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Shadow Banking in Bangladesh with Special Reference to New Normal

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Foreword

As part of the ongoing dissemination of BIBM research outputs, the present research monograph contains the findings of the research project titled "Shadow Banking in Bangladesh with Special Reference to New Normal". The paper was presented in a seminar held in 01 December, 2021.

The paper examines shadow banking components in Bangladesh. In addition, the authors assess the changing trends and the associated risks of shadow operations in COVID-19. The portion of shadow operations of different players of the financial market, its regulatory mechanisms by the supervisory authorities and the monitoring instruments do not follow uniformity and rigorousness. However, the part of less regulated banking and financing activities should not have undermining impact, because certain operations of those institutions can possess shadow elements. The paper recommends the adoption of suitable definition for less regulated entities and their activities based on certain regulatory criteria. Moreover, the activities of those entities need to be categorized and monitored to ensure fair operating environment with uniform incentives. Besides, institutions should fix their own tech-based monitoring framework to manage risks for shadow elements.

It gives me immense pleasure to publish and distribute this research output to the regulators, practitioners of the banks, the academics as well as the common readers. I hope this monograph will be a useful guide especially for the supervisory authority of the financial market and the operators who are targeting smaller enterprises and vulnerable sections of the society.

Md. Akhtaruzzaman, Ph.D.
Director General, BIBM

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The research project titled "Shadow Banking in Bangladesh with Special Reference to New Normal" comes to light with the immense support from many persons, especially from the executives of different banks and non-bank financial institutions to identify the challenges and ways to deal with to their shadow operations. We would like to extend our gratitude to Dr. Md. Akhtaruzzaman, Honorable Director General of BIBM, for his valuable advice, observations and thoughts to progress our research work.

The research team is indebted to the chief guest, panelists and the participants of the seminar for their valuable comments that immensely helped us to improve the quality of the paper. The observations and remarks of Professor Dr. Barkat-e-Khuda, Dr. Muzaffer Ahmed Chair Professor of BIBM, helped us to improve the quality of the paper. Further, the paper benefitted from careful review and editing by Professor Dr. Barkat-e-Khuda. We are also very grateful to Dr. Ashraf Al Mamun, Associate Professor and Director (Research, Development & Consultancy) of BIBM for his support. We are thankful to the office of Research, Development & Consultancy, BIBM to complete the publication process. Finally, we would like to thank all of those who extended their support in this research work.

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RESEARCH MONOGRAPH 62

Shadow Banking in Bangladesh with Special Reference to New Normal

Contents

List of Boxes

List of Tables

List of Figures

Abbreviations

ACD	Agricultural Credit Department
AFI	Alliance for Financial Inclusion
AML	Anti-Money Laundering
ATM	Automated Teller Machine
BB	Bangladesh Bank
BCBS	Basel Committee on Banking Supervision
BDT	Bangladesh Taka
BFIU	Bangladesh Financial Intelligence Unit
BIBM	Bangladesh Institute of Bank Management
BPO	Bangladesh Post Office
BRPD	Banking Regulation and Policy Department
BSEC	Bangladesh Securities and Exchange Commission
CGAP	Consultative Group to Assist the Poorest
CGFS	Committee on the Global Financial System
CIB	Credit Information Bureau
CSR	Corporate Social Responsibility
CY	Calendar Year
DOC	Director of Cooperatives
FCIC	Financial Crisis Inquiry Commission
FDC	Foundation for Development Cooperation
FGD	Focus Group Discussion
FSB	Financial Stability Board
G20	Group of Twenty
GDP	Gross Domestic Product
GoB	Government of Bangladesh
IDRA	Insurance Development and Regulatory Authority
IMF	International Monetary Fund
IPO	Initial Public Offering

KYC	Know Your Customer
LC	Letter of Credit
LLM	Larry Light Money Watch
MFIs	Micro Finance Institutions
MFS	Mobile Financial Services
MI	Market Infrastructure
MRA	Micro Credit Regulatory Authority
NBFIs	of non-bank financial institutions
NGO	Non-Government Organization
NID	National Identity Card
NOC	No-objection Certificate
NPL	Non-Performing Loan
OBU	Offshore Banking Unit
PKSF	Palli Karma-Sahayak Foundation
RBS	Risk-Based Supervision
Repo	Repurchase Agreement
Reverse Repo	Reverse Repurchase Agreement
RMB	Ren Min Bi
SAR	Suspicious Activity Report
SCB	Standard Chartered Bank
SEC	Securities and Exchange Commission
SME	Small and Medium-sized Enterprise
SMESPD	SME and Special Programs Department of Bangladesh
STR	Suspicious Transaction Report
SUERF	The European Money and Finance Forum
TBML	Trade Based Money Laundering
TF	Terrorist Financing
USA	United States of America
USD	United States Dollar

Executive Summary

The thoughts on ‘shadow banking’ evolved with the changing scope and risk-taking ventures by banks and financial institutions. The term ‘shadow bank’ was first pronounced in 2007 by Paul McCulley to describe risky off-balance-sheet activities by banks to sell loans repackaged as bonds, and the term ‘shadow banking’ drew attention during 2007-09 global crisis to indicate destabilizing concerns associated with the ‘securitizing mortgage loans’. The key intention of identifying shadow banking during the crisis was to highlight the necessity of regulating and supervising the activities to escape potential financial instability.

It is recognized that the activities of banks and financial institutions must be highly regulated and monitored, and the concept of ‘shadow banking’ is associated with the regulation and supervision of the financing activities that have implications for the safety and security of the financial sector. Effective regulatory and supervisory framework is particularly crucial to have adequate control over the banking transactions so that the interests of the small depositors can be protected. Shadow banking is neither illegal nor unethical; these are simply less regulated. Shadow banking may not always be a concern for an economy. Shadow banking activities and financial inclusion initiatives are closely associated in several instances. The growth of shadow banking is stimulated by the popularity of financial innovations and deregulation that are finding path over the years. Moreover, growing competition from the non-bank entities is creating incentives for banks to shift a portion of their transactions outside the stringent regulatory boundary of traditional banking. In several instances, shadow banks play crucial roles in ensuring access to financial services by the vulnerable sections of the society. In developing countries, shadow banking expanded and came into focus mainly in the context of addressing the challenge of financial exclusion of the vulnerable sections of society. And, there are opinions that these types of shadow nature of banking may not necessarily be the sources of instability; rather sometimes these are essential for financial stability and crucial for the sustainable finance and growth.

Shadow baking i.e. less regulated products, received special impetus in the new normal scenario as technology driven financial products received greater attraction during the period. Despite recognized economic benefits of these innovative and sustainable banking products, possibilities of systemic risk transmission through these financial services cannot be ignored. To uphold financial stability, the necessity of monitoring the growing magnitude of shadow banking is receiving increasing attention of the policymakers while continuing with the inclusive drives. Especially, maintaining the balance between promoting inclusive finance and handling potential risks and consumer protection is the key issue to be addressed. Against the above background, the study is broadly about conceptualizing and perceiving ‘shadow banking’ in the context of Bangladesh. Specific objectives of the study are to: (i) discuss conceptual issues of shadow banking by reviewing literature and country experiences;

(ii) identify shadow banking components in the context of Bangladesh; (iii) assess changing trends of shadow banking and the associated risks in the context of the COVID-19; and (iv) draw attention of the policy makers and banks with specific recommendations.

The study is mainly based on secondary information. Secondary published sources were used to create conceptual underpinning of the study. An FGD was conducted with the participation of 43 executives of banks and NBFIs associated with mobile banking, agent banking, linkage credit, and alternative delivery channels (List of participants in Appendix Table-1) to discuss challenges and ways to deal with the relatively less regulated activities of banks. This report has been finalized after incorporating the comments of the participants and experts of the banking sector at a seminar.

'Shadow banking', as a structured finance tool, created considerable difficulties for the banks and financial institutions. There are very wide and narrow versions of interpretation of shadow banking concepts. A broad definition of shadow banking includes all financing activities that are allowed but less regulated. There is also an extremely narrow version according to which shadow banking is simply certain banking services offered by less regulated banking institutions. Some definitions of shadow banking focus on certain instruments. Shadow banking connected with regulatory implications is visible in recent definitions. The Financial Stability Board (FSB) differentiates between shadow banking entities and shadow banking activities that take place outside the scope of the regulated banking system. Shadow Banking is also seen as an approach to address unmet credit demand. Shadow banks help create credit access and address several credit unmet needs by commercial banks. In line with the relatively recent broad definitions, shadow banking activities include activities of 'Shadow banks' plus certain activities of 'banks' that are less regulated. And, generally, there are agreements that less regulated banking and financing activities may pose systemic risks to the financial system.

The market for shadow banking has been expanding rapidly with the growing popularity of financial deregulation, especially since early 1980s. The global market for shadow banking is estimated to reach a size of USD72.5 billion by 2027, growing at an average growth rate of 5.4 percent over 2020-2027. Of the economies, USA is said to have over 30 percent of global shadow banking market, followed by China, Japan and Canada with around 5 percent each. Financial innovation and technology have been the commonly noted catalysts for the development of shadow banking. According to Edwards and Mishkin (1995), informational and transaction cost advantages of the nonbanks over banks with the advancements in technology is a contributory factor to the expansion of shadow banking. While traditional banks take time to adopt technological changes, less-regulated financial market participants took advantage and started adopting technology quickly in their service delivery.

Regulatory advantages are considered a major factor in the expansion of shadow banking. According to The Economist (2016), shadow banks have flourished in part that less regulated because tighter capital requirements and restrictions kept them grounded. Several regulatory imposition and reserve requirements on banks spurred the development of alternative credit and deposit products outside the highly regulated zone. According to an estimation, regulatory advantages contributed 55 percent of the expansion of shadow banking, followed by technological advancement that accounts for 35 percent. In the context of COVID-19, on the one hand, technology-based payment and financial services became the lifeblood and expanded rapidly in the less regulated arena; and on the other hand, a section of investors made huge money in ways to extract profit from the affected low-income people and struggling companies.

