ASIAN INFRASTRUCTURE INVESTMENT BANK

PD 000415-BGD
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Project Document
of the Asian Infrastructure Investment Bank

Sovereign-backed Financings

People's Republic of Bangladesh
COVID-19 Emergency and Crisis Response Facility Project
(Under the Covid-19 Crisis Recovery Facility)

Currency Equivalents
(May 23, 2020)

Currency Unit – Bangladesh Taka (BDT)
BDT 1.00 = USD 0.012
USD 1.00 = BDT 85.03

Borrower's Fiscal year
July 1 – June 30

Abbreviations

AIIB	Asian Infrastructure Investment Bank
BB	Bangladesh Bank
BDT	Bangladesh Taka
CAMELS	capital adequacy, asset quality, management, earnings, liquidity and sensitivity
CMSME	cottage, micro, small and medium-sized enterprise
COVID-19	coronavirus disease 2019
CRF	COVID-19 Recovery Facility
DFI	Development Finance Institution
ES	Environmental and Social
ESDD	Environmental and Social Due Diligence
ESEL	Environmental and Social Exclusion List
ESP	Environmental and Social Policy
ESRM	Environmental and Social Risk Management
ESS	Environmental and Social Standards
FI	financial institution
GDP	gross domestic product
GRM	Grievance Redress Mechanism
IPFF	Investment Promotion and Financing Facility Project
MSME	micro, small and medium-sized enterprises
NBFI	nonbank financial institution
NPL	nonperforming loan
OM	operations manual
PCB	private sector bank
PD	project document
PFI	participating financial institutions
PIU	project implementation unit
PSC	Project Steering Committee
PPE	personal protection equipment
PPM	Project-Affected People's Mechanism
RMG	readymade garment
SCB	state-owned bank
SME	small and medium-sized enterprise
SMESPD	SME & Special Programmes Department of Bangladesh Bank

CONTENTS

1. Summary Sheet
The People's Republic of Bangladesh
COVID-19 Emergency and Crisis Response Facility Project

Project No.	PD000415-BGD
Borrower	The People's Republic of Bangladesh
Project Implementing Entity	Bangladesh Bank (BB), the central bank of Bangladesh
Sector/Subsector	Finance/Intermediary financing
Project Objective	To support credit expansion and reduce liquidity constraints brought on by the COVID-19 pandemic to CMSMEs in Bangladesh on a sound macroeconomic basis
Project Description	The project will be supported by a sovereign-backed loan to the People's Republic of Bangladesh (the borrower). The Ministry of Finance (MOF) will be the Executing Agency acting on behalf of the Government of Bangladesh. The MOF will then on-lend the loan proceeds to BB (Subsidiary Loan). The loan proceeds will help diversify and bolster BB reserves and support the expansion of domestic credit through participating financial institutions (PFIs) including banks and nonbank financial institutions on a sound basis. BB will provide loans to PFIs (Refinancing Loans) as refinance against the loans (sub-loans) disbursed to Cottage, Micro, Small & Medium Enterprises (CMSMEs) (Sub-borrowers). The sub-loans will be used for working capital financing comprising employee wages, inventory, payments on short-term debt and other day-to-day operating expenses. This project will be processed under AIIB's COVID-19 Crisis Recovery Facility.[1]
Implementation Period	Start Date: February 2021 End Date: February 2024 (may be extended for an additional year)
Expected Loan Closing Date	February 2024
Cost and Financing Plan	Project cost: USD300 million; AIIB loan: USD300 million
Size and Terms of AIIB Loan	USD300 million The loan will have a final maturity of eight years, including a grace period of three years, and will be made on standard Fixed Spread Loan terms for sovereign-backed loans, with the corresponding average maturity.
Cofinancing (Size and Terms)	N/A
Environmental and Social Category	FI
Risk (Low/Medium/High)	Medium
Conditions of Effectiveness	• Execution and effectiveness of agreement between the borrower and BB for the Subsidiary Loan

[1] The facility was approved by AIIB's Board on April 16, 2020. https://www.aiib.org/en/_common/_download/Decisions-to-Support-the-AIIB-COVID-19-Crisis-Recovery-Facility.pdf

	• Acceptable legal opinions for the Loan Agreement, Project Agreement and Subsidiary Loan Agreement • Adoption of operations manual satisfactory to AIIB, by BB
Key Covenants	• BB to carry out the project following the operations manual • The aggregate amount of lending from BB to the state-owned banks should not be more than USD30 million • The Government of Bangladesh to establish/maintain a Steering Committee chaired by Secretary, Finance Division to provide strategic oversight and policy direction to BB • AIIB's prior approval before making any material amendment to the "Guidelines on Environmental & Social Risk Management for Banks and Financial Institutions in Bangladesh"
Retroactive Financing (Loan % and dates)	The borrower may finance eligible sub-loans disbursed by PFIs from April 26, 2020, the date BB's Refinance Scheme was announced, until the date of signing of the Loan Agreement up to an aggregate maximum of 20 percent of the loan amount
Policy Assurance	The Vice President, Policy and Strategy, confirms that AIIB is in compliance with the policies applicable to the Projects.

President	Jin Liqun
Vice President	D.J. Pandian
Director General	Dongik Lee
Acting Manager	Asim Rana, Principal Investment Officer, Digital Infrastructure & Industry
Team Leader	Neeraj Jain, Senior Investment Officer, Financial Institutions & Syndication
Team Members	Aalok Pandey, Economic Associate Abhijit Sen Gupta, Senior Economist Christopher Damandl, Senior Legal Consultant Danni Li, Investment Associate Giacomo Ottolini, Procurement Specialist Shonell Robinson, supported by Pradeep Kumar, FM Specialist Somnath Basu, Principal Social Development Specialist Zhixi Zhu, Environment Specialist

2. Project Description

A. Project Fit Under the COVID-19 Recovery Facility.

1. **Background.** The coronavirus disease (COVID-19) continues to have a major impact on Bangladesh's economy and the country's small and medium-sized enterprise (SME) sector. Bangladesh has around eight million micro, small and medium-sized enterprises (MSMEs). MSMEs contribute around 20 percent-25 percent of the gross domestic product (GDP)[2] and are an important source of economic growth and employment. Yet this group is not only hard-hit by the COVID-19 pandemic, but also often struggles to access bank loans as banks typically consider SME loans riskier and more expensive to administer. A study by the World Bank shows an estimated financing gap of BDT237 billion (USD2.8 billion) for MSMEs in Bangladesh, and only 27.5 percent of small firms have bank loans/line of credit, compared to 44 percent of large firms in Bangladesh and 30 percent observed in the South Asia region.[3] The project seeks to address this issue by supporting credit expansion and liquidity to the financial industry while ensuring economic stability in Bangladesh so that SMEs and cottages industries have more access to much-needed financing during COVID-19.

2. **Country Context.** Bangladesh is rated BB- and Ba3 by S&P and Moody's. Bangladesh is one of the most densely populated countries[4] in the world (1,130 persons per square kilometer), with a population of about 164.7 million over an area of 144,415 square kilometers. Bangladesh has recorded impressive economic performance in recent years, growing at an average rate of over 7.5 percent between FY2016 and FY2019, with stable inflation and low levels of public debt and current account deficit. Aided by rapid growth and moderate deficits, Bangladesh has been identified as having a low risk of debt distress in IMF's 2019 Article IV Consultation Report and reiterated in the recent IMF-RCF assessment, with various debt indicators below their threshold (refer to Annex 3 for debt sustainability analysis). Rapid growth over the last decade has enabled Bangladesh to transition to a lower middle-income country status in 2015 and fulfill all the eligibility criteria for graduation from the UN's Least Developed Countries list in 2018 and is on track for graduation from the Least Developed Countries category in 2024. Higher growth was associated with improved livelihoods with the percentage of the population living in poverty declining from 24.3 percent in 2016 to 21.8 percent in 2018.[5] Moreover, the proportion of the employed population with daily income below USD1.90 (purchasing power parity) dropped from 14.8 percent in 2016 to 9.2 percent in 2019. The country's recent economic performance and the macroeconomic outlook is presented in Annex 2.

3. **COVID-19 in the Country.** Bangladesh is extremely vulnerable to the COVID-19 pandemic given that (1) it has one of the highest population densities in the world; (2) a significant proportion of households are still living in poverty, with a higher share of households living in slums; and (3) more than 80 percent of the population is employed in the informal sector. All of these make it difficult and expensive to maintain social distancing measures to contain the spread of the virus. At the same time, the health infrastructure in Bangladesh is underfunded as it has the lowest current health expenditure as a percentage of GDP among its South Asian peers.

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[2] World Bank. 2019. Financing Solutions for Micro, Small and Medium Enterprises in Bangladesh. World bank. Washington, DC.

[3] World Bank. 2019. Financing Solutions for Micro, Small and Medium Enterprises in Bangladesh. World Bank. Washington, DC.

[4] The fiscal year in Bangladesh starts on July 1 and ends on June.30. FY2019 refers to the fiscal year beginning July 1, 2018 and ending June 30, 2019.

[5] ADB. Poverty Data, Bangladesh. Asian Development Bank. https://www.adb.org/countries/bangladesh/poverty

4. The first imported case was identified on March 8, 2020 and the numbers of COVID-19 cases in the country have been increasing at a significant rate, with the total number of cases crossing 400,000 on Oct. 27, 2020. To protect the population, the government declared "lockdown" throughout the nation from March 23 to May 30. Bangladesh is the second most affected country in South Asia after India.

5. The COVID-19 pandemic has impacted Bangladesh through multiple channels and its impact is likely to last well beyond the immediate pandemic. The IMF projects that the country's GDP growth rate will fall from 8.2 percent in FY2019 to 3.8 percent in FY2020.[6] This would be lower than the five percent growth at the height of the global financial crisis in 2009. The manufacturing, servicing and trade sectors which together account for around 75 percent of GDP in FY2019[7] is hard-hit by the pandemic due to the mandated national lockdown, extended closure of business establishments and other social distancing measures. The readymade garment (RMG) sector is particularly badly impacted. According to Bangladesh Garment Manufacturers and Exporters Association (BGMEA), international buyers have either canceled or suspended USD3.16 billion worth of shipments involving 1,142 factories affecting 2.28 million workers as of April 29, 2020.[8] The garment sector employs mostly women and thus, the situation will drive more women out of the labor force.

6. The decline in economic activity will cause a substantial reduction in employment opportunities with the Asian Development Bank (ADB) estimating that a serious outbreak would result in job losses ranging between 1.4 to 3.7 million and deepen poverty.[9] Around 25 percent of households living in poverty are employed in informal activities in nonfarm service and construction sectors, which have been substantially impacted by closures.[10] Similarly, 25 percent of households engaged in the manufacturing sector fall below the poverty line. Preliminary research indicates that the poverty rate could double to more than 40 percent during this pandemic. These levels were last seen in 2005, thereby overturning decades of poverty reduction.[11] Details of the impact of the pandemic on exports, remittance, domestic consumption, employment and livelihoods and fiscal position are presented in Annex 3.

7. **Impact of COVID-19 Pandemic on SMEs:** The SME sector forms the lifeline of the Bangladesh economy, accounting for 25 percent of the country's GDP and 70 percent to 80 percent of jobs created in the nonagricultural sector. However, this sector has the potential to contribute more as currently its share in total output lags many other Asian economies like Indonesia (59 percent), Cambodia (58 percent), Sri Lanka (59 percent), Vietnam (40 percent) and India (29 percent).[12] The SME sector's performance in Bangladesh has been greatly constrained by a dearth of avenues for marketing of products and underdeveloped sales channels, limited access to finance due to a low level of financial inclusion, lack of capital and

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[6] IMF. Bangladesh: Requests for Disbursement under the Rapid Credit Facility and Purchase under the Rapid Financing Instrument. In terms of calendar year, the growth in 2020 is estimated to be two percent, a drop of six percentage points from 2019. https://www.imf.org/en/Publications/CR/Issues/2020/06/03/Bangladesh-Requests-for-Disbursement-under-the-Rapid-Credit-Facility-and-Purchase-under-the-49483

[7] Bangladesh Bureau of Statistics.

[8] BGMEA. https://www.bgmea.com.bd/

[9] ADB. The Economic Impact of the COVID-19 Outbreak on Developing Asia. ADB Briefs No. 128. https://www.adb.org/sites/default/files/publication/571536/adb-brief-128-economic-impact-covid19-developing-asia.pdf

[10] World Bank. South Asia Economic Focus. World Bank. https://openknowledge.worldbank.org/handle/10986/11978

[11] SANEM Netizen Forum on COVID-19 Pandemic – Episode 5, South Asian Network on Economic Modelling. SANEM Netizen Forum. http://sanemnet.org/sanem-netizen-forum-on-covid-19-pandemic-episode-5/

[12] Light Castle. 2020. COVID-19 Series Impact on Bangladesh's SME Landscape. Light Castle. https://www.lightcastlebd.com/wp-content/uploads/2020/05/SME_WhitePaper.pdf

skilled manpower and poor training facility. Many of these constraints have been amplified due to the COVID-19 pandemic and the subsequent introduction of social distancing measures. SMEs have been confronting diverse challenges including supply chain disruption, reduced domestic and foreign demand, changing purchasing priorities of consumers and lack of available workers due to the lockdown.

8. A recent survey[13] covering 230 SMEs highlighted that more than 50 percent of the respondents had to shut down their businesses completely due to the unavailability of raw materials and lack of scope to sell their products. Another 28 percent of the respondents reported a more than 50-percent decline in revenues. The decline in businesses had a significantly adverse impact on the cash reserves and even after large cuts in marketing, salary, operational and production expenses, more than two-thirds of the SMEs are expected to exhaust their cash reserve and permanently shut down the business if the lockdown extends beyond four months. Nearly half of the SMEs are anticipating laying off more than 50 percent of their workers if the lockdown persists for more than four months while another 28 percent are expecting 10 percent to 50 percent of employees being laid off in a bid to cut costs.

9. The key to keeping the SMEs afloat and alive during the current crisis is the availability of financing schemes and the rescheduling of existing loans. Even before the COVID-19 pandemic, access to capital remained a major bottleneck as SMEs found it difficult to get loans without having good credit history and personal connection with the banks. The same survey indicated that more than half of the respondents have identified concessional loan as their biggest need to survive the current pandemic induced crisis. The other demands include funding for working capital, the extension of loan duration and greater installment flexibility. Access to concessional financing will keep the SMEs afloat by allowing them to (a) payback existing dues, (b) purchase new inventory and raw material vital for restarting the production process, (c) inject funds to restart operational activities and (d) have funds to pay salaries of employees and thereby minimize retrenchment and protect livelihoods. New cashflow into the enterprises is likely to have a multiplier effect and benefit various participants in the SME ecosystem.[14] Several other countries have resorted to soft loans, interest support and subsidies, grants and allowance to support the SME sector.[15]

10. Over the last 10 years, the focus on SME lending has been spearheaded by the Bangladesh Bank (BB), the country's central bank. BB has established an SME & Special Programmes Department (SMESPD) on Dec. 3, 2009 dedicated to the cottage, micro, small and medium-sized enterprise (CMSME) development in Bangladesh. Under the BB's policy guidance, all banks and nonbank financial institutions (NBFIs) licensed and supervised by BB have to devise a yearly target of credit disbursements to SMEs. The performance in achieving these targets is considered while licensing branches of each bank and nonbank financial institution (NBFI). Recently, BB has also given significant weight to the performance of targets and achievements (including women entrepreneurs' financing) in determining the CAMELS rating[16] of banks. As a result of BB's initiative, the amount of MSME credit has increased year-on-year and the share of MSME credit to total loan advances in the banking system has increased from 17 percent in 2011 to 21 percent in 2019. In December 2019, all banks and NBFIs have disbursed BDT1.68 trillion (~USD20 billion) against 774,122 CMSMEs. 56,706 women-led CMSME enterprises received financing of BDT61.8 billion (~USD0.75 billion) in

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[13] Light Castle. COVID-19 Series Impact on Bangladesh's SME Landscape. 2020. https://www.lightcastlebd.com/wp-content/uploads/2020/05/SME_WhitePaper.pdf

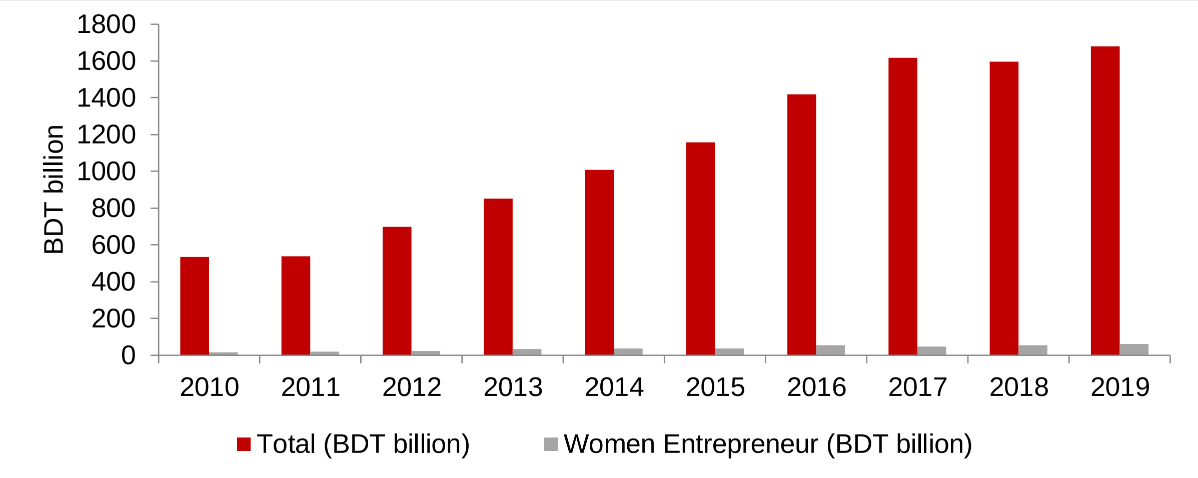
[14] Light Castle. COVID-19 Series Impact on Bangladesh's SME Landscape. 2020. https://www.lightcastlebd.com/wp-content/uploads/2020/05/SME_WhitePaper.pdf

[15] IMF Policy Tracker. IMF. 2020. https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19

[16] Capital adequacy, asset quality, management, earnings, liquidity and sensitivity (CAMELS) is an international rating system used by regulatory banking authorities to rate financial institutions.

