capital region of Delhi was introduced as a pilot project at the end of December 2006. The CTS would be implemented in the rest of the country phase by phase. The Reserve Bank of India Act, 1934, was amended by the Parliament in 2006. This amendment, among other things, has empowered the RBI to determine the Cash Reserve Requirement (CRR) without any ceiling or floor rate.

The RBI had issued draft guidelines on securitizations of standard assets in April 2005. Based on the feedback received from all stakeholders, the final guidelines on securitizations of standard assets were issued on February 1, 2006. The Government Securities Act, 2006, proposes to consolidate and amend the law relating to issuance and management of government securities by the RBI.

The Payments and Settlements Bill, 2006, was introduced in the Lok Sabha on July 25, 2006. The bill seeks to designate the RBI as the authority to regulate payment and settlement systems.

**Nepal**

**Implementation of the New Capital Adequacy Framework (Basel II) in Nepal**

To fall in line with the international best practices and to promote a healthy and sound financial market, Nepal Rastra Bank (NRB) is moving toward the adoption of Basel II. The complexity and sophistication of the Nepalese financial market does not warrant advanced approaches like the IRB Approach or the Standardized Approach. Therefore, NRB intends to start with the Simplified Standardized Approach for credit risk, Basic Indicator Approach for operational risk, and Net Open Exchange Model for market risk.

To facilitate progressing toward implementation of the accord, NRB has set up a “New Capital Accord Implementation Preparatory Committee” and a working-level committee called the Accord Implementation Group (AIG). The AIG consists of officers from the NRB as well as the banking sector. AIG has examined the provisions under Basel II and has conducted a Quantitative Impact Study (QIS) of eight banks based on the assumptions and approach finalized. The impact study indicated a reduction in the risk-weighted exposures in the credit risk of the banks. AIG plans to carry out a second QIS to rationalize the findings. The AIG also prepared a draft capital adequacy framework with detailed guidelines on each of the three pillars, based on the proposed approach, which has been circulated among the stakeholders for review. It is expected that this capital framework will come into effect in 2008.
Prudential Regulations
Prudential guidelines issued by NRB in 2004–05 include the following (2006 guidelines are not available):

2004

• **July:** The rates for refinancing facilities provided by NRB to banks and FIs have been fixed as follows: all previous procedural arrangements relating to refinancing facilities remain unchanged.
  ○ Rate of Refinance provided under Sick Industries Rehabilitation Program: 1.5 percent
  ○ Rate of Refinance to Rural Development Banks and Export Credit and Agriculture Credit in local currency: 3 percent
  ○ All other arrangements except those mentioned in above remain unchanged
  Furthermore, the commercial banks, at the time of making a request for refinancing under the Sick Industries Rehabilitation Program, shall provide certification as to the fulfillment of criteria set by the Sick Industries Rehabilitation Main Committee and the rate of interest charged to the borrower be fixed at 4.5 percent.

• **July:** With reference to loan-loss provision to be created for rescheduled and restructured accounts for 2003–04, banks and financial institutions will have to create a loan-loss provision of 1 percent as applicable to the Pass Loans category on the accounts that are restructured or rescheduled with the recovery of all due interests. But the banks and financial institutions taking advantage of this facility shall not be allowed to distribute dividends to the shareholders from the profits arising out of this waiver.

• **July:** In accordance with the provisions of the Monetary Policy, the rate of cash reserve ratio to be maintained by the banks has been revised to 5 percent for 2004–05. All the procedural aspects per the earlier directive of NRB shall remain in place.

• **July:** The interest rate for the refinance loan to be provided to banks and financial institutions has been revised. The new interest rate for the Sick Industries Rehabilitation Program will be 1.50 percent, while the rate for the refinance loan to be provided to rural development banks and to refinance export and agricultural loans to be provided in local currency shall be 3 percent.

• **July:** The CAR to be maintained by the banks and financial institutions for 2004–05 was 12 percent. Because of the prevailing difficult circumstances, the CAR for 2004–05 has been reduced to 11 percent.

