Structural Adjustment Participatory Review Initiative, Bangladesh
Study Theme 2(C) : Implications of Financial Sector Reforms

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ACRONYMS

ADB	Asian Development Bank
ADR	Advance - Deposit Ratio
AMC	Asset Management Company
ASA	Association for Social Advancement
BA	Bankruptcy Act
BB	Bangladesh Bank
BBO	Bangladesh Bank Order
BBS	Bangladesh Bureau of Statistics
BCD	Banking Control Department [Now it is reorganized as BRPD]
BCO	Bank Companies ordinance
BFS	Board for Financial Supervision
BIBM	Bangladesh Institute of Bank Management
BIDS	Bangladesh Institute of Development Studies
BKB	Bangladesh Krishi Bank
BNP	Bangladesh Nationalist Party
BRAC	Bangladesh Rural Advancement committee
BRC	Banking Reform Committee
BRDB	Bangladesh Rural Development Board
BRPD	Banking Regulations and Policy Department
BSB	Bangladesh Shilpa Bank
BSBL	Bangladesh Samabaya Bank Limited
BSCIC	Bangladesh Small and Cottage Industries Corporation
BSMSC	Banking Sector Management Section Committee
BSRS	Bangladesh Shilpa Rin Sangstha
CAMEL	Capital, Asset, Management, Earnings, Liability
CBA	Collective Bargaining Agency
CBRP	Commercial Bank Reform Project
CIB	Credit Information Bureau
DFI	Development Financial Institutions
DMD	Deputy Managing Director
DNCB	Denationalized Commercial Bank
EWS	Early Warning Signals
FCB	Foreign Commercial Bank
FI	Financial Institution
FSAC	Financial Sector Adjustment Credit
FSRP TA	Financial Sector Reform Project Technical Assistance
FSRP	Financial Sector Reform Project
GDP	Gross Domestic Production
GOB	Government of Bangladesh
HRD	Human Resource Development
IBBL	Islami Bank Bangladesh Limited
IL	Informal Lender
IMF	International Monetary Fund
LE	Loss Incurring

LLRC	Large Loan review Cell
LLRS	Large Loan Reporting System
LRA	Lending risk analysis
MD	Managing Director
MFI	Micro Finance Institution
MIDAS	Micro Industry Development Assistance and Services
MIS	Management Information System
MMTU	Monetary Management and Technical Unit
MLC	Money Loan Court
MOF	Ministry of Finance
MOU	Memorandum of Understandings
MP	Member of Parliament
NBFI	Non-Bank Financial Institutions
NBL	National Bank Limited
NCB	Nationalized Commercial Bank
NCMCB	National Commission on Money, Banking and Credit
NGO	Non– Government organization
NLL	New Loan Ledgers
NLLC	New Loan ledger Card
NPA	Non – Performing Asset
PAR	Performance Audit Report
PCB	Private Commercial Bank
PCR	Project Completion Report
PE	Profit Earning
PFP	Policy Framework Paper
PKSF	Palli Karma Sahayak Foundation
PPS	Performance Planning System
PSE	Public Sector Enterprise
RAKUB	Rajshahi Krishi Unnayan Bank
RBI	Reserve Bank of India
RC	Rural Customers
REER	Real Effective Exchange Rate
ROA	Return on Assets
RWA	Risk Weighted Assets
SAP	Structural Adjustment Program
SAPRI	Structural Adjustment Policy review Initiative
SBS	Scheduled Bank Statistics
SCI	Small and Cottage Industries
SFI	Semi-formal financial institution
SHG	Self - Help Group
SLR	Statutory Reserve Requirement
SME	Small and Medium Enterprise
SPB	Specialized Public Bank
TDTL	Total Demand and Time Liabilities
USAID	United States Agency for International Development
WB	World Bank

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I. INTRODUCTION

The paradigm shift of economic thought in the twentieth century is that financial sector is no more considered as oil to the wheel of economy, it is considered now as the wheel itself. Frequent economic crisis generated from financial sector, especially from banking sector may act in this shift. As the role of financial sector in the economic growth and development through intermediary process is enormous, it is necessary to investigate whether the financial sector performs efficiently and effectively this intermediation task.

the structural adjustment program was initiated in different countries including Bangladesh for redesigning the structure of economy for minimizing the gap between the countries' economic potential and actual outcome. Financial sector reform was a part of the whole package of SAP. Several policy measures were designed to be implemented in phased manner. There have been several studies to assess the outcome of SAP, but most of the exercises were initiated by the progenitors of these reforms.

The SAPRI exercise to evaluate the reform measures is completely different, where participatory process involving stakeholders is the cornerstone of the evaluation.

In the evaluation of financial sector reform the focus would be on effects of these reform measures on the stakeholders (especially rural sector and SME borrowers) of the financial sector and the political economy aspects of reforms. The study is organized in the following manner: section II describes the background of the SAP in the financial sector, the policy design of SAP is presented in the section III. Section IV elaborates the implementation status of SAP in the financial sector. On the basis of the policy design and implementation status the SAPRI analytical framework is canvassed in section V. Section VI presents the main body of the study, as it elaborates the assessments of the policy outcomes. This section comprises empirical analysis (VI.I) as well as stakeholders' perception (VI.II). Section VII revisits SAP and outlines the future policy design and section VIII contains conclusion of the study.

II. BACKGROUND OF THE SAP IN THE FINANCIAL SECTOR

After its liberation in December 1971, Bangladesh inherited an undiversified and undeveloped financial system, which was overwhelmingly dominated by the commercial banks. Out of historic necessity, the then government in power (just after liberation), nationalized and reorganized all the financial institutions excepting a few foreign bank branches (see Table – A1). Since 1972, the financial institutions of Bangladesh used to operate under a regime of rigid government control and central bank regulations. The regulation covered fixation of interest rate on deposits and credits, direction of credit to public sector enterprise [PSE] and priority sectors, directed expansion of bank branches, etc. Till 1982, all the financial institutions were kept under the ownership as well as regulatory control of the government.

During the period, 1972-82, financial network of the banking system increased commendably. The total number of branches increased 13.36 percent annually during 1973-83. At the same time, population per branch reduced remarkably from 50,946 to 20,716. The urban rural proportion of branches, deposits and credit improved significantly in favor of rural areas during the period and thus satisfied the objective of the government in regard to extending baking services to the rural area and extending generous credit to PSEs. Financial institutions during 1972-82 pursued a policy of rapid credit expansion to priority areas in response to government directives with little regard to loan quality. Socioeconomic considerations were given most priority in credit analysis and decision. Many rural branches were opened without considering viability aspects. Lending rates especially for priority sectors were kept at such a lower level, which did not cover the risk, and actual cost factors. A huge proportion of the asset profiles of the financial institutions became overdue. All these had been reflected through decline in the profitability of the nationalized commercial banks [NCBs]. The profitability (defined by net profit deflated by balance sheet total) of NCBs fell down from 0.32 percent to 0.23 percent during 1973-74 to 1982-83. This deterioration of the operational efficiency of NCBs was surfaced inspite of their inappropriate accounting system (i.e., accrual system of income recognition). Not only operational efficiency, level of customer services of the banks also deteriorated during the period. The balance sheet of the performance of the banking sector during 1972-82 was thus mixed-success in achieving economic objectives of expanding financial network and providing easy credit to priority areas, but failure as far as ensuring financial viability and customer services of the banks are considered.

As the policy of the Government of Bangladesh [GOB] regarding the role of private sector had changed particularly since 1976, the need for allowing local private banks to finance increasing activities of the growing private sector, was being keenly felt. This feeling became particularly strong after the disinvestment of some public sector enterprises. Accordingly, the government decided to allow the operation of local private banks and to denationalize 2 (two) out of 6 (six) NCBs (namely Uttara and Pubali Bank) in 1982. The main reason for allowing local private banks was the desire on the part of GOB to demonstrate its commitments to encourage the private sector and to create competition in the banking sector [The National Commission on Money, Banking and Credit (NCMCB) Report. 1986, p-13]. Initially, three banks were set up in private sector in 1982. With the setting up of a number of banks subsequently in this sector, the number of banks of private commercial banks [PCBs] including 2 denationalized commercial banks)as on December, 1999 stood at 31. (see Table A-2).

Under the guidelines formulated for the formation of private banks, all credit restrictions as imposed by Bangladesh Bank (for NCBs) were also made applicable to a private bank. Moreover, sponsors and directors of PCBs were not allowed to take loans from their own banks I) for their own companies/ businesses, ii) individually beyond Taka 1 (one) million (up to a maximum limit of Taka 5 million) without the approval of Bangladesh Bank (BB) and collectively beyond 10 percent of total loanable funds, and iii) on unsecured basis or against their own shares. All requirements of the Bank Companies ordinance (BCO)-1962 as also the relevant provisions of the Bangladesh Bank Order (BBO)-1972 and instructions issued thereunder by the BB were also made applicable to the banks in the private sector [NCMBC Report. 1986, p-15].

It was expected that the measures of denationalization and privatization would generate competition and improve the level of operational efficiency of the banking sector. However, till 1986, operational efficiency did not improve, rather declined. The profitability of the banking institutions went down form 0.32 percent to 0.19 during 1982-86. The period also witnessed unprecedented undue influence of vested interest groups in credit decision making process of the financial institutions (both nationalized and private) resulting in not only misdirection of credit but also non-repayment of credit.

According to Watanagase (1990), nearly 30 percent of NCBs loan portfolio became non-performing by 1986.

The pressure for change and reforms in the banking sector of Bangladesh till mid 1980s was cancelled out by several factors. As the accounting standard and bank reporting requirements were not standard , the banks especially NCB's financial statements did not indicate the real extent of financial distress in the country. Due to the weakness in the accounting procedures, the banks appeared solvent with low return on assets (ROA) and inadequate capital. The overwhelming growth of deposits eased the probable difficulties related to liquidity crisis and undermined the sense of urgency of reform.

To diagnose the malaise and identify ways and means for banking recovery, a National Commission on Money, Banking and Credit was appointed by the GOB in 1986. The commission completed the study and submitted recommendations to the GOB, most important of which were related to overall structure of the banking system; monetary management, especially reserve requirements of the banks and interest rate and refinance policy of Bangladesh bank; various administrative and judicial steps required for overcoming problems of overdue loans of Development Financial Institutions (DFIs) and NCBs; rural and agricultural credit strategy for maintaining adequate credit flow to rural sector; management and operations of banks for improving internal management control and efficiency; strengthening supervisory and inspection capability of Bangladesh Bank; various preventive and punitive measures for protecting the banks against frauds, forgeries and malpractice; and various amendments and/or enactment of laws requiring for improvement of loan recovery and overall financial discipline.

Following the submission of the commission's report, some measures were undertaken namely, setting recovery targets for NCBs and DFIs, various administrative measures for prohibiting defaulters from access to further credit etc. Despite these efforts, however, the situation continued to deteriorate (by 1989, the profitability of banking system went down to 0.11 percent even after following grossly inadequate and inappropriate banking accounting system) and "progress in addressing underlying causes of the sector's deficiencies was slow" [WB, 1997b].

As there was a little progress in addressing underlying causes for the financial sector's deficiencies, the Financial Sector Adjustment Credit (FSAC)/SAP designers therefore, attempted to address them. They identified four groups of causes namely economic, prudential, institutional and legal for deficiencies of banking sector, which are discussed below.

Throughout the two decades after independence, there was overwhelming control over the interest rates structure of banks. Interest rates on loans and deposits were differentiated by type and maturity. Within a sector, different rates were applied to working capital and term loans, with the latter varying according to the debt-equity ratio of the borrowing firms. These mandated rates were changed infrequently, resulting in wide fluctuations in real rates as inflation rate fluctuated. There were no market rates, except on certificate of deposits (which were not an important element because of high rates on other term deposits) and the inter-bank rate.

