Development of a Sustainable Financial System for Bangladesh with Reference to the Global Financial Crisis: An Evaluation

S. M. Sohrab UDDIN[1]
University of Chittagong

Abstract

Economic growth and financial intermediation are highly correlated. Both bank-based systems and market-based systems can be used for intermediation. However, the financial crisis in Japan and in the US has put the developing countries in a dilemma in choosing a bank-based system or a market-based system for the channelization of funds from the surplus to the deficit sector. Bangladesh is no exception. In this regard, the present study, which is based on secondary data, identifies the causes of the global financial crisis and its remedies. In addition, the study highlights the operation of the existing financial system and its performance in Bangladesh. It also recommends a sustainable financial system for Bangladesh with some key factors, which are required for its well being in particular and of the economy at large.

Keywords: Bangladesh, Central Regulatory Authority (CRA), deregulation, global financial crisis.

Introduction

The economic growth of a nation heavily relies on the channelization of funds from the surplus to the deficit sector, which can be done through the process of intermediation. This intermediation process can be bank-based or market-based, depending upon the characteristics of a country. For example, in Japan and Germany banks dominate the intermediation process, whereas Anglo-Saxon countries rely more on the market for their financing requirements (Suzuki et al. 2008). People in developing and under-developed countries are always in a dilemma regarding the development of their financial system. They are not sure whether to go for a bank-based system or a market-based system. However, before the US financial crisis, market-based systems were

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[1] The author is a PhD Student at the Graduate School of Asia Pacific Studies, Ritsumeikan Asia Pacific University, Japan and Assistant Professor at the Department of Finance and Banking, University of Chittagong, Bangladesh. He can be contacted at smsohrabcu@yahoo.com

considered as superior to bank-based systems. But now both the two systems have failed: the bank-based system failed in Japan and the market-based system failed in the US. Therefore, under the present scenario it is really difficult to say which one is better, and developing a new model is not at all an easy job to do, but is not impossible. Looking at the grassroots of the two systems' failure will definitely give some clear insights into the development of the future financial system.

Why did the two systems fail in Japan and in the US? The Japanese relationship banking system worked very well from the 1950s to the mid-1970s. Under this system, a firm maintains a long-term relationship with a bank from which it obtains the lion share of its financing requirements. The main banks also play a corporate monitoring and governance role by intervening whenever things go wrong for the firm, and as a result of this the main bank system also refers to a system of corporate financing and governance (Aoki and Patrick 1994). But everything started to change when the government went for deregulation during the 1980s. The capital structure of Japanese firms underwent a dramatic transformation. Reputed firms with higher profitability and growth opportunities with low risk increasingly depended on capital markets for their financial resources, while firms with lower profitability continued to depend on bank borrowing during the 1980s. Strict bank monitoring also induced firms to rely on stock and bond markets. This large shift along with the freedom allowed banks to take bad risks also meant more banks were competing for deposits (Krugman 2009). The ultimate outcome was moral hazard and speculative investment that led to the financial bubble and its 'bursting' during the 1990s.

On the other hand, the market based system was running successfully before 2007 in the US. Everything dramatically changed when the bubble burst in 2008. Many scholars have been trying to identify the fundamental causes of the financial crisis and accordingly give their opinions. According to Solos (2008), excess in financial markets is due to (i) the regulators failure to exercise proper control and their inability to understand the consequences of financial innovations, (ii) the excessive use of leverage supported by sophisticated risk management models that can calculate known risk but ignore uncertainty inherent in reflexivity, and (iii) the introduction of financial products and mechanisms based on ambiguous assumptions. Before the bubble burst borrowers with less than perfect or no credit history could get a loan. All of these factors led to the formation of financial conglomerates that were considered as organizations too big to fail. But in reality the reverse has happened. In addition, there is every possibility that conflicts of interest will appear in the bank's operations in the future whenever these large financial conglomerates actively participate in the underwriting of financial instruments, financial intermediation, secondary market activities, and managing investors' funds (Kaufman 2009). They have also induced changes in the perception of liquidity. Before the credit bubble it was treated as something related to the asset side of the balance sheet, whereas during the credit bubble it was considered as something relating to the liability side.