In Bangladesh, the operations of banks, NBFIs, MFIs, and insurance companies are regulated and supervised; however, not all these institutions are regulated and monitored following uniform stringent criteria like regulatory arrangement, supervisory arrangement, reporting arrangement, capital and prudential requirements, consumer protection arrangement, and access to regulatory support. Entities like postal department and cooperatives are not regulated or monitored following standard financial sector regulatory criteria. MFS providers and mobile payment service providers or operators are relatively new in the financial arena and are increasingly getting involved with the financial institutions to deliver technology-driven financial services. Though these entities have regulatory and supervisory arrangements, these are hardly under capital and prudential requirements, consumer protection arrangements, and access to regulatory support in case of financial distress. Securities market and capital market-related activities are recognized shadow banking activities throughout the globe. Banks of the country are adequately regulated and NBFIs also appear to be regulated following standard financial sector regulatory criteria. However, certain linkage activities of these entities are having shadow elements/components like mobile financial services, agent banking activities, linkage credit of banks, and NBFIs, factoring, etc.

The above-mentioned entities and activities are different in terms of regulatory stringency and have less regulated or shadow components and elements. However, all less regulated financial services do not have uniform destabilization impacts, and need to be delicately regulated to accrue the beneficial impacts in addressing financial exclusion and poverty in the country. Innovative and technology-focused financial inclusion drives have become an even more powerful development tool in the context of the COVID-19 situation to support vulnerable enterprises, households, and individuals. There are evidences and opinions that though Fintech has great potential to expand credit access quickly, this increased credit provision may not always be sustainable. Inadequate regulation and monitoring of these activities might cause instability while too stringent regulation may deny benefits. Especially, the regulatory and monitoring arrangement is needed to ensure transparency, customer identification, and mandatory redress of customer complaints. Besides, certain issues of distortions due to differential regulatory implications in the innovative financing market should not disincentivize the ongoing movements. The study puts forwards the following recommendations:

Mapping of payment, deposit and credit services by adopting suitable definitions (narrow and broad) is the need of the time based on certain regulatory criteria: regulatory arrangement, supervisory arrangement, reporting arrangement, capital and prudential requirements, consumer protection arrangement, and access to regulatory support. Shadow entities and shadow activities need to be categorized based on their beneficial impacts (financial inclusion, socio-economic development) and stability risks (liquidity risk, leverage risk, interconnectedness and contagion risk, crime risk, etc.). Besides, their movements should be under continuous monitoring. This exercise became particularly necessary in the context of COVID-19 when less regulated banking is receiving a remarkable policy boost throughout the globe.

For fairness, regulatory environment should ensure uniform business incentives to the market players engaged in offering financial services for financial inclusion. This is associated with fair competition, transparency, accountability and efficient monitoring of financing activities for financial inclusion. Thus, MFS providers need to be brought under uniform but lenient regulatory control that might mainly be associated with following certain procedures and furnishing certain information that is crucial for monitoring management, transparency, and customer protections. Financing and credit activities offered through Agents and linkage arrangements should come under monitoring scanner to manage reputation and crime risks of the financial sector. And for that matter, banks/NBFIs may perform in line with a 'guidance framework' prepared through stakeholders' consultations.

Risks associated with MFS, agent banking and linkage activities by the banks and NBFIs should be identified and monitored. Banks and NBFIs should install their own monitoring framework for managing the risks. There should be structured mechanisms for capacity development, disclosure, and customer protection for the less regulated financing activities. Regarding interconnectedness concerns, the less regulated entities should be under continuous monitoring of the regulated banks and financial institutions for their own sake. Considering contagion risk, consortiums of MFS, and agent banking service providers should undertake collective efforts and a uniform risk management approach.

Finally, monitoring and risk management initiatives on the part of market players (banks/NBFIs) would be the best way to escape the possibilities of confronting stringent regulatory framework by the ongoing financial innovations associated with mobile banking, agent banking, and other financial inclusion drives targeting smaller enterprises and vulnerable sections of the society.

Shadow Banking in Bangladesh with Special Reference to New Normal

1. Introduction

It is recognized that the activities of banks and financial institutions must be highly regulated and monitored, and the concept of 'shadow banking' is associated with the regulation and supervision of the financing activities that have implications for the safety and security of the financial sector. Effective regulatory and supervisory framework is particularly crucial to have adequate control over the banking transactions, so that the interests of the small depositors can be protected. Credit intermediation by bank-like institutions may take place under lax prudential regulations, and if the volume of such transactions increased significantly, certain mishaps might affect confidence in the banking sector. Lack of awareness of the necessity of bank supervision among common people might contribute to that end. Especially, it might create huge complexity when there are significant market interconnections between banks and bank-like less regulated institutions (Lauer and Timothy, 2015).

Shadow banking is neither illegal nor unethical; these are simply less regulated. Shadow banking may not always be a concern for an economy. Shadow banking activities and financial inclusion initiatives are closely associated in several instances. The growth of shadow banking is stimulated by the popularity of financial innovations and deregulation that are finding path over the years. Moreover, growing competition from the non-bank entities is creating incentives for banks to shift a portion of their transactions outside the stringent regulatory boundary of traditional banking. Several new forms of 'structured' credit intermediation have flourished over the years and complexities increased along with the associated risks. However traditionally, the shadow financial market in the developing countries is less complex than that in the developed countries as it involves fewer entity types and fewer steps of financial intermediation (Adrian and Ashcraft, 2016). To utilize financial services as a tool for poverty reduction, several types of innovative financial measures are generally implemented across the region as part of broader financial inclusion strategies. In several instances, shadow banks play crucial roles in ensuring access to financial services by the vulnerable sections of the society (BCBS, 2015). In developing countries, shadow banking expanded and came into focus mainly in the context of addressing the challenge of financial exclusion of the vulnerable sections of society. And, there are opinions that these types of shadow nature of banking may not necessarily be the sources of instability; rather sometimes these are essential for financial stability and crucial for the sustainable finance and growth.

Shadow banking i.e. less regulated products received special impetus in the new normal scenario as technology driven financial products received greater attention during the period. Despite recognized economic benefits of these innovative and sustainable banking products, possibilities of systemic risk transmission through these financial services cannot be ignored. To uphold financial stability, the necessity of monitoring the growing magnitude of shadow banking is getting increasing attention of the policymakers while continuing with the inclusive drives. Especially, maintaining the balance between promoting inclusive finance and handling potential risks and consumer protection is the key issue to address (Sheng and Nd Chaw, 2016). 'The Moscow Resolution on Financial Inclusion and Shadow Banking' of the Alliance for Financial Inclusion (AFI) recognized the need for coexistence of regulated banks and less regulated intermediaries for inclusive financial ecosystems, and asserted the challenges in formulating and applying proportionate regulatory and supervisory frameworks for shadow banking.

In Bangladesh, the financial sector is predominantly dominated by banks. The activities of Non-bank Financial Institutions (NBFIs) engaged in leasing, infrastructure finance, housing finance, securities activities etc. are growing. Financial market of Bangladesh also includes Micro Finance Institutions (MFIs) and insurance companies. Operations of these institutions (banks, NBFIs, MFIs and insurance companies) are regulated and monitored by the regulatory authorities like Bangladesh Bank (BB), Micro Credit Regulatory Authority (MRA), Insurance Development and Regulatory Authority (IDRA), and Bangladesh Securities and Exchange Commission (BSEC). However, not all institutions are regulated and monitored following uniform stringent criteria; and all less regulated banking and financing activities must not be having uniform destabilization impact. Certain inclusive services of the banks and NBFIs of the country covering payment, deposit and credit products also appear to have shadow banking elements.

The increasing trend of adopting and recognizing innovative technology in the context of COVID-19 is adding to the contribution of the Fintech in the financing activities and drawing fresher attention to the benefits and concerns of shadow banking in the country.

Against the above background, the study is broadly about conceptualizing and perceiving 'shadow banking' in the context of Bangladesh. The specific objectives of the study are to: (i) discuss conceptual issues of shadow banking by reviewing literature and country experiences; (ii) identify shadow banking components in the context of Bangladesh; (iii) assess changing trends of shadow banking and the associated risks in the context of the COVID-19; and (iv) put forward specific recommendations for policy makers and banks.

The study is mainly based on secondary information. Secondary published sources were used to create conceptual underpinning of the study. An FGD was conducted with the participation of 43 executives of banks and NBFIs associated with mobile banking, agent banking, linkage credit, and alternative delivery channels (List of participants in Appendix Table-1) to discuss challenges and how to deal with the relatively less regulated activities of banks. This report has been finalized after incorporating the comments of the participants and experts of the banking sector at a Seminar.

The report is organized into six sections. Following the introduction, Section-2 is about review of literature on the definitional issues of shadow banking in the global context. Benefits and concerns of shadow banking and associated regulatory approach are discussed in Section-3. Section-4 is about the assessment of shadow banking entities and activities in the context of different regulatory regimes in Bangladesh. An attempt was made to define and map shadow banking in the context of Bangladesh in Section-5. Finally, Section-6 puts forward specific recommendations based on the key observations.

2. Shadow Banking: Definitional Issues, Key Drivers, and Estimation Efforts

The thoughts on 'shadow banking' evolved with the changing scope and risk-taking ventures by banks and financial institutions. The term 'shadow bank' was first pronounced in 2007 by Paul McCulley to describe risky off-balance-sheet activities by banks to sell loans repackaged as bonds,[1] and the term 'shadow banking' drew attention during 2007-09 global crisis to indicate destabilizing concerns associated with the 'securitizing mortgage loans'. The key intention of identifying shadow banking during the crisis was to highlight the necessity of regulating and supervising the activities to escape potential financial instability.

2.1 Defining and Scoping Shadow Banking

In recent years, several definitions came up for characterizing shadow banking in different country contexts. Despite similarities the term 'Shadow Banking' is not interpreted uniformly and there are wide and narrow versions of interpretation. There are also narrow and broad definitions to measure the size of shadow banking.[2] Because the differential definitions, the shadow entities and the shadow products or services of different jurisdictions are not always comparable in precise form.

[1] Paul McCulley, referred 'shadow banking' as "the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures which roughly describes the world of structured finance, which creates and utilizes these types of conduits, vehicles and structures collectively mean 'special purpose entities" (https://scholarship.law.duke.edu/cgi/viewcontent.cgi article).

[2] For example, the shadow banking/non-bank financial intermediary assets using three measures of FSB vary widely: 51 trillion or 14% of total (narrow), 114 trillion (intermediate), and 184 trillion or 49% of total (broad) (FSB, 2020).

‘Shadow banking’ as a structured finance tool created remarkable difficulties for the banks and financial institutions (Kuepper, 2016). There are very wide and narrow versions of interpretation of shadow banking concepts. A broad definition of shadow banking includes all financing activities that are allowed but less regulated. There is also an extremely narrow version according to which shadow banking is simply certain banking services offered by less regulated banking institutions. Some definitions of shadow banking focus on certain instruments. For example, Gorton (2010) termed three basic instruments as part of the shadow banking industry: money market funds, repurchase agreements and collateralized securities issued by the special purpose vehicles.