The FSAC/SAP designers recognized that savings mobilization and hence deposit growth during eighties was better due to massive branch expansion by NCBs throughout the country. But the high administered deposit rates increased cost of funds to the NCBs, added to their excess liquidity and eroded their earnings. Preferential loan rates were often lower than deposit rates, and given the banks' excess liquidity, reduced the incentive to avail refinance from the central bank at low refinance rates. Finally the rigidly controlled interest rate structure failed to reflect a loan's real risk and return.

Among the major causes was also the preferential lending to the priority sectors such as agriculture, export and small scale industry. The NCBs ware obliged to extend preferential credit to these sectors, which in turn was often refinanced by the Bangladesh Bank. By the end of 1985, about two thirds of NCB loans were of the preferential sort. The SAP designers found this preferential lending as one of the major causes of financial distress. There was little or no incentive to screen out bad customers, despite the risks involved in some of the priority sectors, origination of default problem lied in preferential lending to the priority sector along with the lending to SOEs.

The SAP designers also found that administered interest rate structure, together with absence of appropriate loan classification, provisioning and accounting procedures, made impossible for a proper loan portfolio evaluation with obvious detrimental impacts upon resources allocation.

The SAP designers found that the supervision and inspection by the BB was lax, particularly in the areas of capital requirements, loan provisioning and classification and general accounting standards. There were different capital adequacy requirements for foreign and private banks and the NCBs. The NCBs' capital adequacy requirements were much lower, which made them more vulnerable to technical insolvency. In terms of inspection and classification of loans, emphasis by the central bank was placed on security, and not on actual loan performance. The BB allowed banks to accrue interest on overdue loans in the first two years, which was very lenient and allowed the NCBs, and other private banks, to overstate their income. This also enhanced the flow of dividends and taxes to the budget.

The third group of root causes of Bangladesh banking deficiencies was "managerial and institutional weakness". Project appraisal capabilities were weak, and appraisals were often based upon inappropriate assumptions about the policy environment or availability of necessary infrastructure. Debt recovery was poor, and the lack of adequate management information systems compounded the problem. The SAP designers argued that the financial rewards of bank officers should have been linked to loan collection performance, which was absent at that time. Particularly, in the NCBs the efforts were existing to reduce administrative costs, but not intensifying loan collection process.

Along with the problems mentioned above, an inadequate legal and judiciary framework intensified the loan delinquency problems. All financial transactions in Bangladesh were subject to common law, with the result that process was subject to long delays and often arbitrary judgements that subsequently set damaging precedents.

The government often extended concessions to some overdue borrowers, which created “moral hazard problem” and incentives for other borrowers to be reluctant in the repayment performance in the expectation that they might be accorded similar concessions. In the agricultural sector also, loan forgiveness and debt exemption schemes were implemented, which undermined the integrity of the financial system and contributed to the default phenomenon.

In this backdrop, financial sector reform measures were launched under FSAC to support GOB's medium term financial sector reform program in early 1990s. FSAC was approved by the IDA Executive Directors on June 5, 1990 and became effective on June 22, 1990 (first tranche released). The third (final) tranche was released on December 30, 1993 (20 months after the planned date), and the credit was fully disbursed on February 22, 1994. USAID financed the complementary US$ 16.3 million for FSRP TA (Financial Sector Reform Project Technical Assistance). The TA began nine months behind the schedule in September 1992 and was completed in 1995.

III. POLICY DESIGN OF SAP IN THE FINANCIAL SECTOR

On the basis of the above mentioned background the SAP policies regarding the financial sector was designed.

The planned financial sector reform was called for measures to liberalize interest rates, improve monetary policy, abolish priority sector lending, strengthen central bank supervision and regulation of banks, improve the environment of debt recovery and broaden capital market development. This reform agenda followed the economic and sector works by the World Bank and the recommendations of National Commission on Money, Banking and Credit with a view to improving the efficiency of financial intermediation in Bangladesh [WB, 1997a].

The fundamental objective of the financial sector adjustment credit (FSAC) was to improve the functioning of the country's banking system, and increase its effectiveness in supporting the development efforts of GOB [WB, 1997b].

The Financial Sector Reform Program under FSAC was designed with seventeen second tranche and ten third tranche conditions. The tranche conditions focused on the following area:

1. Implementation of a new interest rate policy, with a progressive move toward market determined rates; reimbursement of interest rate subsidies to the banks by GOB during the period of credit;

2. Improvement of the central bank's supervision capabilities and development of appropriate bank reporting requirements together with revised prudential standards;
3. Reclassification of the NCB's loan portfolios with appropriate provisioning;
4. Recapitalization of the NCBs, issuance of GOB bonds to ensure a capital ratio to the extent of 5 percent of deposits, after the provisioning described above and to be maintained at this level during the life of the loan;
5. Achievement of loan recovery and collection targets by the NCBs from the 100 largest defaulters as well as new loans during the life of the project;
6. Establishment of a credit information bureau in the central bank, with the regulation that banks not be allowed to lend to defaulters identified by this bureau and without letters of no objection from the lender who holds the defaulted loan; and,
7. Implementation of the Financial Loan Court Act.

The following broad policy objectives were set for the financial sector reforms:

1. Gradual removal of the distortions in the interest rate structure with a view to improving the allocation of resources ;
2. Providing increased market oriented incentives for priority sector lending;
3. Making subsides in these sectors more transparent;
4. Applying appropriate monetary tools to control inflation;
5. Establishment of appropriate accounting policies including recapitaliztion, regulation and supervision, effective management policy, to put banking system on a sound financial basis.
6. Improvement of debt recovery environment.
7. Strengthening the capital markets.

The complete reform agenda and policy matrix is presented in table A-3.

Along with the financial sector reform program under FSAC, USAID provided a parallel grant as Technical Assistance, which is known as FSRP TA. The project aimed at strengthening the BB, the NCBs and Bangladesh Institute of Bank Management (BIBM).

The main objectives of the FSRP were to:

- Assist with monetary policy reforms at BB
- Help strengthen bank supervision capabilities of BB
- Help improve the efficiency and financial viability of the NCBs, some of which may be suitable for privatization.
- Expand PCBs share in total commercial banking.
- Help improve the quality of training at BIBM and the NCBs

IV. Implementation of SAP in the Financial Sector

IV.I. Implementation of New Interest rate Policy

Among the objectives of SAP, interest rate decontrol was considered as corner stone of the whole reform. The objective was to remove gradually the distortions in the interest rate structure with a view to improving the allocation of resources; providing increased market oriented incentives for priority sector lending. Changing in interest rate policy ought to reflect maturity, risk and administrative cost more adequately, allow for flexibility in meeting changing conditions, and encourage price competition. Returns to banks from lending to higher risk priority sectors should be sufficiently high to provide greater incentive in such lending and ensure that priority sector lending does not undermine the financial viability of the NCBs and shift additional longer term burdens on the government budget. Interest rates for deposits should ensure that savers receive consistently positive real rate of returns while allowing the banks sufficient flexibility to maintain adequate spreads and satisfactory profitability. [World Bank, 1995]. The policy measures under interest rate decontrol can be grouped into three categories [Bhattacharya and Titumir, 1998]:

- move towards more market-determined level and structure of interest rates;
- allow banks to charge different lending rates based on borrower credit risk; and
- phase-out interest rate subsidies.

Even before the implementation of SAP reform, Bangladesh Bank announced a new policy guideline in 1989 [vide BCD Circular No. 33, dated 16.11.89] on the interest rate deregulation. Before 1989, Bangladesh Bank determined the deposit and lending rates for the commercial banks. According to the new regulation, banks were free to set on their own the interest rates for deposit and lending within a band set from time to time by the

Bangladesh Bank. In 1992 the interest rate bands were removed from all but three of the lending sectors and banks were allowed to fix lending interest rate on their own judgement. Bangladesh Bank also removed the ceiling on deposits and allowed multiple rates within a lending category and increased the frequency of interest rate changes by individual banks (from six months to every month) [vide BCD Circular No. 7, dated 09.03.92). In 1997 the floor rate of the deposits also removed [vide BRPD Circular No. 1, dated 11.02.97]. From August 1999, the interest bands form the agriculture and SME sectors were removed [BB, Economic Trends, Volume XXV No. 3 March, 2000, p. 66]. From 1994 the SME sector was subsidized by 3% for term loan. This subsidy has been removed also from July 1999 [Bangladesh Bank, 1999]. The details regarding phasing out of interest rate structure is presented in the table A- 4.

If we compare the target and achievement of implementation of the SAP policies, we observe that a lot of liberalization measures regarding the interest rates have been implemented. The only restriction till mid-1999 in place was interest rate bands in three priority sectors, namely agriculture, export and small industries. But form the late 1999 the export sector alone enjoys the interest rate bands.

IV.II. Monetary Policy Reforms

The overall objective of monetary policy reform was to introduce flexible, indirect monetary management moving away from direct credit controls and sectoral allocations of credit. This objective responded to the shift to a market economy.

In order to achieve the above, the following steps were undertaken:

1. A Monetary Policy Committee chaired by BB's Governor was established to review monetary policy and determine what actions to take. The MPC is supported by the Monetary Management and Technical Unit (MMTU) established to support the financial reform program.
2. The BB 91 day bill was established and started to be auctioned monthly. No secondary market has emerged.

3. The rediscount window was established and the various refinance rates were abolished and all lendings to commercial banks are made at bank rate. Management of the rediscount window presently combines monetary policy and bank supervision objectives.
4. The exchange rate has been managed on the principle keeping the real effective exchange rate (REER)[1] steady.

IV.III. Strengthening Financial Institutions

IV.III.I. Bangladesh Bank

One aspect of strengthening BB is ensuring a strong system of supervision over the banks, which is very necessary in order to see that the financial regulations are followed faithfully by the banks. Before 1990, bank supervision in Bangladesh was focused on implementation of economic directives of the GOB. Since banking strategy has changed (from controlled to liberalization), now BB needs to pay more attention to prudential and less to economic regulations, leaving the decisions of who is to get credit and at what price to the bank management themselves.

There are different elements of prudential regulations, but two aspects, namely capital adequacy and appropriate loan classification and provisioning have assumed greater importance in financial reform program of various countries. The banking system of Bangladesh had been ignorant in regard to both of these aspects. Capital adequacy did not receive sufficient attention due to the assumption that banks and financial institutions owned by the government can overcome any financial crisis. Moreover, capital requirements were not same for all types of banks (NCBs, PCBs, and FCBs[2]). With the enaction of Bank Companies Act 1991, uniform capital requirement of 6 percent of total demand and time liabilities of a bank was prescribed for all types of banks. Since 1996, BB has started calculating capital adequacy of the banks as per internationally accepted norm of 8 percent of risk weighted assets.

[1] REER is calculated on the basis of effects of market forces, weights of individual currencies in the currency basket and inflation rates of the countries in the basket and local inflation rate.
[2] Foreign Commercial Banks

Another important aspect of prudential regulation is loan classification and provisioning, on which highest thrust has been placed during reform era. Before 1989, the standards for judging the loan qualities were not uniform for all banks, those too were mostly subjective. Moreover, since the loans were backed by the so-called securities, the urge on the part of the banks to make adequate provisions for whatever loans they classified was almost non-existent. Not only that, the banks used to enter the notional interests form those classified loans as their income into the financial statements (on the basis of accrual accounting practice). To overcome such irrational practice and reflect truly the profit position of a bank, BB formulated a detailed loan classification and provisioning norms and measures. Since then, the banks have been classifying their loan portfolios accordingly and by this time (since 1999) the norms of classification and provisioning have been elevated to international standard in five phases [For details see appendix table A-5].