• **July:** Banks and FIs were required to divest their investment in shares of other banks and financial institutions by mid-July 2004. In this regard, the investment in shares that were not divested by mid-July 2004 and whose divestment is not restricted by statute shall require a provision of 100 percent in 2004–05.

• **August:** The earlier provision requiring preapproval from NRB to conduct banking transaction in the public holidays and beyond the normal banking hours has been repealed. The banks can now conduct such kind of banking transactions under pre-intimation to NRB.
2005

- **March:** Banks and FIs have been given the minimum guidelines to be incorporated in the formulation of the loan write-off bylaw of the respective banks. Some of the major guidelines are as follows:
  - Banks should develop criteria to identify the loans that are unrecoverable and should formulate the bylaw for the write-off of these accounts with the approval of the board.
  - Banks may write off loans that fall under the loan-loss category per NRB directives with 100 percent loan-loss provision. However, all loans with past dues of more than five years and with 100 percent provision should be compulsorily written off.
  - The borrower and other related parties to the loan must be included on the blacklist of the Credit Information Center.
  - Banks should maintain separate and updated information in relation to the loans written off.
  - Banks should establish a separate unit for the recovery of written-off loans and should continue their efforts for the recovery of such written-off loans.
  - Banks should disclose the details of the loans written off during the year in its annual accounts. They should also submit the details of such loans to the Bank Supervision Department and Credit Information Center within 15 days from the date of fiscal year-end.

- **April:** The procedure for calculation of the cash reserve ratio as defined by the circular of July 28, 2003, has been amended. The new methodology will be based on seven days a week and the basis will be the average weekly deposit of four weeks before that date. The average weekly deposit and the cash reserve will be calculated as the sum of the deposits of the bank and their balance with NRB for the week (Sunday to Saturday) and divided by the number of days, independently. Banks are now required to submit the required information within a fortnight from the end of the week. All other procedural aspects in relation to CRR calculation and penalties remain the same.

- **May:** In case of restructuring and rescheduling of loans of industries, recommended by the Sick Industries Interim Investigation and Recommendation Committee of the Ministry of Industry, Commerce, and Supply, with the recovery of minimum 12 percent of interest and completion of other formalities, banks will have to create a provision of only 25 percent. But, where the interest recovery has been less than 12 percent, banks will have to create provisions per the existing regulation.

- **May:** Banks should arrange to disclose the permanent account number (PAN) of individuals/firms/companies with registration in the value added tax (VAT), in the credit application.

- **May:** The rate of the refinance for export loans funded in foreign currency was revised to 3.25 percent with effect from May 30, 2005, with all the procedural aspects and the conditions remaining the same.

- **May:** The previous directive on blacklisting issued on June 4, 2004, was retracted and a new one was issued. The directive has made the credit information, in respect of loans and advances above a sum of NRs 2.5 million, mandatory. The new directive is more stringent and makes a distinction between
willful and nonwillful defaulters. This directive includes provisions to blacklist the valuator and to recommend for the action against the Chartered Accountants who certify the false documents of the borrowers. The directive includes provisions to recommend for the seizure of passports of blacklisted borrowers. The new directive covers various areas, including procedures to be followed for inclusion in the blacklist; restrictions on the sanction of loans and facilities; conditions for inclusion in the blacklist; identification of individuals, firms, companies, and other organized institutions qualifying for the blacklist; and conditions in which names can be taken off the blacklist.

- **July:** In the beginning of 2005–06 (Nepali FY 2062–63), all circulars separately issued by NRB for commercial banks, development banks, finance companies and microcredit banks were replaced by a unified directive and were issued by the NRB’s Banks and Financial Regulations Department via Bai. Bi. Ni. Bi. 148/1/2062/63/Dated: 2062.4.3/July 18, 2005. These directives came into effect on July 16, 2005.

- **August:** All finance companies licensed by NRB (C category licensed FIs) may, by obtaining a license from the Public Debt Department of NRB, carry out the function of “buying and selling or accepting the bonds issued by His Majesty’s Government (HMG) or Nepal Rastra Bank.”