2019 from banks and NBFIs. Table 1 shows credit disbursement to CMSMEs by banks/NBFIs including women-led enterprises.

Table 1. Disbursement of CMSME Credit by Banks/NBFIs (BDT billion)



Source: Bangladesh Bank.

11. Private commercial banks account for the majority (76 percent) of total outstanding MSME loans followed by public commercial banks (18 percent) as of June 2019. Table 2 shows the share of SME loans by different categories of banks/NBFIs and the percentage of MSME loans in their portfolio.

Table 2. Share of SME Loans and Percentage of MSME loans in Total Portfolio (as of December 2019)

	Share of SME Loans, %	**Percentage of MSME Loans in total portfolio, %**
Public Commercial Banks	16.99	20.20
Public Specialized Banks	0.78	6.43
Foreign Banks	0.96	5.79
Private Commercial Banks	76.66	21.52
NBFIs	4.61	18.78
Total	**100**	**20.26**

Source: Bangladesh Bank.

12. Due to the large demand for SME financing, BB also initiated refinance schemes that aim to provide liquidity support to banks and NBFIs against their disbursed credit to SMEs. BB, through its SMESPD, and with the help of government and different development partners such as ADB and JICA is implementing a total of six refinance schemes for banks and NBFIs currently against their disbursed CMSME credit. All these funds are revolving in nature. In addition to those, three other refinance schemes have been completed. A total of BDT82.79 billion (~USD1 billion) has been provided to different banks and NBFIs under different refinance schemes up to June 2019 against 60,181 enterprises. Out of the total refinance, 43 percent as a medium-term loan, 29 percent as a long-term loan and 28 percent as a working capital loan has been provided.

13. **Government Responses.** The Government of Bangladesh has launched a broad-based stimulus program to support enterprises and workers to address the effects of the pandemic, funded by government budget and external financing. The stimulus packages declared so far now stands at around USD13.25 billion, which is 4.01 percent of GDP (refer to Annex 4 for list of fiscal packages). The stimulus package includes (1) a special fund for salary support to export-oriented manufacturing industry workers to prevent job losses, (2) provision of working capital through the banking system to protect the affected industries and

services sector including SMEs and cottage industries (at a subsidized rate of interest), (3) expansion of a financing facility provided through export development fund (EDF), (4) preshipment credit refinance scheme, (5) expansion of old age and widow allowance programs, (6) cash transfers to targeted poor people, (7) free food distribution, (8) open market sales, (9) special honorarium for doctors, nurses and medical workers, (10) support to farm mechanism and additional procurement paddy/rice, (11) agriculture refinance scheme, (12) Credit Risk Sharing Scheme for CMSME sector, and (13) a new social protection program (cash transfer) for the destitute workers of the export-oriented readymade garment and leather sector workers.

14. The Government of Bangladesh announced a BDT200 billion (~USD2.4 billion) stimulus package for CMSMEs on April 13, 2020, where participating financial institutions (PFIs) will provide working capital loans from their funds to COVID-19 affected CMSMEs (SMESPD Circular-1 dated April 13, 2020). The interest rate of these loans is nine percent per annum, four percent of which will be paid by the client(s) and the rest five percent will be given by the government directly to the banks/NBFIs as subsidy.

15. BB further formed a Revolving Refinancing Scheme (Refinance Scheme) amounting to BDT100 billion (~USD1.2 billion) from its resources, to provide liquidity support to PFIs and assist them in their working capital financing under the government's stimulus package. Under the Refinance Scheme, BB will refinance up to 50 percent of loans disbursed by PFIs to CMSMEs (SMESPD Circular-2 dated 26 April 2020).

16. **Central Bank Responses.** BB took various steps to keep credit from freezing. Before the crisis, the total capital adequacy ratio for the banking industry was 10.5 percent, but the capital buffer is likely to have been eroded during the lockdown period.[17] Regulatory forbearance was exercised to support the banking industry which is likely to experience growing nonperforming loans (NPLs) issues after the pandemic. BB took measures to delay NPL classification and extend the tenures of trade instruments. The Refinance Scheme is part of the measures BB has taken to improve banking sector liquidity. Apart from this and to boost liquidity in the system, BB will buy treasury bonds and bills from banks. Effective from April 14, 2020, BB fixed the cash reserve ratio at 3.5 percent on a daily-basis requirement and four percent on a biweekly average basis. The repo rate was reduced from six percent to 5.25 percent. In July 2020, BB cut the bank rate for the first time in 17 years from five percent to four percent. BB also raised the advance-deposit ratio and investment-deposit ratio by two percentage points to facilitate credit to the private sector and improve liquidity. BB also stipulated restrictions on dividend payment by the banks depending on their capital adequacy ratio.

17. **The Government's Request for AIIB Financing.** On May 10, 2020 the Ministry of Finance (MOF) of Bangladesh requested AIIB financing to support working capital loans for CMSMEs to address the adverse impact of the pandemic.

18. **The proposed project will support Bangladesh to expand credit on a sound macroeconomic basis, thereby allowing banks/NBFIs to provide more working capital financing to CMSMEs to sustain economic activity**. The spread of COVID-19 and the subsequent downturn in the economy has raised the need for government to undertake several measures for credit expansion including credit to the CMSME sector.[18]

[17] World Bank. 2020.The cursed blessing of public banks. World Bank.

[18] According to the FY2021 monetary policy statement, public sector credit is expected to expand by 44.4 percent while private sector credit will expand by 14.8 percent.

19. While Bangladesh's reserves have reached a high of nearly USD40 billion in September 2020, this is assessed by authorities to be a temporary phenomenon and reserves are likely to decline in the coming months. Part of the recent increase in reserves is driven by a one-off surge in remittances as a result of additional incentives to encourage repatriation through formal channels. Remittances would likely taper off given the downturn in economic activity globally, and as overseas workers lose employment.[19] There also has been significant import compression due to weak economic activity and lower oil prices with imports declining by over 25 percent between March and July 2020. As remittances slow down and import demand revives, with an improvement in economic activity and a rise in commodity prices, the current account deficit is likely to widen resulting in some loss of reserves. The proposed project will allow Bangladesh to pursue credible monetary policy and undertake credit expansion without worsening the macroeconomic fundamentals, by diversifying and strengthening its reserves position as it undertakes this credit expansion. It would help in ensuring the efficacy of the monetary transmission mechanism and stabilize the economy.

20. AIIB proceeds will support BB to provide additional liquidity support to the PFIs, over and above the Refinance Scheme while supporting growth and stability. PFIs will be able to refinance up to 100 percent of their lending under the combination of the AIIB facility and BB's refinancing scheme.

21. The definition of CMSMEs adopted by BB is presented in Table 3. It is based on fixed assets (excluding land buildings) and/or the number of employees. A CMSME is not a public limited company and complies with the following criteria:

Table 3. Definition of CMSME Adopted by Bangladesh Bank

Enterprise size		Fixed asset excluding Land & Building (in USD thousand)	Employment	Annual Turnover (in USD thousand)
Cottage		<12	Max. 15	-
Micro	Manufacturing	12 but <90	16-30	-
	Service	<12	Max. 15	-
	Trading	<12	Max. 15	240
Small	Manufacturing	90 but <180	31-120	-
	Service	12 but <240	16-50	-
	Trading	12 - 2.4	16-50	240 - 2400
Medium	Manufacturing	1800 – 6000	121-300 (Max 1000 for RMG/Labor-intensive industry)	-
	Service	240 – 3600	51-120	-

Source: SMESPD Circular no 02 dated 05 September 2019.
Exception: RMG and Knitwear sector industries which are members of BGMEA and/or Bangladesh Knitwear Manufacturers and Exporters Association (BKMEA) with labor employment 100-2000.

Note 1: If any enterprise falls under a particular category under one criterion (total fixed assets or employment) but a larger-size category under the other, then the enterprise will be classified into the latter category.

[19] In July 2019, Bangladesh introduced a two percent cash incentive on inward remittances. In May 2020, the regulations were further relaxed with remittances up to BDT500,000 being given the incentive without submitting any documents while the time limit to submit documents for remittances over BDT500,000 was raised from 15 days to two months.

22. **Strong economic rationale for AIIB to partner with the government.** Given that the SMEs in Bangladesh account for 35.5 percent of overall employment,[20] it is imperative to ensure adequate support to the CMSMEs so that they can sustain their operations and the livelihood of millions is protected while creating buffers for macroeconomic stability. By supporting the credit expansion and bolstering the liquidity of banks/NBFIs, CMSMEs will have more access to financing to help address the much-needed working capital needs and sustain their operations. This, in turn, will help minimize loss of livelihoods, rise in poverty and second-round negative demand impacts associated with job losses.

23. **Financial Sector.** The banking sector is playing an important role in channeling assistance to the economy as a substantial portion of the stimulus package is expected to be provided via subsidized bank loans.

24. The banking sector is facing some challenges and despite the recent strong economic growth, nonperforming loans (NPLs) have increased from 6.1 percent in 2011 to 11.7 percent in June 2019.[21] A major proportion of the NPLs is saddled with the state-owned commercial banks (SCBs). Due to weak governance, increasing capital shortfalls, operational inefficiencies and an ineffective legal framework, the NPL ratio has registered a nearly three-fold increase between 2011 and 2019, and stood at over 31 percent in June 2019.

25. Recognizing the problem of high NPLs, BB has initiated measures to strengthen the banking system and started amending several laws to enforce more discipline. This has resulted in a modest decline in NPLs with the banking sector NPLs falling to nine percent and SCBs' NPL declining to 24 percent in December 2019.

26. However, repeated loan rescheduling, regulatory forbearance and failure to deal with weak and insolvent banks have hindered progress. With a large portion of the stimulus measures being rolled out through the banking system and the credit risk being borne by these banks, banking soundness and governance need to be strengthened. This will warrant loans to be appropriately targeted and properly monitored with necessary due diligence and risk assessment considerations.[22]

27. The authorities being aware of these have introduced measures in the stimulus package to preserve the health of the banking system. The BDT200 billion (~USD2.4 billion) stimulus package announced by the government in April 2020 includes measures like (a) banks/NBFIs to provide details of loan disbursement regularly to BB, (b) banks/NBFIs should not be classified as the problem/sick bank/FI, (c) proper provision and reserves to be maintained by banks/NBFIs in case of nonrealization of loans, (d) banks/NBFIs to have separate monitoring units while BB will also form separate monitoring teams to coordinate with banks/NBFIs, (e) banks/NBFIs failing to realize interest and repayment from a client will not be provided subsidy, and (f) banks/NBFIs will get the interest subsidies every quarter upon submitting the request to BB and after proper scrutinization of the request. At the same time, the provisions under the AIIB loan facility also seek to preserve banking soundness while maximizing benefits. These include (a) forbidding loan defaulters and clients who have repeatedly rescheduled loans from availing this facility, and (b) imposing a cap on the loan amount that can be availed by a sub-borrower.

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[20] The Daily Star. Study conducted by the International Cooperation Organisation for Small and Medium Enterprises in Asia (ICOSA), https://www.thedailystar.net/business/news/sme-contribution-still-negligible-study-1807207

[21] Bangladesh Bank Quarterly (October – December).2019. Bangladesh Bank. https://www.bb.org.bd/pub/quaterly/bbquarterly/oct-dec2019/overview.pdf

[22] IMF. Bangladesh: Requests for Disbursement under the Rapid Credit Facility and Purchase under the Rapid Financing Instrument. IMF Staff Report.

28. After the COVID-19 pandemic recedes the authorities will have to continue their efforts at resolving the banking sector problems.[23] According to IMF's Rapid Credit Facility disbursement staff report these would entail focusing on: (i) introducing risk-based supervision and avoid regulatory forbearance; (ii) strengthening corporate governance in private commercial banks; (iii) ensuring that classification and provisioning requirements are in line with Basel standards; (iv) addressing the poor financial performance of state-owned commercial banks (SCBs); and (v) putting in place an effective framework for resolution of weak banks.

29. **Alignment with AIIB's COVID-19 Crisis Recovery Facility.** The project is aligned with the decision to support AIIB's COVID-19 Crisis Recovery Facility, as approved by the Board on April 16, 2020, specifically in respect to the scope of financing in paragraph 14.3 of the facility paper on "financings to address liquidity constraints for clients in infrastructure and other productive sectors."

30. **Alignment with the Country's Priorities.** The project is aligned with the current overarching development priorities of the country—mitigating the adverse social and economic impact of the COVID-19 pandemic and strengthen access to finance for CMSMEs. The project will supplement the government program to protect affected CMSMEs, keeping the jobs of employees as well as the competitive edge of entrepreneurs intact. The project will support banks/NBFIs in their efforts to maintain the availability and accessibility of financing to industries and businesses hard-hit by the pandemic. In the absence of the AIIB's support, bank/NBFIs could constrain themselves with liquidity, given the strong demand for financing by the CMSMEs. The project will also facilitate the recovery and long-term sustainable development of Bangladesh.

31. **Lessons Learned from Previous Projects.** This will be AIIB's first financial institution (FI) project in Bangladesh. AIIB will work with an experienced partner BB which has the knowledge and experience of similar projects. BB has implemented similar projects with other MDBs including World Bank, ADB and JICA. The project team has reviewed relevant project documents of these MDBs.

32. The main lesson learned comes from the fact that the implementation structure of this project has been designed in almost an identical way to JICA's two-step loan project to SMEs, the World Bank's IPFF project and on a high level, also similar to ADB's SME development project in Bangladesh. This allows AIIB to build on an established system and capacity of BB that have proven successful. During the time of their engagement with MDBs, BB has developed a track record of established system and procedures for selecting, appraising PFIs, monitoring the performance, collecting the loans, and applying MDB's policies with regards to applicable Environmental and Social (ES) safeguards. The experience of working with these MDBs and learning from the capacity building programs has significantly enhanced BB's technical capacity. Detailed examples of BB's projects financed by other MDBs are presented in Section 3/A.

33. Other lessons learned through projects of other MDBs:

34. Need a clear definition of SME–ADB's SME project found that the SME nomenclature was frequently misunderstood and used inappropriately. This project has taken a clear

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[23] IMF. Bangladesh: Requests for Disbursement under the Rapid Credit Facility and Purchase under the Rapid Financing Instrument, IMF Staff Report.

definition of CMSMEs adopted by BB and BB will ensure sub-borrowers will correctly meet the definition of CMSMEs (table 3).

35. Standardized loan forms–ADB's SME project found that the PFIs used different spellings in fields and the fields were different. This made analyzing the sub-loans impossible. For this project, the operations manual will specify standardized reporting templates to be filled out by PFIs, which will be submitted regularly to BB, including refinancing loan application form, loan disbursement statement and interest rate subsidy statement.

36. Remain flexible–World Bank's IPFF project found that it is important to remain flexible for accommodating changes in project parameters in response to changes in the market conditions and market demand. Restructuring might happen considering changes in market conditions. The implementation period of this project will be short and the project team will constantly work with BB to ensure that the project parameters remain in line with market requirements.

B. Project Objective and Expected Results.

37. **Project Objective.** The objective of this project is to support credit expansion and reduce liquidity constraints brought on by the COVID-19 pandemic to the cottage, micro, small and medium-sized enterprises (CMSMEs) in Bangladesh on a sound macroeconomic basis.