Posner (2009) suggests that low interest rates in the early 2000s and the deregulation movement that began in the 1970s in fact laid the foundation of the crisis. Low interest rates made borrowing cheap, and that resulted in low personal savings rates and high personal debt rates. It also encouraged people to purchase houses and invest in stocks, which led to asset bubbles and consequent bubble burst. On the other hand, deregulation allowed financial intermediaries like investment banks, money market funds, hedge funds, and commercial banks to offset each other by offering 'substitute' services. In particular, because of the removal of the *Glass-Steagall Act* in the US, the commercial banks extensively relied on short-term credit other than deposits and real estate investment trusts (REITs), and were involved in lending in addition to investment banking. As a result, the financial market became very competitive and profit margins were squeezed. In response to this, banks tried to reduce risk by securitized debt and credit default swaps which were liked by regulatory authorities as tools for spreading risk and thereby making financial crisis less likely to occur (Zandi 2008). But unfortunately this was not true again and almost all of the subsequent losses came from pursuing the flawed trading strategy of borrowing short and investing in long-term senior mortgage backed securities (Milne 2009). Rating agencies also badly misguided the risks and everybody was focusing on meter reading without understanding the forces at work (Bryan and Rumelt 2009). As noted by Shiller (2008: 6), "the housing bubble combined with the incentive system implicit in the securitization process amplified moral hazard, further emboldening some of the worst actors among mortgage lenders."

The resulting financial turmoil has deepened at an alarming rate and affects not only financial, credit, and currency markets but also the real economy. In Bangladesh, even though the impact of the financial crisis has not been directly felt mainly due to shielding of the economy from the most immediate effects of the crisis, the looming economic conditions and financial market instability in the developed and several emerging economies can create adverse impacts on the Bangladesh economy. No doubt it is difficult to predict how the financial crisis would affect the poor countries, but it is relatively safe to conclude that the effects are more likely to be indirect for Bangladesh since the country has little direct exposure to the failing US financial institutions and toxic assets in the developed world. Still a developing country like Bangladesh can learn many lessons from the global financial crisis and accordingly develop or reshape their financial systems so that they can avoid the occurrence of financial crises in their own territory. In this regard, the present study was undertaken to propose some guidelines for the development of a sustainable financial system for Bangladesh by focusing on the global financial crisis.

Objectives of the Study

The principal objective of the study was to propose a sustainable financial system for Bangladesh with reference to the on-going global financial crisis. To accomplish this objective, the following specific objectives were covered:

1. To identify the fundamental reasons of the global financial crisis and the lessons to be learnt from the global financial crisis;
2. To develop a sustainable financial system for Bangladesh;
3. To suggest a policy framework for the efficient functioning of the proposed financial system.

In order to accomplish the above objectives, the first section of this study elaborates the existing financial system in Bangladesh and its performance; the second part discusses the reasons for and lessons to be learnt from the crisis; and the last part proposes a sustainable financial system through some recommendations.

Methodology of the Study

The present study is based on secondary data. In particular, the study concentrates on the existing literature on the global financial crisis in order to detect the reasons for the crisis and its corresponding remedies. In addition, various annual reports were also considered in order to give a snapshot of the existing financial system in Bangladesh and its performance.

The Financial System in Bangladesh – Background

The present structure of the financial system in Bangladesh comprises of various types of banks, insurance companies, and non-bank financial institutions. Bangladesh Bank[2] is at the top of the banking system and is accountable for assuring prudential administration and central banking activities for all types of banks operating within the

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[2] According to the Bangladesh Bank Annual Report (2008-2009), "Bangladesh Bank, the central bank of the country, was established as a body corporate vide the Bangladesh Bank Order, 1972 (P.O. No. 127 of 1972) with effect from 16th December, 1971. The general superintendence and direction of affairs and business of the Bank are entrusted to a nine member Board of Directors which consists of the Governor as chairman, a Deputy Governor, three senior government officials and four persons having experience and proven capacity in the fields of banking, trade, commerce, industry or agriculture - all nominated by the government".