- **August:** The bank rate and refinance rate have been fixed as follows: other conditions and procedural arrangements with respect to bank rate and refinance rate facilities to be provided to the bank and FIs by this bank remain unchanged.
  - The existing bank rate of 5.5 percent has been increased to 6 percent
  - The existing refinance rate of 3 percent for export credit and agriculture credit to be availed in local currency has been increased to 3.5 percent
  - Other than the above, all other arrangements remain unchanged

- **August:** The loans provided by any commercial banks, currently under the coordination of the Bank of Kathmandu to the workers going for foreign employment under the HMG Youth Self-Employment and Employment Training Program, as well as the loans extended by any licensed FIs by obtaining loans from the commercial banks for the purpose of providing foreign employment loans, will be considered for inclusion under the Deprived Sector Loans of the respective commercial banks.

- **September:** Additional actions against willful defaulters should be implemented per the provisions of the decision of HMG (Council of Ministers) regarding actions to be initiated against the willful defaulters of banks and FIs.

- **October:** Existing clause 2 of the Consolidated Directives issued by NRB to the banks and FIs concerning the branches and offices is replaced by the following: “The A, B, and C class licensed institutions, fulfilling the minimum paid-up capital as prescribed by Nepal Rastra Bank, shall apply for opening of a branch office within the approved working area with a business plan to Bank and Financial Institutions Regulations Department of NRB.”

**Other Policy Developments**

NRB has continued to review the relevant legislations and regulations in 2005–06 to develop the regulatory framework that meets international standards and
resolves the issues of the banking industry. To improve the financial sector legislative framework, some new acts, namely the Bank and Financial Institution Act, 2006; Insolvency Act, 2006; Secured Transaction Act, 2006; and Company Act, 2006, were enacted. Money Laundering Control and Deposit and Credit Guarantee Acts are to follow.

**Pakistan**

**Implementation of the New Capital Adequacy Framework (Basel II) in Pakistan**

After conducting several Quantity Impact Studies and theoretical as well as empirical studies in consultation with the industry, the State Bank of Pakistan (SBP) issued a road map in March 2005 outlining the implementation process of Basel II. In terms of these guidelines, banks would initially adopt the simplified Standardized Approach and go on a parallel run for one and half years starting from July 2006. In pursuance of the road map, banks submitted their individual plans mentioning the specific approach (Standardized or IRB) they intend to adopt and their internal arrangements for its implementation. The majority of the banks expressed their intention to first adopt a comparatively simple Standardized Approach, keeping in view the requirement of more sophisticated systems for the advanced approaches. Banks that decide to go for the IRB Approach will first have to seek the approval of SBP. A comprehensive review exercise on the part of SBP culminated in a more specific bank-wise internal plan. To streamline the implementation process and to ensure better coordination, each bank nominated its respective coordinators as the head of the group level along with formulation of Basel II units.

Under the Standardized Approach, the capital requirement against credit risk would be determined based on a risk profile assessment by rating agencies recognized by regulators as External Credit Assessment Institutions (ECAIs). To ensure transparency in the recognition process, the eligibility criteria for recognition of ECAIs was devised in consultation with all stakeholders based on broad guidelines described in Basel II. Scrutiny resulted in granting ECAIs status to two rating agencies (The Pakistan Credit Rating Agency [PACRA] and JCR-VIS Credit Rating Co. Ltd.) as both were meeting the minimum requirements laid out in the criteria. The recognition implies that the banks would use ECAI’s risk assessment rating of its portfolio to calculate the capital requirement under Basel II. In this regard, SBP issued detailed Eligibility Criteria for Recognition of ECAIs in July 2005. Banks are required to consider the credit ratings assigned by the SBP-recognized ECAIs only. Mapping of ratings with the appropriate risk weights was finalized in consultation with recognized ECAIs. Detailed instructions for adoption of various approaches to calculate the capital adequacy requirements for credit, market, and operational risk were issued on June 27, 2006. Capital reporting formats under Basel II instructions were prescribed in March 2007. These formats primarily cover capital calculation under Standardized Approaches for credit and market risk and Basic Indicator and Standardized Approaches for operational risk.