The banking supervision by BB has also been restructured through adding off-site surveillance function with the on-going on-site supervision. In respect of off-site supervision, the banks in Bangladesh have been started to be CAMEL rated[3] since 1994. According to BB rules, the commercial banks having CAMEL scores of 4 and 5 would be considered as Problem Banks. BB has also organized a Problem Bank Cell for efficient handling and improvement of financial health of problem banks. On the basis of ratings, early warning signals (EWS) are also being issued to some banks and memorandum of understandings (MOUs) were signed with the problem banks. To help in the improvement of asset quality, one Credit Information Bureau (CIB) as a separate department has been set-up in BB. One large loan Review Cell has also been installed at BB. For licensing and monitoring NBFIs, one new department has been opened in BB.

IV.III.II. Commercial Banks

The first line of defense against bank insolvency and financial system distress is the quality and character of management within the banks themselves (Pollizatto, 1992) and therefore, efforts to strengthen the financial system through building strong management cadre were also focussed in the financial sector reform program of Bangladesh. The major

[3] A composite rating of a bank's capital, asset quality, management, earning capacity and liquidity situations.

aim of FSRP stationed at BB was to improve the operations of NCBs through development of new banking technologies, computerization of banking operations, upgradation of skills of human resources of the banks, changing the back-dated internal banking practices and corporate and credit cultures etc. During FSRP period, 1992-96, FSRP consultants developed a number of new management and operational tools such as lending risk analysis (LRA), large loan reporting system (LLRS), new loan ledgers (NLL), performance planning system (PPS), management information system (MIS) etc. and disseminated these tools and techniques through various training programs to a large number of bank officers, especially of NCBs.

Another aspect of strengthening NCBs was to recapitalize them so as to increase their capital base, which was done through issuance of government bonds (around Tk. 50 billion) to NCBs.

IV.IV. Improving Debt Recovery Environment and Legal Framework

The policy designers identified five major causes behind the loan default problem:

1) the past practice of directed lending for "priority sector";
2) An inadequate legal framework for loan recovery and contract enforcement assured borrowers that in case of default their personal assets would not be expropriated;
3) Frequent loan forgiveness/ waiver packages which eroded credit discipline;
4) Lending indiscriminately to immature and inexperienced entrepreneurs many of whom preferred to gain immediate benefits by diverting credit funds, instead of reaping long-term benefits from an established industry;
5) Formula based lending with fixed debt equity ratios (80:20), which greatly reduced the entrepreneurs' personal stake in the enterprise.

As already mentioned, the past practices of priority sector directed lending has been discontinued and refinance for priority sector lending has been replaced by single window rediscounting facility by BB for the banks.

For improving the debt recovery status in PSEs, the NCBs undertook special programs to identify large borrowers requiring restructuring. The NCBs fixed "monitorable" targets for collection and resolution of legal cases for 100 largest defaulters and for new loans over Tk. 1 million approved by NCB head offices. Under the reform program, NCBs ought to be allowed to select legal counsel of their choosing from panels for debt recovery cases.

In order to improve debt recovery environment and overall lending quality, a number of new laws, regulations and instruments have been formulated, which can be divided into four broad groups such as : i) screening, ii) monitoring, iii) transparency, and iv) lender's recourse regulations [Choudhury and Moral, 1997].

Table 1. New Loan Regulations

Screening	Monitoring	Transparency	Lenders recourse
i) LRA ii) CIB iii) Loans to Insiders and Connected Parties iv) Interest Rate Deregulation	i) NLLC ii) LLRS iii) PPS iv) Off-site Supervision	i) Loan Classification and Provisioning ii) Risk based Capital Adequacy	i) Money Loan Court Act, 1990 ii) Bankruptcy Act, 1997

Source: Choudhury and Moral, 1997.

The quality of lending depends on quality of screening, which further depends on quality of information about the borrowers intention to repay. Lending Risk Analysis is one of the new management and operational tools for improving the credit risk calculation initiated by FSRP TA in 1993. The BB made LRA mandatory for all banks for lending above Tk. 10 million. Some of the banks reduced the minimum limit of loans for applying LRA techniques. LRA techniques are supposed to ensure that low risk borrowers should pay lower lending prices and high risk borrowers should pay higher prices.

CIB was established in the BB for providing information about the creditworthiness of the borrower to the lending banks and to monitor the existing loan of the borrower for avoiding duplicity in lending and monitor the repayment status of the previous borrowings (whether the borrower is a defaulter). It has been made mandatory for all banks for lending above Tk. 5 million. Now the CIB report is required for the amount above Tk. 1 million.

To resolve the insider and connected lending problem, the Bank Companies Act, 1999 (Act 14 of 1991) and subsequent amendments in 1995 (Act 25 of 1995) contained section 27 to ensure that loans to connected parties are not granted at arm's length, on terms not more favorable than those extended to similarly situated outside borrowers, that proper internal control and credit limits are in place and concentration of credit avoided. The BB issued a circular (vide BCD Circular No. 15, dated 18.07.1995) regarding the restriction on loans and advances to private banks' directors.

FSRP designed and introduced the New Loan ledger Card (NLLC) for improving the accounting practices in recording the loan status that would ensure easy identification of problem loans. Large Loan reporting System had been introduced in NCBs to monitor large loans more closely and regularly. The BB also established Large Loan review Cell (LLRC) to review all newly sanctioned, renewed and rescheduled loans by scheduled banks over Taka 10 million. Performance planning system (PPS) was another management tool which was developed by FSRP and adopted by NCBs. Off-site supervision through CAMEL rating, as introduced by BB, is also useful for loan portfolio monitoring. To make the loan portfolio status of a bank transparent, the new loan classification and provisioning system and new measurement of capital adequacy were also introduced by the BB. To ensure lenders recourse on borrowers Money Loan Court Act, 1990 was launched. The number of Money Loan Courts throughout the country is around 90. Subsequently, the Act was amended in 1990 (Act 51 of 1990), 1992 (Act 25 of 1992), 1994 (Act 2 of 1994) and 1996 (Act 26 of 1996). For the same purpose, one Bankruptcy Act, 1997 has also been formulated and enacted. Under the Bankruptcy Act (BA)-1997, the government has set up two exclucive bankruptcy courts, one in Dhaka and the other in Chittagong.

V. SAPRI ANALYTICAL FRAMEWORK

GENERAL FOCUS

The general focus of the study is on the following:

- to review relevant policies and the backdrop that led to adoption of such policy changes, to investigate whether the adopted reform measures and objectives were justified, effective and enough in tackling the arising conditions of the financial sector.
- to examine the outcome (reasons responsible for success or failure) of the reform measures.
- to analyze the consequences of outcome on the banking system and its different stakeholders.
- to analyze the present situation and draw a future policy framework based on the participation of stakeholders.

PRINCIPAL HYPOTHESIS

The research component of the SAPRI, Bangladesh is geared towards targeted learning on the issues identified through three regional consultative meetings, six focus group discussions, and opening National Forum. The Forum decided that one of the research questions that would be pursued in the study phase would be the following:

Has the financial sector in Bangladesh experienced an efficient allocation of resources in terms of access to credit and market mediated equilibrium price for credit, following the financial sector reform program?

AREAS OF INVESTIGATION

With a view to address the stated research question, the study has attempted to comprehend the following areas:

- Revisit the design of the FSRP in order to find out the appropriateness of the reform measures including institutional reforms;

- Review the interest rate structure with a view to examining the improvement in the allocation of resources;
- Assess whether liberalization of interest rate has led to reduction of the cost of borrowing through market mediated process; and
- Investigate whether access to credit has improved to the productive sectors in terms of availability;
- Analyze accounting policies including loan classification, provisioning, re-capitalization in order to assess the degree of transparency and disclosure as well as improvement of recovery in the banking sector.
- Analyze regulatory, supervisory and management policy in order to assess whether the banking system put on a sound financial basis.
- Review the restructuring of NCBs and its branches and its implications on the rural economy and the small producers;
- Examine the debt recovery environment including the legal framework;
- Examine the role of private sector banks in achieving competitive market based system.

METHODS OF INVESTIGATION

The study has adhered to general principles set out and guidelines laid in the SAPRI Methodological Framework, prepared by SAPRI Global Technical Committee. The study should have taken a gender aware political economy approach with a view to understanding the political, social, and institutional structures and processes that shape policy decisions and impacts. But the political economy approach could not be made gender focussed due to the limitations in data availability. Nevertheless, the study attempted to capture all relevant explanatory variables on both the supply and demand side, including policy changes as well as exogenous factors and shocks.

As the reforms measures have been undertaken in the financial sector of Bangladesh not only with in the structural adjustment policy framework, but also before and after the launching of SAP, the authors felt justified to extend the time horizon of analysis also before (pre – 1990) and after (after 1995) the SAP.

Using the above time horizon the analysis sequence followed by the authors was as follows:

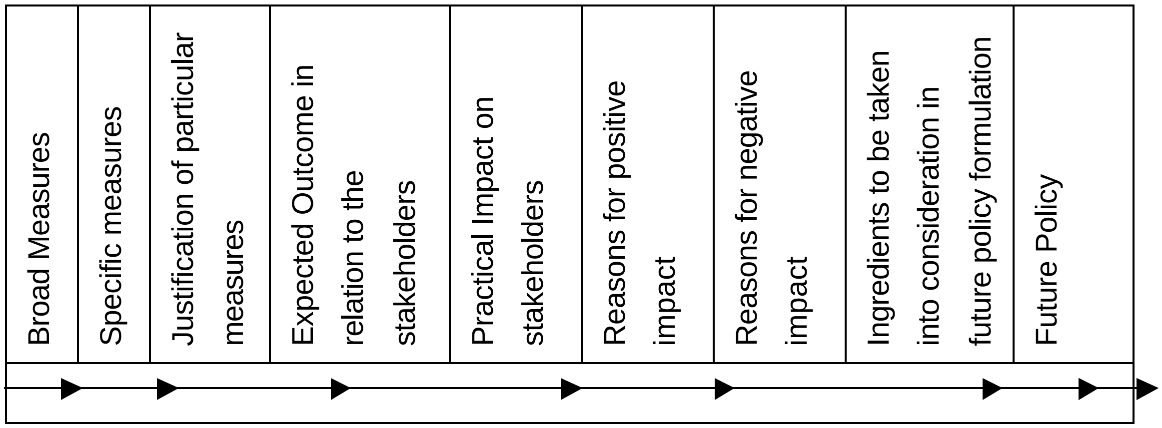


Figure 1. Sequential Horizon of Impact Analysis

For examining the reasons of success and failures of reform measures of the financial sector the authors have defined "success" and "failure". A success measure has two dimensions:

a) achievement of full compliance with the desired outcome (e.g. introduction of a particular law, or interest rate deregulation);
b) After achieving the desired outcome whether the particular measure has created the desired impact on the target group or overall economy.

Non-fulfillment of any of the above dimensions implies failure on the part of the adopted measures.

According to the areas of investigation let us discuss the methodology undertaken in this study for analysis of the policy outcomes.

In the assessment of outcomes, we first diagnosed the financial market structure in Bangladesh, which is an important factor to determine nature of pricing and competition. We have considered nominal interest rate spread as a proxy for competition in the banking sector of Bangladesh. In a competitive market, relationship between the lending interest rate and deposit interest rate can be derived as follows:

$$i_l = \frac{1}{1-k} i_d$$

Where, k = required reserve ratio

i_d = Interest rate on deposit

i_l = Interest rate on lending.

Then the nominal interest rate spread is:

$$i_l - i_d = \frac{k}{1 - k} i_d$$

The coefficient *k/(1 – k)* determines how much spread should be in the competitive market. If the reserve requirement is 20 percent of liabilities, then the spread should be maximum 25 percent of the nominal weighted average deposit interest rate. If the spread exceeds this limit, we can say that market is not fully competitive. As much as the spread is away form this limit, the more the market tends to be oligopolistic.