38. **Expected Results.** The expected results will be used to monitor the achievement of Project Objective Indicators against baseline and annual targets covering the following results:

1) Number of eligible sub-borrowers receiving financing
2) Percentage of loan value in CMSMEs
3) Percentage of nonperforming loans in the PFIs' portfolio funded through AIIB facility

39. **Expected Beneficiaries.**

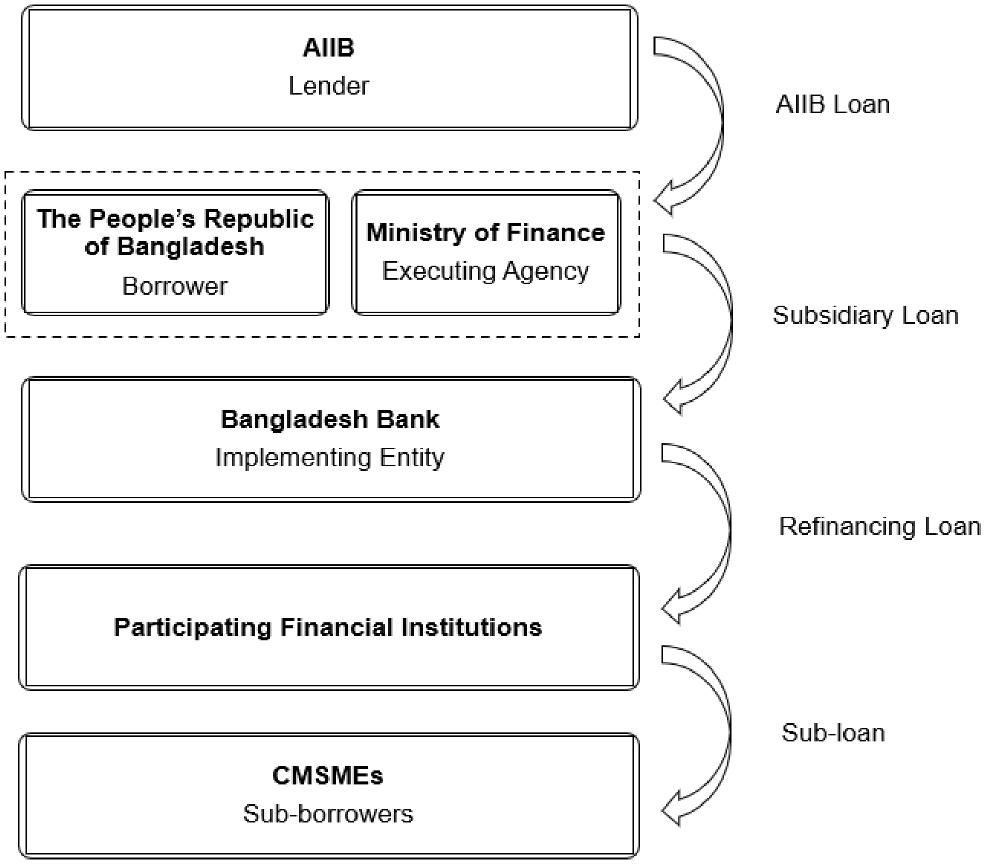
1) The Government of Bangladesh and BB which will receive the required liquidity for supporting their CMSMEs
2) PFIs which will receive liquidity financing at an affordable rate
3) CMSMEs which will receive support to address liquidity and working capital challenges under the current environment

C. Description and Components

40. **Overview.** The project will be supported by a sovereign-backed loan to the People's Republic of Bangladesh (the borrower). The government's Ministry of Finance (MOF) will be the executing agency acting on behalf of the government. MOF will then on-lend the loan proceeds to BB (Subsidiary Loan). The loan proceeds will help diversify and bolster BB reserves and support the expansion of credit through participating banks and nonbank financial institutions (collectively, PFIs) on a sound basis. BB will provide loans to PFIs (Refinancing Loans) as refinance against the loans (sub-loans) disbursed to CMSMEs (sub-borrowers). The sub-loans will be used for working capital financing comprising employee wages, inventory, payments on short-term debt and other day-to-day operating expenses.

41. The project has the following key players and loans:

Figure 1. Key Players and Loans



Source: AIIB

42. BB will create a project implementation unit (PIU) for this project in the SME and Special Programmes Department (SMESPD) of BB to manage and channel the proceeds from the Subsidiary Loan to PFIs. This PIU will be built on existing team members who have conducted similar projects before. Implementation of the project will be guided by the operations manual (OM), which will include the eligibility criteria for PFIs, sub-loans and sub-borrowers and compliance with AIIB's policies and standards.

43. The PIU will invite applications from banks and financial institutions, examine their eligibility vis-à-vis the PFI eligibility criteria to be set out in the OM and listed in Annex 7 and confirm the accreditation of the PFI. The PFI shall make disbursement of the sub-loans before submitting its request for a Refinancing Loan. To receive Refinancing Loans, eligible PFIs will have to apply to PIU with the list of eligible sub-loans, in the specific format required by PIU, at intervals set out in the OM for sub-loans disbursed during that interval. PIU will review applications against the expected sub-loan and sub-borrower eligibility criteria to be set out in the OM and listed in Annex 8. PFIs will be able to refinance up to 50 percent of loan amounts disbursed to CMSMEs at a four percent interest rate, for three years (which can be extended for one more year). A process flowchart of this refinancing facility is presented in Annex 6.

44. The PIU will be required to ensure that 70 percent of the Subsidiary Loan is allocated to the cottage, micro and small enterprises and the remaining 30 percent for medium enterprises. The manufacturing and service sectors will be given a higher priority. Total allocation for the manufacturing and service sectors will be 65 percent altogether and allocation for the trading sector will be 35 percent. The government might decide to change the allocation ratio in the future and if they do so, the government will be required to obtain AIIB's prior approval.

45. The benefits and challenges of the project are as follows:

46. Benefits

1) Wider reach (works well for smaller companies like those found in Bangladesh)
2) PFIs have greater knowledge and experience dealing with their client base
3) Faster deployment of funds once sub-borrowers are identified

47. Challenges

1) Less control over the lending process
2) Dependency on BB and PFIs' knowledge and experience, ES, financial assessment and monitoring systems

D. Cost and Financing Plan

48. **Amount and Currency.** The total financing amount of this sovereign-backed project is USD300 million. Based on conversations with BB, USD300 million is adequate to support the needs for credit expansion to meet the demand for PFIs, while underpinning macroeconomic stability. AIIB's loan proceeds will support BB to expand credit and provide additional liquidity. The maximum amount of lending to each sub-borrower will be determined based on banks'/NBFIs' own decision. However, for existing clients the amount should not exceed the bank's/NBFI's previous year's sector-specific credit limit (new clients are not subject to the limit).

- **AIIB Loan (AIIB to Bangladesh).** The People's Republic of Bangladesh will be the borrower. The AIIB loan will be USD300 million with principle and repayments in USD.
- **Subsidiary Loan (Government to BB).** The Government of Bangladesh will on-lend proceeds from the AIIB loan to BB in BDT based on terms and conditions set out in the Subsidiary Loan Agreement.
- **Refinancing Loans (BB to PFIs).** BB will further on-lend to PFIs in BDT. On-lending to PFIs will be on a "first-come, first-served" basis and subject to the availability of balance in the Project Operating Account and the Revolving Fund Account. The aggregate amount of lending from BB to the state-owned banks should not be more than USD30 million.
- **Sub-loans (PFIs to sub-borrowers).** PFIs will make working capital loans in BDT to sub-borrowers. Limit to a single sub-borrower is set out in Annex 8.

49. **Maturity.**

- **AIIB Loan.** Tenor would be eight years, including three years of grace period
- **Refinancing Loans.** Maturity will be limited to the maturity of sub-loans which is capped at one year (excluding grace period). A grace period of up to three months may be provided to a PFI if it provides the same to its sub-borrowers. The facility will run for three years (maybe extended for one more year), during which PFIs can draw the facility from time to time.
- **Sub-loans.** Maturity will be capped at one year. Sub-borrowers can avail of funds under this facility only once during the three-year duration of the Refinance Scheme and only through one of the PFIs and on a "first-come, first-served" basis. In case a sub-borrower cannot avail of this fund due to the PFI exceeding its limit, it can avail for funds through another PFI.

50. **Pricing.**

- **AIIB Loan.** The loan will follow the AIIB's General Conditions for Sovereign-backed Loans and will be made on standard Fixed Spread Loan terms for Sovereign-backed Loans.
- **Subsidiary Loan.** The loan pricing will be as per the Subsidiary Loan Agreement. Pricing would be negotiated between the Government of Bangladesh and BB. It will not be more than what BB takes from the PFIs.
- **Refinancing loans.** PFIs can borrow funds from BB at four percent per annum under the facility.
- **Sub-loans.** The sub-loan pricing will be nine percent per annum, of which four percent will be paid by sub-borrowers and five percent will be subsidized by the government.

E. Implementation Arrangements

51. **Implementation Period.** February 2021-February 2024 (may be extended for an additional year, via an agreement between the borrower and AIIB).

52. **Executing Agency.** The Finance Division of the Ministry of Finance will execute the project on behalf of the borrower. It bears the prime responsibility of receiving and repaying AIIB loans from and to AIIB. The borrower shall bear the exchange risk.

53. **Implementing Entity.** BB will be the implementing entity of the project. BB will be responsible for the overall administration and supervision of the project. Leveraging BB's regulatory role will be important in controlling adverse selection and moral hazard on the part of the PFIs. BB is the central bank and apex regulatory body for the country's monetary and financial system. BB performs all the functions that a central bank in any country is expected to perform including but not limited to maintaining price stability through economic and monetary policy measures, managing the country's foreign exchange and gold reserve, and regulating the banking sector of the country. BB has a reserve of USD39.1 billion at the end of September 2020.

54. PFIs will also be involved in the implementation of the project. The PFIs will undertake credit risks of the sub-loans and be responsible for the detailed assessments of sub-borrowers' soundness, financial and economic feasibility, and ESRM aspects. The PFIs will also monitor the implementation of the disbursed loans and will maintain accounts and records which will allow smooth review/monitoring and assessment of the individual sub-loans and the entire portfolio under this facility.

55. **Implementation Management.** BB will create a project implementation unit (PIU) for the project. This unit will come from the SMESPD of BB. It will be responsible for the accreditation of PFIs by evaluating them against the eligibility criteria; receiving, reviewing and approving PFIs' refinance requests. It will monitor the utilization and repayments of the Refinancing Loans and submit project progress reports to AIIB quarterly. It will be responsible for overall coordination with PFIs and monitor PFIs' compliance with the Participation Agreements to be executed for the Refinancing Loans. It will also be responsible for preparing disbursement projections and send withdrawal applications following AIIB requirements.

56. The PIU will be headed by an official nominated by the governor of the Bangladesh Bank. To ensure the smooth operation of the project, a Project Steering Committee (PSC) chaired by the secretary of the Finance Division will be set up comprising members from BB, Economic Relations Division, and the Planning Commission and Ministry of Planning. A representative of AIIB may be called as an observer when required. The PSC will be

responsible for strategic oversight and policy direction. Also, BB will monitor project implementation as part of its regular administrative channel. A key players chart that specifies the role at each level is presented in Annex 6.

57. The project team has performed due diligence on BB and is satisfied with its implementation capacity considering its track record and existing resources in place. BB's human resource quality and institutional capacity as the central bank have been instrumental to the success of similar on-lending projects it has undertaken in the past. The SMESPD is headed by a general manager, supported by a deputy general manager, full-time project managers and an adequate number of staff members who will specifically handle all relevant tasks related to the project. BB may assign appropriate level staff members in the PIU. The staff in PIU will be responsible for different functions including (1) Treasury and Recovery, (2) General Administration, (3) Administration and Appraisal, and (4) Monitoring. See Annex 6 for an organization chart.

58. Also, the Sustainable Finance Department of BB will provide additional human resources and support to the PIU in the area of ESMS. BB's ES Guidelines were issued in 2017 and developed through a long process of in-house study and research along with technical support from IFC and consultations with banks/NBFIs and other DFIs. BB's ESRM Guidelines are comprehensive and aligned with AIIB's Environmental and Social Policy. The project team has conducted due diligence of the existing ESMS of BB and agreed the ESMS will be applied to this project (paragraph 107).

59. **Eligible PFIs.** Only those PFIs that are found to be qualified by PIU based on its evaluation against agreed eligibility criteria will be allowed to receive refinance under this facility. Details of the proposed eligibility criteria are set out in Annex 7. Key terms are summarized below:

60. <u>Financial performance</u> including (a) minimum three years' experience with audited records; (b) maintain minimum capital adequacy required by BB; (c) maximum 10 percent nonperforming loan ratio; (d) profitability for two consecutive years including the latest; (e) not be classified as problem/sick banks/ NBFIs (as categorized by the BB) or the early warning bank according to the CAMELs rating of BB;

61. <u>Business practices</u> including maintain (a) anti-money laundering procedures complying with Bangladesh Financial Intelligence Unit requirements; (b) proper risk management measures; (c) adequate organization, management, staff and other resources; (d) acceptable ES assessment procedures for screening, monitoring and reporting; and

62. Exceptions to some of these eligibility criteria will be provided for the eight state-owned banks[24] to ensure that the facility is accessible by everyone who needs it, as state-owned banks have a dominant presence in rural and other far-flung areas.

63. BB is experienced in selecting PFIs based on eligibility criteria as they have done such selection for similar projects in the past. PFIs will be identified by PIU based on due diligence conducted to analyze their financial aspects as well as to determine their ability to handle social and environmental issues. However, since the facility is aimed at improving access to credit by CMSMEs, it is deemed appropriate to make the facility available to as many eligible financial institutions as possible. The integrity of the PFIs' credit administration process will act as a mitigating factor to the adverse selection risk. BB, under its position as the central

[24] Sonali Bank, Janata Bank, Agrani Bank, Rupali Bank, Bangladesh Krishi Bank, Basic Bank, Bangladesh Development Bank and Rajshahi Krishi Unnayan Bank.

bank of the country, has proven capacity to monitor and manage credit risks of the PFIs in the country. Each selected PFI will conclude a comprehensive Participation Agreement with BB which is a basic agreement to be applied to all the Refinancing Loans made to each PFI.

64. PIU will submit the list of all PFIs that have been accredited by BB, to AIIB on monthly basis. If the PFIs do not meet the proposed eligibility criteria, AIIB will have the right to remove these PFIs and will inform PIU.

65. PFIs will be required to maintain compliance with eligibility criteria and applicable policies throughout the implementation period. PIU will continue to monitor and review PFIs' compliance with the eligibility criteria. PFIs that are found to be in noncompliance will be required to submit remedial plans for examination by PIU. If the submitted plans are deemed satisfactory to bring the PFIs back into compliance within a reasonable time limit, PIU may agree to allow them to maintain the PFI status during this time. Otherwise, the PIU shall take action to stop disbursing the Refinancing Loan until the PFI satisfies the criteria. AIIB reserves the right to disallow disbursements from the credit facility to any PFI determined not to be complying with any of the above criteria unless and until the PFI can satisfy the criteria.

66. **Eligible Sub-loan and Sub-borrowers.** The proposed eligibility criteria for sub-loans and sub-borrowers are set out in Annex 8. The overarching principles are that sub-borrowers should be in the CMSME sector and registered and operating primarily in or have a fixed place of business in Bangladesh. The sub-borrower should be operating in an eligible sector, complies with local laws and regulations and meets each of the PFI's eligibility criteria in terms of creditworthiness, foreign exchange position, ES requirements and KYC requirements. Key eligibility requirements are summarized below.

67. Sub-loan eligibility criteria. Each sub-loan must meet eligibility requirements including (a) be made only to an eligible sub-borrower for working capital purpose, (b) be in the local currency, (c) have a maximum tenor of one year (excluding grace period), and (d) loan proceeds may not be used for activities included under the ES requirements (e.g., Category A and high-risk Category B activities) or under the AIIB's Environmental and Social Exclusion List (ESEL).

68. Sub-borrower eligibility criteria. Eligibility criteria will be determined following the existing prevailing criteria established by BB and additional AIIB requirements and would include (a) meeting requirements relating to fixed assets, turnover, number of employees (Table 3), (b) being registered and operating primarily in Bangladesh or has a business address in the People's Republic of Bangladesh and (c) meeting PFIs' requirements with respect to creditworthiness, integrity checks, ES requirements and procurement practices.

69. **Eligible Sectors.** Sub-borrowers belonging to the manufacturing, trade and services sectors will be eligible for the AIIB facility.

70. **Operations Manual.** This project will be implemented following an operations manual (OM) to be agreed upon by BB and AIIB. The OM includes implementation arrangement, eligibility criteria and operational procedures for monitoring, reporting, financial management and ES risk management.

71. **Key Agreements.** The project will be implemented through the following agreements: 1) Loan Agreement between AIIB and People's Republic of Bangladesh; 2) Subsidiary Loan Agreement between the Government of Bangladesh and BB; 3) Project Agreement between AIIB and BB; 4) Participation Agreement between BB and each PFI; and 5) Sub-loan Agreement between PFIs and each sub-borrower.

72. **Approval and Recovery of Refinancing Loans to PFIs.** PIU is responsible for the approval and recovery of loans made to PFIs under the AIIB facility. PFIs will have to submit a Demand Promissory Note (DP Note) against the refinanced amount during each instance of availing refinance facility. This DP Note will be treated as ongoing security for BB's current and future receivable (with applicable charges and expenses on refinance) to that PFI for the refinanced loan. The DP Note will also be treated as ongoing security whether there is a credit balance in the account, the loan is partially paid, or a portion of collateral is adjusted at any point in time. Please see Annex 5 for a flow diagram of the process followed for Refinance Loans.

73. Necessary initiatives will be taken to recover the loans by the PFI at the field level. But there will be no relationship, whatsoever, between the recoveries of the disbursed amount by the PFI and repayment of principal and accrued interest to BB. In case PFI fails to repay any installment of the loan as per the repayment schedule, BB may realize the installment amount plus applicable interest by debiting them against the current account of the concerned PFI maintained by PFI with BB. PFI shall inform PIU and take necessary steps to repay or adjust the refinanced loan amount as soon as any sub-borrower settles/adjusts the loan. If PFI fails to make the repayment, does not provide information about the early settlement or provides wrong information to take refinance facility, an added two percent charge will be imposed in addition to the interest rate of the refinance scheme to be collected by BB.

74. **Approval and Recovery of Sub-loans.** PFIs will be responsible for the approval and recovery of sub-loans. Proper provision and reserve should be maintained by the PFIs in case of nonrealization of sub-loans.

75. **Monitoring and Evaluation.** PIU and PFIs will both be responsible for monitoring and evaluation. PIU will form a monitoring team or teams to coordinate with PFIs.