The gap between previously adopted disclosure practices and new requirements under the market discipline (Pillar III) of Basel II were identified and detailed requirements for public disclosure were issued in February 2006. These in-
structions provide for the disclosures to be made by the banks under the different approaches of the Basel II that each adopts. A detailed survey to assess the level of preparedness of the banks regarding Basel II implementation was conducted in February 2007. This survey was in identifying and assessing the issues prevalent in the banking industry at large. Implementation of Basel II poses considerable challenges for the banking system in Pakistan. To meet the gigantic task, the banks and SBP are engaged in capacity building in terms of upgrading their IT systems and enhancing expertise of the human resource base. SBP conducted a number of seminars and workshops on new capital accord and risk management techniques for internal and external stakeholders and remained engaged in improving its IT systems to get extensive regulatory reporting in line with the maximum disclosure requirements under Basel II.

SBP envisaged adopting different approaches under Basel II in the following manner:

- Standardized Approach for credit risk and Basic Indicator and Standardized Approach for operational risk from January 1, 2008
- IRB Approach from January 1, 2010, with banks and development finance institutions (DFIs) permitted to implement it sooner if the State Bank approves their internal risk management systems

Banks and DFIs were required to adopt a parallel run of one and a half years for the Standardized Approach starting July 1, 2006, and two years for IRB Approach starting January 1, 2008.

**Prudential Regulations**

Among the prudential guidelines issued by the SBP in 2005–06 are the following.

**2005**

- **January**: Establishment of subsidiaries or brokerage companies by banks and DFIs (BPD Circular 1).
- **March**: Prudential regulations for corporate and commercial banking (BPD Circular 8).
- **March**: Relaxation of the regulatory framework for housing finance (BPD Circular 10).
- **March**: Placement of funds under Fe-25 deposits (BPD Circular 9).
- **April**: Establishment of subsidiaries or brokerage companies by banks and DFIs (BPD Circular 13).
- **April**: Prudential regulations for corporate and commercial banking (BPD Circular 14).
- **April**: Rates of return on deposits (BPD Circular 16).
- **May**: Prudential regulations (BPD Circular 19).
- **July**: Guidelines for infrastructure project financing (BPD Circular 23).
- **September**: Prudential regulations (BPD Circular 25).
- **October**: Classification of dormant or inoperative accounts (BPD Circular 26).
- **October**: Amendment of Regulation M-1 on prudential regulations for corporate and commercial banking (BPD Circular 29).
October: Withdrawal of redundant or old instructions (BPD Circular 28).

October: Prudential regulations for agricultural financing (BPD Circular 27).

November: Guidelines for Higher Education Financing Scheme (BPD Circular 31).

November: Introduction of basic banking account (BPD Circular 30).

2006

January: To encourage transparency and promote consistency in the market-based pricing of loans, Banks and DFIs were directed to use Karachi Inter-bank Offered Rate (KIBOR) as a benchmark for determining the pricing of all rupee corporate and commercial bank lending. It has been observed that some banks are using longer-tenor benchmark rates for shorter-tenor loans. This practice is not correct. It is, therefore, clarified that (1) for fixed-rate time loans, the tenor of the benchmark rate should be the same as the tenor of the fixed loan; (2) for tenors exceeding three years and not covered by KIBOR, banks are advised to use appropriate benchmarks such as secondary market yields on the relevant tenor of Pakistan Investment Bonds; and (3) for floating-rate time loans, the tenor of the benchmark rate should be the same as of repricing tenor set for the floating-rate loan.

May: Banks and DFIs, among other things, were required to classify their existing investment portfolio into HFT, AFS, and Held-to-Maturity categories by September 30, 2004. It has been observed that some of the banks and DFIs have moved their risky portfolio to the Held-to-Maturity category to avoid booking a revaluation deficit and have categorized their good portfolio in the HFT and AFS categories. At the same time, they are using Held-to-Maturity securities to manage liquidity by entering into repossession transactions in the interbank market. To discourage such practices, SBP has decided that the securities classified as Held-to-Maturity by the banks and DFIs should neither be sold nor used for entering into repossession transactions in the interbank market or borrowing under the SBP repossession facility or discount window with effect from July 1, 2006. However, the banks and DFIs are allowed a one-time reclassification of their securities. This process of reclassification should be completed by June 15, 2006. The banks and DFIs shall also ensure that the securities acquired or purchased after June 15, 2006, shall, at the time of their acquisition or purchase, be categorized into any of the three categories and the decision taken to that effect shall be recorded in writing on the investment proposal or deal ticket.