The interest rate deregulation ought to have reduced the real lending rate. For analyzing the outcome of the policy in this regard the authors analyzed the trend of real lending interest rate, calculated as a difference between the weighted average lending interest rate and inflation rate. For inflation rate 1990 was taken as base year as it fit with the starting year of FSAC/SAP in the financial sector.

By productive sector the authors mean the non-trade sector. Up to 1999 the government categorized agriculture, SME and export as the priority sectors. For analyzing the policy outcome in regard to efficient resource allocation the authors have considered the above mentioned sectors.

The authors interpreted efficiency in credit allocation in two ways. One is advance deposit ratio, another is credit allocation index. The credit allocation index was calculated as follows:

$$I_{ti} = \frac{A_{it}}{Q_{it}}$$

where

I_{ti} = Credit allocation index for i-th sector for year t

A_{it} = Advances to the i-th sector for year t by all scheduled banks

Q_{it} = Contribution to GDP by i-th sector for year t

Along with the quantitative analysis the authors compared the policy of the government regarding the resource allocation from the viewpoint of economic objectives of the particular regime for the period before SAP and after SAP.

The authors defined several policy and infrastructure variables, which affected the resource allocation. Among the policy variables, the interest rate policy, prudential policy and policy of creating specialized institutions are important. Among the infrastructure variables the legal framework, supervisory framework are analyzed here. The authors also consider the moral hazard aspects which affected the resource allocation.

For analyzing the outcome of the policy measures of strengthening financial institutions the authors analyzed the implementation of new loan classification and provisioning requirement policy. In this regard, the problem of inappropriate sequencing of policy measures was also discussed. For analyzing the impact of loan classification the simple trend analysis of total classified loans was not adequate, because the loan classification standard was not same throughout the period in question. But trends in growth rate of advances and growth rate of classified loan might be interesting for making any significant comments on the improvement of the situation in the banking sector. Any non-systematic trends for different categories of banks might be explained as the positive or negative impact of this policy. Therefore, the trend analysis of the growth rates of advances and classified loans was done in the study form 1993 (as the loan classification standard was implemented in 1992).

With a focus on political economic aspects of SAP, the SAPRI analytical framework emphasizes on the efficient allocation of resources through improved access to credit. For this purpose the authors analyzed the asset concentration index. The trend analysis of these figures show whether after the FSAC/SAP the asset concentration in few hands increased or decreased. An increasing situation indicates the failure of FSAC/SAP in this regard and vice versa.

PRIMARY SURVEY

The SAPRI analytical framework is participatory. The information on the access to credit by the priority sector was not available form the secondary sources. The comparison of before-after scenario was impossible. But the authors performed primary survey for the two of the three priority sectors viz., rural sector and SME sector to derive a picture of access to credit. The authors also have drawn some input form different stakeholders of the supply side.

Primary Survey on Access to credit for Rural Sector

To make the study representative a stratified sampling approach was adopted. From each of the former administrative divisions [Dhaka, Rajshahi, Khulna and Chittagong] we have selected randomly six districts [Kishorganj, Gopalganj, Chandpur, Rangpur, Lalmonirhat and Bhola] so that at least one district represents the division. From each of the districts we have selected randomly one thana [Hosenpur, Gopalganj sadar, Kachua, Tista and Borhanuddin]. From each of the thanas we have selected three villages randomly [Shaheber Char, Birpaiksha, Dhankura, Nizra, Ulpur, Dumudia, Gani-er-char, Shahabaz, Harishwar, Kacharir Par, Gokunda, Tista, Joinagar, Badurpur, Hasanpur, Balurchar, Boromanika, Lakshmipur]. Total sample size was 480, where from each of the thanas we have selected at least 80 households. For collection of information regarding the access to credit we have used both structured questionnaire and unstructured interview method to ensure participatory approach. For calculation of access to credit we have used a Symantec model based on elimination principle [details in section VI.II.I].

Primary Survey on Access to credit for SME Sector

For the survey we have selected three areas: Gazipur, Narshingdi and Dhaka metropolitan area. Total sample size was 190. Among them 80 from Dhaka Metropolitan area, 55 form Narshingdi and 55 from Gazipur. The entity under the SME was considered either with a manpower size within 50 and asset within Tk. 5 milion. A broad spectrum of enterprises was undertaken in this study. For analyzing the access to credit we have used the same Symantec model as in case of rural sector. But here we have considered a simplified version [see details in section VI.II.II].

Time series data of pre, during and post adjustment were used to establish attributes of causality. The secondary data sources were the relevant documents of World Bank such as the Policy Framework Paper (PFP), Project Completion report, Performance Audit report, as well as equivalent reports on sectoral operations in Bangladesh, Bangladesh Bank, Ministry of Finance, Bangladesh Bureau of Statistics, Bangladesh Institute of Development Studies, Commercial Banks and independent researches.

VI. ASSESSMENTS OF POLICY OUTCOMES

VI.I. Empirical Analysis

VI.I.I. Interest Rate Policy

In Bangladesh, till the end of 1980s (even after denationalization and privatization), the banks were operating in a protective environment characterized by administered interest rates and drected credit (for NCBs). Consequently, it was argued, the interest rate structure was distorted, competition was absent and allocation of resources was inefficient in the banking system of Bangladesh. Therefore, one of the important objectives of the reform measures in the financial sector was to remove gradually the distortions in the interest rate structure with a view to improving competition, especially price competition and allocation of resources.

Interest rate policy shifts after SAP in Bangladesh has already been discussed. However, the overall policy shifts can be divided into four phases:

1. In 1970s, the central bank deliberately fixed both deposit and lending rates to achieve the resource allocation according to the economic policy. The interest rate was generally low with a view to stimulating the domestic investment.
2. In 1980s, the deposit rates were kept generally higher than the inflation rate to make real deposit rate positive. Generally, more and more exceptions were introduced or special lending categories were identified for directed lending.

3. In early 1990s, in the era of SAP, interest rate bands were established for 11 exhaustive categories, fixed by the government. For lending below a shadow rate determined by the BB, the government paid subsidies to the banks, thus making subsidies transparent. The reform allowed banks freely to set interest rate as long as they remained within the bands. Deposit rates were freed except that a floor and ceiling for saving and fixed deposit were established. At the same time directed lending was redesigned, the BB initiated a rediscount facility – essentially for lending to the banks – at an uniform rate, thereby replacing an entire menu of refinance rates.
4. In 1992, the lending rate bands were removed form all but three sectors (namely agriculture, export and small industry sectors). The banks were free to set any lending rate. Floors on saving and fixed deposits were continued but ceilings were removed. In 1997, the floor rates of deposits removed. From August 1999, interest bands on agriculture and SME loans were also removed.

As a whole most of the reform measures relating to interest rates were implemented, with a view to bringing price competition in the financial market and thus efficient allocation of resources.

In the assessment of outcomes, we first want to diagnose the financial market structure in Bangladesh, which is an important factor to determine nature of pricing and competition. We have considered nominal interest rate spread as a proxy for competition in the banking sector of Bangladesh. In a competitive market, relationship between the lending interest rate and deposit interest rate can be derived as follows:

$$i_l = \frac{1}{1-k} i_d$$

Where, k = required reserve ratio
i_d = Interest rate on deposit
i_l = Interest rate on lending.
Then the nominal interest rate spread is:

$$i_l - i_d = \frac{k}{1-k} i_d$$

Table 2 shows that throughout 1990s the interest rate spread remains very high, equal to or more than 7 percent. The interest rate spread was rather low during 1980s. The nominal lending rate and spread, which are desirable in a competitive market, have been derived using the above formulas. The calculation shows that the desirable lending interest rate ought to be below 10 percent since 1992. With a reserve requirement of 20 percent, spread between lending and deposit rate should be around 2 percent in a competitive market. From the table, we also observe that there is no relationship between bank rate and market interest rate. If we consider the bank rate alongwith the interest rate spread, we can conclude that the Bangladesh financial market is still highly distorted and fragmented.

Table 2. Indicator of Market Structure through Interest Rate Spread (In percent)

Year	Bank Rate	Lending interest rate	Deposit interest rate	Desirable lending rate	Desirable spread	actual spread	Spread Adjusted for Provision
1986-87	10.75	14.7	8.59	10.74	2.15	6.11	
1987-88	10.75	14.66	8.69	10.86	2.17	5.97	
1988-89	10.75	14.68	8.88	11.1	2.22	5.8	
1989-90	9.75	14.83	9.06	11.33	2.27	5.77	
1990-91	9.75	14.99	9.11	11.39	2.28	5.88	
1991-92	8.5	15.12	8.11	10.14	2.03	7.01	2.282035
1992-93	6.5	14.39	6.51	8.14	1.63	7.88	1.922938
1993-94	5.5	12.78	5.34	6.68	1.34	7.44	1.498254
1994-95	5.5	12.22	4.86	6.08	1.22	7.36	1.375155
1995-96	6.5	13.41	6.11	7.64	1.53	7.3	1.790887
1996-97	7.5	13.69	6.67	8.34	1.67	7.02	1.960303
1997-98	8	13.97	6.98	8.725	1.745	6.99	2.074451
1998-99	7	14.15	7.08	8.85	1.77	7.07	1.77

Note: Lending and Deposit Interest rates are taken as weighted average. The data of spread adjusted for provision is not available for the years upto 1991-91 as the provisioning was introduced in 1992.
Source: Bangladesh Bank, Economic Trends, various issues

Table 3. Interest rate structure in the scheduled banks [weighted average]

Year	Interest Rate on deposit	Interest Rate on advances	Inflation Rate (1990-100)	Real Rate of Interest on deposit	Real Rate of Interest on Advances
1987	8.62	14.59	10.45	-1.83	4.14

1988	8.8	14.62	11.3	-2.5	3.32
1989	8.94	14.66	8.03	0.91	6.63
1990	9.12	14.87	-	9.12	14.87
1991	9.07	14.91	8.9	0.17	6.01
1992	8.11	14.98	5.14	2.97	9.84
1993	6.6	14.17	1.31	5.47	12.86
1994	5.48	12.79	1.81	3.67	10.98
1995	5.04	12.47	5.25	-0.21	7.22
1996	6.2	13.37	4.02	2.18	9.35
1997	6.83	13.82	3.87	2.96	9.95
1998	7.115	14.04	4.48	2.635	9.56
1999	9.115	14.01	5.12	3.995	8.89

Source: 1. Bangladesh Bank. Economic Trends, Various Issues
2. ADB. 1998. **Key Indicator of Developing Asian and Pacific.** Volume XXIX, Oxford University Press, p. 37.

On the lending side, government still has considerable influence on the interest rate structure due to the dominance of NCBs in the market place. On the deposit side, due to the presence of several special government savings schemes with high rates of return, the interest rate structure is still distorted. The interest rate remained high in real terms [table 3]. Theoretically, the high real interest rates following a period of interest rate deregulation may be expected in a market with oligopolistic structure and other imperfections like inadequate prudential regulations and supervision framework and weak and inefficient financial institutions.

One may argue that NPA problem of Bangladesh banking sector might be responsible for high interest rate spread. But our estimation shows that NPA cannot fully explain the high interest rate spread in Bangladesh.

The ultimate purpose of interest rate deregulation was to ensure a smooth and efficient functioning of financial market under competitive market forces. So, banks are now totally free to determine the structure of deposit and lending rates. Lending rates are supposed to be based on cost of fund, administrative expenses, cost of provision and an allowances for profit margin. However, in reality, very few banks are found to follow this sort of scientific procedure. Rather, in regard to price fixation, they simply follow one another. In this regard, one interesting observation is that the banks are divided into two distinct clubs; one PCB club and another NCB club. The relatively smaller banks of each club generally follow the relatively bigger ones in terms of price fixations. Chaudhuri et. al (1995) observe, "All these flexibility and autonomy have been given to the banks to generate competition, especially price competition among them. But it is yet to be appreciably visible in our financial markets, an important reason being the long practicing (around two decades) of controlled and directed banking, with which bankers and bank managements are accustomed and still requiring a lot of time to come out from the vestiges of controlled banking".