Shadow banking connected with regulatory implications is visible in recent definitions. The Financial Stability Board-FSB (2011) differentiates between shadow banking entities and shadow banking activities that take place outside the scope of the regulated banking system. Similarly, Pozser et al. (2012) define shadow intermediation as entities and activities where prudential regulations are not stringently applied like in the banking system. Sometimes shadow banking is perceived as illegal banking which is not true as per the recognized definitions (Schwarz, 2012). Shadow banking is neither illegal nor unethical. Sometimes it is complex and is less regulated.

Shadow Banking is also seen as an approach to address unmet credit demand. According to Claessens, et al., (2012), shadow banks help creates credit access and address several credits need unmet by commercial banks. In line with the relatively recent broad definitions, shadow banking activities include activities of ‘Shadow banks’ plus certain activities of ‘banks’ that are less regulated. And, generally, there are agreements that less regulated banking and financing activities may pose systemic risks to the financial system (FCIC, 2010).

2.2 Major Drivers of the Growth and Development of Shadow Banking

The market for shadow banking has been expanding rapidly with the growing popularity of financial deregulation mainly since early 1980s (Tobias and Donna, 2021). The global market for shadow banking is estimated to reach a size of USD72.5 billion by 2027, growing at an average growth rate of 5.4 percent over 2020-2027. Of the economies, USA is said to have over 30 percent of global shadow banking market followed by China, Japan and Canada with around 5 percent each (ResearchAndMarekts.com, 2021).

Financial innovation and technology have been the commonly noted catalysts for the development of shadow banking. According to Edwards and Mishkin (1995), informational and transaction cost advantages of the nonbanks over banks with the advancements in technology is a contributory factor to the expansion of shadow banking.

While traditional banks take time to adopt technological changes, less-regulated financial market participants took advantage and started adopting technology quickly in their service delivery (FCIC, 2010).

Regulatory advantages are considered a major factor in the expansion of shadow banking. The Economist (2016) analyses, shadow banks have flourished in part because tighter capital requirements and restrictions kept them grounded, and notes that less regulated financing may not always be bad. Several regulatory imposition and reserve requirements on banks spurred the development of alternative credit and deposit products outside the highly regulated zone (Rosengren, 2014). According to an estimation, regulatory advantages contributed 55 percent of the expansion of shadow banking followed by technological advancement that accounts for 35 percent (Edmund, 2017).

In the context of COVID-19, on the one hand, technology-based payment and financial services became the lifeblood and expanded rapidly in the less regulated arena, on the other hand, a section of investors made huge money in ways to extract profit from the affected low-income people, and struggling companies. According to a recent Survey by Copenhagen Business School (2021), American shadow banks like private equity, venture capital, and hedge fund firms invested and extracted huge profits from the struggling individuals and companies during the COVID-19 crisis- the profits came from both booming sectors (health, technologies, delivery services etc.) and struggling sectors (airline, energy, hospitality sectors, etc.).

2.3 Adoption of Definition and Estimation Efforts of Shadow Banking

There are indications that the size of the shadow market is increasing, however, aggregate data on shadow banking is not fully reliable and comparable. The sizes of shadow banking are not always comparable precisely because the nature of shadow products is similar but not the same. Even, broad and narrow definitions were followed in estimating the size of shadow banking in the context of a single country. In a study on China, Kroeber (2015) points out a range of six estimates (following narrower and broader definitions) of the size of shadow banking that produced figures ranging from about RMB 5 trillion to RMB 46 trillion, or roughly 8 to 80 percent of the size of China's GDP. Not all countries have official definitions. Some countries adopted definitions based on FSB, however generally adopted definitions of shadow banking in some countries are significantly different (AFI, 2019).

Structured finance and complex financing shadow products are common in developed countries. Shadow banking products may be segregated considering the point of service delivery, and an important phenomenon is the growth of connectedness between shadow savings instruments and capital markets, especially bonds (CGFS and FSB, 2017). In the context of many developing countries, shadow banking products are offered as alternative financial instruments for the underserved (Dang et al., 2014). And in most instances, these products are less complex in developing economies as compared to that in developed countries like USA (Adrian and Ashcraft, 2016).

AFI (2019) finds activities of the peer-to-peer lenders, money lenders, and cooperatives are the most commonly recognized shadow banking in most economies. Other components include factoring, leasing, financing by development institutions, and public pension (as reflected in the AFI survey outcome). Differences in definitions and the nature of financing activities are reflected in the mapping exercises of shadow banking in different counties (Box 2.1).

Box-2.1: Activities/Institutions Considered Shadow or Less Regulated in Selected Countries
Australia: Insurance, Superannuation, Securitization, Money Market Funds, Registered Financial Corporations, Other Managed Funds, Credit Unions &Building Societies. **China:** Insurance, Postal Savings, Pension Funds, Rural Cooperative and Commercial Banks, Credit Cooperatives, Leasing Companies, Auto Finance Companies, Trust and Investment Companies, Money Brokers. **Malaysia:** Unit trust funds, securitization companies, development financial institutions (not licensed under the Development Financial Institution Act), pawnbrokers, building societies, fund management industry, non-bank entities of hire purchase financing, non-bank finance providers for education, and social security organizations. **India:** Insurance companies, Non-bank financial companies, Cooperative banks, Mutual funds, and some others**.** **Japan:** Public financial institutions, financial dealers, brokers Securities investment trusts, finance companies, structured finance entities, Insurance companies, and pension funds. **Costa Rica:** Unsupervised Cooperatives, Pawn Shops, and Appliance Sales. **Cambodia:** Pawn shops and real estate developers.
Source: Based on Habib et al., 2019.

3. A Review of the Concerns and Benefits of Shadow Banking, and the Regulatory Approach

Concerns about shadow banking were open and common in the context of the global crisis of 2007-09. Politicians and economists unanimously expressed their concerns that shadow banking has the potential to trigger financial downfall (The Economist, 2016). FCIC (2010) observes, during the crisis of 2007-09, less regulated banking system contributed significantly to asset bubbles in the real estate market. The study adds, the long-term funding using the short-term sources created huge liquidity risks during the period. Recognizing destabilizing potentials of shadow banking, FSB highlighted 'maturity transformation' or short-term liabilities transformed into long-term assets; 'liquidity transformation' use of liquid liabilities to purchase fewer liquid assets); 'leverage' or use of the technique for higher gain that has a possibility of losses; and 'regulatory arbitrage' tendency of shifting to the less regulated zone to escape regulatory stringency (FSB 2011; IMF 2013).

Regarding the associated risks, a paper by the SUERF (2012) cites systemic risk factors if business does move to shadow banking: *one,* a significant volume of intermediation with lax prudential norms and the associated losses might affect confidence in the banking and financial sector; *two,* interconnectedness or linkages between banks and non-bank credit intermediaries (that are generally less regulated) might affect the stability of the banking and financial sector (CGAP, 2015). Alongside pointing out concerns associated with 'financial stability and systemic risks', 'cross-border regulatory arbitrage when interconnected', and 'amplification of financial and business cycles', Zoltan (2010) identifies shadow banking challenges associated with conducting monetary policy: it is not easy to capture comprehensive information and thus project the financial market activities that are outside the banking regulatory and supervisory framework and thus challenging to target these as part of monetary policy formulation; the interconnectedness of less regulated intermediation and commercial banks might distort information content that is required for monetary policy formulation.

The challenges and risks of shadow banking may not be visible or understandable in a normal situation. LLM (2017) observes that shadow banks and their activities may not appear problematic to the policymakers in the normal circumstance, and these might be tempting to the nonbank intermediaries with high returns. According to Daniel Sanches who is a senior economist at the Philadelphia Federal Reserve Bank, shadow or less regulated banking activities offers useful services to the common people however might prove to be risky under certain vulnerable circumstance in the financial market. It means, these less regulated institutions and activities may not be inherently risky and are important forces to handle financial exclusion (Ungarino et al., 2016).

In developing countries, shadow banking instruments are generally associated with inclusive drives such as microfinance products; financial services by the cooperatives; and technology driven services targeting vulnerable sections (BCBS, 2015). Financing gaps are meet by the shadow banking services in several instances (FDC, 2014). In many instances, technology driven digital financial services, relatively less regulated, are extensively in use to offer affordable micro finance services covering payment, saving, credit and insurance facilities (Lauer and Lyman, 2015). Ezrati (2017) observes innovative technologies have helped traditional banks and other non-bank entities to address the need of the small traders and vulnerable individuals. New financial innovations and e-platforms (alibaba, e-bay, etc.) began to offer payment and associated services that are becoming competitive forces of the formal sector banks. E finance and e-commerce cannot be ignored as these have positive implications in the forms of competition and innovation, and negative implications in the forms of fraud and systemic spillover (Sheng and Nd Chaw, 2016).

It is well known that following the global financial crisis of 2007–2009, the G20 has called for identifying and monitoring less regulated or shadow banking activities. However, it does not seem true and relevant to the global inclusive finance movement. It is to be remembered that the destabilizing innovations like complex derivatives contributed to the financial crisis, which is not true regarding the inclusive products. Practically, these specially designed products targeting low-income people seem to be different from the products that have destabilizing effects on the financial crisis (CGAP, 2015). Sometimes financial regulation and supervision do not keep pace with the development, and regulators fail to monitor the growing inclusive and innovative financial products that might add fuel during vulnerable periods (Ungarino et al., 2016). Likewise, observations by Pymnts (2018) reflect that while innovative payment services serve un-served and underserved customers sustainably, these generally do not trigger the financial crisis or financial stability. The necessity of non-bank financial intermediaries in introducing innovative financial services and channeling funds to handle financial exclusion challenges of the emerging and developing economies are highlighted in the Moscow Resolution (2016). The Moscow Resolution also recognizes the positive association between inclusive finance and financial stability.

For handling shadow banking concerns, the spill-over effect between the regular banking system and the shadow banking system needs to be mitigated (FSB, 2013). According to FSB, financing activities must be distinguished between shadow banking activities based on potential stability risks to encourage or discourage certain activities for financial stability. And for that the changing trends, developments, and sizes of shadow banking should be measured in absolute terms, and also in proportion to the Total Debt, GDP, and Size of the Banking Sector, as suggested by the FSB.