76. Monitoring by AIIB-During the loan implementation period, AIIB retains the right to review all Refinancing Loans and sub-loans and conduct supervisory visits, including visits to the PIU, PFIs and sub-borrowers, at its discretion. AIIB will evaluate progress on the proposed indicators through regular reporting by PIU and through implementation support visits, including a biannual review of the implementation process. An annual project audit will be executed by the Foreign Aided Projects Audit Directorate (FAPAD), a specialized arm of the Office of the Comptroller & Auditor General, which is the Supreme Audit Institution. The audit shall be made on the "Statements of Designated Account, Project Operating Account and Revolving Fund Account" and the "Statements of Expenditures" and be submitted to AIIB annually within nine months after the end of each fiscal year until up to the financial closing period of the project in the form as determined by the auditor.

77. Monitoring by PIU-The PIU will form monitoring teams to coordinate with PFIs. PIU remains responsible for monitoring the progress of refinancing at the level of the PFIs and the PFIs' management of sub-loans individually and collectively. PIU remains obliged to regularly monitor the progress of the Project through site visits to the PFIs and the sub-borrowers. PIU shall prepare and send to AIIB unaudited project financial reports on a semiannual basis and audited project financial reports on an annual basis in the prescribed format agreed by AIIB and PIU. PIU will be adequately staffed with sufficient resources allocated to ensure the provision of monitoring data.

78. Monitoring by PFIs-The PFI is responsible for monitoring the progress of sub-loans at the level of sub-borrowers individually and collectively. The PFI is obliged to monitor closely, the progress of the sub-loan through site visits and management interviews. The PFI shall report the findings from monitoring activities to PIU monthly and also whenever requested by PIU. PFI shall collect data on the result monitoring indicators, for the baseline and actual achievement and report to PIU. PFIs will submit their annual audited financial reports to PIU,

which will make them available to AIIB. Each PFI will maintain a separate database system with adequate backups regarding the project facility loans.

79. **AIIB's Implementation Support.** Subject to travel disruptions caused by the COVID-19 pandemic, AIIB will carry out monitoring visits, physically or virtually, to BB and selected PFIs biannually to oversee the implementation of the project. No technical assistance is envisaged.

3. Project Assessment

A. Technical

80. **Project Design.** The technical design of the project is considered viable and appropriate. Refinancing loans and sub-loans under this project will be appraised and implemented based on Bangladeshi standards, in line with the relevant technical guidelines issued by the BB and PFIs, and in compliance with the project's implementation arrangements set out in the OM. Financial management, procurement, monitoring and reporting, and ES risk management also need to follow AIIB requirements, which will be set out in the OM.

81. In conducting the credit appraisal and approval of the sub-loan applications, the PFI ensures that the sub-loan examined complies with the prevailing rules and regulations imposed by the government and/or the regulatory authority (BB) concerned. The PFI also is required to abide by other policies and guidelines issued by BB including (a) the SME Credit Policies and Programmes, devised by SMESPD of BB, and (b) Guidelines on Environmental & Social Risk Management for Banks and Financial Institutions in Bangladesh, which has been determined to be consistent with AIIB's Environmental and Social Policy.

82. **Operational Capacity.** The project team has assessed BB and is satisfied with the bank's capacity as the central bank. The project is also satisfied with BB's capacity to select PFIs and ensure applicable policies are implemented from PFIs to the sub-loans. BB is deemed appropriate to implement the project because of its large contribution to the CMSME sector, its experience in executing similar facilities, its ready access to information in determining the financial soundness and capabilities of PFIs for providing credit to the CMSME sector and its function as administrator of the Credit Information Bureau, which gathers information regarding borrowers. BB's regulatory and supervisory capacity has been strengthened under the World Bank's Central Bank Strengthening Project. Under the project, guidance and support were provided in designing a new bank regulation policy and strengthening prudential regulations, reporting, and enforcement. BB has made progress in improving its financial reporting, auditing, and control systems; and has adopted the International Accounting Standards as its accounting basis. Furthermore, the project will be administered by well-qualified professionals in BB's SME & Special Programs Department (SMESPD). This department has managed various SME refinancing schemes with World Bank, ADB, JICA, etc. (Table 4). BB will regularly monitor (i) PFIs' continued eligibility based on eligibility criteria, and (ii) eligible disbursements against estimated PFI targets to CMSMEs consistent with AIIB policy. BB will ensure good transparency, corporate governance and risk management throughout the project.

83. BB has significant experience in operating similar refinance schemes with support from other multilateral development banks and by themselves. For example, BB has implemented the World Bank-assisted Investment Promotion and Financing Facility Project (IPFF). The World Bank's project document and actual discussions with World Bank personnel show that the project has worked well. 16 banks/NBFIs received funds and adopted World Bank Performance Standards for management of environmental and social risk management

(ESRM)[25] enabled by ES capacity building program. Phase 2 of the IPFF project has released funds to 12 banks and NBFIs.[26] The SMESPD of BB, as the PIU of this project, is experienced in SME refinancing of similar projects. For example, it has implemented the ADB-assisted Small and Medium Sector Development Project (SMESDP), where 32 banks/NBFIs received funds to lend to SMEs. It also implemented the JICA-assisted Financial Sector Project for the Development of Small and Medium-Sized Enterprise (FSPDSME) which released funds to 26 banks/NBFIs and provided technical assistance to PIU with special emphasis on SME banking and prudential regulation of small business lending. Table 4 shows the CMSME refinance schemes BB is currently operating.

Table 4. Different Refinance Schemes of BB for CMSMEs
(up to June 2019)

Name of Fund	Refinance Amount (BDT billion)				No. of Beneficiary (sector-wise)			
	Working capital	Mid-term loan	Long term loan	Total	Industry	Trade	Service	Total
1. Refinance Scheme for Argo based Industries in Rural Areas	7.4	2.3	7.3	17.0	2,337	-	-	2,337
2. Small Ent. Refinance Scheme	9.1	20.7	8.3	38.1	12,416	18,172	5,114	35,702
3. New Enterprises Refinance Fund for CMSEs	0.0	0.2	0.0	0.2	201	-	166	367
4. Islamic Shariah-based Refinance Fund	3.7	0.5	1.2	5.4	165	521	45	731
5. JICA FSPDSME	0.7	3.8	3.3	7.8	509	34	387	930
6. JICA UBSP	-	-	0.4	0.4	5	-	-	5
7. IDA Fund (EGBMP)	0.8	1.3	1.0	3.1	1,368	1,306	486	3,160
8. ADB SMESDP -1	1.5	1.3	0.6	3.4	800	2,096	368	3,264
9. ADB SMEDP -2	0.0	5.7	1.8	7.5	3,765	7,435	2,445	13,645
Grand Total	**23.2**	**35.8**	**23.8**	**82.8**	**21,606**	**29,564**	**9,011**	**60,181**

Source: SME & Special Programmes Department, Bangladesh Bank.

B. Economic and Financial Analysis.

84. The economic and financial analysis of the project is dependent on the merits of each of the refinancing loans and sub-loans to be financed by PIU and PFIs. Therefore, the actual economic and financial impact/data relevant to the project will not be known until all eligible sub-loans are reviewed and financed.

85. **Economic Analysis.** The project will lead to more SMEs sustaining operations, minimizing unemployment, reducing poverty and accelerating an economic recovery from the COVID-19 crisis.

86. Supporting SMEs. The SMEs form a lifeline for the Bangladesh economy accounting for 25 percent of the country's GDP and 70 percent to 80 percent of jobs created in the nonagricultural sector. Access to additional concessional financing will help the SMEs to inject funds that would pay salaries and maintain minimum activities and payback existing dues and thereby minimize retrenchment and protect livelihoods. New cashflow into the enterprises is likely to have a multiplier effect and benefit various participants in the SME ecosystem.

87. Supporting the Economy. Given that the SMEs in Bangladesh account for 35.49 percent of overall employment, it is imperative to ensure adequate support to the SMEs so that they can sustain their operations and to protect the livelihood of millions. This would also

[25] World Bank. Bangladesh-Second-Investment-Promotion-and-Financing-Facility-Project . http://documents1.worldbank.org/curated/en/775941568358678085/pdf/Bangladesh-Second-Investment-Promotion-and-Financing-Facility-Project-Infrastructure-Growth-Through-Private-Public-Partnership.pdf

[26] The Financial Express. Eight Banks, four NBFIs ink deal with BB on IPFF II. 2018. https://thefinancialexpress.com.bd/trade/eight-banks-four-nbfis-ink-deal-with-bb-on-ipff-ii-15337

prevent vulnerable households from sliding back into poverty. Bolstering the competitiveness of the SMEs and ensuring their sustenance will help minimize loss of livelihoods, rise in poverty and second-round negative demand impacts associated with job losses. It will help preserve human capital and avoid negative coping strategies. The project will also help preserve supply chains as SMEs have strong backward and forward linkages.

88. **Financial Analysis.** Like the economic analysis, the financial outcomes of the project will be dependent on the PFIs selected and the sub-loans to be financed. Without knowing which PFIs will be financed at this stage, it is difficult to perform an analysis of PFIs. However, there are safeguards at BB that will ensure the recovery of funds from PFIs in the case of late/no repayment. These safeguards will include interest penalty, removal from the eligible PFI list and recovery of the full amount of loan at once. BB will carry out proper due diligence and risk assessment considerations to maintain the banking sector's soundness. Once the pandemic is over, BB and the government will have to work to strengthen the financial sector soundness. A detailed analysis of the banking and NBFI sectors can be found in Annex 9.

C. Fiduciary and Governance

89. **Procurement.** The project will be refinancing the working capital loans provided by PFIs to CMSMEs. Short-term working capital facilities and trade finance facilities are not expected to be used to finance any CAPEX projects. The sub-loans are not expected to finance contracts for goods or services. However, if they do, they are likely to be small contracts, in which case the Procurement Policy applicable to Private Entities would apply, and the beneficiary will procure the items following its standard commercial practices for such items.

90. **Funds Flow and Disbursements.** The project requires the following accounts to be opened and maintained with BB: (1) the Designated Account, (2) the Project Operating Account and (3) the Revolving Account.

91. The facility will adopt an advanced method for disbursement. Under this method, AIIB will disburse funds as specified in the Disbursement Letter, to a segregated **Designated Account** denominated in USD opened at BB with its Forex Reserve and Treasury Management Department (FRTMD). Subsequent disbursements will be made on the submission of withdrawal application and statement of expenditures for eligible expenditures when the advance amount up to the percentage specified in the Disbursement Letter has been disbursed to the PFIs. The minimum and maximum single disbursement amount will be specified in the Disbursement Letter. The funds disbursed in the designated account will be converted to local currency and transferred to the **Project Operating Account** designated in local currency which will be maintained and operated by PIU and from which the disbursement of refinancing funds to the PFI shall be made. PIU will be responsible for transferring local currency funds to **current accounts of PFIs** maintained at BB on receipt of the statement of loan provided by the PFI to the sub-borrowers.

92. Each PFI will separately receive, maintain and monitor Refinancing Loan proceeds using their financial management systems. Each PFI will open a segregated bank account for the funds received from the Refinancing Loan for the payment and repayment of principal and interest and other charges related to sub-loans. PFIs will report to PIU on the disbursement of funds to CMSMEs in the prescribed format and time interval required by PIU and set out in the OM.

93. All expenses of the project will be paid from BB and no other entity will handle AIIB fund transfer. The principal portion of repayment from PFIs shall be credited in **Revolving Fund Account** for subsequent application of the funds. For disbursing the second and succeeding loans to PFIs, PIU may utilize the funds accumulated in the Revolving Fund

Account for disbursement but only after the revolving account reaches a threshold amount agreed with AIIB. BB will request additional funds from AIIB while it continues to utilize funds in the revolving account. The exchange risk between USD and taka shall be borne by the Government of Bangladesh. The procedure with regards to the use of the Revolving Fund Account will be detailed out in the OM. Further details of disbursement arrangements will be set out in the Disbursement Letter. A funds flow diagram is presented in Annex 6.

94. **Financial Management.** BB will undertake the financial management (FM) function of the project overall. BB's existing loan management and accounting systems will be utilized. BB has well-established internal controls in place in which there is a clear segregation of duties, proper review and authorization of transactions. In addition to the existing internal controls, FM procedures will be guided by the OM. The internal audit needs to be conducted as per policy of the BB and the internal audit report should be provided to AIIB on request. For the effective control of the operation, PIU is recommended to develop its management information system (MIS). Based on the IT system developed for the management of the Refinancing Loans, PIU should be able to establish the basic MIS. This system may be updated throughout the life of the project as needed to reflect any updates to the existing procedures and processes.

95. BB financial statements are prepared following International Financial Reporting Standards (IFRS). The PFIs' financial statements are prepared following Bangladesh accounting standards that are primarily based on IFRS. BB has developed the capacity to apply IFRS and to effectively supervise and oversee financial institutions through the World Bank's Central Bank Strengthening Project.

96. The PFIs will undertake the FM function of the sub-loans. PFIs will have their accounts and financial statements (balance sheet, income statement and statement of sources and applications of funds) audited annually in accordance with Bangladesh auditing standards by independent external auditors. The PFIs will submit their accounts and financial statements to PIU, which will make the statements available to AIIB not later than six months after the end of the fiscal year. In addition, the PFIs will submit semiannual unaudited financial statements to BB.

97. The Designated Account, the Project Operating Account, the Revolving Fund Account and Statement of Expenditure to be prepared for the expenditures financed from Subsidiary Loan shall be audited annually by FAPAD. The Audit Report shall be furnished to AIIB annually within nine months after the end of each fiscal year of BB, up to the financial closing period of the project. The management response on the management letter issued by the auditor should be submitted along with the audit report to AIIB. The status of the settlement of audit observations should be submitted along with the semiannual unaudited financial reports.

98. **Governance and Anti-corruption.** BB and each of the PFIs will be required to ensure that the project is implemented in strict compliance with AIIB's Policy on Prohibited Practices. Implementation will be monitored regularly by the PFI and PIU and reported to AIIB. For any suspected prohibited practices in relation to AIIB loans and the project, the PIU shall be required to report to AIIB. Further, the PFIs will report to the PIU and the sub-borrowers to PFIs regarding these concerns. AIIB reserves the right to investigate, directly and indirectly through its representatives, alleged corrupt, fraudulent, collusive, or coercive practices relating to the project and to take necessary measures to address any issues on time.

99. **AML/CFT**. Bangladesh Financial Intelligence Unit (BFIU) has issued Money Laundering and Terrorist Financing Risk Assessment Guidelines for the banking and FI sector in January 2015 which provide the basic ideas of identifying, assessing and mitigating money laundering and terrorist financing risks that banks and FIs may encounter in doing their business. The guideline is treated as minimum instruction and indication to identify and assess

the risk of money laundering and terrorist financing in their businesses and take effective measures to mitigate the identified risk. The guidelines then outline in further detail the specifics of such periodic risk assessments to be performed and the mitigants to be applied. The BFIU has issued in September 2012 the "Guidance Notes on Prevention of Money Laundering and Terrorist Financing" which are designed to assist banks and FIs in combating money laundering and terrorist financing. Bangladesh Bank, as part of its supervisory process, will use these guidance notes as minimum criteria against which it will assess the adequacy of policies, internal controls and procedures of the banks and FIs. The "Guidance Notes on Prevention of Money Laundering" issued by Bangladesh Bank have been prepared by the Focus Group on Prevention of Money Laundering. This group was established under the aegis of the Bangladesh Bank to oversee the issue of guidelines to facilitate the implementation of the Prevention of Money Laundering Act 2002.

100. The guidance notes responsibilities as well as the supervisory power of Bangladesh Bank are clearly outlined to fulfill the requirements under Bangladesh's Money Laundering Prevention Act (MLPA). All the documents assessed are based on FATF's requirements.

101. However, the Asia/Pacific Group on Money Laundering (APG),[27] one of the sister organizations of FATF, has adopted the mutual evaluation report (MER) of Bangladesh in September 2016, and further undertaken a follow-up review of the progress of Bangladesh in addressing the technical compliance deficiencies identified in its MER in 2019. According to the Follow-Up Report (FUR) issued in August 2019, Bangladesh has made good progress in addressing the technical compliance deficiencies identified in its MER and was re-rated on five recommendations (technical compliance re-ratings are given where sufficient progress has been made). Despite that, the FUR considered that Bangladesh still needs to improve AML measures on transparency and beneficial ownership of both legal persons and legal arrangements (FATF Recommendations R. 24 and 25). The FUR concluded that "Bangladesh will remain on enhanced follow-up, and will continue to report back to the APG on progress to strengthen its implementation of AML/CFT measures."

102. **Reporting and Monitoring.** BB and PFIs will be responsible for monitoring and reporting the project progress. PIU will monitor the outcomes from the utilization of borrowed funds under the facility periodically through reports submitted by the PFIs in prescribed formats and time intervals as required by PIU and set out in the OM. In addition to the off-site supervision, PIU may conduct surprise onsite inspection of the PFIs and the sub-borrowers to ensure the effective end-use of the funds.

103. Monthly reporting to AIIB. PIU shall submit a list of PFIs newly accredited by PIU during the month, until the completion of the project.

104. Quarterly reporting to AIIB. PIU shall submit a progress report quarterly, until the completion of the project, in a prescribed format to be agreed in OM together with the up-to-date list of approved PFIs.

105. Semiannual reporting to AIIB. PIU shall submit unaudited financial reports to AIIB no later than 45 days after the end of each semiannual period. The reports include Statement of Designated Account, Project Operating Accounts, Revolving Fund Accounts and Statement of Expenditure.

106. Annual reporting to AIIB. PIU shall submit the following statements/reports within nine months from the end of each fiscal year of PIU, until the completion of the project:

[27] Bangladesh is a member of the APG.