Therefore, in addition to government led distortion and NPA, collusive behavior and misconceived price strategies have resulted in the persistence of high interest spread. As a result, the objective of bringing competition in the market place through interest rate deregulation could not be achieved.

VI.I.II. Resource Allocation

The logic behind the imposition of credit control after the independence was to correct the imperfection in the credit market, which led to economically and socially inefficient credit allocation. The credit ceilings and prohibitions policies were directed toward controlling the flow of total credit. They included ceilings on total lending by individual banks, lending to public and private sectors, lending to different loan size classes, and lending for certain economic purposes. The allocational instruments used were lending targets and guidelines, margin requirements, refinance policies, government guarantees and linking to new urban and rural branches. Specialized banks were also served as allocational instruments. Ceilings on lending interest rates were directed primarily towards the welfare and subsidy objectives. All these various forms of directed and controlled lending/ banking were dismantled through undertaking reform measures. Not only competitiveness, interest rate deregulation was also sought for efficient resource allocation on the part of banks. It was said that even PCBs would go for priority sector lending, if interest rates are not repressed and allowed to be determined freely by the market forces. Now, let us see how far it was materialized.

Efficient resource allocation has several interpretations. Banks are collecting deposits and these are the liabilities of the banks. The level of disbursement of loanable funds after fulfilling the reserve requirements can be interpreted as the efficiency of resource allocation. The second interpretation is that how much loanable funds are available for productive sector. The productive sector means the non-trade sectors. For the second interpretation the calculation of economic sectorwise output-loan ratio and loan-output ratio may be very much applicable.

The table 4 shows the efficiency of credit allocation in terms of advances-deposits ratio of all banks. The ratio has declined from 0.91 in 1990 to 0.82 in 1998. In the

Table 4. Efficiency of Credit Allocation through Deposit-Advances Ratio(Tk. in Crores)

Year	Deposit	Adv./Deposit	Deposit-Reserve	Adv./Deposit-Reserve
1987	14762.96	0.835	14762.96 - 3321.67	12328.41/11441.29=1.078
1988	17405.55	0.838	17405.55 - 4351.39	14586.195/13054.16=1.117
1989	19953.4	0.879	19953.4 - 4988.35	17529.27/14965.05=1.171
1990	22536.85	0.909	22535.85 - 5633.96	20477.57/16901.89=1.212
1991	25619.9	0.845	25619.9 - 6020.68	21648.87/19599.22=1.105
1992	28968.9	0.815	28968.9 - 6083.47	23615.97/22885.46=1.032
1993	32859.9	0819	32859.9 - 6571.98	26919.28/26287392=1.024
1994	37833.4	0.767	37833.4 - 7566.68	29015.25/30266.72=0.959
1995	42024.2	0790	42024.2 - 8404.84	33202.13/33619.36=0.989
1996	46406.15	0.811	46406.15 - 9281.23	37618.9/37124.92=1.013
1997	52334.07	0.803	52334.07 - 10466.81	42008.79/41867.26=1.003
1998	59066.4	0.821	59066.4 - 11813.28	48489.46/47253.12=1.026

Source: Bangladesh Bank, Economic Trend and Scheduled Bank Statistics, Various Issues.

years 1994 and 1995, the ratio was even less than 0.8. The advances-deposit ratio after adjusting for reserve also indicates the same trend. Throughout the period, the ratio is above one, mainly because of I) considering outstanding advances position that includes both principal and interest, and ii) undertaking a number of donor aided lending projects for which donor funds (rather than deposit resources) are utilized. However, advance-deposit ratio (ADR) does not serve as a reliable indicator of efficiency in resource allocation for three reasons: first, while the amounts of both deposit accretion and credit expansion could be very small, the ratio could be high, giving a misleading picture of ADR; secondly, to the extent that the ratio does not take into account banks investment in securities other than SLR purposes, it fails to provide a complete picture of resource deployment; and finally, with the introduction of prudential requirements like loan classification and provisioning and capital adequacy norms, it is not resource deployment per se, but the quality of credit that should be the prime concern to banks.

Table 5. Sectoral Distribution of Advances by Scheduled Banks (% of Total)

Sectors	1987	1988	1990	1991	1992	1993	1994	1995	1996	1997	1998
Agriculture	24.94	22.93	21.07	16.62	17.75	16.70	17.32	16.31	15.36	14.09	12.23
Fishing	1.51	1.58	1.62	1.62	1.59	1.51	1.42	1.29	1.08	1.08	1.43
Forestry	0.03	0.03	0.01	0.01	0.01	0.01	0.01	0.03	0.02		0.02
Large and Medium Scale Industry	24.30	19.56	25.39	26.48	25.76	26.22	24.16	26.71	25.72	26.56	27.99
Small Scale & Cottage Industry	3.32	3.49	1.13	1.35	1.41	1.39	1.61	1.51	1.09	1.43	1.53
Working Capital Financing	4.72	4.79	9.72	9.94	9.14	9.07	11.09	9.35	11.73	11.43	10.45
Large and Medium	4.33	4.46	8.69	8.73	8.05	7.91	9.73	8.01	10.30	10.02	9.08
Small Scale & Cottage Industry	0.39	0.33	1.03	1.22	1.09	1.15	1.36	1.34	1.43	1.41	1.36
Construction	3.22	3.33	3.89	4.92	5.12	5.19	5.57	5.40	5.35	5.60	5.36
Electricity, Gas Water and Sanitary	0.60	0.50	0.18	0.26	0.02	0.09	0.21	0.10	0.20	0.03	0.02
Transport and Communications	2.97	2.50	1.47	1.58	1.51	1.33	1.37	1.56	1.48	1.50	1.41
Storage				0.87	0.83	0.80	0.94	0.89	1.25	1.12	1.47
Trade	33.70	37.39	46.25	31.76	32.69	32.18	29.94	29.59	28.93	29.00	28.41
Export	5.75	5.84	9.08	4.64	5.31	6.09	6.20	5.81	5.27	5.63	5.98
Import	7.46	8.41	19.67	6.12	6.66	5.61	6.43	6.55	6.21	7.03	6.71
Miscellaneous	3.40	3.67	1.14	4.60	4.77	4.92	6.37	7.26	7.74	8.17	8.69

Source: Bangladesh Bank. Scheduled Bank Statistics, Various Issues

The sectoral distribution of advances by the scheduled banks of the country, as given in the table 5, shows the drastic reduction of banks advances to the agriculture sector, largest contributor to GDP, over 1987 – 1998 form 24.94 percent to 12.23 percent. The small and cottage industry's share in total bank advances also declined form 3.32 percent in 1987 to only 1.53 percent in 1998. Large and medium scale industry sector experienced a little higher share in banks advances over the period, 1987 – 1998, yet this is the sector which also experienced highest loan default.

Therefore, on the whole, the sectoral distribution of bank advances after the SAP financial reforms as compared to before SAP does not show better allocation of resources in favor of productive/ priority sectors. The sectoral distribution of advances on the part of NCBs and PCBs separately are shown in Table A-6 and A-7. The PCBs provision of advances to productive sectors are not at all significant in both before and after SAP financial reforms.

Table 6. Credit Allocation Index: Ratio of Advance Proportions to GDP Proportions

Sector	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Agriculture	0.677	0.649		0.598	0.49	0.52	0.513	0.557	0.542	0.509	0.474	0.428
Industry	2.955	2.832		3.68	3.795	3.519	3.478	3.315	3.313	3.434	3.491	2.631
Construction and Housing	0.237	0.238		0.29	0.36	0.376	0.38	0.406	0.395	0.396	0.419	0.401
Power, Gas, Water and Sanitation Services	0.769	0.537		0.15	0.187	0.013	0.054	0.117	0.053	0.105	0.016	0.011
Transport, Storage and Communication	0.257	0.208		0.124	0.207	0.197	0.179	0.191	0.202	0.223	0.214	0.234
Trade Services	3.687	4.038		5.11	3.5	3.612	6.542	3.194	3.01	2.872	2.854	2.783
Small Scale Industry	0.859	0.894		0.524	0.629	0.62	0.636	0.745	0.721	0.648	0.734	0.398

Loan-output ratio, as an indicator of efficient credit allocation (Table 6) also substantiates the argument of improper allocation of resources after interest rate and directed credit deregulation. The ratio, in case of agriculture, fell down from 0.677 to 0.428 during 1987 – 1998. During the period, the contribution of agriculture sector to GDP also decreased but decline of agricultural advances by banks was much more pronounced, as a result, loan-output ratio of agriculture decreased. But in case of industry sector, the ratio increased over 1987-1998, which indicates that the rate of growth of bank advances for industry sector was much higher than the increase of share of industry in GDP. The loan-output ratio for small industry declined drastically form 0.859 in 1987-1998 to 0.398 in 1998, because of significantly larger reduction of bank advances than decline of share in GDP.

With the reforms reducing the role of directed credit, bankers are being given larger control over their assets and so will increasingly be held responsible for any likely loan losses. With banks stock of human and managerial capital being shaped by the pre-reforms environment bankers will for sometime view this greater control over asset management as akin to facing a riskier environment and so will be less willing to advance loans, especially to priority sectors. The net result then is a combination of high interest rates and less advances for productive sectors by banks despite the reforms making more liquidity available in the monetary system.

The productive/priority sectors would not only allure fewer advances by the banks, but also call for increased collateral requirements (as these sectors are considered more risky). This effect would be stronger for those who were just meeting credit requirements but now run into collateral constraints. Those who are already constrained by collateral may get no loans at all. This not only reduces the number of productive borrowers but also results in loans being provided to less productive borrowers having sufficient collateral.

The contradictory thing is that on the one hand, as a prime objective, the SAP attempted to improve efficiency of credit allocation through interest deregulation for the priority sector, on the other hand, these priority sectors were under control till 1999. The export sector is still under interest rate control. This situation reflects that the objectives of the government and SAP were different regarding the improvement of efficiency in credit allocation. Government wanted to correct the inefficiency though control, at the same time SAP wanted to improve efficiency through decontrol.

The above discussion indicates that a serious moral hazard problem followed interest rate (partial) decontrol, with weak financial institutions, inadequate supervision and prudential regulations and an oligopolistic market structure. Real interest rates reached historically high levels [see table 3], as banks sought to cover bad debt provision requirements, with current borrowers penalized to pay for past defaulters. Moreover, government led distortion and collusive and misconceived price behavior of banks also contributed towards high real interest rates. At the same time, neither NCBs nor PCBs showed interest for extending resources to the productive sectors, because of high perceived risks and costs, which resulted in serious misallocation of resources in Bangladesh. The PAR also concluded, "interest rate reform did not contribute to an improvement in resource allocation, but simply increased to cost of resources." [WB. 1997b, p-267].

VI.I.III. Strengthening Financial Institutions

Imposition and strict enforcement of prudential regulations namely, appropriate loan classification and provisioning and capital adequacy, constitute one of the most important aspects of strengthening financial institutions as enforcement of these regulations would ensure safety and soundness of the financial institutions and system as a whole. Moreover, efficient allocation of resources cannot only be determined by lending volume and composition, at the same time lending quality is also very important, which is basically reflected through loan classification and provisioning and is also related to capital adequacy requirements of the banks. In fact, the ultimate goal of implementation of the prudential regulations was to improve the risk control in bank lending.