Collecting reliable information for understanding the features of shadow banking is crucial, which has rightly been acknowledged in the adopted Moscow Resolution (2016) on "Financial Inclusion and Shadow Banking". Cases on the development and regulating and supervising of these activities in different global economies might be very helpful for drawing lessons from the other jurisdictions to handle upcoming financial instabilities. The vulnerabilities received newer attention during COVID-19 when the instabilities in the financial sector are steaming from mismatches, leverage, and multiple interconnectedness FSB (July 2021).

In the new normal, technological development created newer ground for digital financial services to boost financial inclusion, and the role of digital financial inclusion became vibrant in mitigating the devastating impact of the Corona crisis. There are now ample pieces of evidence to show that digital finance is crucial for financial inclusion; these innovations are complements to the traditional banking and financial services; and these services are faster, more efficient, and cost-effective for reaching lower-income households and small, micro, and cottage enterprises. However, the developments are also accompanied by stability risks, cyber security concerns, and consumer protection fears that require special attention from the management and policymakers. Evaluating the performance of Chinese bank credit and Fintech Zhengyang and Huang (2021) find that Fintech companies are contributing significantly to growing credit access to new and vulnerable borrowers after the start of the pandemic, however, the non-performing loans of the Fintech increased by three-times after the outbreak of the crisis, where as there is no significant change in the NPL rate of bank loans. The outcomes point to the potential benefits of shadow banking as well as potential risks. Moreover, technology-driven innovations are bringing fresher challenges to the existing anti-money laundering frameworks in the financial sector.[3] However, imposing stringent regulations and supervision might be counterproductive and may further incentivize shadow banking activities.[4] Rather, a regulatory approach would be required for a delicate balance of promoting innovations and stability risk minimization[5].

[3] "The changing technology-based payment and financing patterns are bringing enormous convenience to the banks and clients; however, offenders are using these to launder money and causing new challenges to the traditional counter-money laundering system" [BIBM, 2017].

[4] "Implementation of more stringent regulation and compliance requirement in the coming days might further push the banks and financial institutions to shift part of their activities outside the regulated environment and therefore increase shadow banking activities" [Sheng, Andrew and Nd Chaw Soon, 2016]

[5] "Policymakers will also need to consider novel approaches to ensure high-quality supervision and regulation, support the safe use of innovative technologies while ensuring that regulation remain proportionate to the risks. Fortunately, supervisors across countries have recognized the need to adapt regulatory approaches that strike the right balance between enabling financial innovation and address challenges and risks to financial integrity, consumer protection, and financial stability." [IMF, 2020]

4. An Assessment of Shadow Banking Entities and Activities in the Context of the Regulatory Regime of Bangladesh

Bangladesh Bank is the regulator of banks and non-bank financial institutions; and has been empowered to award licenses for establishing banks and NBFIs. Banks are being licensed vide Article no 31 of the Bank Company Act, 1991, NBFIs are being licensed vide Article 4, Chapter II of the Financial Institutions Act, 1993. Bangladesh Bank is empowered to conduct inspection of bank and NBFI vide Article no 44 of the Bank Company Act, 1991 and Article no 20 of the Financial Institutions Act, 1993. Bangladesh Bank is empowered to call for periodic statements, any information from a bank and NBFI vide Article 69 of Bangladesh Bank Order 1972, Article 36, 51 of the Bank Company Act, 1991 and Article 12 of the Financial Institutions Act, 1993. As a regulator, the central bank is required to perform its duties as described in the Bangladesh Bank Order 1972 (Habib et. al, 2019).

A set of permissible activities of a banking company has been defined in Bank Company Act, 1991 for banks and Financial Institutions Act, 1993 for NBFIs. Transactions with related parties are clearly defined for banks in the Bank Company Act, 1991; however, for the NBFI, no clear definition of transactions with related parties is stipulated in the Financial Institutions Act, 1993. Bangladesh Bank assesses the performance and risk profile of Bank and NBFI on a regular basis based on the data provided by them. Inclusive finance products are offered by banks and NBFIs. However, NBFIs cannot offer to check deposit accounts and take demand deposits, and thus, certain deposit products targeting low income people are generally only offered by banks. Both commercial and CSR driven inclusive activities of banks and NBFIs are monitored and supervised by the different departments of Bangladesh Bank.

Repo and Reverse Repo activities are conducted among central banks, banks and NBFIs, and the central bank of the country has been monitoring arrangements for that. Bangladesh Bank has a guideline and several circulars for the banks and NBFIs on Repo transactions. Every transaction is being done through Market Infrastructure (MI) module of the Core Banking Software.

A guideline on Mobile Financial Services (MFS), first issued by the BB in 2011 that allowed two ownership structure-related models: one, an MFS provider can function as a bank wing; two, MFS provider may work as a bank subsidiary where a single bank holds at least 51 percent partnership. Later, Bangladesh Bank issued the regulation titled “Bangladesh Mobile Financial Services (MFS) Regulations, 2018” that replaced the previously issued guideline. The banks and subsidiaries that want to provide MFS services in the country have to take licenses from Bangladesh Bank. The agents do not need any permission from the central bank and need to sign an agreement with the provider. Banks must have agent selection policy that is clear and well documented. They must be identified, equipped and monitored by the banks themselves. Regarding regulatory framework, Bangladesh MFS Regulation 2018 and BFIU Circular 20 are the key documents for dictating compliance requirements of the MFS industry (Box-4.1) MFS operators submit their monthly reports as well as the details of their agent transactions to Bangladesh Bank monthly using templates. Regarding supervisory arrangement of agents, the MFS providers are primarily responsible for agent supervision. According to the current guideline, there are no particular capital requirements for an MFS provider.

Box-4.1: Key Regulations Associated with MFS Industry in Bangladesh
Compliance requirements are mostly directed as part of Bangladesh MFS Regulation 2018 and BFIU Circular 20. Necessary regulatory guidelines and standards are prescribed for the licensed MFS as per the regulation. Description of the permitted services and allowed operational models for MFS providers are detailed in the regulation. Intending to ensure a safe operational platform for the customers and stakeholders, BFIU Circular 20 prescribes guidelines for MFS businesses covering AML and TF requirements, KYC rules, reporting of suspicious transactions (STR/SAR) and other due diligence while offering services to customers. Transaction limits are also determined in commensuration with 'Risk Based Approach' of the Bangladesh Bank.

As the ownership structures of the major MFS in Bangladesh are different, thus regulatory structure is also dissimilar. BKash is a subsidiary of BRAC Bank. A bank led model was followed by the Dutch-Bangla Bank for introducing its MFS i.e. Rocket. Nagad, a different approach that outsourced by Bangladesh Post Office[6] to Third Wave Technologies, is offering financial services to its customers by sending and receiving cash and other payments through its digital channel. Nagad operates without MFS license having a No-Objection Certificate (NOC) from Bangladesh Bank since its inception. Due to different ownership structures their regulatory stringency seems to be different.

Agent banking is another related area of both shadow banking and financial inclusion drives, and it is a relatively new area of venture for banks in Bangladesh. Bangladesh Bank

[6] Bangladesh Post Office is ruled by the Postal Act which was primarily designed to operate Postal Savings Accounts, a department of the Ministry of Posts and Telecommunications and provide remittance services to rural people through postal accounts.

has issued various circulars, circular letters and guidelines on Agent Banking operations in Bangladesh. In 2013, Bangladesh Bank first issued a guideline on Agent Banking for Banks for promoting agent banking for enhancing financial inclusion. The prudential guidelines (issued in September 2017) on Agent Banking Operation in Bangladesh required obtaining prior approval from Bangladesh Bank for agent banking operation (new agents, agent banking outlets) separately. Agent selection criteria of the banks are to submit to Bangladesh Bank for getting a license. Upon commencement of Agent Banking activities, a Bank is to be reported to two different departments of Bangladesh Bank. After engagement of agent, banks are to submit quarterly progress reports of their agent banking activities to Bangladesh Bank. As per BB guidelines, banks are to inspect their agent banking activities. Bangladesh Bank, if deemed necessary conducts inspections on bank, agents. Agents are closely monitored by the bank. Banks are to submit quarterly reports to Bangladesh Bank. There is no capital requirement for banks to start agent banking activities. There are similarities between the approach and services offered through 'Agents' and 'Booths'/ 'Sub-Branch' of the banks, however, from regulatory perspectives they are different (Box-4.2).

Box-4.2: Inclusive Drives through Regulated Banking Booth/ Sub-Branch of Banks

Bangladesh Bank allowed banks to operate 'banking booths' as part of business development centers in December 2018. And after one year, the central bank allowed the 'banking booth' of scheduled banks to act as a sub-branch, keeping the functions of a bank's such installations unchanged. For setting up sub-branch, the banks need approval from their respective boards and the central bank. The sub-branch operates almost like a full-fledged branch of a bank. Except foreign transactions, all types of banking services are allowed to carry out in a sub-branch. It is expected that the fees, charges and commission of services from the sub-branches would be lesser.

There are certain linkage arrangements of banks/NBFIs with partnering organization or MFIs mainly to promote inclusive financing ventures. Generally, banks/NBFIs enter into a contract with NGO/MFI for linkage credit program and there are incentives in the form of refinance/cash allowance declared by Bangladesh Bank. There are separate regulatory authorities for controlling and supervising NGOs and MFIs in Bangladesh. Bangladesh Bank, in some cases, allows Banks and NBFIs to reach the target groups through NGO's/MFI's network. In those cases, banks/NBFIs are to ensure the compliance with the guidelines for that credit prescribed by Bangladesh Bank and report to Bangladesh Bank. Bangladesh Bank issues special provisions for the sectors that require linkage credits.

Upon application from a bank, Banking Regulation and Policy Department (BRPD) of Bangladesh Bank provides licenses for Offshore Banking units. Bangladesh Bank issued policy for offshore banking operations for the banks in Bangladesh in 2019 intending to strengthen monitoring and supervision of offshore banking operations. Under policy, OBUs can provide banking transactions, either in lending or in borrowing, only which are allowed in the policy. As per the policy, OBUs can invest abroad for a maximum of 25% of demand and time liabilities. Moreover, OBUs are to comply with capital requirements; keep CRR and SLR against their liabilities; implement ALM guidelines; and report to CIB; and prevent TBML for their offshore banking operations. Moreover, regulatory limits for funded and non-funded exposure imposed by the central bank are applicable for offshore banking operations.