1) Statement of Designated Account, Project Operating Accounts, Revolving Fund Accounts and Statement of Expenditure
2) Current Repayment and Overdue Status Report of Refinancing Loans
3) A certified copy of Audit Report[28] on the Statements of the Designated Account, the Project Operating Account, Revolving Fund Account and Statement of Expenditure
4) Annual review of the performance of the PFIs
5) Financial statements of the PFIs (including the balance sheet and the profit and loss statement)

107. **Environmental and Social**

108. **Applicable Policy, Categorization, Instruments, Risks and Management.** AIIB's Environmental and Social Policy (ESP) including the Environmental and Social Standards (ESS) and Environmental and Social Exclusion List (ESEL) applies to this project. The project has been assigned Category FI. BB has established "Guidelines on Environmental & Social Risk Management (ESRM) for Banks and Financial Institutions in Bangladesh" (ESRM Guidelines), which are equivalent to an Environmental and Social Management System (ESMS). The ESRM Guidelines have been implemented for several projects with other IFIs. The ESRM, which has been assessed and found to be consistent with the ESP, will be applicable for this project and will be reflected in the operations manual (OM) of this project.

109. The PFIs are a group of state-owned and private banks and NBFIs that will be selected by BB based on eligibility criteria, including their previous environmental and social performance and compliance with ESRM Guidelines. The PFIs will be required to apply the ESRM. The sub-borrowers will be selected based on the criteria set out in the ESRM Guidelines. In this project, Category A and high-risk Category B[29] activities, activities listed in AIIB's ESEL and the Exclusion List of ESRM Guidelines will be excluded from eligibility for financing. Thus, in most cases, environmental and social risks and impacts of sub-loans will be limited. The ES eligibility criteria will be elaborated in the OM.

110. **Environmental and Social Management System and Capacity.** Each PFI will, as a condition of eligibility for financing under the AIIB loan, be required to adopt an ESMS following the ESRM Guidelines. The ESRM Guidelines illuminate the procedures for handling ES risks for subprojects, from transaction screening, ES risk categorization, ES due diligence, to assessment and approval for financing and monitoring of ES risk. The PFIs of this project will follow the provisions specified for MSMEs in the ESRM and undertake the role of screening, selection, due diligence, implementation and management of compliance of the sub-borrowers and sub-loans.

111. The ESRM has identified eight groups of activities of the small enterprise sector that may have medium ES risk including (1) washing, dyeing and finishing units of the RMG sector, (2) small steel rerolling mills, (3) brick kilns, (4) units for tanning, dressing and dyeing of leather and fur, (5) pesticides, agrochemical and nitrogen manufacturing units, (6) chemicals and chemical products manufacturing units, (7) rubber and plastic products manufacturing units, and (8) batteries and accumulators manufacturing units. For SMEs involving those activities and for the medium enterprise sector, the PFI is required to carry out ES due diligence (ESDD). A time-bound ES Action Plan (ESAP) will also be prepared and relevant covenants will be

[28] Audit conducted by Foreign Aided Project Audit Directorate (FAPAD).
[29] These high-risk Category B sub-loans to be excluded from the AIIB financing are those transactions that may potentially result in: (i) land acquisition or involuntary resettlement, (ii) risk of adverse impacts on Indigenous Peoples and/or vulnerable groups, (iii) significant risks to or impacts on the environment, community health and safety, biodiversity, and cultural resources, and/or (iv) significant occupational health and safety risks.

included in the loan documentation. For the small enterprise sector with low ES risk activities, BB's Exclusion List presented in the ESRM will be applied, in addition to AIIB's ESEL.

112. A team will be formed in PIU where staff from the Sustainable Finance Department of BB will be included to implement the ESRM Guidelines for this project through requiring appropriate screening, approval and monitoring procedures for PFIs and sub-loans. The Sustainable Finance Unit of BB has developed the ESRM Guidelines and has been engaged in its implementation on several IFI-supported projects. The capacity of the Sustainable Finance Department team is satisfactory, according to AIIB's due diligence.

113. This project aims to provide immediate support to the liquidity of PFIs and ultimately to CSMEs that have been affected by COVID-19 pandemic. In line with the emergency nature of COVID Response, BB will ensure that the ESMS of the PFI are aligned with the ESRM Guidelines. AIIB team will monitor the implementation of the ESRM Guidelines and conduct postreview of PFIs' ESMSs and ES performance of the sub-borrowers on a sample basis to accelerate the approval process of subprojects.

114. **Stakeholder Engagement, Consultation and Information Disclosure.** The PFIs will conduct stakeholder consultations and establish a line of communication with the affected people to understand and monitor potential impacts as specified in each of their ESMS. BB's ESRM has been published on its website.[30] The information on this project has been disclosed on AIIB's website.[31] ES documentation (e.g., ESDD, ESAP, etc.) of sub-loans prepared by the PFIs in light of their ESMS will be reviewed and documented by the ES staff in the PIU of BB. Such documents will be available with BB's PIU for any future audit.

115. **Project-level Grievance Redress Mechanism.** BB addresses concerns under the Grievance Redress Mechanism (GRM) through its Financial Integrity and Customer Services Department (FICSD). FICSD is the existing grievance channel in BB which will be used in this project. Communities and individuals who believe that they are adversely affected as a result of sub-loans may submit complaints to the existing GRM channels in BB.

116. **Independent Accountability Mechanism (IAM).** AIIB's Policy on the Project-Affected Peoples Mechanism (PPM) applies to this project. The PPM has been established by AIIB to provide an opportunity for an independent and impartial review of submissions from project-affected people who believe they have been or are likely to be adversely affected by AIIB's failure to implement its ESP in situations when their concerns cannot be addressed satisfactorily through the project-level GRM or the processes of AIIB Management. Information on AIIB's PPM is available at: https://www.aiib.org/en/policies-strategies/operational-policies/policyon-the-project-affected-mechanism.html

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[30] Bank of Bangladesh. 2018. Guidelines on Environmental & Social Risk Management for Banks and Financial Institutions in Bangladesh. Bank of Bangladesh.
https://www.bb.org.bd/aboutus/regulationguideline/esrm_guideline_feb2017.pdf

[31] AIIB. 2020. Bangladesh: COVID-19 Emergency and Crisis Response Facility. AIIB. Beijing.
https://www.aiib.org/en/projects/details/2020/proposed/Bangladesh-COVID-19-Emergency-and-Crisis-Response-Facility.html

D. Risks and Mitigation Measures

Table 5. Summary of Risks and Mitigating Measures

Risk Description	Assessment	Mitigation Measures
Implementation capacity (BB) Risk that BB is unable of implementing the Project as approved	**Medium**	BB as the central bank is the most appropriate organization to implement and administer the Project given its ready access to information to determine the financial soundness and capabilities of PFIs for providing credit to the CMSME sector and its prior experience in implementing similar projects with World Bank, JICA and ADB. BB has the necessary ES and financial management capacity to avoid misselection of PFIs and misuse or misappropriation of funds or assets. AIIB reserves the right to conduct periodic onsite and offsite review missions to BB.
Implementation capacity (PFIs) Risk that PFIs are unable of implementing the project as approved	**Medium**	PFIs will be selected based on a set of predetermined eligibility criteria agreed by AIIB and PIU. The PFIs will be briefed on AIIB implementation requirements. PFIs' loan disbursements and internal processes will be regularly reviewed by PIU and AIIB to avoid misuse or misappropriate of funds. AIIB reserves the right to conduct periodic onsite and offsite review missions to selected PFIs and sub-borrowers. The project enables the removal of PFIs in case of performance shortcomings.
Macroeconomy Risk of a severe macroeconomic downturn induced by COVID-19 pandemic.	**Medium**	The country is engaging in substantial fiscal and monetary stimulus to help the economy recover from COVID-19. There is a structured oversight mechanism by the Ministry of Finance and BB to mitigate macroeconomic uncertainties.
FM Risk Risk of noncompliance with criteria for lending to eligible sub-borrowers	**Medium**	The operations manual will be developed detailing the selection procedures of eligible sub-borrowers and PFIs. BB should review the selection of eligible sub-borrowers and loan approval procedure and recoverable status of the loan.
Credit risk Risk of default by the Government of Bangladesh	**Low**	The borrower is the government with a low chance of default. Aided by rapid growth and moderate deficits, Bangladesh has been identified as having a low risk of debt distress in IMF's 2019 Article IV Consultation Report, with various debt indicators below their threshold. While overall public sector debt was around 35 percent of GDP in FY2019, public

		sector external debt remained below 15 percent of GDP.
FX risk Risk that unhedged FX exposures due to weaker BDT leads to potential losses	**Low**	AIIB loan will be disbursed and repaid in USD and hence, there is no FX risk for AIIB. For BB, it has sufficient foreign currency reserves to manage the FX risk.
ES risk	**Medium**	Working capital loans are short-term in nature and not normally tied to physical long-term assets or specific operations. Through the screening, assessment and contracting of sub-loans and their monitoring, the generally limited number of potentially adverse ES impacts and risks will be minimized to the extent possible. BB has established an ESMS which is consistent with AIIB ESP requirements. It has in-house ES resources and gained knowledge and experience through prior projects with World Bank, JICA and ADB. ES procedures and management of PFIs will be assessed by BB as one of the qualifying criteria to be PFIs. Similarly, ES procedures and management of sub-borrowers will be assessed by PFIs as one of the qualifying criteria to be eligible sub-borrowers.
Operational risk Risk that it could be hard to manage and stay on track for quality assurance given many PFIs will participate in the scheme	**Medium**	The risk is mitigated by (1) lending cap to PFIs and (2) PIU has a good system in place to closely monitor the progress of the project through site visits to the PFIs and the sub-borrowers. There will be quarterly reporting by the PFIs to PIU and in turn to AIIB for AIIB to discover any negative issues from early on.
Structural challenge of MSME segment Risk that it could be hard to manage and stay on track for quality assurance given MSMEs are typically hard to track	**Medium**	The risk is mitigated by (1) lending cap to sub-borrowers and (2) PFIs' monitoring system in place through site visits and management interviews. The PFI will collect and report the outcome of monitoring to PIU regularly.

Annex 1: Results Monitoring Framework

Project Objective:	To reduce liquidity constraints brought on by the COVID-19 pandemic to cottage, micro, small and medium enterprises (CMSMEs) in Bangladesh									
Indicator Name	**Unit of measure**	**Base-line** Data Year	**Cumulative Target Values**						**End Target**	**Frequency**	**Responsibility**
			YR1	**YR2**	**YR3**	**YR 4**	**YR 5**	**YR n**			
Project Objective Indicators:											
1. Percentage of nonperforming loans in the PFIs' portfolio refinanced through AIIB facility	Percentage	0%	<=5%	<=5%	<=5%				<=5%	Annualy	PIU
2. Number of eligible sub-borrowers receiving financing	Number	0	1500	2800	4000				4000	Annualy	PIU
3. Percentage of loan value in cottage, micro and small enterprises	Percentage	0%	[70]%	[70]%	[70]%				[70]%	Annualy	PIU
4. Percentage of loan value in medium enterprises	Percentage	0%	[30]%	[30]%	[30]%				[30]%	Annualy	PIU
Immediate Indicators:											
1. Number of sub-borrowers with women owners or with one or more women in executive positions	Number	0	400	720	1040				1040	Annualy	PIU
2. Number of PFIs	Number	0	30	30	30				30	Annualy	PIU
3. Number of jobs created/retained by sub-borrowers (disaggregated by gender)	Number	0	[M-10000 F-2000]	[M-20000 F-4000	[M-30000 F-6000				[M-30000 F-6000]	Annually	PIU

Annex 2: Sovereign Credit Fact Sheet

1. Recent Economic Development

1.1. Bangladesh is a lower-middle-income country with GDP per capita at USD1,698 and a population of 161.2 million.[1] Bangladesh's economy has performed exceedingly well with growth steadily increasing from 7.2 percent in 2016 to eight percent in FY2018. Growth in FY2019 is also estimated to have been healthy at 8.2 percent. It is, however, expected to decline sharply in FY2020 as the COVID-19 crisis has affected remittances and garment exports. The growth acceleration in FY2019 was driven by higher public investment on large infrastructure projects, strong private consumption buoyed by remittances and exports growing faster than imports. Manufacturing growth has been robust due to the strong performance of the readymade garments sector. In FY2019, inflation has remained broadly stable around the central bank's target of 5.5 percent. The increase in nonfood inflation due to adjustment in natural gas price and currency depreciation has been offset by a decline in food inflation due to a good harvest and lower global food prices. The central bank kept the policy rates unchanged through FY2019 as inflation remained stable. Domestic credit has been healthy during most of FY2019, although it was mostly driven by government borrowing as growth in private credit moderated.

1.2. Slower than expected revenue collection and higher spending pushed the overall deficit to 5.3 percent of GDP in FY2019, crossing the ceiling of five percent for the first time in a decade. Both current and capital spending grew at a rapid pace, reflecting election-related spending and development expenditure. The government continues to prefer concessional external borrowing especially to finance infrastructure projects.[2] External public debt, at 15 percent of GDP, remained favorable. The ratio of external debt to GDP remains favorable at below 20 percent of GDP with public and publicly guaranteed external debt being around 15 percent of GDP.

1.3. The current account deficit after widening significantly to 3.5 percent of GDP in FY2018 is estimated to be 1.7 percent of GDP in FY2019. Exports of readymade garments accelerated, reflecting strong demand from newer markets like Australia, Canada and China. After remaining strong in the first half of the year, import growth slowed down during the second half of FY2019 due to lower demand for garment intermediates and capital imports and a sharp decline in rice imports. Remittances grew strongly, buoyed by the depreciation of the currency and measures taken to facilitate transfers through official channels.

2. Economic Indicators

Table 6. Selected Macroeconomic Indicators-Bangladesh (FY2016-FY2021)

Economic Indicators	**FY 2016**	**FY 2017**	**FY 2018**	**FY 2019**	**FY 2020***	**FY 2021***
Real GDP growth**	7.2	7.3	7.9	8.2	3.8	5.7
CPI Inflation (% change, average)**	5.7	5.4	5.8	5.5	5.7	5.6
Current account balance (% of GDP)**	0.6	-0.5	-3.5	-1.7	-2.2	-3.5
Central government overall balance (% of GDP)**	-3.4	-3.3	-4.6	-5.3	-6.3	-6.1
Nominal gross public debt (% of GDP)	33.3	33.4	34.6	35.9	39.1	40.7

[1] The income group classification for fiscal year 2019 is based on World Bank criteria, details seen: https://datahelpdesk.worldbank.org/knowledgebase/articles/906519; Population data use World Bank 2018 data.
[2] ADB. 2019. Asian Development Outlook 2019. Strengthening Disaster Resilience. ADB. Manila.

Public gross financing needs (% of GDP)	5.0	8.2	8.0	9.0	10.4	11.4
External debt (% of GDP)	18.5	18.0	20.0	18.5	18.7	18.3
Gross external financing need (% of GDP)	1.5	2.9	6.8	6.9	5.1	5.2
Net Foreign Direct Investment Inflow (% of GDP)	0.6	0.7	0.7	0.9	0.5	0.8
Gross official reserves (months of imports)	7.2	6.4	6.0	5.9	5.6	4.8
Broad money (M2, % change)	16.3	10.9	9.2	9.9	11.3	13.4
Exchange rate (BDT/USD, EOP) ***	78.4	80.6	83.7	84.9	84.7	

Note: * denotes projected figures.
FY2019 ran from July 2018 to June 2019.
** FX data from Thomson Reuters, 2020 FX rate as of June 8, 2020.
Source: IMF's Country Report No. 19/299, September 2019 and IMF's Country Report 20/187, June 2020.

3. Economic Outlook and Risks

3.1. Bangladesh's growth in 2020 is projected to decline sharply to 3.8 percent due to disruptions related to the ongoing COVID-19 pandemic. The national lockdown has dented private consumption as people working in the informal sector face loss of earnings.[3] This is likely to be exacerbated by disruptions in remittance flows as migrants lose work in foreign countries or find it difficult to remit as financial agencies are closed. Private investment, which has been weak in recent years is expected to dampen further as uncertainties related to COVID-19 persist. Industrial output is also likely to decline due to the lockdown, shortage of intermediate imported inputs and unavailability of workers. Public investment is also likely to witness some stagnation as the government focuses on supporting the vulnerable sections of the economy. Exports of readymade garments, which account for 80 percent of overall merchandise exports are expected to fall significantly as some of the major export destinations faced strong economic headwinds and have curtailed discretionary spending. However, growth is expected to rebound in 2021 as economic activity normalizes, helped by policy support.

3.2. Inflation is expected to remain around the central bank target of 5.7 percent in FY2020. Part of the decline in aggregate demand on account of reduction in disposable income will be boosted by the fiscal stimulus announced by the government. Expansionary monetary policy is also expected to push prices up. The banking sector stress could go up as weak economic activity pushes up nonperforming loans thereby constraining lending.

3.3. With the government increasing spending to counter the impact of the COVID-19 pandemic, the fiscal deficit is expected to increase. Recurrent expenditure is expected to grow significantly as the government rolls out various relief measures including scaling up of social protection schemes and supporting payroll of the manufacturing sector. A downturn in economic activity will also adversely impact tax collections. Public debt is expected to inch up a bit because of the higher deficit. Bangladesh has a favorable debt profile as the majority of the public debt is denominated in domestic currency and held by residents. External public debt is also expected to remain around current levels. Overall, Bangladesh exhibits low risk of debt distress.