banking industry. On the other hand, the Securities and Exchange Commission (SEC) of Bangladesh is the regulatory body for stock-market related activities. According to the Bangladesh Bank Annual Report (2008-2009), the financial system of Bangladesh consists of 4 state-owned commercial banks, 5 government owned specialized banks, 30 domestic private commercial banks including 7 Islamic banks and 2 denationalized banks, and 9 multinational banks. The financial system of Bangladesh also includes 29 non-bank financial institutions, 298 microfinance institutions, 27 insurance companies, and a number of non-schedule and co-operative banks. Out of 29 non-bank financial institutions one is government owned, 15 are domestic private, and 13 are established under joint venture with foreign participation. Furthermore, Dhaka Stock Exchange Ltd. (DSE) and Chittagong Stock Exchange Ltd. (CSE) are the two stock exchanges operating within the financial system.

Currently, two credit rating companies are also working in Bangladesh: the Credit Rating Information and Services Ltd (CRISL) and the Credit Rating Agency of Bangladesh Ltd (CRAB). In addition, there are five trustees of asset-backed securities and mutual funds, seven asset management companies, and six security custodians.

The process of securitization has not yet geared up in Bangladesh since there are only two cases of asset-backed securitization. The first ever asset-backed securities were introduced in Bangladesh in November 2004. An amount of BDT 359 million (local currency of Bangladesh) was floated in the country by the Industrial Promotion and Development Company (IPDC) of Bangladesh, a non-bank financial institution. Later, in February 2005 another issue of BDT 190 million was floated by another non-bank financial institution, namely the Industrial Development Leasing Company (IDLC) of Bangladesh (Siddiquee et al. 2006). On the other hand, loan sales by commercial banks and the trading of derivative securities have not yet started in Bangladesh. The government is planning to initiate the trading of financial derivatives by the end of the year 2010.

Tracing the Development of the Financial System

According to Suzuki and Adhikary (2009), the progress of the financial system in Bangladesh can be organized into three major phases: the first phase, from 1972–1982, a period when the government was focusing on nationalization and reconstruction; the second phase, 1983–1989, when denationalization and privatization took place; and the third phase, 1990–the present, a period when the government has been emphasizing financial liberalization through initiating a broad-based financial liberalization measure under the name of the 'Financial Sector Reform Program (FSRP)' (Suzuki and Adhikary 2009).

Performance of the Banking Sector

The banking sector in Bangladesh is very much competitive. All of the banks are operating within a small industry where excessive competition has always existed. The prevailing market competition induces the banks to disburse loans without proper screening of the borrowers. According to Islam et al. (1999), "in spite of the liberalizing and privatizing of the banking sector in the 1980s with a view to increasing efficiency and competition, the robustness of the credit environment deteriorated further because of the lack of effective recourse on borrowers." All of these banks make disbursed loans to non-performing loans, which not only badly affects the banks, but also the entire economy as a whole. The performance of the banks can be judged on the basis of many variables and the non-performing loans to total disbursed loans is one of the significant variables that reflects the efficiency of commercial banks. Tables 1 and 2 give an idea about the non-performing loan scenario of the banking sector of Bangladesh. According to those two tables, the percentage of non-performing loans to total loans in Bangladesh has been decreasing over the period from 1998–2007, still the percentage was significant (13.20%) during the calendar year 2007. In comparison to South Asian countries like India and Sri Lanka, Bangladesh has held the highest percentage of non-performing loans to total loan disbursements during recent years. In particular, the percentage was 13.56% in 2005 compared to 5.20% for India and 9.60% for Sri Lanka.

What Can Bangladesh Do?