Banks and financial institutions offer Supply Chain Finance to SMEs for daily working capital in the form of factoring, reverse factoring, distributor finance, invoice finance etc. Currently, many NBFIs and banks are in market with this product very much within the regulatory framework of banks and NBFIs. However, case of international factoring is different. Here, in general, trade financiers abroad can discount of export bills of local exporters. While discounting export bills from abroad, exporters make financing arrangements with the agents in Bangladesh of foreign trade financiers. In this context, except for the financing agreement between exporters and agents of foreign trade financiers, no other contractual agreement is visible for such trade transactions. The factors or agents of the process are not under the stringent regulatory framework of banks.

Promoting startup financing is another timely approach in the country to address financial inclusion challenges of innovative ventures. Very recently, BB has set up a refinancing facility up to BDT 10 million for startup financing. Under this arrangement, banks can get money from the BB at the rate of 0.5 percent interest and are allowed to charge start-ups another 3.5 percent. Apart from the BB's BDT 500 crore refinance fund, the central bank has also made it mandatory for all scheduled banks to form separate start-up funds with their own funds. Therefore, the banks have been asked to set aside 1 percent of their operating profits for the years from 2021 to 2025. The start-up firms would get up to one-year grace period against their loans. The loans must be disbursed in at least three phases and cannot be disbursed at a single payment. The disbursing of subsequent phases would depend on implementation of the preceding installments. An entrepreneur can only borrow a loan from a bank for one project and a personal guarantor will be required, and there cannot be more than two guarantors. Loans will be classified under the existing policy, where banks have to keep a 5% provision against classified loans, 20% against doubtful loans, and 30% against bad loans (BB, 2021).[7] This is not the traditional venture financing model of start-up and it is very much within the regulatory setup of regular loans from banks.

The country has regulatory framework for securities market. Under BSEC's rules, regulations, laws and ordinances, they are permitted to monitor the internal control system and internal & external audit of the Securities Companies/Investment Banks/Corporate Bond Issuer if and when necessary. BSEC also takes various measures including corrective action to streamline the internal control and audit system of related companies. BSEC is also empowered to regulate Securities Companies/Investment Banks/Corporate Bond Issuer for external audit and public disclosure and thereby monitor those accordingly. Regarding supervisory arrangement, daily Market surveillance is conducted by BSEC over the transactions of two stock exchanges through instant watch system. Regarding capital and prudential requirements, for banks and Financial Institutions, BASEL requirement for capital adequacy is mandatory. On the other hand, other stakeholders may increase their capital through issuance of IPO, Right share, or Bond subject to approval from BSEC. The BSEC's requirement for capital calculation is not in line with BASEL norms to date. BSEC introduced a complaint management system for consumer protection.

IDRA has been working for the systematic development and regulation of insurance industry intending to implement the “The National Insurance Policy 2014”. Regarding reporting, internal control, and disclosure requirements, there are certain provisions in the IDRA Act. Submission of half yearly, annual reports and others statements are required as per directives and provisions under IDRA laws. Under IDRA’s rules, regulations and laws, IDRA is required to monitor the internal control system and internal & external audit of the insurance companies as and when necessary. IDRA is also trying to implement various measures including corrective action to streamline the internal control and audit system of related companies. In connection with adequacy of the regulatory and supervisory arrangements, certain things are in the process of adaption. BSEC’s instant watch system for day to day surveillance is applicable for listed insurance companies. IDRA is empowered to conduct different inquiries from time to time as and when necessary. As a whole, introduction of Risk-based Supervision (RBS) is existed at primary level. IDRA is not yet considering risk level to determine minimum capital requirement.

Microfinance services, a key area of financial inclusion, are offered by the MFIs Grameen Bank, state-controlled commercial banks, private commercial banks, specialized banks and some ministries of the GoB. As the regulatory authority, Microcredit Regulatory

[7] BB SMESPD Circular No-04 dated March 29, 2021.

Authority (MRA) is engaged to ensure transparency and accountability of microfinance activities by the MFIs. MRA is responsible to implement the MRA Act that contains provisions for imposing penalties for non-cooperation by the employees of an MFI during, inspection, investigation or audit on that organization by MRA. Regarding supervisory arrangement, the MRA assesses performance and risk profile of the individual institution regularly. For off-site analysis and deposit safety net, MRA performs risk grading of MFIs based on 20 indicators. Capital regulations are not relevant for MFIs.

Activities of cooperatives cover several economic areas. Cooperatives are licensed and registered and the ‘permissible activities’ by the cooperatives are clearly defined in the Cooperative Societies Act, 2018. Cooperatives Societies are required to submit the statements of their financial positions to the DOC. However, there is no binding legal and regulatory imposition for having proper internal control and audit of the cooperatives. Public disclosure is not widely enforced. DOC could conduct special inspections as and when warranted. The DOC is not mandated to take action against unregistered cooperatives.

Bangladesh Post Office (BPO) offers various financial services for its customers. These are Money Order, Electronic Money Order, Postal Savings Bank, Postal Insurance Services, and Remittance transfer services, Postal Cash Card and Selling of Bangladesh Sanchaypatras, Bonds etc. The reporting arrangements are different for each product/service. Postal Savings Bank offers limited banking services (savings bank account, fixed term deposit account) to all. Postal Insurance Services are being offered, controlled and monitored by separate wings of Bangladesh Post Office. The reporting arrangement is centralized. Nagad is a venture of Bangladesh Post Office and Third Wave Technologies to offer digital financial. Bangladesh Post Office has arrangements with different remittance companies like Western Union for Remittance Transfer Services and Selling of Bangladesh Sanchaypatras, Bonds etc. Bangladesh Post Office has 3-tiered supervisory system in operation. Head Office inspects its general post offices as well as district head post offices. In addition, Office of the Accounts and Auditor General regularly conduct audit on BPOs. Branch Offices and Sub Post Offices report their activities to their respective head post offices through daily statements of affairs.

In Bangladesh, technology-driven innovation and shadow banking expansion are mainly associated with financial inclusion drives. The COVID-19 disruption prompted market players and the policymakers of the country to encourage technology-driven financial services and, financial services through MFS Providers and Agents started expanding rapidly. Some banks are extensively working to introduce newer digital products[8] and

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[8] The City Bank, along with bKash, launched the country’s first collateral-free instant digital loan service; Bank Asia has decided to form a subsidiary Digital Bank subject to necessary approval from the regulator.

experimenting with digital solutions.[9] The success and sustainability of these initiatives would be remarkable in reaching the unreachable with the banking and financial services by the formal sector market players of Bangladesh. Practically, destabilizing shadow innovations are hardly present in the inclusive finance landscape of the country.

Despite notable beneficial features and stability attributes of the technology-driven inclusive drives, there are concerns that the absence of monitoring may tempt less-regulated players to get into risky endeavors that promise very high returns. Sometimes, some risky activities and malpractices may take place at levels that are outside the regulatory or the management purview of the banking operations. It is also not easy for banks to have control over all the activities that are outsourced for cost-effective service delivery.[10] With the absence of adequate consumer protection and monitoring measures, regulated banks may come across reputational risk, credit risk, and crime risks.[11] These shadow banking entities and activities are not risky inherently, however, under certain circumstances; these entities/agents may become fragile and might be subject to panics.[12] Shadow banking can affect the stability of the banking sector when there is significant market interconnectedness[13] between banks and nonbanks, and there are scopes of maturity and liquidity transformation.[14]

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[9] Standard Chartered Bank (SCB) piloted first LC transactions in Bangladesh using blockchain; SCB, bKash, and Valyou of Malaysia are at the final stage of commercial testing of blockchain based cross-border remittance service.

[10] For example, banks commonly receive complaints from customers about getting fake notes from ATM booths; third parties upload money in ATMs and there are scopes to manipulate.

[11] In agent banking operation, the agent is the flag-bearer of that bank in the locality, therefore, any unlawful activities by the agent, in turn, will diminish the image and reputation of the concerned Bank; loan proposals processed by Agents/Agent banking outlets are not subject to same extent of scrutiny/regulation as that of traditional loan proposal, which in turn, may cause deterioration of overall asset quality of the Bank.

[12] "Use of mobile apps has made informal cross-border remittance transactions vibrant and extremely easy; sometimes, remitters and recipients do not even know that these services (without engaging a bank) are illegal" [Habib, Shah Md. Ahsan, 2017, Ensuring Greater Penetration of MFS in Remittances, Financial Express]; a recent news of fund embezzlement by the employees of a digital mobile banking service under Bangladesh Post office is a terrible incident for the fast growing digital financial services industry; the continuation of such incidences may cause panic and affect the confidence of the people on the services.

[13] Regulated banking institutions have serval programs and arrangements with the non-bank entities like MFIs, insurance companies, mobile financial and mobile network service companies etc.

[14] MFIs that issue exclusively short-term microcredit cannot adversely affect systemic stability but it is very difficult to ensure that all MFIs are utilizing deposit and funds from banks to finance micro lending; because of the week monitoring arrangement, there are anticipations that MFIs are diverting funds for many other enterprise development long term investments); a section of MFIs may face liquidity problem as well as default risk as they borrow short term from banks and fund providers like PKSF but utilize the funds for non-Agri and non-micro credit operations.

5. An Attempt to Define and Map Shadow Banking in Bangladesh

5.1 Defining and Analyzing Regulatory Perspectives of Transactions

Considering different definitions adopted in different countries and the banking and financing activities of Bangladesh, shadow banking in Bangladesh may broadly be defined as:

Shadow Banking is the financial intermediation connected with savings, credit, and payment by the legally established or registered entities that are either not permitted to do such things as their primary or first line of business and/or that are not adequately regulated. An entity could be a shadow bank or certain activities of an entity might also be considered shadow.

The definition does not include unregistered and illegal financial intermediation activities as part of shadow banking**.** It is well recognized that for mapping and estimating the size of the Shadow Banking activities in Bangladesh, an 'entity-based' or 'activity-based' approach alone would not be sufficient rather a combination of both the approaches may offer a more comprehensive output. Thus, activities of certain entities of the financial sector and certain activities of other entities may form the coverage of shadow banking in the country. Entity wise and activity-wise regulatory coverage mapping exercises (Tables 5.1, 5.2, 5.3 and 5.4) were conducted, based on regulatory arrangement; supervisory arrangement; reporting arrangement; capital and prudential arrangement; consumer protection arrangement; and access to financing support by the regulators (the paper heavily draws on Habib et al., 2019 in pursuing the exercises).