3.4. The current account deficit is expected to moderate slightly in FY2020. Much of the decline in the deficit will be driven by lower oil prices and lower demand for capital imports as investment weakens. The decline in imports is expected to offset the reduction in remittances and slowing of exports, especially garment exports. However, the deficit is expected to increase in FY2021 due to a drop in exports and remittances.

[3] On March 23, 2020, the Government of Bangladesh declared a general holiday from March 26 to April 4, which has been extended until April 25.

Annex 3: Debt Sustainability and Impact of COVID-19

1. **Debt Sustainability Analysis:** Aided by rapid growth and moderate deficits, Bangladesh has been identified as having a low risk of debt distress in IMF's 2019 Article IV Consultation Report and reiterated in the recent IMF-RCF assessment, with various debt indicators below their threshold. While overall public sector debt was around 35.9 percent of GDP in FY2019, public sector external debt remained below 15 percent of GDP. To combat the economic effects of COVID-19 and the resulting lockdown, the government has unveiled a stimulus package of BDT1 trillion (USD11.8 billion). The Government of Bangladesh intends to finance this through domestic and external borrowing, with about USD2.9 billion being raised from external funding. Bangladesh's favorable debt dynamics allow authorities to increase borrowing in response to the pandemic. The additional overall public sector borrowing along with lower GDP growth will increase Bangladesh's total debt to 39.1 percent of GDP in FY2020 and 40.7 percent in FY2021. The additional external funding, including funding from various MDBs, will raise public sector external debt to 16 percent of GDP in FY2020 before declining to 15.8 percent in FY2021. These borrowings would also lead to overall debt levels as well as debt service payments increasing over the medium term. Despite the increase, Bangladesh's debt indicators remain well below the threshold. Even after accounting for various shocks under different stress scenarios like lower GDP growth, a higher deficit, lower export earnings and remittances, a sharp depreciation of the domestic currency the debt indicators remain well below the threshold.[4] Should the impact of COVID-19 be more protracted, debt indicators will worsen but are expected to remain below thresholds.

2. **Impact on Exports.** Exports have been one of the main drivers of economic and social development in Bangladesh. However, lockdowns and social distancing measures across countries have disrupted global supply chains and dampened demand from overseas markets. With Europe and the United States (accounting for 73 percent of the country's market, combined) in recession, about USD3.2 billion of export orders had already been canceled or suspended as of April 16, 2020, affected 2.3 million workers.[5] As a result, exports are expected to contract by 17.9 percent in FY2020 compared to a growth of 10.1 percent in FY2019.[6] Much of the impact will be felt in the labor-intensive readymade garment (RMG) industry, which exported goods valued at USD34.1 billion in FY2019, accounting for 84 percent of total exports and 11.3 percent of GDP.[7] The industry employs about 4.1 million people, most of them women.

3. **Impact on Remittances.** Remittances, which make up about six percent of GDP and play a vital role in supporting domestic consumption and aiding poverty reduction, are also showing signs of decline. Inward remittances during April and May 2020 amounted to USD2.6 billion, which is 18 percent lower than a year ago. Remittances are expected to further drop by 7.1 percent in FY2021. Bangladeshi migrant workers, most of whom are employed in Gulf countries, have been adversely impacted by both the COVID-19 pandemic and a sharp decline of oil prices. The reduction in remittance inflow will impact consumption and put the livelihood of many migrant workers' families at risk.

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[4] IMF. Bangladesh: Requests for Disbursement under the Rapid Credit Facility and Purchase under the Rapid Financing Instrument, Staff Report. https://www.imf.org/en/Publications/CR/Issues/2020/06/03/Bangladesh-Requests-for-Disbursement-under-the-Rapid-Credit-Facility-and-Purchase-under-the-49483

[5] Bangladesh Garment Manufacturers and Exporters Association. 2020. https://www.bgmea.com.bd/

[6] IMF. Bangladesh: Requests for Disbursement under the Rapid Credit Facility and Purchase under the Rapid Financing Instrument, IMF Staff Report. https://www.imf.org/en/Publications/CR/Issues/2020/06/03/Bangladesh-Requests-for-Disbursement-under-the-Rapid-Credit-Facility-and-Purchase-under-the-49483

[7] Export Promotion Bureau, Bangladesh. 2019.

4. **Impact on Domestic Consumption.** Domestic consumption accounts for 75 percent of the economy.[8] The nationwide lockdown and social distancing measures have resulted in significant slowdown and stoppage of economic activities. A Google mobility report provides indications of the cliff-like drop of domestic consumption which will severely impact retail, accommodation, restaurants, and transportation sectors. These are sectors with a high concentration of SMEs that employ large numbers of low-wage workers.

Figure 2. Reduced Domestic Economic Activities
(COVID-19 Community Mobility Report)

Source: Google. April 2020. COVID19 Community Mobility Report. Bangladesh.

5. **Impact on Fiscal Position.** Before the pandemic, the country's budget deficit was expected to return to the five percent range.[9] However, the pandemic and consequent stoppage of economic activities is expected to reduce tax receipts significantly. Nontax revenue will also be severely affected by the reduction of imports and other fee sources. Expenditure is expected to increase sharply due to countercyclical measures, which amounts to USD11.67 billion or around 3.5 percent of GDP. ADB estimates the fiscal deficit is likely to rise to 7.5 percent of GDP in FY2020. IMF projects fiscal deficits of 6.3 percent and 6.1 percent of GDP respectively for FY2020 and FY2021, while World Bank projected higher deficits of 7.7 percent and 9.8 percent.[10]

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[8] Bangladesh Bureau of Statistics (BBS). 2019. Gross Domestic Product (GDP) of Bangladesh 2018–19 (F). Dhaka.

[9] ADB. 2020. Asian Development Outlook (ADO) 2020. ADB. Manila

[10] World Bank. 2020.The Cursed Blessing of Public Banks. World Bank.

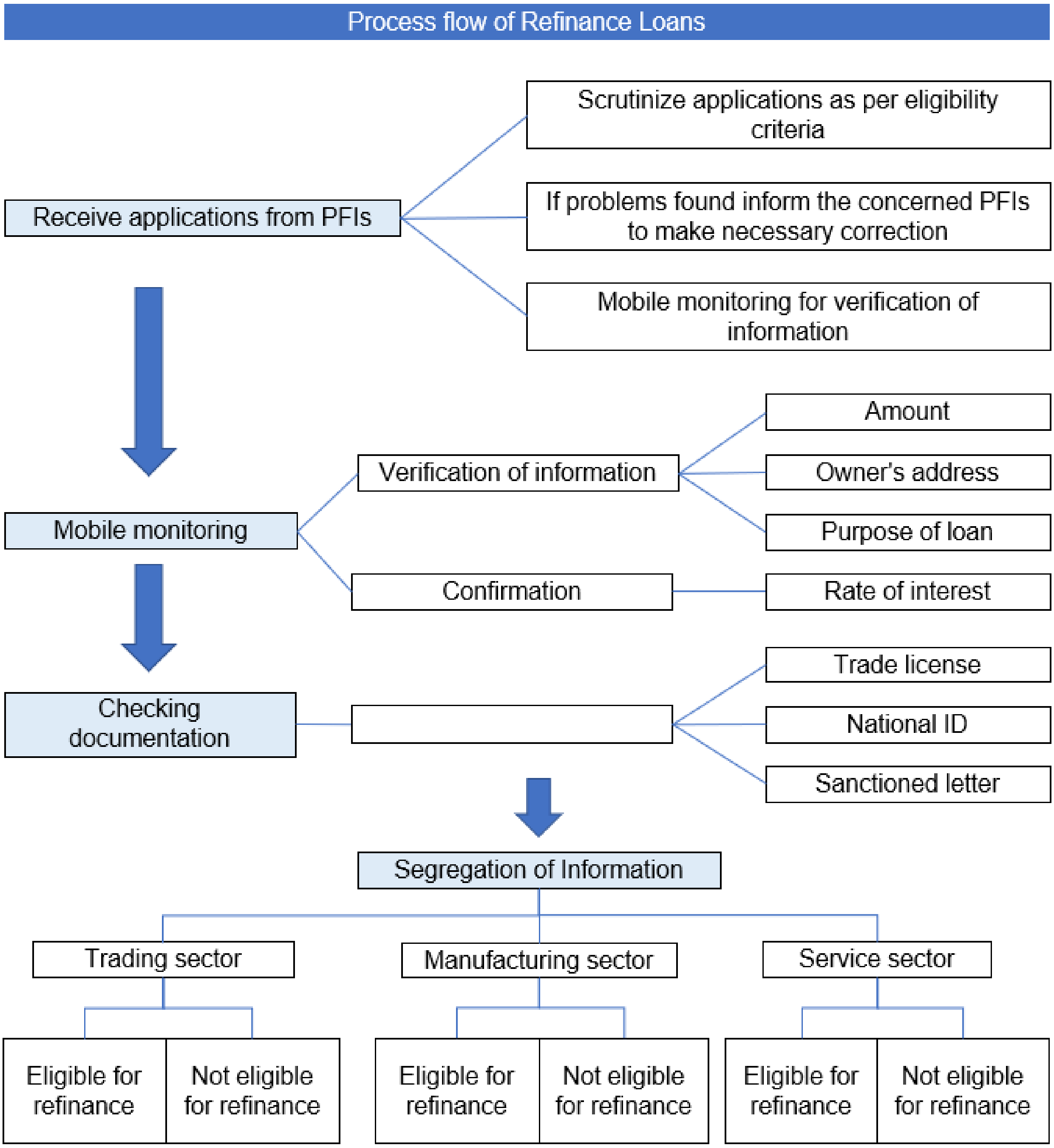
Annex 4: Bangladesh COVID-19 Stimulus Packages

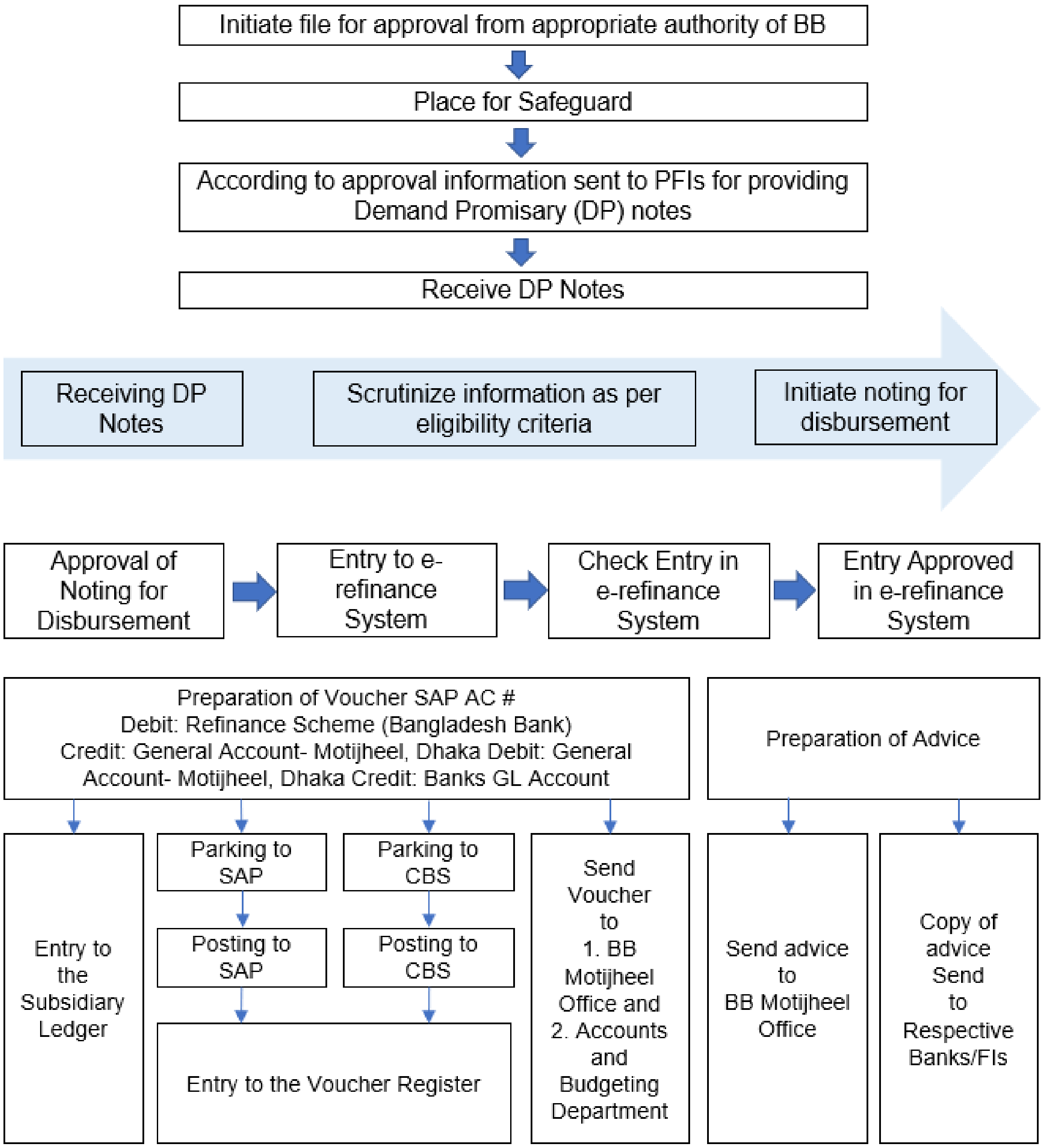
Various Fiscal Packages Declared by Honorable Prime Minister
(As of September 2020)

Serial No	Name of the Package	Amount (BTD 10million)
1	Special fund for salary support to export-oriented manufacturing industry workers	5,000
2	Working capital loans provided to affected industries and service sector	33,000
3	Working capital loans provided to SMEs, cottage industries	20,000
4	Expansion of facility provided through Export Development Fund (EDF) by Bangladesh Bank	12,750
5	Preshipment credit refinance scheme	5,000
6	Special honorarium for doctors, nurses, medical workers	100
7	Compensation in case of death or infection by COVID-19	750
8	Free food distribution	2,503
9	OMS of rice at 10 taka/kg	251
10	Cash transfer to targeted poor people	1,258
11	Expansion of cash allowance programs	815
12	Construction of home for homeless people	2,130
13	Additional procurement of paddy/rice (2.0 lac ton)	860
14	Support for farm mechanization	200
15	Subsidy for agriculture	9,500
16	Agriculture refinance scheme	5,000
17	Refinance scheme for professional farmer and small traders	3,000
18	Employment creation	2,000
19	Interest subsidy for commercial banks	2,000
20	Credit risk-sharing scheme for SME sector	2,000
21	Safety net program for export-oriented Industry's distressed workers	1,500
	Total (In Crore Taka)	**112,633**
	Total (In Million USD)	**13,251**
	As % of GDP	**4.03**

Annex 5. Process Flow Diagram for Refinance Loans

Figure 3: Process Flow of Refinance Loans

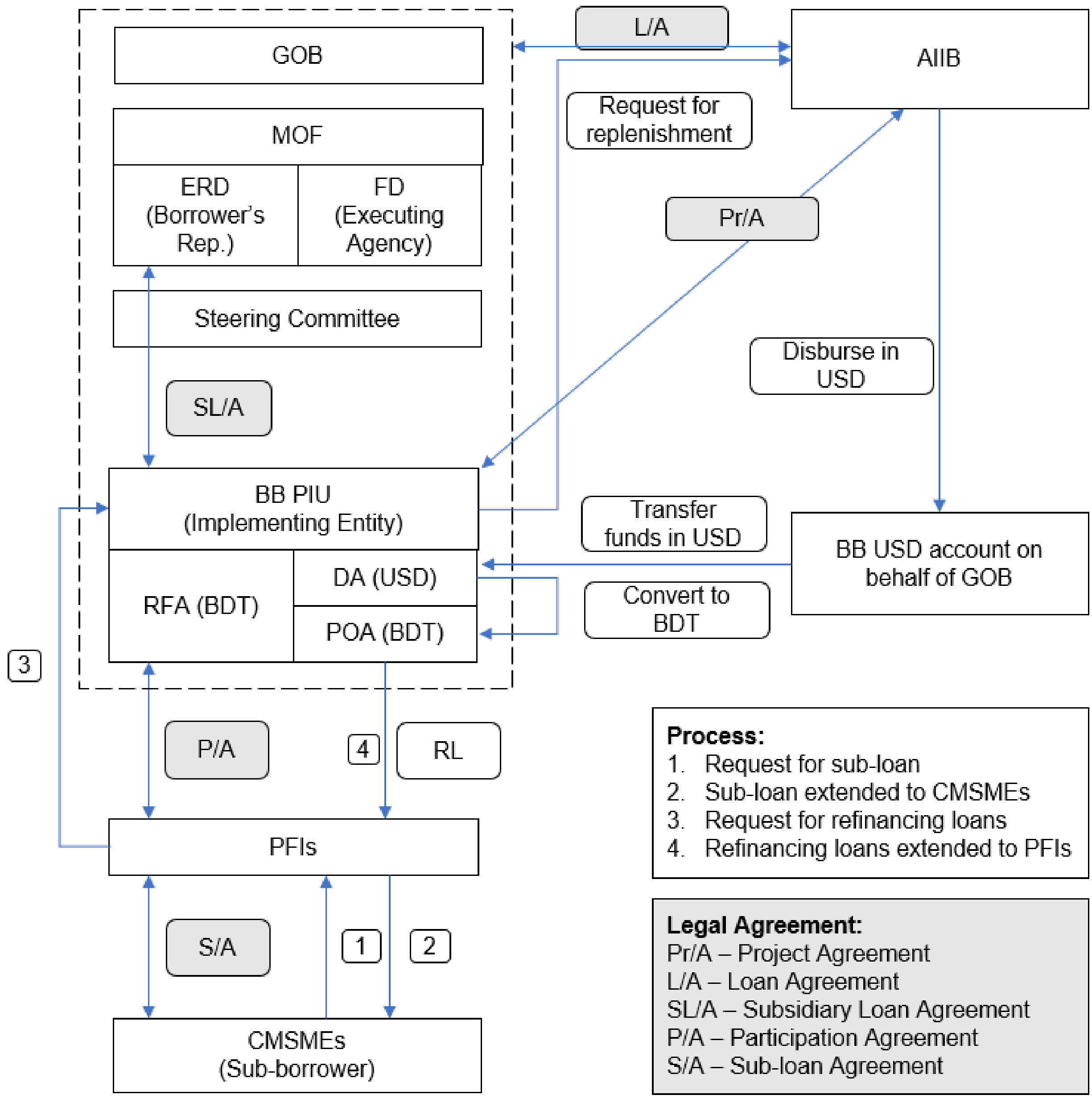




SAP AC = SAP Access Control, BB = Bangladesh Bank, CBS = Core Banking System, FI = financial institution, GL = General ledger