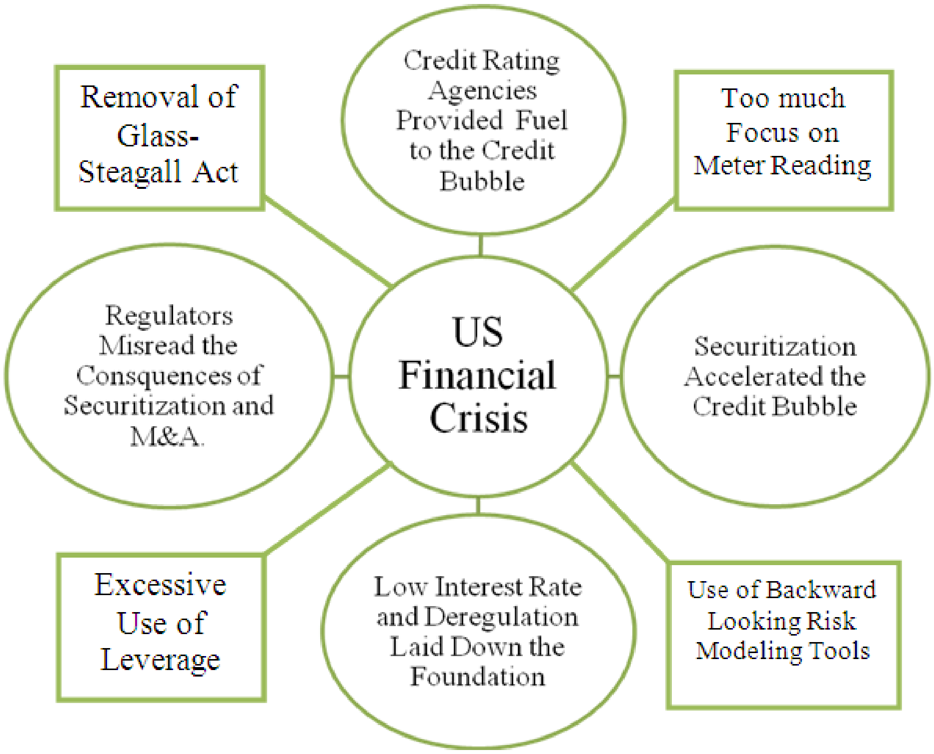
There is no doubt that the bank-based system is better than the market-based system for any country in the Asia Pacific region. The culture of Bangladesh is more suited to the relationship-based banking of Japan. The government can allow banks with sound financial health to patronize a particular firm under a specific industry with all of the services required to become successful. But it is too late to do so. This may be one question to debate since the government has already embraced financial liberalization, which fundamentally caused both the two systems to fail in Japan and in the US. Another fact is that both the stock exchanges in Bangladesh, namely the Dhaka Stock Exchange Ltd. (DSE) and the Chittagong Stock Exchange Ltd. (CSE), are in full swing of their operations since the total market capitalization of the DSE jumped to BDT 931.03 billion on June 30, 2008 as against BDT 475.86 billion at June 30, 2007, showing a 95.66 percent increase (DSE Annual Report 2007–2008). On the other hand, the market capitalization of CSE increased from BDT 56,364 million in 2001 to BDT 219,942 million in 2005. In this circumstance, if the government neglects the capital market and focuses on the bank-based system it may create more problems. Therefore, it is better to provide a modified version of the existing financial system which will be more sustainable in the future. Before that, it is necessary to highlight the fundamental causes of the global financial crisis and some recommendations given by various authors regarding the US financial crisis.

Causes and Lessons to be learnt from the US Financial Crisis

There are many reasons that worked together to accelerate the credit bubble in the US and the corresponding bubble burst in 2008. Figure 1 gives some of the reasons of the crisis. Under the present scenario, it is better to concentrate on the recommendations given by learned authors, which will provide some insight about the modification of the existing financial system in Bangladesh. It will help the government to protect its financial system from financial turmoil.

According to Shiller (2009), none of the proposals suggested by the US government after the financial crisis represents a true institutional innovation; rather most of them are undertaken from a short-term perspective without considering the full range of issues. He suggests incorporating financial innovations with an emphasis on assuring safeguards for the society as a whole, of which innovations made by the Grameen Bank of Bangladesh are a good example. They are merely quick fixes that fail to address the full scope of the problem. He suggests ensuring the job of extending innovations of modern financial technology together with effective safeguards throughout the society, and that the innovations made by the Grameen Bank of Bangladesh can be an example.

Figure 1: Fundamental Reasons of the US Financial Crisis.