The loan classifications and provisioning status of the banking system of Bangladesh have been given in tables 7 and 8. The table - 7 shows that over the years, 1990-99, classified loans as percentage of total outstanding loan has increased form 27 percent to 43 percent. However, It is difficult to compare the figures of proportion of classified loans in total loan portfolio straightforward due to the regular change [from 1994 every year classification became stringent] in classification criteria. It seems obvious that if at the time of introducing new loan classification system a loan became classified after one year of overdue and if it is now classified after three months, the total volume of classified loans and its proportions in total loans should increase over time. So, for comparison of classification figures and analyzing the impact of new classification standard, it is more logical to use some ratios. In the table - 9 we have shown the growth rate of advances and growth rate of classified loans for different categories of banks. The growth rate of classified loans can exceed the growth rate of advances for two reasons. One, due to the deterioration of loan portfolio further, other, due to the change in classification standards. In the table - 9, we observe that the growth rate of classified loans of all banks exceeded the growth rate of advances in most of the years, especially since 1996. The same trend is also observed for NCBs. For PCBs and FCBs this trend is not regular, i.e., in some periods the growth rate of classified loans exceeded the growth rate of advances, and in some periods, the situation was vise versa. When the growth rate of classified loan is less than the growth rate of advances even after implementation of higher and tighter phases of loan classification system, we can conclude that situation improves in the banks due to improvement in risk control.

Table 7. Classified Loans of Different Banks (In percentage)

Year	NCB	PCB	FCB	All Banks
1989	28.55	25.23	18.55	27.06

1990	29.00	25.00	21.00	27.00
1992	27.49	31.10	12.64	27.87
1993	32.22	44.80	10.46	35.01
1994	31.93	44.32	8.82	34.65
1995	31.00	39.21	5.40	31.98
1996	32.55	34.77	4.72	36.86
1997	36.57	31.38	3.58	37.48
1998	40.38	32.96	4.14	41.07
1999	46.98	28.98	4.19	43.07

Note: All Banks also include the DFIs for years 1996-1998.

Source: Bangladesh Bank

Table 8. Provisioning Shortfall by Different Banks (In percentage)

Year	NCB	PCB	FCB	All Banks
1989	-85.00	-83.70	-41.14	-83.60
1990	-83.12	-66.79	-4.59	-76.65
1991	-7.24	-64.21	9.51	-20.59
1992	-31.72	-35.21	3.13	-31.97
1993	-25.09	-66.65	4.40	-39.51
1994	-33.05	-54.26	3.20	-39.82
1995	-51.19	-53.20	20.40	-50.69
1996	-51.18	-45.61	22.46	-39.96
1997	-54.75	-43.89	33.61	-42.25
1998	-61.49	-43.72	30.71	-46.50
1999	-64.11	-41.23	-3.33	-48.73

Note: All Banks also include the DFIs for years 1996-1999.

Source: Bangladesh Bank

Instead of blaming further deterioration of loan portfolio, one might hold continuos upgradation of loan classification norms as responsible for higher growth of classified loan than the growth of loans. The gradual upgradation of classification standard started after 1994. Therefore, there is no scope of putting blame on classification standard for the deterioration of loan quality upto 1994. Moreover, one should not forget that because of the practice of 'evergreening"[4] of loans, a considerable amount of loans have been avoiding classification status. In India, all rescheduled loans are considered as sub-

[4] Evergreening loan occurs in several ways: through rescheduling and interest waiver, arrangement of repayment for some "valuable" customers not from the customer's sources, but through issuing fresh loan to minimize the classification rate.

standard (RBI Bulletin, July- 1999). The practice of loan classification in Bangladesh has also been observed to be dependent only on the loan payment status – without regard to the borrowers' creditworthiness or to the market value of collateral, as a result of which potential delay in recognizing bad loans are considerable. Therefore, because of "evergreening" process and linking of loan classification to loan repayment, the absolute volume and proportion of classified loan have definitely been suppressed of in Bangladesh.

Finally, the fact is that either by old criteria (one year overdue) or by new criteria (three months overdue) the loan classification status/NPA situation is very discouraging in Bangladesh by any international standard. It does not matter when a man dies due to one drop of poison or one bottle of poison – the ultimate result is same, the man is dead. However, the only successful aspect of implementing loan classification system is that it shows how deep the crisis of NPA is in the domestic banking sector.

Table 9. Impact of Loan Classification

Year	NCBs		PCBs		FCBs		All Banks	
	Growth Rate of Advances	Growth Rate of Classified Loan	Growth Rate of Advances	Growth Rate of Classified Loan	Growth Rate of Advances	Growth Rate of Classified Loan	Growth Rate of Advances	Growth Rate of Classified Loan
1993	15.63	35.51	12.70	62.32	10.21	-8.79	14.45	43.78
1994	4.35	3.42	12.63	11.42	19.88	1.01	7.62	6.51
1995	15.97	12.57	17.46	3.92	40.14	-14.22	17.74	8.67
1996	13.45	19.14	12.05	-0.63	12.12	-2.01	33.82	54.23
1997	11.74	25.54	13.84	2.74	17.96	-10.43	11.17	13.03
1998	9.38	20.78	12.81	18.48	16.30	34.42	13.78	24.68
1999								

Source: Bangladesh Bank.

According to the prudential norms, classified loans are required to be provided for. The Provisioning requirements against various classes of classified loans of Bangladesh banking system have also been upgraded in line with international best practices. As compared to 1992, the provisioning shortfall of the banking system went up form 31.97 percent in 1992 to 48.73 percent in 1999. In case of NCBs, the provisioning shortfall increased alarmingly up to 64.11 percent in 1999, for the PCBs it is 41.23 in 1999 (Table 8).

Another important prudential requirement is fulfillment of capital adequacy norms, which was re-fixed at 8 percent of risk weighted assets (RWA) in 1996. For upgradation of capital requirement to international standard, unlike loan classification, no phasing out scheme was announced. In January 1996 BRPD circular announced re-fixation of capital requirement approach (from 6 percent of total demand and time liabilities to 8 percent of risk weighted assets) and asked the banks to report BB complying the new requirements of capital in June 1996. However, as on 1998, the actual capital as percentage of risk weighted assets on the part of all banks, NCBs, and PCBs stood at 7.43 percent, 6.42 percent and 7.90 percent respectively (Table 10).

The re-fixation or raising of asset risk based capital standard might have negative impacts on efficiency of resource allocation also. As D'Souza (2000) puts it, " Apart from reducing their asset holdings, banks might react to capital requirements [E/A; where E is equity, (8 percent of RWA) and A is assets] by switching from high risk weighted assets to those assets with a lower risk weighting. Thus, finding it costly to increase capital, banks adjust both the composition and level of lending" (p-293). In the context of Bangladesh, if not level, at least composition of lending has been adversely affected because of re-fixation of risk- asset based capital requirements.

Table 10. Capital Adequacy of Different Banks (In percentage)

Year	NCB	PCB	FCB	All Banks
1992	4.29	5.00	10.12	5.81
1993	5.72	5.29	11.34	6.76
1994	5.18	4.97	13.90	6.50
1995	4.91	4.97	13.17	6.30
1996	5.36	7.02	20.03	6.79
1997	5.25	7.34	18.79	6.70
1998	6.42	7.90	18.22	7.43

Note: All Banks also include the DFIs for years 1996-1999.

Source: Bangladesh Bank

Risk-based capital standards have several other weaknesses. Among these weaknesses are the focus on credit risk only and downplay of interest rate, liquidity and exchange rate risks and failure to differentiate between credit risk within the same asset class. It might therefore be desirable to institute a minimum leverage ratio, based on total capital as a percentage of total assets, to supplement the risk-based capital standard.

The major purpose of imposing prudential norms on the banks is to make them risk-conscious which is expected to bring favorable changes in their operational behavior and help the banks in improving their operational performances. But the trend of classified loan, provisioning and capital shortfall on the part of banks, especially NCBs, over the years does not give any proof that the banks are becoming risk-conscious or prudent. Unfortunately, all these problems of classified loan and provision and capital shortfall are not transparent in the published accounts of the banks. Ensuring full disclosure is not only an important aspect of prudential regulation, but also required for fulfilling international accounting standard and most importantly, it constitutes a very effective "market discipline" approach.

The prudential regulatory approach has the weakness that it requires substantial reliance on supervision by the central bank. Here, it must be remembered that it is not only the bankers who are required to be adjusted to the new environment (of banking) but also regulations and supervisors as well. The objective now is a transformation of bank supervision from a system of checking on compliance with various directives on mainly credit to one that aims to encourage prudent risk taking. The task of supervisors is to provide credible threats that unsound banking practices will be detected and summarily dealt with.

However, the huge NPAs and continuous non-compliance of provisioning and capital requirements of the banks indicate that the BB has not been able to enforce effective supervision and provide credible threats to unsound banking practices. The BB has so far identified a number of problem banks (on the basis of CAMEL rating) and also signed MOU with those banks. It has been observed that even after passing a long time, these problem banks are not found to be improving their overall financial health and the BB has also not taken appropriate corrective actions for non-compliance by the problem banks. This not only reflects "sheer negligence" on the part of the problem banks, but also "supervisory forbearance' on the part of the BB. Choudhury and Moral (1999) observed, "supervisory and regulatory forbearance has been one of the main reasons for the past banking problems."

For effective and meaningful bank supervision, the BB needs two things; autonomy (free from political and vested interest groups influence) and quality human resources. The lack of autonomy on the part of the BB is especially true for applying prudential regulatory influence on NCBs. One ADB study conducted in 1995 observed, "the bank supervision and inspection capabilities of the BB are practically weak because of serious shortcomings in staff-competencies. Interim evaluation of FSRP-TA project in 1995 argued in this context, "there is a small out of 400 to 500 BB inspectors who have the skills and experience of properly performing bank supervision."

As we all know, an effective legal system is a sine qua non for enforcing financial contract on the contracting parties. In section-IV, various measures, especially legal, which have been undertaken so far for improving debt recovery environment and loan quality, have been discussed. Even after adopting so many measures, neither loan quality nor recovery environment improved, if not further deteriorated. The huge loan delinquency of Bangladesh banking system reflects the weakness of legal infrastructure, which cannot ensure lenders' recourse on borrowers. It is said that bank supervision has become useless because of insufficient legal enforcement. As stated earlier, new legal frameworks were added to help the banks for getting back their money from the delinquent borrowers. Unfortunately, the new legal system also proved to be ineffective in realizing money from defaulters. The Money Loan Court, till 1999, has been able to realize only 9.41 percent of fund out of total suited amount. Though the newly established Bankruptcy Courts have not come across any major problems, yet because of the delay in receiving a list of receivers from the government, the process of taking possession of the assets of the persons adjudged bankrupt is being delayed. In some cases, stay orders are also issued by the High Court Division. Therefore, this sort of ineffectiveness on the part of the legal system is encouraging the borrowers to refrain from paying the legitimate dues of the banks. Not only the legal system, bankers are also found in some cases responsible for the delay in court settlement [Rahman, 1999].

The management efficiency of the NCBs was thought to be achieved through introduction of a number of new management and operational tools such as LRA, NLL, PPS, MIS etc. The impact evaluation of FSRP-TA Project (1995) itself recognized that though many of the operational building blocks needed to permit NCBs to function soundly had been provided successfully by FSRP, yet effective incorporation of new operating procedures required leadership and vision on the part of senior management, which was not ubiquitous in the NCBs. Almost same conclusion was drawn by Cookson and Alamgir (1993), when they said, "the expected improvement of the management of NCBs has not been forthcoming after the financial sector reform measures are taken in Bangladesh." The behavior and attitudes at the banks board and executive level in both the NCBs and PCBs have changed little since 1990.