Annex 6. Key Players and Funds Flow

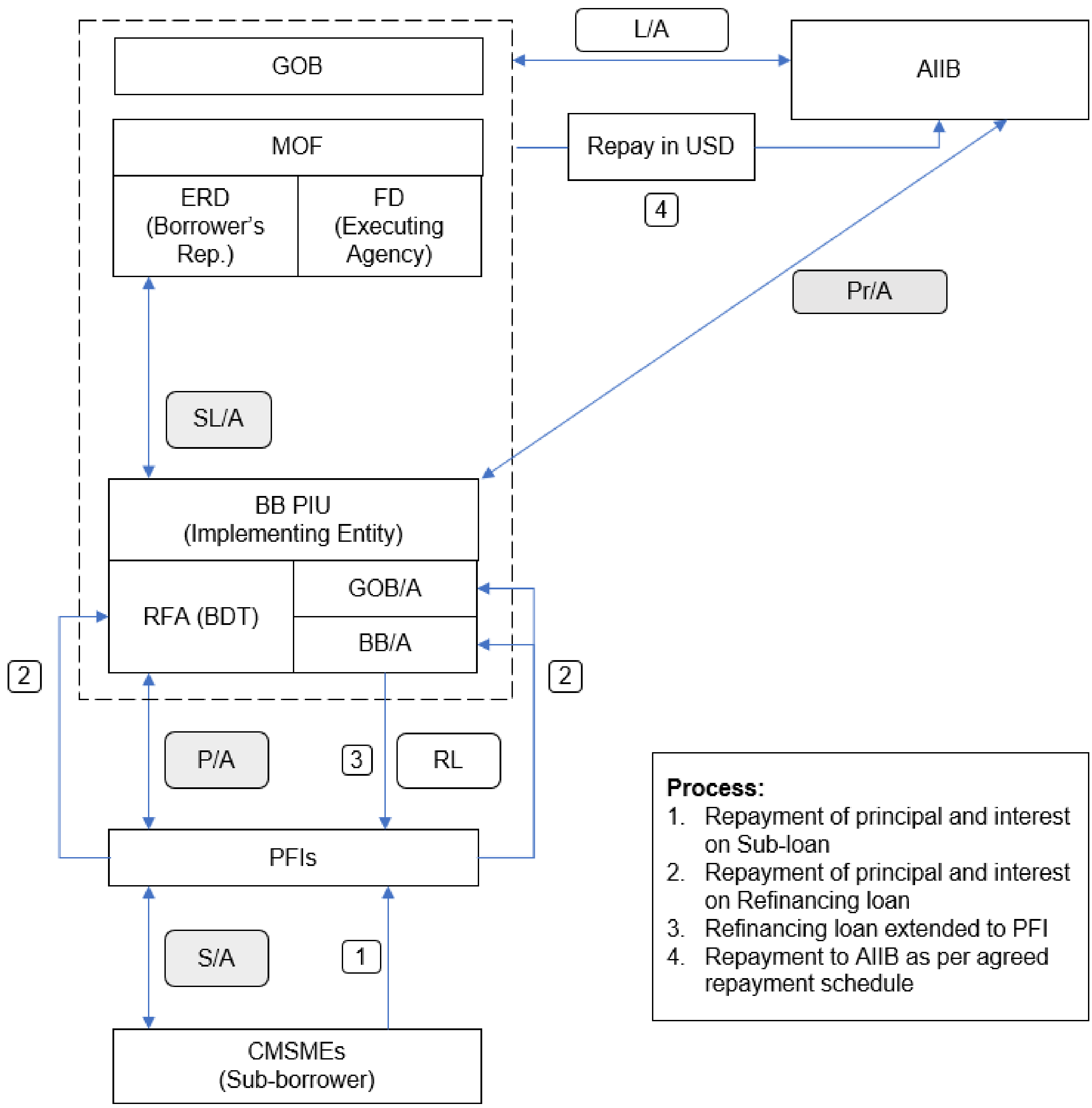
Figure 4: Disbursement



Source: Bangladesh Bank, AIIB

AIIB = Asian Infrastructure Investment Bank, BDT = Bangladesh taka, DA = Designated Account, ERD = Economic Relations Division of MOF, FD = Financial Institutions Division of MOF, GOB = Government of Bangladesh, MOF = Ministry of Finance, POA = Project Operating Account, RFA = Revolving Fund Account, RL = Refinancing loan, PIU = Project implementation unit, PFIs = Participating financial institutions, CMSMEs = Cottage, micro, small and medium sized enterprises

Figure 5: Repayment



AIIB = Asian Infrastructure Investment Bank, BDT = Bangladesh taka, ERD = Economic Relations Division of MOF, FD = Financial Institutions Division of MOF, GOB = Government of Bangladesh, MOF = Ministry of Finance, RFA = Revolving Fund Account, RL = Refinancing loan, PIU = Project implementation unit, PFIs = Participating financial institutions, CMSMEs = Cottage, micro, small and medium sized enterprises, BB/A = BB's Revenue Account, GOB/A = GOB's Revenue Account

Annex 7: Proposed Eligibility Criteria for Participating Financial Institution

1. **Eligible Participating Financial Institution**

In order to be eligible for financing with proceeds of the project, a PFI must comply with the following criteria.

(a) An organization must be a bank or nonbank financial institution (NBFI), duly licensed, approved and supervised by BB;
(b) It must have minimum three years' experience of business operation in banking and/or finance with audited records (according to the requirements of the national financial regulatory authority);
(c) It should maintain BB declared rate of Capital Adequacy, Cash Reserve Ratio (CRR); Statutory Liquidity Ratio (SLR) [Note: these conditions are not applicable to state-owned banks[11]];
(d) It should be profitable for two consecutive fiscal years including the latest one;
(e) It should have a maximum nonperforming loan of 10 percent [Note: this condition is not applicable to state-owned banks as stated;
(f) It should not be classified as the problem/sick bank and NBFIs or the early warning bank according to the CAMELS rating for BB's monitoring and supervision.
(g) It should take proper risk management measure and compliance with anti-money laundering related guidelines of the Bangladesh Financial Intelligence Unit (BFIU); the FI should not have substantially breached AML laws and regulations, or been subject to any significant findings or recommendation on improvements by the local regulatory authority over the past three years;
(h) It should have adequate organization, management, staff and other resources necessary for its efficient operation;
(i) It should have ES assessment procedures for screening, monitoring and reporting as acceptable to BB and AIIB;
(j) In addition to the above criteria, if banks and financial institutions are deemed to have significant insufficiency in fulfilling the prudential regulations in the aspects, including but not limited to the following, and if such insufficiency is deemed to adversely affect their operations and management, such banks and financial institutions shall not be eligible:

- Transparency (e.g., submission and/or disclosure of financial statements)
- Corporate Governance (e.g., control and management of business risk or corruption)
- Risk Management (e.g., capacity of risk assessment and adoption of adequate procedures)

2. **Participation Agreement.**

(a) Documentation. If a PFI application is approved, the PFIs must enter into a Participation Agreement with BB.

(b) Key provisions. The Participation Agreement shall include, but not limited to the following obligations of PFI.

[11] 1.Sonali Bank Ltd., 2. Janata Bank Ltd., 3. Agrani Bank Ltd., 4. Rupali Bank Ltd., 5. Bangladesh Krishi Bank (BKB), 6. RAKUB (Rajshahi Krishi Unnayan Bank), 7. BASIC Bank, 8. BDBL (Bangladesh Development Bank Ltd).

(i) To comply with all the rules and regulations applicable to banks and financial institutions in Bangladesh;

(ii) To comply with the eligibility criteria at all times unless the PFI is at the remedial stage and is so allowed by BB;

(iii) To comply with all the terms and conditions of sub-loans as specified below as well as in the operations manual;

(iv) To conduct its operations and affairs, with due diligence and efficiency and in accordance with sound administrative, financial, economic and managerial standards;

(v) To supervise and monitor the proposed use of sub-loans to assure that the purpose of the project shall be accomplished;

(vi) To disclose or submit all information required by PIU, including, but not limited to, audited financial statements and reports required by PIU for the implementation and monitoring of the project;

(vii) To provide prompt notice, upon becoming aware, of any information it obtains regarding a violation of AIIB's Prohibited Practices Policy by the PFI and the sub-borrower or any person acting on its behalf;

(viii) To allow PIU to suspend, terminate or withdraw loan when violations are observed;

(ix) To enable PIU, BB or AIIB to inspect the PFI or any sub-borrowers and review any relevant records and documents maintained by the PFI, if PIU, BB or AIIB so requests;

(x) To maintain a lending and investment policy conducive to the growth and development of small and medium-sized enterprise sector and maintain suitable procedures and an adequate number of suitably qualified staff to enable it effectively appraise the financial and environmental risk of sub-loan in accordance with sound lending and investment policy and in keeping with the principles, terms and conditions of existing policies of Bangladesh Bank, which are applicable for CMSME financing.

(xi) To provide detail of sub-loan disbursements in the agreed interval and submit reports within the agreed period to PIU as per prescribed formats, or as mentioned by the Bangladesh Bank from time to time for refinancing.

(xii) To maintain separate monitoring units for this project.

(xiii) To payback the released fund to BB including the accrued interest, as per pre-determined terms and conditions and prescheduled times as mutually agreed by both parties.

(xiv) To submit a Demand Promissory note at each instance of taking refinance to ensure repayment (principal as well as accrued interest) against sanctioned amount.

(xv) Other provisions:

a) BB will realize the amount refinanced to a PFI along with applicable interest/profit/charges on maturity or completion of one year, whichever is earlier, from the date of refinancing by debiting their current accounts with BB.

b) If a PFI fails on a scheduled payment for any unacceptable cause, BB will preserve the right to exclude such banks/NBFIs from the facility.

c) If the PFI is found to have received refinance under the facility on the basis of a false or incorrect statement or information, or for any purpose other than implied in the agreement, BB will have the right to impose and recover penalty at a time at the rate of two percent above than the prevailing rate on the refinanced amount for the entire refinanced period and can recover the full amount including interest/profit/penalty at one instance.

d) If BB cannot recover scheduled installments due to PFI's insufficient balance, it preserves the right to impose a penalty at the rate of two percent above the prevailing rate on the installment amount for the overdue period and to recover the full amount including interest/profit/penalty at one instance.

e) If BB finds that a PFI does not adjust or take necessary steps to adjust any early adjusted fund by its sub-loan, BB reserves the right to impose a penalty at the rate of two percent above than the prevailing rate on such amount for the unadjusted period and to recover the full amount including interest/profit/penalty at one instance.

Annex 8: Proposed Eligibility Criteria for Sub-loans and Sub-borrowers

1. **Eligible Sub-loans**

To be eligible for financing with proceeds of the facility, a sub-loan must meet the following requirements:
(a) The sub-loan must be made only to an eligible sub-borrower for an eligible purpose.
(b) The sub-loan must be denominated in the local currency.
(c) The maximum tenor of the sub-loan should be one year (excluding grace period), a maximum grace period of three months may be provided.

2. **Eligible Sub-borrowers**

To be eligible to receive a sub-loan, the intended sub-borrower of the sub-loan must meet the following requirements:
(a) The sub-borrower must be private sector enterprises in any type of the following:
- Limited liability company
- Proprietor; or
- Partnership

(b) The sub-borrower must be in the cottage, micro, small and medium enterprise (CMSME) sector, with criteria defined by Bangladesh Bank.
(c) The size of eligible sub-borrower shall be based on the definition of CMSMEs set by the 2016 Industrial Policy of the Government of Bangladesh which the BB has adopted. It is based on fixed assets (excluding land buildings) and/or the number of employees. CMSME is not a public limited company and complies with the following criteria:

Figure 6: Definition of Cottage, Micro, Small and Medium-sized Enterprises Adopted by the Bangladesh Bank

Enterprise size		Fixed asset excluding Land & Building (in USD thousands)	Employment	Annual Turnover (in USD thousands)
Cottage		<12	Max. 15	-
Micro	Manufacturing	12 but <90	16-30	-
	Service	<12	Max. 15	-
	Trading	<12	Max. 15	240
Small	Manufacturing	90 but <180	31-120	-
	Service	12 but <240	16-50	-
	Trading	12 - 2.4	16-50	240 - 2400
Medium	Manufacturing	1800 – 6000	121-300 (Max 1000 for RMG/Labor-intensive industry)	-
	Service	240 – 3600	51-120	-

Source: SME & Special Programmes Department, Circular No. 02 dated Sep. 5, 2019.
Exception to the definition: RMG and Knitwear sector industries which are a member of BGMEA and/or BKMEA with labor employment of 100-2000.
Note: If any enterprise falls under a particular category under one criterion (either total fixed assets or employment) but falls under a larger size category under the other, then the enterprise will be classified into the latter category.

(d) The sub-borrower must be registered and operating primarily in the People's Republic of Bangladesh or has a business address in the People's Republic of Bangladesh.
(e) The sub-borrower must not be a loan defaulter. If a loan of a CMSME is rescheduled for more than three times that CMSME entity will not be eligible for this facility.
(f) A single enterprise/client can avail of funds from this package for a maximum of one year.

(g) The maximum lending amounts to each sub-borrower is determined based on banks'/NBFIs' own decision. However, for existing clients the amount should not exceed the bank's/NBFI's previous year's sector-specific credit limit (new clients are not subject to the limit).
(h) The sub-borrower has obtained all necessary local approvals, certifications and permits, and complies with all applicable national environmental, social, health and safety legislation and employment regulations and standards in effect.
(i) The sub-borrower meets the PFI's requirements in, *inter alia*: creditworthiness, foreign-exchange position, integrity checks, ES requirements, and procurement practices
(j) The sub-borrower (a) demonstrates the compliance of all their activities with applicable ES regulatory requirements and commits to maintaining that status during the tenure of the sub-loan, (b) represents not having recently been administratively or judicially convicted of a material breach of environmental and social regulations, and (c) is not being reported in mainstream or social media as materially contravening good ES practices.
(k) The sub-borrower must meet the PFI's requirements in capacities to, *inter alia*: ensure adequate and proper financial accounting of all incomes and expenditures, prepare financial statements relating to all its activities according to the prescribed policy of the Bangladesh Bank.
(l) The sub-borrower must not be included on AIIB's debarment list when the sub-loan is made or the proceeds of the sub-loan are advanced to it.[12]
(m) Neither the sub-borrower nor any person acting on behalf of the sub-borrower has engaged in any Prohibited Practice under AIIB's Prohibited Practices Policy [13] concerning the sub-loan or other activity being financed.

3. Eligible Purposes

(a) The proceeds of a sub-loan may be used only for working capital requirements.
(b) The proceeds of a sub-loan may not be used for any of the following purposes:
   (i) Any activity that appears on AIIB's Environmental and Social Exclusion List;
   (ii) Any Category A and high-risk Category B[14] activities, and activities listed in the Exclusion List of ESRM Guidelines of BB;
   (iii) Any payment to a person or for any import of goods if such payment or import is prohibited by any resolution of the United Nations Security Council under Chapter VII of the United Nations Charter.
(c) The proceeds will not be used to adjust existing loans or for balancing, modernization, rehabilitation and expansion of existing businesses or new initiatives.

4. General Guidelines for Environment and Social Appraisal

PFIs must screen and categorize each sub-loan, review and conduct due diligence on the environmental and social risks of each sub-loan and review and approve an environmental and social action plan incorporating the sub-borrower's environmental and social commitments concerning the sub-loan, all in a manner consistent with BB's Guidelines on

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[12] AIIB. 2020. Debarment List. AIIB. Beijing. https://www.aiib.org/en/about-aiib/who-we-are/debarment-list/index.html
[13] AIIB. 2020. Policy on Prohibited Practices. AIIB. Beijing. https://www.aiib.org/en/policies-strategies/operational-policies/prohibited-practices.html
[14] These high-risk Category B sub-loans to be excluded from the AIIB financing are those transactions that may potentially result in: (i) land acquisition or involuntary resettlement, (ii) risk of adverse impacts on Indigenous Peoples and/or vulnerable groups, (iii) significant risks to or impacts on the environment, community health and safety, biodiversity, and cultural resources, and/or (iv) significant occupational health and safety risks.