June: SBP has reviewed the Prudential Regulation R-4 for Corporate and Commercial Banking on Clean Exposure that requires the banks and DFIs to ensure that aggregate exposure against all their clean facilities shall not, at any point in time, exceed the amount of their equity. It has been decided to set higher limits for assuming unsecured exposure on a case-by-case basis, taking into account the following factors:

- Capital adequacy, Asset quality, Management quality, Earnings, and Liquidity (CAMEL) rating of the bank or DFI
- Quality of unsecured portfolio in terms of percentage of classified advances and write-offs and charge-offs
Past track record of dealing in the relevant clean products. The banks/DFIs that wish to take clean exposure in excess of their equity level will be required to obtain prior approval from SBP, and their requests will be processed in light of the above criteria. All other instructions on the subject will, however, remain unchanged.

- **June:** To facilitate the downscaling financial services of the commercial banks, SBP has prepared guidelines for them to provide microfinance services under four different modes, which include the following:
  - Establishment of microfinance counters in the existing branches
  - Designating stand alone microfinance branches
  - Establishing independent microfinance subsidiary
  - Developing linkages with microfinance banks and nongovernmental organizations and microfinance institutions (NGO/MFIs).

The microfinance operations of commercial banks under Modes I, II, and IV will be subject to Prudential Regulations issued separately under the Banking Companies Ordinance of 1962 (BCO) for commercial banks undertaking microfinance. Microfinance operations under Mode III will be governed under MFIs Ordinance 2001 and Prudential Regulations applicable on microfinance banks.

- **July:** SBP has made the following amendments and additions, in public interest, in the Prudential Regulations for Corporate and Commercial Banking with immediate effect to ensure compliance with Financial Action Task Force recommendations on anti-money laundering, safeguard the interest of depositors from risks arising out of money laundering, and to reinforce the measures being taken by the banks and DFIs for proper management of their institutions:
  - KYC
  - Anti-money laundering measures
  - Suspicious transactions

- **July:** To create awareness and to facilitate the public in making informed decisions, the SBP has decided that, henceforth, banks and DFIs shall make complete disclosure of the lending and deposit rates of all consumer products offered by them by posting this information on their Web site as well as prominently displaying on entrances or window of their branches. Banks and DFIs would also disclose annualized percentage rates on all consumer products. In case of deposits, the expected rate of return under the profit and loss sharing (PLS) system will be clearly indicated for each tenure. For lending products, banks and DFIs shall clearly indicate whether the rate is fixed or floating. In case of floating rate, in addition to mentioning the existing rate, the information regarding the tenure of the benchmark (KIBOR or any other rate plus a predefined spread) used and periodicity of repricing should be disclosed. The banks and DFIs, in addition to the above, will take adequate measures to inform their customers about the intricacies of automated teller machines (ATMs), credit cards, and their charges as well as cardholder obligations.

- **July:** In terms of Section 31 of the BCO all banks and DFIs in Pakistan are required to surrender to SBP all those deposits that have not been operated during the last 10 years, except deposits in the name of a minor or a government
or a court of law. To facilitate banks and DFIs, instructions on the following subjects issued since 1968 to date have been reviewed and consolidated:

- Definition of unclaimed deposits and instruments
- Reporting of unclaimed deposits and instruments
- Surrender of unclaimed deposits
- Notice to the holder of unclaimed deposits and instruments
- Preservation of documents
- Information in account opening form (AOF)
- Procedure for refund of unclaimed deposit surrendered to SBP

- **August**: Banks are required to cap their investment in shares at 20 percent of their equity except strategic investment. Strategic investment was defined as “an investment which a bank/DFI makes with the intention to hold it for a longer term of duration and should be marked as such at the time of investment and can only be disposed of with the prior approval of State Bank of Pakistan” (as per BPD circular dated August 1, 2006, State Bank of Pakistan).