Table-5.1: Entity-wise Regulatory Coverage Mapping

	Regulatory Arrangement	Supervisory Arrangement	Reporting Arrangement	Capital& Prudential Requirements	Consumer Protection Arrangement	Access to Regulators Financing/ Support
Banks	Adequate	Adequate	Adequate	Yes (Risk based)	Yes	Yes
NBFIs	Adequate	Adequate	Adequate	Yes (Risk based)	Yes, but limited	Yes, but Limited
Insurance Companies	Moderate	Moderate	Moderate	Yes, but not risk-based	Yes	Not practiced
Capital Market	Moderate	Moderate	Moderate	No	Yes	No
MFIs	Moderate	Moderate	Moderate	No	Yes	No
MFS Providers	Adequate	Moderate	Moderate	No	Yes	No
Payment Service Provider/Operator	Adequate	Moderate	Moderate	No	No	No
Postal Dept.	Moderate	Moderate	Moderate	No	No	No
Cooperatives	Inadequate	Inadequate	Inadequate	No	No	No

Table-5.2: Summary of Regulatory Coverage (Entity-wise)	
Shadow Criteria	**Entities of the Financial Sector**
Adequately Regulated	• Banks
Regulated	• Non-Bank Financial Institutions
Moderately Regulated	• Insurance Companies • Micro Finance Institutions • MFS Providers • Payment Service Provider/Operator • Financial/Payment Services by Postal Department • Capital Market Intermediaries
Least Regulated	• Cooperatives

Table-5.3: Activity-wise Regulatory Coverage Mapping

	Regulatory Arrangement	Involvement of Un/Less Regulated Parties	Supervisory Arrangement	Reporting Arrangement	Capital& Prudential Requirements	Consumer Protection Arrangement
Linkage Credit by Banks[15]	Adequate	Yes	Moderate	Moderate	Yes	Yes
Linkage Credit by NBFIs[16]	Adequate	Yes	Moderate	Moderate	Yes	Yes
MFS by Banks[17]	Adequate	Yes	Moderate	Moderate	Yes	Yes
Agent Banking[18]	Adequate	Yes	Moderate	Moderate	Yes	Yes
Off-shore Banking	Adequate	No	Adequate	Adequate	Yes	Yes
Factoring-Domestic	Adequate	No	Adequate	Adequate	Yes	Yes
Fac.-International	Adequate	Yes	Moderate	Moderate	Yes	Yes
Repo & Reverse Repo	Adequate	No	Adequate	Adequate	Yes	Yes
Start-up by Banks[19]	Adequate	No	Adequate	Adequate	Yes	Yes

[15] Through MFIs
[16] Through MFIs
[17] Own MFS
[18] Private Individuals/Organizations
[19] BB Refinancing and Banks' Own Funds

Table-5.4: Summary of Regulatory Coverage (Activity-wise)	
Shadow Criteria	**Activities of the Financial Sector**
Adequately Regulated	• Repo & Reverse Repo • Offshore Banking • Startup by Banks • Domestic Factoring
Moderately Regulated Services of Banks/NBFIs	• Mobile Financial Services • Agent Banking Activities • Linkage Credit (by Banks /NBFIs) • International Factoring

Considering the regulatory control over the activities, the size of Shadow Banking may be estimated, following Narrow Definition or Broad Definition (Table-5.5).

Table-5.5: Assessment of Shadow Banking Landscape following Narrow and Broad Definitions	
Narrow Definition of Shadow Banking (Entity)	- Cooperatives
Broad Definition of Shadow Banking (Entity and Activity Combined)	***Entities*** • Cooperatives • Micro Finance Institutions • MFS Providers • Insurance Companies ***Activities*** • Financial/Payment Services by Postal Department • Capital Market Intermediation (Brokerage house, Merchant Bank, Asset Management Company, Alternative Investment Fund, Fund Manager, Green Bond etc.) • Certain Services by Banks/NBFIs (Mobile Financial Services; Agent Banking; Linkage Credit; International Factoring Services).

5.2 Trends of Less Regulated Banking and Financing Activities

The new normal circumstances prompted policymakers to support technology driven financial services, and banks in the country have been responding to the policy calls. As of June 2022, 12 banks were offering MFS. Notable growth in the number of agents, registered clients, and transactions are evident due to the proactive approach of the policy makers (Table 5.6 and 5.7). This is also true for MFS in the context of COVID-19 outbreaks as well.

Table 5.6: Expanding MFS in Bangladesh				
Description	**September 2019**	**September 2020**	**September 2021**	**Up to May 2022**
Number of Agents	949950	1017055	1141693	1188184
Number of Registered Clients [in Lac]	759.78	947.87	1064.54	1126.15
Number of Active Accounts [in Lac]	343.89	410.35	406.46	457.62
Number of Total Transactions	212361529	273008126	324856111	348546984
Total Transaction in Taka [in Crore]	35433.0	49121.2	65135.06	64946.67
Source: Based on BB Website				

Table 5.7: Growth of MFS in Bangladesh			
Description	**September 2020**	**September 2021**	**Up to May 2022**
Number of Agents	7.06%	12.25%	4.07%
Number of Registered Clients [in Lac]	24.76%	12.31%	5.79%
Number of Active Accounts [in Lac]	19.33%	-0.95%	12.59%
Number of Total Transactions	28.56%	18.99%	7.29%
Total Transaction in Taka [in Crore]	38.63%	32.60%	-0.29%
Source: Based on BB Website			

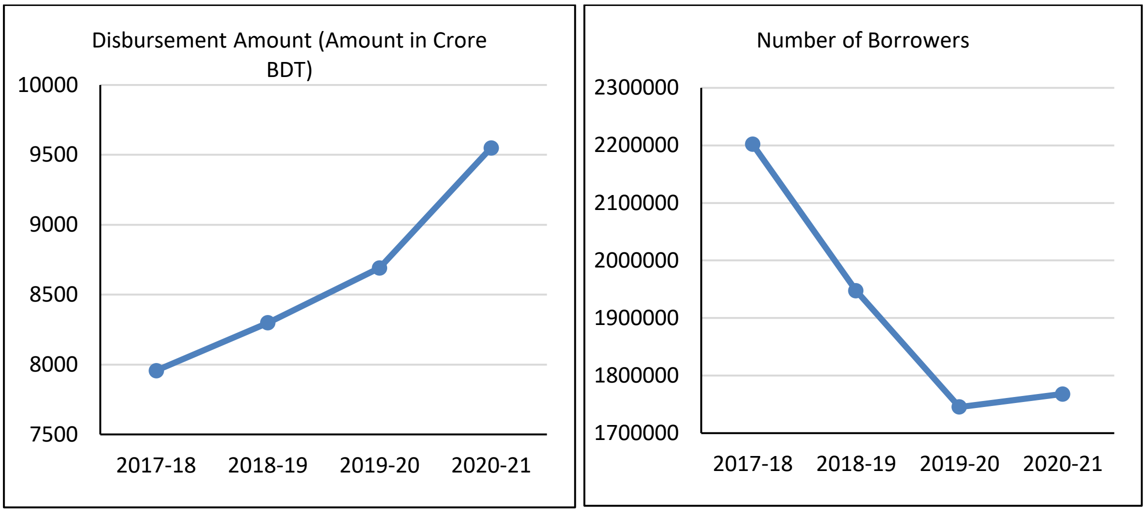
Agent banking activities have received notable expansion from CY2020. About half of the banks were licensed for agent banking and 30 banks were already in operation as of mid-2022. Growth in recent period was remarkable (Tables 5.8 and 5.9), especially, the increasing number of women accounts. Inward remittance growth through agent banking services is notable. Successful technology adaption would bring further improvements. Though 30 banks are in operation, only a few banks are expanding and controlling the whole market. On the digital venture, Bank Asia Limited has decided to form a subsidiary company for conducting digital banking activities, subject to necessary approval from the regulator.

Table 5.8: Expanding Agent Banking Activities				
	September 2019	**September 2020**	**September 2021**	**Up to June 2022**
Number of Agents	6589	10173	13467	14299
Number of Outlets	9392	14011	18073	19737
Number of Accounts	3963766	8224614	12911018	16074378
Number of Female Accounts	1417797	3551976	5550959	7937867
Amount of Deposit (Tk. In Crore)	6079.7	12918.4	22048.8	28085.3
Amount of Loan Disbursed (Tk. In Crore)	28.6	160.5	461.4	7645.6
Amount of Inward Remittance (Tk. In Crore)	610.0	3294.2	2587.2	9704.8
Source: BB website & Based on Agent Banking Activities, Quarterly Report				

Table 5.9: Growth of Agent Banking Activities			
	September 2020	**September 2021**	**Up to June 2022**
Number of Agents	54.39%	32.38%	6.18%
Number of Outlets	49.18%	28.99%	9.21%
Number of Accounts	107.49%	56.98%	24.50%
Number of Female Accounts	150.53%	56.28%	43.00%
Amount of Deposit	112.48%	70.68%	27.38%
Amount of Loan Disbursed	461.19%	187.48%	1557.04%
Amount of Inward Remittance	440.03%	-21.46%	275.11%
Source: BB website & Based on Agent Banking Activities, Quarterly Report			

Banks and NBFIs having inadequate number of branches in rural and/or targeted areas execute credit operations in partnership with the rural network of the MFIs of the country. As instructed by the central bank, the banks channeling agricultural loans through MFIs are required to have detailed work plans and monitoring arrangements; and banks are also required to submit certain specific information and statements. For this purpose, the MFIs shall have to disburse crop loans along with income-generating and poverty alleviation activities. During 2017-18 and 2020-21, the total volume of linkage credit increased consistently, with the number of borrowers also rising. This indicates the increase in the size of the loans over time, though the trend changed a bit during 2019-20 to 2020-21 (Figure-5.1). Expansion of agent banking and sub-branches of banks might be the reason for declining demand for bank-MFIs partnerships and the number of borrowers.