Source: Author

Solos (2008) suggests that a new paradigm, the recognition of reflexivity is required, which can be defined as "act of self-reference where an action 'bends back on' and affects the entity instigating the action." He also argues that the following needs to be done:

- The authorities must exercise more vigilance and control during the expansionary phase. This will regulate supply of money and credit creation;
- Regulators must reassert control over the use of leverage. It will reduce both the size and the profitability of the financial industry;
- A clearing house or exchange must be established for credit default swaps, which will assure submission of existing and future contracts by fulfilling necessary capital structure and margin requirements.

Geisst (2009) mentions that a combined effort of the Federal Reserve and the Treasury should act together to coordinate fiscal and monetary policies in the US, especially when these involve consumer and mortgage credits. He also recommends the following for the betterment of the financial system:

- Larger down payment and stronger borrower ratios usually would be sufficient to slow the agencies' intermediation;
- Change the tax laws regarding capital gains on housing;
- The whole issue of complexity in financial design needs to be addressed because that sort of complexity has produced much confusion among legislators;
- Securitization process needs to be repaired immediately;
- European coverage concept of securitization is better than American uncovered one;
- Mortgage credit should be included in the category of consumer credit.

Kaufman (2009) calls for an overseer which will look after the issues relating to capital adequacy, business practices, conflict of interest, and other measures with regard to consistency and competitiveness and assure institutional set up for the players in the derivative markets. Moreover, he suggests to spin-off the assets of big conglomerates and they should be under tight supervision so that it will be possible to ensure that an institution may be 'too good to fail' rather than current proposition of 'too big to fail.' He also criticizes the International Monetary Fund (IMF) and wishes to have a more effective international supervisory body in order to supervise and regulate major financial markets and institutions around the world.

A Proposed Financial System

The financial system of Bangladesh is not yet that complicated and hence it is the right time to reshape the financial environment for the future. The introduction of loan sales and other financial derivatives will definitely make the market more complex. Most of the authors mentioned in this article propose controlled liberalization, since too much freedom can ensure economic prosperity in the short run but not in the long run. Under the current financial system in Bangladesh, both the depository and investment intermediaries enjoy a deregulated environment. Bangladesh Bank monitors the bank market whereas Securities and Exchange Commission (SEC) monitors the stock and bond markets. But the problem is that there is no coordination among the two regulatory bodies. There is every possibility that one business organization that takes loans from banks as well as issuing securities may not submit the same performance report to a bank and the stock exchange. This anomaly of information remains hidden due to lack of coordination amongst the two regulatory bodies. Even the credit rating agencies are developing their ratings systems by incorporating quantitative models without considering the ratings made by the Bangladesh Bank and SEC, although these possess more information about a particular bank or business firm. In this regard, the government of Bangladesh can establish a new entity in the name of a Central Regulatory Authority (CRA) that will monitor both the banking market and the stock market. This would help to overcome the existing problem of information asymmetry between the two regulators by maintaining a central financial database, which is currently not available in Bangladesh. Figure 2 outlines the proposed financial system, however the key role of the authority will be to ensure an effectively supervised atmosphere under the ongoing liberalized and market-based regime of the financial system. In order to ensure this the proposed CRA has to consider the following key factors to uphold a sustainable financial system.

Factors to be considered

1. Partial Loan Sale: During the subprime situation banks and other financial institutions sold loans and created new loans. In this there was no monitoring from a bank's perspective. But this is not good at all. There should be some regulation so that banks could not be able to sell the entire loan. This would ensure the involvement of banks in monitoring borrowers after securitization. It would also ensure the reporting of loans in a bank's balance sheet rather than eliminating them from it. The regulators of Bangladesh should consider this when loan sales start in Bangladesh. It would be better if the government delegates the authority to the proposed Central Regulatory Authority (CRA) to implement this partial loan sale arrangement;
2. The Boundary of Doing Business: The removal *Glass-Steagall Act* was one of the fundamental reasons for the US financial crisis. It eliminated the boundaries of doing business for financial intermediaries. In Bangladesh as per the law, commercial banks deal with the lending and borrowing of money and only a few of them are involved in merchant banking. On the other hand, investment banks deal with advising, underwriting, and secondary market activities. The government should continue this segregation when it initiates loan sale and derivative trading in the financial market, so that financial institutions cannot cross their boundaries and embrace their own downfall by becoming too big. It is also important to make sure that the securitization process will not become that complex in the future;
3. Credit Rating Reform: The credit rating agencies also misunderstood the risk during the credit bubble in the US. They undertook rating by using their own quantitative models. They did not incorporate the ratings done by the central bank and the SEC. Currently the same thing is also happening in Bangladesh. But it will be better if the credit rating agencies can incorporate the comments of the central bank and the SEC regarding an individual borrower or a business firm or a financial institution, since both