### Other Policy Developments

In April 2005, the Shariah Board of the SBP approved and incorporated some of the suggestions given by different stakeholders in the Essentials of Islamic Modes of Financing to ensure compliance with minimum Shariah standards by banks conducting Islamic banking in Pakistan. These essentials are issued as General Guidelines to be followed by banking institutions conducting Islamic banking in the country (see the SBP Web site at www.sbp.org.pk/).

To provide regulatory framework for payment systems and electronic fund transfers, the Payment Systems and Electronic Fund Transfers Act was enacted in 2007.

### Sri Lanka

**Implementation of the New Capital Adequacy Framework (Basel II) in Sri Lanka**

In January 2008, the Central Bank of Sri Lanka (CBSL) joined the global trend by implementing the Basel II framework in Sri Lanka. A consultative paper was released to banks providing guidelines on the major areas of the framework in June 2007. These new guidelines replaced the guidelines issued in 2006 on the parallel computation of capital adequacy. The impact of Basel II on the banks’ capital was monitored based on the results from the parallel computation of capital adequacy under the new guidelines since June 2007. The Capital Adequacy Computation under Basel I was the effective statutory capital ratio during this period of parallel runs. CBSL has directed that initially, during this period, the CAR under Basel II should be computed on a bank-only (solo) basis. Incorporating the feedback received from the stakeholders on the consultative paper, the Directions on Basel II were issued in December 2007 to banks for implementation of Basel II from January 2008. Accordingly, banks are required to apply the Standardized Approach for credit risk, the Standardized Measurement Method for market risk, and the Basic Indicator Approach for operational risk in computing the capital requirement. The Directions issued contains four parts—that is, the direction, the guide-
Prudential Regulations
Among the prudential guidelines issued by the SBCL in 2005–06 are the following.

**2005**
- **January:** Licensed specialized banks: deposit direction (amendment).
- **February:** Direction under section 46 (1) of the Banking (Amendment) Act.
- **February:** Order published under section 47 (4) of the Banking Act.
- **February:** Security to be obtained for an accommodation granted to a director.
- **February:** Banking (Amendment) Act: Issue of directions, and so on.
- **February:** Public disclosure by publication of bank accounts in the press.
- **February:** Submission of the monthly and quarterly compliance reports.
- **March:** Banking Act (Single-Borrower Limit) Direction No. 2 of 2005.
- **March:** Accommodation to directors and related companies.
- **March:** Affidavit to be submitted under section 42 (2) of the Banking Act.
- **March:** Appointment of directors of banks (amendment).
- **March:** Declaration to be submitted by person proposed as a director.
- **April:** Enhancement of minimum capital requirement for banks (licensed commercial banks).
- **April:** Enhancement of minimum capital requirement for banks (licensed specialized banks).
- **May:** Introduction of products based on Islamic principles.
- **July:** Request to maintain capital in foreign currency.
- **August:** Annual license fee for licensed specialized banks.
- **August:** SBL Direction No. 4 of 2005.
- **August:** Request to maintain capital of banks in foreign currency.
- **September:** Publication of quarterly financial statements of banks in the press.
- **September:** Imposing a Default Charge on Failure to Maintain Adequate Funds in RTGS (real-time gross settlement) Settlement Accounts for Settlement of Net Clearing Obligations of Licensed Commercial Bank.
- **October:** Banking Act: SBL.