Figure-5.1: Disbursement Amount (in Crore BDT) and Number of Borrowers in Linkage Credit



Source: ACD, BB

Activities of capital market received newer boosts with the establishment of SEC (in 1993) mainly in the mid-1990s. Despite several challenges, capital market activities in the country expanded in response to a number of consolidation measures. Bonds, though have worldwide popularity as popular securities, have a marginal impact in the securities market of Bangladesh because of only a few listed bonds being traded on the exchanges. The corporate bond market in Bangladesh is at its very early stage. Efforts are taking place for expanding bond market. The NGO, SAJIDA Foundation, has been permitted by BSEC to raise BDT 1 billion to use the funds raised through the Green Zero-Coupon Bond to enhance its microfinance program projects like agriculture, sanitation and solar projects.[20] BSEC also approved for Pran Agro Ltd to float a non-convertible coupon bearing green bond worth BDT150 crore.[21] Green bond is expected to strengthen an organization's capital and liquidity, keeping environmental balance. Funding through bonds is finding ground in the country. These financing activities are relatively less regulated compared to banks; however, such activities are welcoming development for the financial sector of Bangladesh. Supervised by the BSEC, alternative Investment funds and startups,

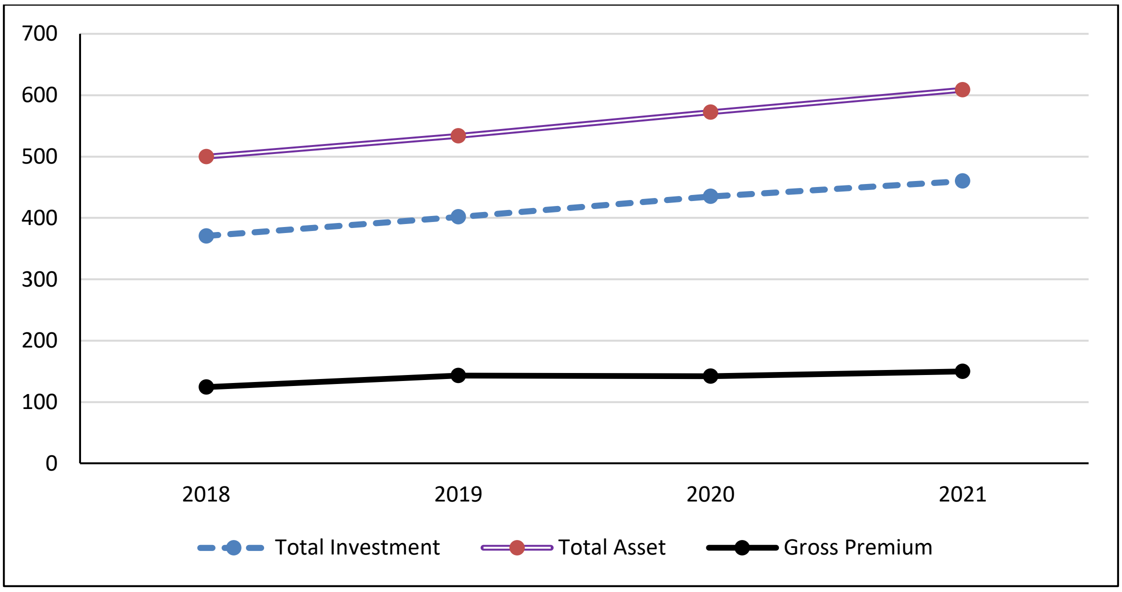
[20] https://thefinancialexpress.com.bd/stock/bsec-approves-green-bond-for-first-time-in-bangladesh-1617810399

[21] https://www.dhakatribune.com/business/stock/2021/07/08/pran-agro-s-150c-green-bond-gets-the-nod

traditionally a relatively less regulated segment', are drawing attention of the foreign investors; and some of the NBFIs have also engaged in the venture funds.

Despite several challenges, the insurance sector is expanding. Currently, 81 insurance companies are in operation under the regulatory control of the IDRA, of which 35 are life and 46 are non-life insurance companies with around 8000 branches. The sector employed around 40 thousand employees and has around 4 lac agents. Life insurance companies have been having around three times market share in terms of both gross premium and total assets. According to the latest annual report of IDRA, the gross premium remained consistent and investment trends in the insurance sector improved. However, the asset size of the sector declined during 2019-2021 (Figure-5.2). This indicates contraction of the insurance industry in response to the COVID-19 challenges.[22]

Figure-5.2: Amount (in Billion Taka) of Investment, Asset and Gross Premium of Insurance Sector and Their Growth



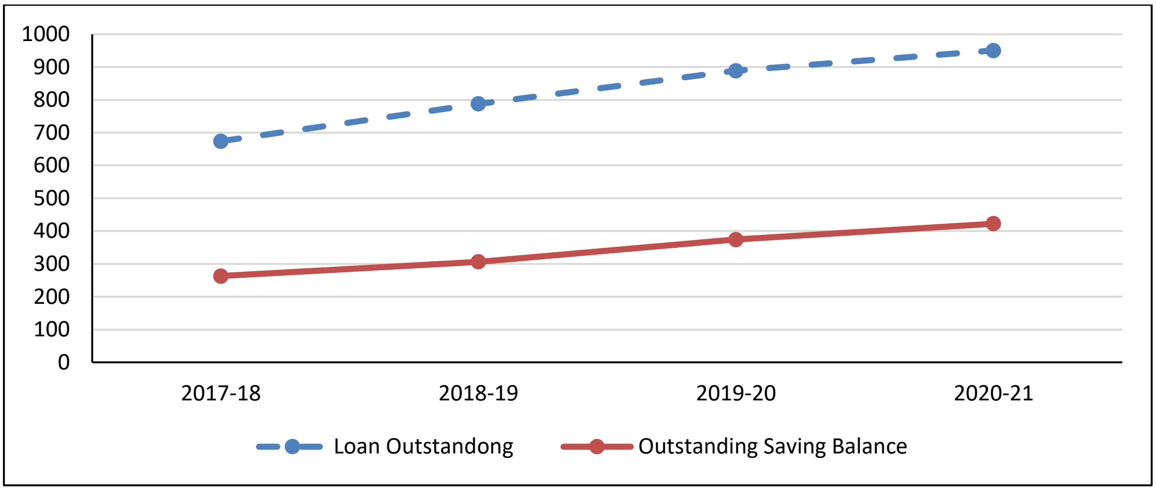
Source: Annual Report, Financial Institutions Division, Ministry of Finance, GoB

MFIs were brought under formal regulatory setup, following the establishment of MRA, and by the time over 750 NGO-MFIs have been allowed to operate with increasing number of branches and employees. As of June 2021, around 20955 branches were operating throughout the country with over 1.75 lac employees and over 35 million clients. In recent years, MFIs and Banks/NBFIs have developed several linkage programs to address rural

[22] By comparing COVID-19 and non-COVID-19 status, the results on Bangladesh show that this pandemic has a significant contribution to the contraction of the insurance sector (Haque et al., 2021).

and remote clients of the country. The sector maintained consistent growth in loan outstanding and saving balance during 2017-2021 (Figure-5.3).

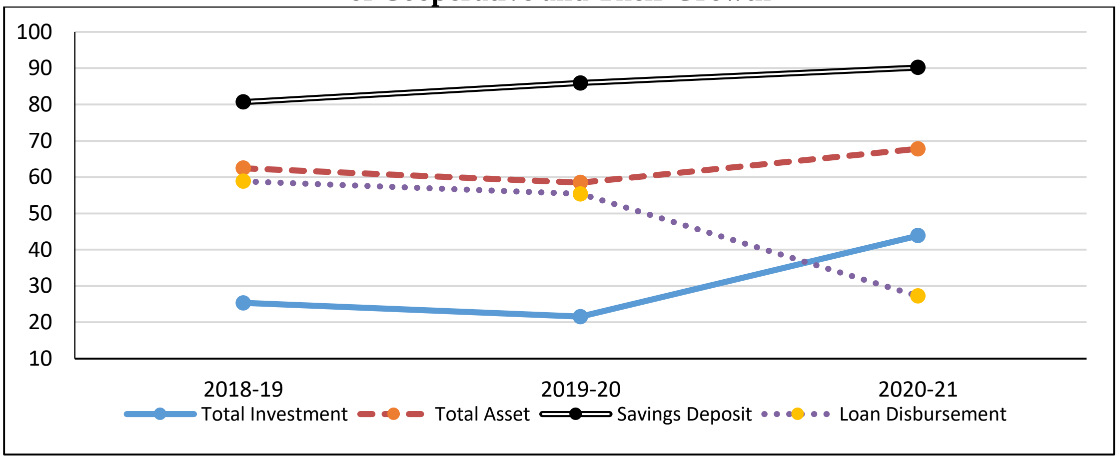
Figure-5.3: Amount (in Billion Taka) of Loan Outstanding and Outstanding Savings Balance of MFIs



Source: Annual Report MRA

Activities of cooperatives expanded throughout the country over the years. As of June 2021, there were over 196300 cooperatives with 11.7 crore members. Cooperative societies have created jobs for 9.63 lac people through their activities (Department of Cooperatives of GoB). Cooperatives' total assets, total investments, and total savings improved even during COVID-19 period. The visible decline in loan disbursement during 2019-20 to 2020-21 is associated with the visible increase in investment during the same period (Figure-5.4).

Figure-5.4: Amount (in Billion Taka) of Investment, Asset, Deposit and Loan Disbursement of Cooperative and Their Growth



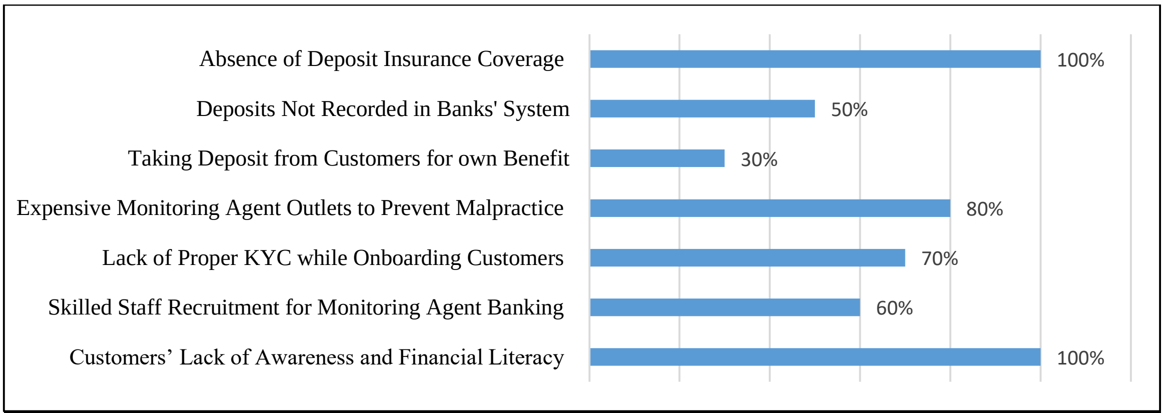
Source: Annual Report, Department of Cooperatives, GoB

5.3 Identifying Challenges of Less Regulated Banking Activities-Outcome of FGD

Benefits of MFS were particularly visible during the COVID-19 situation. FGD discussions identified certain challenges associated with MFS operation in Bangladesh that have implications for regulatory issues and concerns. According to the FGD participants, Mobile banking became core banking for customers during COVID-19, with almost 30 or 40 lacs new accounts being opened. However, the lack of mobile phones and NIDs (for students' scholarship funds, etc.) constrained use of mobile banking among others. The complaints on MFS services reduced over time most of which are associated with awareness problems and information gaps; and sometimes problems with servers at local levels. There are sporadic instances of irregularities by the MFS agents. Differential ownership structure associated with different regulatory provisions for three major MFS service providers is recognized. There are suggestions in the FGD for uniform regulatory provisions for the MFS for greater efficiency and fair competition. Interoperability across MFS providers and greater coordination with telecommunications providers would help enhance client identification for greater financial inclusion and compliance, they opined.