the central bank and the SEC have their own ratings;
4. Revisit Deposit Insurance Premium Calculation: So far the rate of deposit insurance premium is the same for all the banks, which is not at all justifiable. This encourages risky banks to take risky investment and discourages good banks. At the same time, it is really difficult to introduce a new system. If the central banks charge different banks with different rates, this will badly affect the confidence of the depositors of particular banks. Therefore, the central bank of Bangladesh should continue with the same rate but can provide other benefits to good banks compared to low-performing banks, so that banks always have the tendency to improve their performances.
5. Coordinated Effort: It is always necessary to maintain long-term stability of the entire financial system of a country. Coordinated effort among the regulatory bodies is primarily required to do so. The proposed Central Regulatory Authority (CRA) will ensure coordination among the Treasury, central bank, and SEC, which will in turn help the government to fix fiscal and monetary policies;
6. Adequate Use of Leverage: Excessive use of 'leverage' also accelerated the US crisis. In order to regulate leverage, sound capital adequacy ratio is an utmost necessity. This capital adequacy ratio should not be determined for a long-term basis. It should be monitored on a continuous basis to prevent bad consequences. Again the government of Bangladesh can delegate the authority to the proposed Central Regulatory Authority (CRA) so that banks use leverage optimally rather than excessively;
7. Controlled-deregulation: It has already been mentioned that deregulation also laid down the foundation of the US financial crisis. There is obvious doubt about the future continuation of this long cherished deregulation. Now, it is the right time to go for controlled-deregulation rather than a free form of deregulation;
8. Interest Rate Monitoring: This is another macroeconomic factor which is required to monitor on a continuous basis. The US financial crisis also makes it clear that a low rate of interest is not always good for the economy. It should not be fixed for a long period of time. Central Regulatory Authority (CRA) can handle this by consulting with the Treasury and the central bank;
9. Reformation of Reward System: Awarding large bonuses becomes a serious issue after the crisis. This kind of bonus system is also present in Bangladesh, predominantly in the private sector. The government should also consider this with immense prudence and impose some kind of regulation.

Conclusion

The financial crisis will reshape the financial world over years to come. The future sustainability of a country's financial system largely depends how quickly and smoothly it can adapt to the changing financial environment. It is clear from the crisis that the ongoing regime of financial liberalization cannot provide guarantees against financial distress. The crisis also urges for the importance of government intervention to regulate market players to behave prudently even under the regime of the market-based financial system. This study aims at developing a sustainable financial system for Bangladesh, with reference to the global financial crisis and proposes to establish a new institution CRA capable of generating quality information. The new institution will not focus on the administratively regulated financial sector, rather it will ensure an effectively supervised financial atmosphere for attaining incentives from market mechanism through innovation and competition, which will not only help to enhance the economic prosperity of the country but also to sustain it. The important issue for Bangladesh may be to translate the current global crisis into an opportunity to step forward under this continuously changing financial atmosphere.

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Appendices

Table 1: Non-performing Loans as % of Total Loans.

Year	Total Loans (BDT in billion)	NPL as % of Total Loans
1998	527.32	40.65
1999	580.83	41.11
2000	654.42	34.91
2001	749.49	31.49
2002	851.73	28.01
2003	914.90	22.10
2004	1079.71	17.60
2005	1292.51	13.56
2006	1543.60	13.20
2007	1724.30	13.20