Environmental & Social Risk Management (ESRM) for Banks and Financial Institutions in Bangladesh.[15]

For each sub-loan, PFI's appraisal of environmental and social risks must include:

(a) screening the sub-loan against AIIB's Environmental and Social Exclusion List;
(b) reviewing and categorizing the sub-loan according to its potential environmental and social risks and impacts;
(c) assessing compliance of the sub-loan with applicable environmental and social laws.

5. **Sub-loan Agreement (Loan Contract between PFIs and sub-borrowers)**

(a) **Documentation**. If a sub-loan application is approved, the PFIs must enter into a loan agreement for the sub-loan which provides PFIs with rights adequate to protect their interests and those of AIIB, including the provisions set out in subparagraph (b) below.

(b) **Key provisions**. Each sub-loan agreement must require the sub-borrower to:

(i) use the proceeds of sub-loans exclusively for the working capital;
(ii) carry out the activity being financed with due diligence and efficiency and following sound technical, economic, financial, managerial, fiduciary, integrity and environmental and social standards and practices;
(iii) not engage in any Prohibited Practice in relation to the sub-loan or other activity being financed, or authorize or permit anyone to do so on its behalf;
(iv) notify the PFI of any violation of AIIB's Policy on Prohibited Practices or if any international financial institution imposes any sanction on the sub-borrower;
(v) manage its operations and carry out the activity being financed following the Guideline on Environmental & Social Risk Management (ESRM) for Banks and Financial Institutions in Bangladesh by BB;
(vi) maintain a financial management system in a manner adequate to reflect the operations, resources and expenditures related to the activity being financed;
(vii) prepare financial statements following consistently applied accounting standards;
(viii) provide right to inspect, by itself or jointly with representatives of BB and/or the AIIB, if they shall so request, to inspect the activity being financed and any relevant records and documents;
(ix) provide right to obtain all such information as AIIB, BB or PFI may reasonably request relating to the foregoing administration, operations and functional conditions of the sub-borrower, and to the benefits to be derived from the activity being financed;
(x) involve any remedies against the sub-borrower, including suspension, termination, or withdrawal of the sub-loan, which will be available to PFI by law, in event of failure of the sub-borrower to perform its obligation under contract with PFI;
(xi) provide right to take any legal action against the sub-borrower in case of default following the prevailing rules and regulations and prudential regulations/guidelines of BB.

[15] BB's ESRM is consistent with AIIB's Environmental & Social Policy.

Annex 9: Analysis of the Banking and NBFI Sectors

1. Banking Sector

1.1. **Overall.** The banking industry in Bangladesh consists of 59 banks dominated by private commercial banks (PCBs) which account for two-thirds of industry assets and deposits, followed by state-owned commercial banks (SCBs) which account for more than a quarter of industry assets and deposits. Foreign commercial banks (FCBs) and development financial institutions (DFIs) represent a much smaller share of the market.

Figure 7. Banking System Structure

	No. of banks	No. of branches	Total assets (BDT billion)	% of industry assets	Deposits (BDT billion)	% of industry deposits
SCBs	6	3,746	3732.2	25.6	2,868.4	26.6
DFIs	3	1,412	324	2.2	286	2.6
PCBs	41	5,060	9769.7	67	7,127.2	66
FCBs	9	68	747.1	5.2	517.2	4.8
Total	**59**	**10,286**	**14,572.9**	**100**	**10,798.7**	**100**

Source: Bangladesh Bank 2018-2019 Annual Report.

1.2. **Capital adequacy.** The Capital to Risk Weighted Assets Ratio (CRAR) of the banking industry was 11.6 percent as of December 2019, 1.6 percentage points above the regulatory requirement. The CRAR of PCBs increased to 13.6 percent from 12.9 percent in June 2019, whereas SCBs saw a modest decline from 7.7 percent to five percent.

1.3. **Asset quality.** The NPL indicators of the banking sector show some improvement at the end of December 2019 as reflected by the reduction in nonperforming loans (NPLs), enhancement in liquidity condition, stability in capital adequacy and improvement in provision maintained. The gross NPL ratio went down from 11.7 percent to 9.3 percent in June 2019, driven by SCBs and PCBs. The reduction of NPLs was affiliated with the “One Time Exit Policy” for bad loan rescheduling offered by Bangladesh Bank (BB) at the beginning of FY20 and scaled up efforts for loan recovery by banks. The industry-wide net NPLs declined to one percent in December 2019 from 2.6 percent in June 2019.

1.4. **Management soundness.** Total expenditure to total income is used to determine the management soundness of a financial institution. At the end of June 2019, the expenditure to total income (EI) ratio of the banking industry stood at 81.3 percent. The EI ratios of the SCBs and DFIs were higher than the industry average reflecting higher operating expenses.

1.5. **Earnings and profitability.** The profitability of the banking industry was low with an average return on asset (ROA) at just 0.4 percent in December 2019 and unchanged versus June 2019. ROA for SCBs and PCBs improved by a small margin however, ROA for DFIs and FCBs slightly deteriorated.

1.6. **Liquidity.** Overall liquidity conditions in the banking sector remained adequate and stable at the end of December 2019. The statutory liquidity reserve (SLR) rate stood at 18.7 percent (against the minimum requirement of 13 percent) and up 0.5 percentage points from June 2019, driven by SCBs and PCBs. FCBs have the highest SLR ratio followed by the SCBs. The ratio for DFIs is zero as they do not need to maintain SLR. The advance deposit ratio (ADR) in the banking sector stood at 76.6 percent as of December 2019 (against prudential limits of 85 percent). The LCR (liquidity coverage ratio) in the banking sector was 177.28 percent as of June 2019 (against the minimum requirement of 100 percent), indicating that almost all the banks had a reasonable buffer of high-quality liquid assets to cover the cash outflow for a minimum of next 30 calendar days under a stressed scenario. The net stable funding ratio in the banking sector was 111.56 percent as of June 2019, indicating that banks are more depended on stable funding rather than volatile funds to expand their business activities.

1.7. Figure 8 shows the CRAR, gross NPL, net NPL, ROA and SLR ratio by type of banks for two comparable periods.

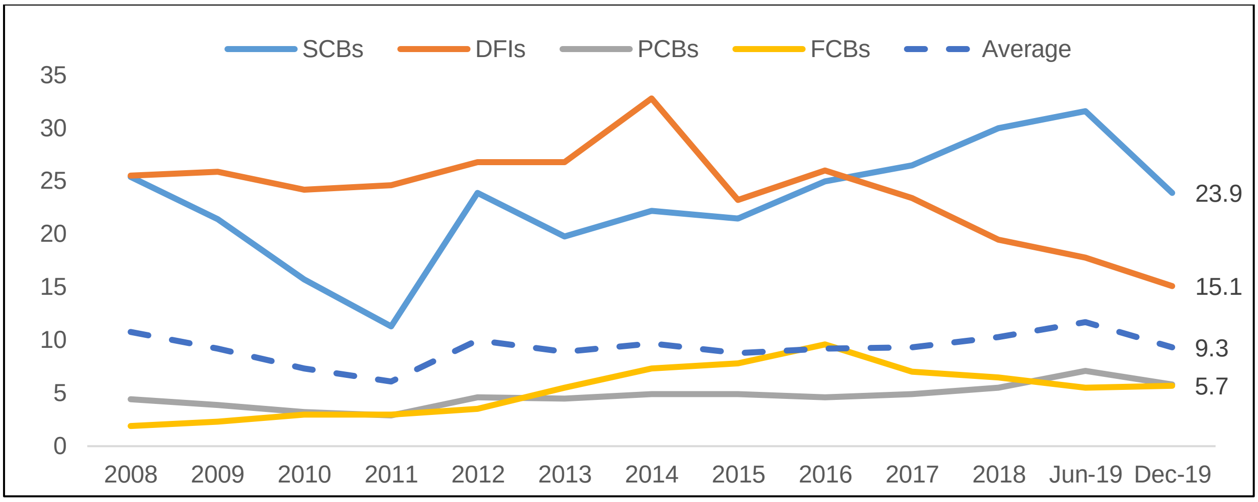
Figure 8. Key Ratios for Banking Sector

	CRAR		**Gross NPL ratio**		**Net NPL ratio**		**ROA**		**SLR ratio**	
	June-19	**Dec-19**	**June-19**	**Dec-19**	**June-19**	**Dec-19**	**June-19**	**Dec-19**	**2018**	**June-19**
SCBs	8.5	5.0	31.6	23.9	8.7	6.3	-0.8	-0.6	24.8	26.6
DFIs	-31.2	-32.0	17.8	15.1	4.6	3.0	-2.7	-3.3	0.0	0.0
PCBs	12.9	13.6	7.1	5.8	1.5	-0.1	0.7	0.8	14.2	15.1
FCBs	28.7	24.5	5.5	5.7	0.1	0.2	2.6	2.3	48.4	36.3
Total	**11.74**	**11.6**	**11.7**	**9.3**	**2.6**	**1.0**	**0.3**	**0.4**	**18.2**	**18.7**

Source: Bangladesh Bank.

1.8. **NPL Management.** Nonperforming loans (NPLs) have become a major concern for the banking sector. The government and the central bank have taken various policy measures in this regard. Banks have been asked to ensure proper due diligence while disbursing new loans to prevent the creation of new NPLs and expedite their recovery drive through the disposal of the long pending lawsuits by increasing monitoring and employing lawyers and creating of task forces at the head office, regional office and branch level. However, considerable success was not achieved in case of classified loan recovery due to disbursing credit without proper risk analysis, etc. Bangladesh Bank along with the government is taking necessary initiatives for regulatory and legal reform to create a suitable environment for existing NPLs recovery. Several policy initiatives have been taken by BB to reduce NPLs through restructure, rescheduling, recovery, one-time exit and write-off in FY2019. Besides, effective practice of corporate governance, transparency and accountability in all aspects, efficient credit risk management, managerial efficiency and adaptation of modern technological changes may improve the overall NPL problem. These measures have taken effect with gross NPL reduced across the board in December 2019 versus June 2019.

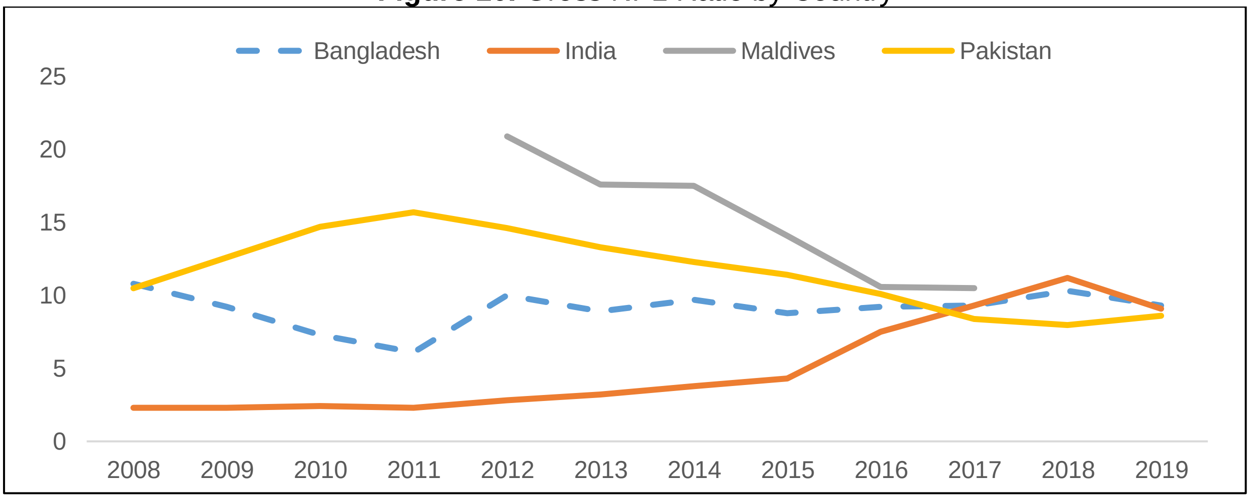
Figure 9. Gross NPL Ratio for Banking Sector



Source: Bangladesh Bank.

1.9. **NPL Comparison by Country.** The figure below shows the gross NPL ratio of key countries in South Asia including India, Pakistan and Maldives. It is observed that the NPLs for these countries have converged to around 10 percent in recent years, i.e., the NPL of Bangladesh is broadly in-line with similar markets.

Figure 10. Gross NPL Ratio by Country



Source: (1) ADB, March 2019, Non-performing loans in Asia: Determinants and macro-financial linkages. (2) Statistica.

1.10. **Risk Management by BB. The Bangladesh Bank (**BB) has issued six core risks management guidelines to ensure robustness, efficiency and effectiveness of risk management systems. BB assigns a comprehensive risk management rating for each bank on a half-yearly basis. The risk rating is based on available information in the Comprehensive Risk Management Report, minutes of executive risk management committee (ERMC) and board risk management committee meetings and compliance status of BB instructions submitted by the concerned bank and other sources. The financial condition of the banks is monitored throughout the year based on periodic on-site inspections. In FY2019, BB conducted over 2,500 on-site inspections. Financial Integrity and Customer Services Department (FICSD) has been working relentlessly to settle customers' complaints against various banking and financial services. In FY2019, a total of 5,357 complaints were received by the department.

1.11. **Prudential Regulations.**

i. Banks operate under full control and supervision of BB which is empowered to do so through the Bangladesh Bank Order, 1972 and Bank Company Act, 1991.

ii. Under Basel-III regulation, banks are required to maintain the Minimum Capital Requirement at 10 percent of the Risk Weighted Assets (RWA) or BDT 5 billion as capital, whichever is higher. All banks must hold Common Equity Tier 1 capital of at least 4.5 percent of total RWA at all times and build up additional Capital Conservation Buffer.

iii. Internal Capital Adequacy Assessment Process (ICAAP), as a part of the implementation of Pillar II of Basel III, is also ongoing. Banks have to evaluate their internal processes and strategies to ensure adequate capital resources covering all material risks and submit the ICAAP reports to BB.

iv. CAMELS rating, one of the major supervisory tools for the evaluation of banks is used to evaluate banks.

v. BB carries out two types of supervisory activities (i) off-site supervision and (ii) on-site inspection. The Department of Off-site Supervision of BB is accountable for conducting off-site supervision of banks.

2. NBFIs Sector

2.1. **Overall.** At present, 34 NBFIs are operating in Bangladesh. Among them, three are government-owned, 12 are joint ventures with foreign participation, and the rest (19) are local, privately-owned companies. The branch network of NBFIs increased to 273 as of June 30, 2019. Total assets of NBFIs increased to BDT874.3 billion as of June 2019, with liabilities to assets ratio reduced to 86 percent from 87.6 percent in 2018.

Figure 11. Assets, Liabilities, Deposits of NBFIs

BDT billion	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Total assets	436.3	520.1	611	713.9	839.9	851.6	874.3
Total liabilities	350.4	424.2	509	606.46	726	762	751.8
Liabilities/assets ratio	80.3	81.5	83.3	84.95	86.4	87.6	86
Total deposit	198.3	238.5	318.1	382.43	468	480.1	458.1
Deposit as % of liabilities	56.6	56.2	62.5	63.1	64.4	63	60.9

Source: Bangladesh Bank 2018-2019 Annual Report.

2.2. **Rating.** Like banks, the performance of NBFIs is also evaluated through the CAMELS rating. At the end of June 2019, out of 34 NBFIs, the composite CAMELS rating is shown below.

i. 14 were "2 or Satisfactory,"
ii. 10 were "3 or Fair,"
iii. 7 were "4 or Marginal" and
iv. 1 were "5 or Unsatisfactory."
v. 1 FI is yet to come under this rating and another one is in the liquidation process.

2.3. **Financial Performance.** At the end of June 2019, the NPL for NBFIs was 11.9 percent, 1.9 percentage points above the regulatory requirement. ROA of all the NBFIs was 0.3 percent, unchanged from 2018. The SLR for the NBFIs operating without taking term deposit is 2.5 percent as of June 2019, lower the minimum requirement of five percent.

2.4. **Risk Management by BB. The** BB has taken some policy measures to put in place good corporate governance in NBFIs. NBFIs are required to maintain provision for expected losses on loans, advances, leases, investments considering aging analysis. For rescheduling of loans, NBFIs must receive down payments from clients. BB has issued guidelines on five core risk areas for NBFIs, namely, (1) credit risk management; (2) internal control and compliance; (3) asset-liability management; (4) prevention of money laundering and terrorist financing; and (5) information and communication technology security. To address and manage all the risks in a more prudent and organized way, BB also issued the "Integrated Risk Management Guidelines for Financial Institutions" to adopt improved policies and procedures in line with international best practices for their risk management framework. During FY2019, the Financial Institutions Inspection Department (FIID) of BB conducted total 42 comprehensive inspections on head offices and branches of financial institutions. This department also monitors the implementation status/progress of the recommendations made in the inspection reports.

2.5. **Prudential Regulations.** Nonbank financial institutions (NBFIs) are regulated under the Financial Institution Act, 1993 and controlled by BB. NBFIs are subject to the prudential guidelines/limits such as income recognition; asset classification and provisioning norms; capital adequacy norms; single and group borrower limits; prudential limits on capital market exposures; classification and valuation norms for the investment portfolio; CRR/SLR requirements; accounting and disclosure norms and supervisory reporting requirements issued by the BB. NBFIs have been instructed under the Basel III Accord to maintain a Capital Adequacy Ratio (CAR) of not less than 10 percent with at least five percent in core capital. At present, term liabilities are subject to a statutory liquidity requirement (SLR) of five percent on a biweekly basis, inclusive of an average 2.5 percent cash reserve ratio (CRR) on a biweekly basis. Due to COVID-19, BB has reduced the CRR requirement by one percentage point for 1.5 percent.