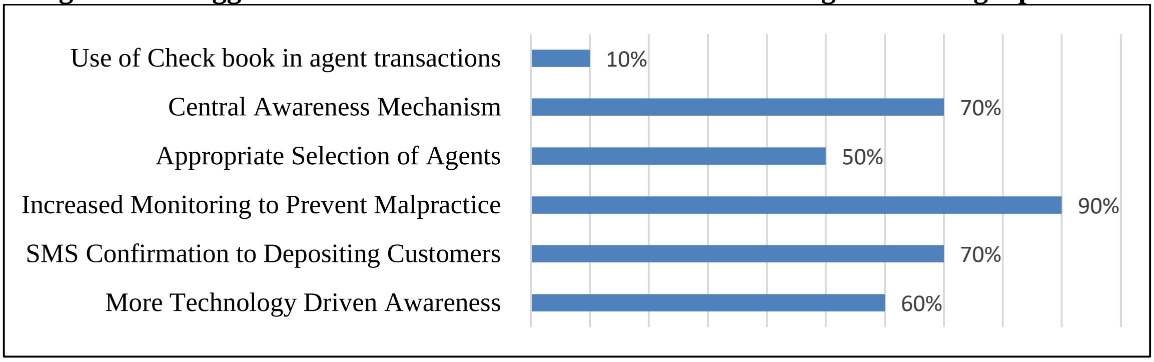
As bank branches were closed due to COVID-19, practically all agent banking outlets were open during COVID-19, resulting in improved relationships between agents and banks. Furthermore, during COVID-19, foreign remittance surged as a result of the expansion of agent banking, which decreased cost and service charges. However, there were also a few instances when agents disappeared with banks' money or agents handled deposits and loans informally without having any record of transactions. Key challenges and suggested measures on agent banking have been captured in the following three figures (Figures 5.5, 5.6, 5.7).

Figure-5.5: Key Challenges Faced by the Banks in Agent Banking



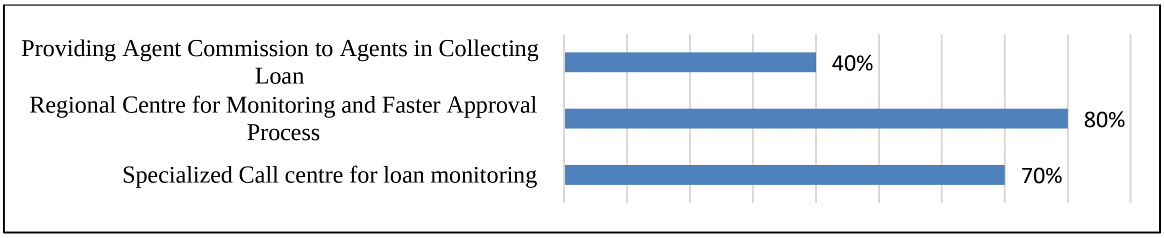
Source: Focus Group Discussion (FGD)

Figure-5.6: Suggested Measures to Ensure Safe and Efficient Agent Banking Operation



Source: Focus Group Discussion (FGD)

Figure-5.7: Suggested Measures for Safe Credit Facilitation through Agent Banking Channels



Source: Focus Group Discussion (FGD)

Bank-MFI linkages are receiving attraction with the expansion of agent banking and banking activities through sub-branches. In several instances, inefficiencies of MFIs caused challenges in loan disbursement and recovery. Banks are sometimes also unsure about the efficiency and capacity of a local level MFI as a partner organization.

6. Key Observations and Recommendations

In Bangladesh, not all the entities are regulated and supervised by uniform stringent criteria. Some operators are relatively new in the financial arena and are offering innovative technology driven financial services. Certain linkage activities of these entities are having shadow elements/components like mobile financial services, agent banking activities, linkage credit of banks, and NBFIs, factoring, etc. Though these entities have regulatory and supervisory arrangements, these are hardly under capital and prudential requirements, consumer protection arrangements, and access to regulatory support in case of financial distress. Inadequate regulation and monitoring of these activities might cause instability while too stringent regulation may deny benefits. The study puts forwards the following recommendations:

One, Mapping of payment, deposit and credit services by adopting suitable definitions (narrow and broad) is the need of the time, based on certain regulatory criteria: regulatory arrangement, supervisory arrangement, reporting arrangement, capital and prudential requirements, consumer protection arrangement, and access to regulatory support. Shadow entities and shadow activities need to be categorized, based on their beneficial impacts (financial inclusion, socio-economic development) and stability risks (liquidity risk, leverage risk, interconnectedness and contagion risk, crime risk, etc.). Besides, their movements should be under continuous monitoring. This exercise became particularly necessary in the context of COVID-19, when less regulated banking is receiving a remarkable policy boost throughout the globe.

Two, Regulatory environment should ensure uniform business incentives to ensure fairness to the market players engaged in offering financial services for financial inclusion. This is associated with fair competition, transparency, accountability and efficient monitoring of financing activities for financial inclusion. Thus, MFS providers need to be brought under uniform but lenient regulatory control that might mainly be associated with following certain procedures and furnishing certain information that is crucial for monitoring management, transparency, and customer protections. Financing and credit activities offered through Agents and linkage arrangements should come under monitoring scanner to manage reputation and crime risks of the financial sector. And for that matter, banks/NBFIs may perform in line with a 'guidance framework' prepared through stakeholders' consultations.

Three, Risks associated with MFS, agent banking and linkage activities by banks and NBFIs should be identified and monitored. Banks and NBFIs should install their own monitoring framework for managing the risks. There should be structured mechanisms for capacity development, disclosure, and customer protection for the less regulated financing activities. Regarding interconnectedness concerns, the less regulated entities should be under continuous monitoring of the regulated banks and financial institutions for their own sake. Considering contagion risk, consortiums of MFS, and agent banking service providers should undertake collective efforts and a uniform risk management approach.

Finally, monitoring and risk management initiatives on the part of market players (banks/NBFIs) would be the best way to escape the possibilities of confronting stringent regulatory framework by the ongoing financial innovations associated with mobile banking, agent banking, and other financial inclusion drives targeting smaller enterprises and vulnerable sections of the society.

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Appendix Table-1: List of Participants in Focus Group Discussion

SL	Name of the Participants	Name of the Banks and Financial Institutions
1.	Mr. Md. Mamunur Rashid Mollah	Agrani Bank Ltd
2.	Mr. Md. Karim	Agrani Bank Ltd
3.	Mr. Md. Abdul Motaleb	Agrani Bank Ltd
4.	Mrs. Shipra Basu	Agrani Bank Ltd
5.	Nilanjana Chakma	Agrani Bank Ltd
6.	Mr. Md. Rashedul Islam	Agrani Bank Ltd
7.	Mr. Md.Monirul islam	Agrani Bank Ltd
8.	Mr. Maynal Hossain	Rupali Bank Ltd
9.	Mrs. Zebu Sultana	Rupali Bank Ltd
10.	Mr. Md. Monirul Haque	Rupali Bank Ltd
11.	Mr. Al Kanan Chowdhury	Jamuna Bank Ltd
12.	Mr. Md. Jasim Uddin	Bank Asia Ltd
13.	Mr. Ishtiaque Ahmed Rahat	Bank Asia Ltd
14.	Mr. Md. Jasim Uddin	Bank Asia Ltd
15.	Mrs. Shahnaz Akhter	Bank Asia Ltd
16.	Mr. Md. Nazmul Hasan	BRAC Bank Ltd
17.	Mr. Tapos Kumar Roy	BRAC Bank Ltd
18.	Mr. S. M. Saiful Islam	BRAC Bank Ltd
19.	Mr. Md Anisur Rahman	Islami Bank Bangladesh Ltd
20.	Mr. Shahidullah Mazumder	Islami Bank Bangladesh Ltd
21.	Mr. Kazi Mohammad Ismail	Islami Bank Bangladesh Ltd
22.	Mr. Kazi Mohammad Ismail	Islami Bank Bangladesh Ltd
23.	Mr. Md. Salah Uddin Tanvir	Al-Arafah Islami Bank Ltd
24.	Mr. Md. Moynal Hossain	Al-Arafah Islami Bank Ltd
25.	Mr. Md. Monzur Hasan	Al-Arafah Islami Bank Ltd
26.	Mr. Manjur Hasan	Al- Arafah Islami Bank Ltd
27.	Mr. Ashaduzzaman Pramanik	Social Islami Bank Ltd
28.	Mr. Md. Aolad Hossain	Social Islami Bank Ltd
29.	Mr. Kanchan Sarwar Dani	Social Islami Bank Ltd
30.	Mr. Mahan	Mutual Trust Bank Ltd
31.	Mr. ASM Ziaul Hider	Mutual Trust Bank Ltd
32.	Mr. Aolad Hossain	Mutual Trust Bank Ltd
33.	Mr. Md. Saif	Dutch-Bangla Bank Ltd
34.	Mr. Pollab Kumar Saha	Dutch-Bangla Bank Ltd
35.	Mr. M Abbas Ali	Dutch-Bangla Bank Ltd
36.	Mr. Md. Mahmudul Hasan Sohel	NRB Commercial Bank Ltd
37.	Mr. Kazi Md. Safayet Kabir	NRB Commercial Bank Ltd
38.	Mr. Md. Harun or Rashid	NRB Commercial Bank Ltd
39.	Mr. Saif Wasi Koroni	Standard Chartered Bank
40.	Mr. Md. Kamruzzaman khan	LankaBangla Finance Ltd.
41.	Md. Ahsan Aziz	IPDC Finance Ltd.
42.	Mr. Mostaq Ahmed	bKash
43.	Mr. Md. Ahsan	IPDC Finance Ltd

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