The operational and management tools, which have been provided by FSRP, were mainly focussed on improving the credit screening and monitoring process of the bank. One of the screening tools is LRA, which is supposed to reflect the degree of risk of repayment involved with the borrower. In terms of applying this tool, though NCBs are found to some extent successful, yet there are doubts whether they (NCBs) have been able to use LRA effectively and honestly to reflect the credit risks of the borrowers. Had the NCBs been successful in implementing LRA, there would not have been further deterioration in loan quality during post new loan regulations period. In regard to LRA applications, bankers themselves complained about manipulation and non-availability of required data for taking loan decisions. The PCBs are found to be very much lagging behind in terms of adopting LRA. Not only that, they are also found not very much interested in using new loan monitoring technique like NLL. The bankers also sometimes speak about the lack of expertise on their part in applying the new loan techniques. In this context, it is to be mentioned that all the new loan techniques taken together constitute a "total shift" from the earlier (before new loan techniques) practice of loan decisions by the bankers. This is not mere a "mechanical shift" (in the sense of determining credit risk, loan monitoring etc. scientifically, which were not even conceived earlier). Therefore, for applying new loan techniques, not only expertise, but also willingness/motivation on the part of bankers are required. However, both expertise and motivation are seriously lacking, for which the implementation of the new loan techniques could not be made effective. The new loan regulations are not also broad-based covering the whole portfolio of loans. The LRA has been made mandatory, but for only above Taka 10 million. Though some of the NCBs have reduced the limit for LRA on their own, yet a huge number of loans are still outside the purview of LRA or any other method of risk analysis.

While loan screening and monitoring standard of the banks did not improve, not to speak of reaching international standard, but the loan classification and other prudential requirements were asked to be compiled at international standard. As a result of this mismatch, proportion of classified loan appears to be magnified. At this moment, in many respects, the loan classification standard of Bangladesh is even tighter than India. In spite of fully recognizing the need for reaching international banking standard in terms of loan classification (and also provisioning and capital requirement), we should have been careful about matching between improvement in loan screening and monitoring standard and raising of loan classification standard to international level. Another sort of mismatch we observe in case of maintaining a balance between decontrolling the economic regulations and broadening and enforcing prudential regulations by Bangladesh Bank. It is desirable that at the time of reducing economic regulations, the prudential regulations should be broad-based, tightened and made enforceable. Otherwise, delinquent bank management and borrowers would take advantage of pervasive economic deregulations and laxity and narrow-base of prudential regulations. In Bangladesh, while economic deregulations in respect of price (interest rate), direction of credit, entry requirements etc. had been made, prudential regulations (like loan classification, provisioning, capital adequacy, prohibition of insider lending etc.) had also been made, but at a much slower pace (as compared to that of economic deregulations) and enforcement of these prudential regulations on the banks could not also be ensured. Moreover, adequate and effective reforms in legal matters relating to ensuring lenders' recourse on borrowers could not be instituted. Because of this mismatches instead of reducing, banking problems rather magnified and manifested, during the post financial sector reforms period.

VI.I.IV. Improving Debt Recovery Environment

In the reform agenda under the policy objective of strengthening the NCBs for improving the debt recovery environment a measure was undertaken by fixing a target of collection and resolution of legal cases for 100 largest defaulters and for new loans approved by NCB head offices. For implementing the policy measure the GOB published a list of the 100 largest defaulters and excluded them from further credit. This action later proved ineffective and also it pre-empted a middle course, which could have at least ensured partial recovery of credit against the threat of "eventually going public".

The GOB several times attempted to address the loan default problems. The GOB empowered the DFIs (BSB and BSRS) to foreclose on the assets of defaulting enterprises without court process. However, this measure also became ineffective since potential bidders were prevented by the debtors from even inspecting the properties. A situation of lawlessness, when law enforcing agencies fail to maintain ruling of law, a liaison between the debtors and the powerful politicians, can only explain severe ineffectiveness of government directives.

Money Loan Court Act was enacted in 1991. But the performance of this court is not very encouraging. If we look at the trend of settlement of the suits, we can observe a gradual improvement in the status of settlement, from settlement rate of 12.77 percent in 1991, in 1996 it became 32.40 percent for all banks. But if we look at the amount, in 1996 the recovery amount as a percentage of whole amount due was only 7.69 percent. It indicates that only the suits with small amounts were settled. The "powerful" borrowers remained out of reach of the court. This is also an empirical evidence that the court system does not work properly due to the pressure of "vested interest group".

Table 11. Performance of Money Loan Court Act

Year	No. of Suits and Amounts					% of Settled Suits					% of Recovery Amount				
	NCBs	PCBs	DFIs	FCBs	Total	NCBs	PCBs	DFIs	FCBs	Total	NCBs	PCBs	DFIs	FCBs	Total
1991	11804 (6699.3)	4044 (2933.6)	4325 (739.8)	121 (397.0)	20294 (11332.5)	9.90	24.35	9.75	13.22	12.77	1.75	2.80	2.13	6.64	2.13
1992	14044 (9420.3)	5128 (5559.4)	5353 (2983.5)	136 (557.4)	24661 (18522.4)	20.75	29.50	13.30	25.53	20.98	3.26	2.71	1.29	7.30	2.90
1993	16798 (11263.9)	6301 (7477.7)	6201 (3766.4)	141 (844.0)	29441 (3352.0)	25.72	32.45	20.00	28.83	25.98	4.38	3.81	1.99	8.87	3.98

1996	25831 (18093.1)	7852 (16547.3)	7785 (5602.1)	143 (1038.8)	41611 (281.3)	36.34	27.13	24.47	43.35	32.40	9.42	5.98	4.47	22.01	7.69
1999	32804 (36963.04)	10225 (31977.02)	10919 (11099.22)	167 (1250.61)	54215 (81299.78)	43.13	38.48	30.92	68.86	39.87	8.63	9.88	6.11	46.11	9.41

Note: Figures in the brackets indicate amount in million Taka

Source: Bangladesh Bank

We can quote the comment of the President of the Peoples Republic of Bangladesh, which actually validates our above arguments: " Terrorists and defaulters are the imperative sources of power of present political parties (BIBM, 1999).

A study conducted by BIBM revealed the empirical evidence of collusion of political parties and loan defaulters [Islam, 1999]. Among 2117 defaulters, identified by the research group primarily selected 1000 top defaulters as sampling frame. Out of these, only the defaulters of Dhaka and Chittagong were selected as probable sample unit. After screening out the "non-cooperating" and "vanished" units, the research team selected 125 units for study on random basis. Out of this 125 units, 83.20 percent of units were production oriented, 6.4 percent were trade oriented and 10.40 percent were service oriented. Among these units public limited companies accounted for 43.20 percent, private limited companies accounted for 52 percent, proprietorship 3.20 percent and partnership 1.6 percent.

The analysis shows that before implementation of SAP the degree of political affiliation of the key person of the defaulted enterprise was slightly higher than the post SAP period. Before SAP the affiliation was 72 percent, after SAP it was reduced to 70.4 percent, but still it is very strong.

Table 12. Political Affiliation of the Key-person

	Frequency
Present Situation	
No Affiliation	28.0
Awami League	19.2
BNP	35.2
Jatiya Party	10.4
Others	1.6
Contact with All Parties	5.6
Total	100.0
Past Situation	

No Affiliation	29.6
Awami League	17.6
BNP	26.4
Jatiya Party	20.8
Others	0.8
Contact with All Parties	4.8
Total	100.0

Source: Islam et al., 1999

From the table it is clear that the degree of political affiliation of business increased from the period 1976-81 onward. The important outcome of the analysis is that proportion of affiliation was significant in the 1982-1990 and 1991-1996 periods, which hints to the massive patronization of the then ruling parties.

The majority of the defaulted loans (77.6 percent) were sanctioned as a result of approaching of the key person to the different hierarchy of the power structure. The minister category occupied 46.4 percent, followed by the member of parliaments (35.1 percent), ruling party leader (13.4 percent), trade union leader (4.1 percent)

Table 13. Political Affiliation of the Enterprises' Key Person by the Year of Establishment of the Firm (% of Key Persons)

Political Affiliation	Before 1975	1976-1981	1982-1990	1991-1996
No Affiliation	9.6	4.8	11.2	2.4
Awami League	0.8	1.6	13.6	3.2
BNP	3.2	7.2	8.0	16.8
Jatiya Party	1.6	3.2	4.0	1.6
Others	0	0	1.6	0.0
All	0.8	0	3.2	1.6
Total	16.0	16.8	41.6	25.6

Source: Islam et. Al., 1999

and others (1.0 percent). The scenario has strengthened the assumption that the political personalities interfere the sanctioning process of bank loans.

Table 14. Approached Personality by Key-Person for Loans [In percentage]

Status of Approach	Frequency
Approached to some one for loan other than bank officials	77.6
Hierarchy of personality Approached	

Minister	46.4
MP	35.1
Ruling Party Central leader	13.4
Labor leader	4.1
Others	1
Total	100

Source: Islam et al., 1999

VI.I.V. Rural Banking and Restructuring of Rural Branches of NCBs

Before liberation, only BKB used to participate in rural banking operations. Since 1974, NCBs started expanding in rural areas somewhat reluctantly at the instances of government. In the later part of 1970s and in the first part of 1980s both BKB and NCBs expanded very rapidly to increase the flow of credit to the rural areas. The main reason of rapid expansion was to increase the flow of credit in rural areas.

The proportion of rural branches increased from 47 percent in 1973-74 to 67 percent in 1983 and since then the proportion declined gradually, in 1998 it stood at 61 percent [Table-15]. This dramatic increase in the share of rural branches was made possible by compelling the banks to open more and more rural branches in a large way to implement one government sponsored agricultural credit program initiated in 1977 [Adams and Nelson, 1981]. This ultimately resulted in unplanned proliferation and sub-optimal geographical coverage by rural branches. As the denationalization and privatization process started in 1982-83, and later added by financial sector reform process in 1989-90, the proportion of rural branches did not increase rather declined. Before 1982-83, nationalized banks were required to establish two rural branches in order to open a branch in urban area (NCMBC, 1986, p-12). But this directive was discontinued after starting of denationalization and privatization process in 1982-83. Very recently, Bangladesh Bank imposed a new regulation for the newly established PCBs to open a new rural branch among each new five branches. However, since 1983, newly formed private and denationalized commercial banks did not open any "rural" branches and NCBs were observed to be concerned more with "consolidating" existing rural branches rather than opening new rural branches. However, BKB kept on opening new rural branches. In 1982-83, BKB was also asked to 'take over" more than one hundred loss incurring rural branches of Uttara and Pubali Bank, just before denationalizing them. Uttara and Pubali could have been denationalized/privatized along with loss incurring rural branches or these branches could have been closed. Instead, BKB was entrusted to run these loss incurring rural branches. BKB was again forced to take over 70 loss incurring branches of Rupali Bank in 1984-85, just before offering Rupali Bank's share to general public. This policy of "nationalization of loss" (and "privatization of profit") is certainly bound to go against the development of a viable rural banking structure.