**2006**
- **January:** Publication of Quarterly Financial Statements of Banks in the Press.
- **February:** Submission of Audited Financial Statements by Banks.
- **February:** Publication of Audited Financial Statements of Banks in the Press.
- **March:** Reporting of Post-Tsunami Remittances received through NGOs and non-NGOs to the Central Bank of Sri Lanka.
- **March:** Inadequate and Incorrect Disclosures and Press Statements by banks.
- **March:** Banking Act—Direction on the Prudential Norms for Classification, Valuation, and Operation of the Bank’s Investment Portfolio.
- **March:** Banking Act—Determination on the Computation of a Capital Charge for Market Risk.
• **March:** Parallel Computation of Basel I and Basel II.
• **March:** Reversal of unearned income and classification of advances as nonperforming.
• **March:** Guidelines on Business Continuity Planning.
• **May:** Implementation of the Provisions of Part IX (Sections 72 to 76) of the Banking Act on Abandoned Property.
• **May:** Classification of Banking Outlets.
• **May:** Conduct of NGO Accounts by Licensed Banks.
• **May:** Amendment to LankaSettle System Rules: August 2003 (as amended) Daily Operating Schedule of the LankaSettle System.
• **May:** General Direction—Payment and Settlement Systems Act No. 28 of 2005.
• **June:** Draft Guidelines on the Computation of the Capital Ratio under Basel II.
• **June:** Prevention of Frauds using Electronic Cards.
• **June:** Conduct of NGO Accounts by Licensed Banks (second Direction is issued).
• **June:** Payment of Taxes by the Banking and Financial Sector.
• **June:** SBL—Compliance with the Aggregate Exposure Limit.
• **August:** SBL Direction No. 2 of 2005 as amended by Direction No. 4 of 2005 (for Licensed Commercial Banks incorporated outside Sri Lanka).
• **November:** Banking Act—Amendments to the Direction on Maintenance of the CAR.
• **November:** Banking Act—Amendment to the Determination and Notice on Maintenance of the CAR.
• **December:** Banking Act—Amendments to the Direction on Requirement to Maintain a General Provision for Advances.
• **December:** Minimum Capital Requirement of Licensed Commercial Banks.
• **December:** Standard Times for Settlement of Inter-participant Transactions in the LankaSettle System.

**Other Policy Developments**

In 2005, the Payment and Settlement Systems Act No. 28 of 2005 was enacted to provide for the regulation of payment, clearing, and settlement systems; for the disposition of securities in the books of the Central Bank; for the regulation of providers of money services; and for the electronic presentment of checks.

In addition to the Convention on the Suppression of the Financing of Terrorism Act, enacted in September 2005, two laws were passed in early 2006 to deal with prevention of money laundering.

The Prevention of Money Laundering Act (PMLA) introduced the offense of money laundering to the laws of the country, but the Financial Transactions Reporting Act (FTRA) provides for the mechanism to monitor and report financial transactions to ensure that the offenses of terrorist financing and money laundering are dealt with strongly.

To give effect to the FTRA, a Financial Intelligence Unit was established in March 2006 in the CBSL and is now fully functional.
In March 2006, CBSL formed the National Payments Council (NPC), the highest decision-making body of the country with regard to the Payment Settlement Systems (PSS) in Sri Lanka (including representatives of all major stakeholders). The CBSL has prepared a PSS policy in consultation with the NPC. The proposed policy, which is planned for the next four-year period (2007–10), provides a framework to mitigate risks and increase efficiency, as well as a road map with measurable action points.

During the first half of 2006, provisions of the Banking Act, No. 30 of 1988, were amended to address several deficiencies in the act.

In March 2006, the Parliament passed the Monetary Law (Amendment) Act, No. 6 of 2006, thus strengthening the powers of the Monetary Board in relation to credit operations of the commercial banks and specialized banks.

With a view to deterring illegal and hazardous practices relating to payment devices, the Payment Devices Frauds Act (No. 30 of 2006) was enacted by the Parliament in September 2006. This act prohibits fraudulent and unauthorized production, trafficking, possession, and use of payment devices.

In August 2007, the Central Bank released the exposure draft on corporate governance for banks soliciting the views, comments, and suggestions from the stakeholders of banks and the general public. Based on these suggestions, comprehensive corporate governance rules have been issued with effect from January 1, 2008.

In December 2007, CBSL issued directions with regard to board committees, independent directors, roles and responsibilities of the board, and so on. A few of the major points relevant to comments made in the report are summarized below:

- **Board Committees**: Each bank should have at least four board committees, that is, audit, human resources and remuneration, nomination, and integrated risk management committees. The board shall present a report of the performance on each committee, as well as on their duties and roles, at the annual general meeting.