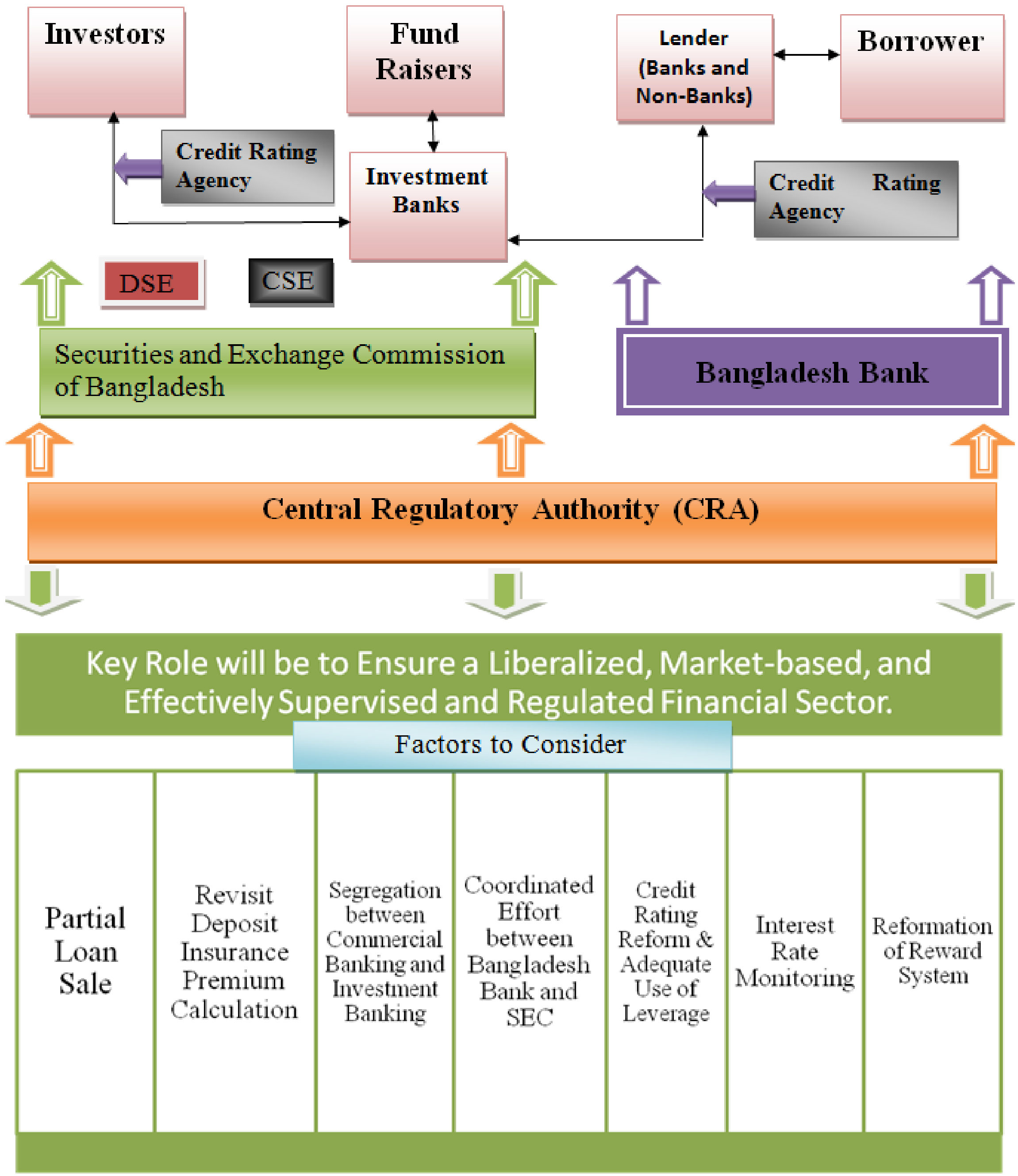
Source: Banking Regulation & Policy Department, Bangladesh Bank, 2008.

Table 2: Non-performing Loans in South Asian Countries.

Year	NPL as % of Total Loans		
	Bangladesh	India	Sri Lanka
2001	31.49	11.4	15.3
2002	28.01	10.4	15.3
2003	22.10	8.80	13.7
2004	17.60	7.20	9.10
2005	13.56	5.20	9.60

Source: Global Financial Stability Report, IMF and Bangladesh Bank. Financial Sector Review, May 2006, Bangladesh Bank

Figure 2: Proposed Financial System for Bangladesh



Source: author