- **Internal Audit Committee**: Each bank should have an internal audit committee with broad responsibilities for (1) the appointment of the external auditor for audit services to be provided in compliance with the relevant statutes; (2) the implementation of the Central Bank guidelines issued to auditors from time to time; (3) the application of the relevant accounting standards; and (4) the service period, audit fee, and any resignation or dismissal of the auditor, provided that the engagement of the audit partner shall not exceed five years and that the particular audit partner is not reengaged for the audit before the expiry of three years from the date of the completion of the previous term.

- **Board Composition**: The number of directors on the board shall not be fewer than 7 and not more than 13. The period of service of a director is 9 years and the maximum age is 70 years. The number of executive directors shall not exceed one-third of the number of directors of the board. The board shall have at least three independent nonexecutive directors or one-third of the total number of directors, whichever is higher. Detailed criteria have been set to determine the independence of a director.

Sources: Information available from the regulatory authorities of the five countries and their official Web sites; Indian Banks’ Association 2006a, 2006b, and 2006c; and Reserve Bank of India 2006a, 2006b, 2006c, and 2007.
International Best Practices in Corporate Governance

Organisation for Economic Co-operation and Development

Corporate governance refers to the structures and processes for the direction and control of companies. It is concerned with the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

The Organisation for Economic Co-operation and Development Principles of Corporate Governance (OECD 2004) provides the framework for the work of the World Bank Group in this area and identifies the key practical issues: the rights and equitable treatment of shareholders and other financial stakeholders, the role of nonfinancial stakeholders, disclosure and transparency, and the responsibilities of the board of directors (World Bank 2003). The good governance practices outlined by the OECD also serve as the basis for the questionnaire developed to assess the corporate governance of South Asian countries in this report (see table 9.1).

Basel Committee on Banking Supervision

In February 2006, the Basel Committee on Banking Supervision issued eight principles-based corporate governance schemes to enhance corporate governance for banking organizations, indicating the need for the adoption of corporate governance principles in banks.
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Table 9.3 South Asia Corporate Governance Status, 2006

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<th>Country</th>
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<tr>
<td>Bangladesh</td>
<td>Bangladesh Bank has issued guidelines for banks. However, these guidelines are still at the development stage, with room for improvement. In particular, the guidelines need to be augmented by legal provisions governing beneficial ownership, minority shareholders’ rights, remuneration of directors, and roles and responsibilities of external and internal auditors. Bangladesh also needs to work toward full conformity with international accounting and auditing standards.</td>
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<td>India</td>
<td>Reserve Bank of India has issued guidelines that are both comprehensive and commendable. Yet several areas need further review, the main one being the harmonization needed on the governance rules applicable to government-controlled banks and those applicable to private banks. Minority shareholders’ rights also should be revisited.</td>
</tr>
<tr>
<td>Nepal</td>
<td>Nepal Rastra Bank has issued detailed guidelines on corporate governance for banks. They need to broaden these guidelines, however, to include investor rights and disclosure rights, beneficial ownership, and the responsibilities of the auditors. A key improvement would be better adherence to international accounting and auditing standards.</td>
</tr>
<tr>
<td>Pakistan</td>
<td>The State Bank of Pakistan has issued a comprehensive handbook of corporate governance for banks. In addition, in late 2005 Pakistan established the Pakistan Institute of Corporate Governance to further strengthen the corporate governance culture by providing training and awareness. Still, some areas need review, including further disclosures on beneficial ownership, safeguards on stakeholders’ rights, transfer of ownership and management, and competitive compensation packages.</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>The Central Bank of Sri Lanka has issued a code of corporate governance for banks and other financial institutions. Yet disclosure requirements and detailed guidelines are needed on many issues, such as stakeholder rights, beneficial ownership, special voting rights, rights of shareholders to vote on bank operations, regulatory and government control of share transactions, and minority shareholder rights. In August 2007, the Central Bank released the exposure draft on corporate governance for banks soliciting the views, comments, and suggestions from the stakeholders of banks and the public. The implementation of the code is scheduled for January 2008.</td>
</tr>
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</table>

Source: Corporate governance responses received from the supervisory authorities; Indian Banks’ Association 2006a, 2006b, and 2006c; Reserve Bank of India 2006a, 2006b, 2006c, and 2007.