Table 15 : Proportionate Share (in percent) of Rural Banking in Bangladesh

Year	Branches		Deposit (%)		Credit (%)	
	Urban (%)	Rural (%)	Urban	Rural	Urban	Rural
1980	35.97	64.03	84.01	15.99	88.12	11.88
1981	34.58	65.42	83.55	16.45	86.97	13.03
1983	33.09	66.91	82.34	17.66	80.52	19.48
1984	32.96	67.04	82.02	17.98	74.15	25.85
1985	32.73	67.27	81.68	18.32	73.83	26.17
1986	33.06	66.94	80.74	19.26	74.13	25.87
1987	33.13	66.87	80.89	19.11	76.8	23.2
1988	33.44	66.56	79.58	20.42	76.94	23.06
1989	33.71	66.29	79.68	20.32	76.84	23.16
1990	34.02	65.98	78.83	21.17	76.59	23.41
1991	34.12	65.88	78.72	21.28	80.75	19.25
1992	35.93	64.07	78.15	21.85	80.16	19.84
1993	37.13	62.87	77.26	22.74	80.74	19.26
1994	37.78	62.22	78.11	21.89	80.08	19.92
1995	38.31	61.69	77.9	22.1	80.22	19.78
1996	38.74	61.26	77.93	22.07	80.93	19.07
1997	38.96	61.04	76.86	23.14	82.2	17.8
1998	39.34	60.66	77.38	22.62	82.89	17.11

Source: Bangladesh Bank. Scheduled Bank Statistics, Various issues

It also appears from the table - 15 that the share of rural deposit increased gradually but the share of rural credit decreased during 1980s and 1990s. It has already been shown that after SAP financial reforms, the share of agriculture sector in total credit reduced drastically. The net flow of agricultural credit before and after SAP has been shown in table - 16.

Table 16 : Net Flow of Agricultural Credit by All Banks(Tk in million)

Year	Disbursement	Recovery	Net-Flow	% of Recovery
1981-82	4238.4	3143.4	1095	48.49
1982-83	6785.5	3423.3	3362.2	41.89
1983-84	10053	5175.7	4877.3	41.8
1984-85	11528.4	5839	5689.4	38.54

1985-86	6317.2	6071.5	245.7	25.56
1986-87	6672.8	11075.6	-4402.8	41.27
1987-88	6563.1	5957.8	605.3	23.57
1988-89	8076.2	5779.6	2296.6	18.98
1989-90	6867.8	7019.4	-151.6	17.61
1990-91	5956	6253.2	-297.2	13.72
1991-92	7945.9	6621.1	1324.8	15.88
1992-93	8418.5	8692.3	-273.8	18.42
1993-94	11007.9	9791.2	1216.7	19.04
1994-95	14900	11241.1	3658.9	19.96
1995-96	14820	12730	2090	21.64
1996-97	15173	15942.7	-769.7	23.61
1997-98	16428.4	16990.7	-562.3	24.46
1998-99*	30190	19583	10607	13.73

Source: Scheduled Banks Statistics
* Research Department, Bangladesh Bank
* Excluding Private Banks

In many years in 1990s, the net flow of agriculture credit (disbursement minus recovery) was negative. Therefore, it shows that not only share of agriculture in total credit reduced, even whatever inflow of credit was made by way of disbursement that was also siphoned off in the name of recovery from agriculture sector. On the other hand, one is required to keep in mind that the proportionate share of rural deposit was higher than that of credit throughout 1990s. This all indicates that almost whole deposit, which was mobilized from rural areas, was transferred to urban areas. Negative net flow of credit implying more recovery than disbursement, does not imply high rate of recovery in case of agriculture credit. In fact, the recovery rate was also low (table - 16).

This low rate of recovery, added with the withdrawal of refinance facility because of financial reform measures induced the banks, especially NCBs to reduce their provision of credit to the rural sector. Moreover, though the economic aspects of directed credit such as refinance facility, subsidized interest rates etc. were removed, yet the political influence, especially waiver of credit repayment, did not stop. This sort of political influence injected a feeling among rural borrowers that bank credit is not to be returned. Other than political interference, there are many factors contributing to low rate of recovery such as faulty borrower selection procedure, lack of supervision, low rate of interest, untimely and less than required provision of credit to rural customers etc. For the low rate of repayment or high rate of default, bankers are required to classify a huge amount of loan for which a large amount of fund has also to be provided for, which in turn, greatly contributed to poor financial performance (i.e. profit) by the rural branches. As a result, a lot of rural branches are now running at losses.

Though loan classification and provisioning is the most important reason for non-viability or losses of many rural branches, yet there are some other causes. In the context of Indian Banking some authors (Sampath, 1990; Prakasam, 1983) found significant correlation between the age and viability of the rural branches. In case of Bangladesh it is difficult to find any systematic relationship, but one analysis found that [Choudhury et al., 1994], most of the loss-incurring branches were established in and after 1977, when the banks (especially NCBs) were forced to open rural branches. Another important factor of non-viability was over-staffing, inefficient and poorly trained manpower. Due to complex procedure of borrowing from banks and easier availability of funds from alternative sources banks face market competition in the rural financial market than in urban areas. Moreover, the institutional structure and approach of the banks are not suitable for rural banking. One BIBM survey conducted in 1995 found that sometimes lower transfer price (rate at which branches transfer fund to controlling offices), low volume of business, many competitors in the same locality, higher volume of "burden" (difference between non-interest expenditure and non-interest income), etc. are also contributing to non-viability of rural branches. It is already stated that rural banking network which grew over the years in rural areas did not develop spontaneously rather reluctantly at the instance of government. It is also observed that from the very beginning, the whole concept of rural banking was developed focusing on how to increase credit flow in the rural areas, ignoring other aspects of banking such as mobilization of fund form rural areas and proper utilization of fund.

Though the proportionate share of rural deposit is higher than rural credit, yet having 61 percent of total branches, rural banking is commanding only 23 percent of total deposits which cannot be considered as a good performance (table 15). One may make responsible only overall socio-economic condition of rural areas for low level of rural deposit mobilization. In addition to it, one endogenous factor pertaining to concerned bank management is also equally responsible for lower level of deposit mobilization. The bank marketing approach in rural areas has been wrong. Banks have tried to reach the rural customers with the financial products that they market for urban customers resulting in non-fulfillment of rural customers' needs and thus lower level of resource mobilization.

In 1993, GOB formed a Committee to identify and suggest which loss incurring branches of NCBs are to be closed or merged with some other branches of the same bank or another bank with a view to "rationalize the continuously loss incurring branches". The Committee identified 106 loss incurring rural branches of NCBs (out of around 1000 loss incurring rural branches of NCBs) and BKB-RAKUB (based on the criteria of having no potentiality of becoming viable on the part of that losing branch within next 3 years) to be closed or handing over to BKB and RAKUB or merging with some other branches.

One may question the "rationality" of government's rationalization program. How did the committee arrive at the conclusion that those 106 branches would not be viable within next 3 years? What are the monetary and non-monetary costs involved with these closures/takeover/mergers? Is it (costs) less than the benefit to be accrued after rationalization? It is to be kept in mind that in a branch banking system, not all branches are required to be profitable, some of the branches may even be loss incurring. Moreover, as stated earlier, accounting loss of a branch may be due to many competitors, low transfer price, high cost of fund etc. All the reasons are not equally contributing to the losses of all loss-incurring branches. Some of the reasons are present for a particular branch and some are not present. Exact causes of loss of each branch should be identified first, and then it should be examined whether the problems of a particular loss-incurring branch can be overcome within next 3 years (or some other uniform time period) so as to make it viable. Only after that exercise, government should decide which branches are to be closed, otherwise in the name of rationalization, some of the branches will be closed which would ultimately reduce the network of financial services of the rural Bangladesh.

The above analysis suggests that following financial sector reform measures, the overall share of rural banking has been diminishing. Proportion of rural bank branches is going down. BKB has been overburdened with loss-incurring branches of NCBs. Higher deposit share than credit in rural areas and negative and marginal net flow of credit in rural areas indicate a huge siphoning of resources from rural to urban areas. All these have been further aggravated by the GOB's branch rationalization program, which has only selected the rural branches for closing down.

VI.I.VI. Role of Private Commercial Banks

Competition among the banks was sought to be fostered by allowing new banks in the private sector to increase the share of PCBs and thereby decreasing the dominance of NCBs, in addition to interest rate deregulation to generate price competition. That interest rate deregulation could not generate any effective competition, rather created collusive behavior on the part of both NCBs and PCBs, has been discussed earlier. The private commercial banks were licensed for operation in three installments, in the first part of 1980s and in the first and last quarters of 1990s. The proportionate share of PCBs (including denationalized banks) over the years has been shown in table 17. The share of PCBs in respect of branches, deposit and credit is higher in 1990s than 1980s, because of entry of

Table 17 : Proportionate Share (in percent) of PCBs in Bangladesh

Year	Branches			Deposit (%)			Credit (%)		
	PCBs	NCBs	FCBs	PCBs	NCBs	FCBs	PCBs	NCBs	FCBs
1983	N/A	80.6	0.42	3.61	83.13	7.4	2.14	70.39	5.01
1984	N/A	78.94	0.43	7.88	80.47	6.35	5.05	66.63	5.01
1985	12.89	67	0.42	18.34	70.89	6.37	13.51	58.26	5.29
1986	12.99	66.3	0.43	19.99	68.97	6.57	14.91	56.74	5.45
1987	13.47	65.59	0.42	21.49	67.59	7.24	17.82	53.93	6.25
1988	14.15	64.84	0.41	22.9	65.67	7.3	18.58	54.24	5.83
1989	14.87	64.01	0.4	24.41	64.04	7.15	19.39	53.88	5.92
1990	15.45	63.65	0.39	26.06	62.43	7.14	21.05	52.78	5.75
1991	15.88	63.2	0.39	26.12	64.05	5.27	23.51	53.81	4.03
1992	16.44	62.78	0.31	27.06	63.63	4.52	25.08	52.11	3.97
1993	16.59	62.54	0.31	27.55	62.41	3.99	25.11	53.47	3.86
1994	17.25	62.31	0.36	27.66	61.84	4.66	25.47	52.21	4.34
1995	18.22	61.77	0.38	21.85	62.07	5.18	25.13	52.36	5.32
1996	18.32	61.4	0.44	28.45	60.87	6	25.6	52.73	5.16
1997	18.82	60.95	0.46	27.11	61.53	6.25	25.57	53.65	5.43
1998	19.26	60.58	0.49	27.22	60.22	7.36	25.58	51.09	5.4

Source : Scheduled Banks Statistics.

second batch of PCBs in the banking market. However, even after allowing so many private banks, their share in overall banking did not increase appreciably, implying that dominance of NCBs are yet to be broken through. Moreover, the PCBs of 1990s have been observed to derive their most of the business from the old PCBs (of 1980s), rather than reducing the share of NCBs. One may observe the improvement of all PCBs in regard to fulfilling the prudential requirements (such as loan classification, provisioning and capital adequacy), and this has been made possible because of new PCBs, which were established in 1990s. The better performance of new PCBs is due to existence of prudential norms, for which scope of becoming financially indisciplined on their part was minimized. However, in regard to allocation of resources especially to productive sectors, the newly established PCBs simply followed the path of old ones.

VI.I.VII. Women in Banking

VI.I.VII.I. Demand Side

As women represent almost half of the population and half of the potential labor force in Bangladesh, every policy implementation should be focused on gender disparity aspects As the SAPRI attempts to take a gender aware political economy approach, the authors attempted to look both into the supply side and demand side of women representation in the banking system. The research papers on the activities of MFIs and NGOs focusing the women are in abundant. But the overall picture of women participation in demand side and supply side of the banking system is absent. Saha et. al (1995) and Khalily (1995) make the only notable contributions in Bangladesh context. The time and financial constraints under the SAPRI framework did not allow us to conduct full-fledged separate survey in this issue. Therefore, a few issues of the above mentioned papers have been taken as base for the discussion on "Women in Banking".

The share of women in banking services has been measured in terms of their share in number of accounts and amount in deposits as well as credits. Table X exhibits the share of women in banking as on December 1993. Although women are contributing as a whole 26.26 percent in total deposit amount, the share in credit is only 1.79 percent. The survey by Saha et. at (1995) shows a severely skewed picture of banking services provided to women. Irrespective of the types of branches (ladies branch, branch headed by lady manager, or branch headed by male manager) the women are contributing more than what they are getting in terms of accessibility to credit. Even in Ladies branches, women are getting credit access only to 21.52 percent of total loanable funds. This ratio is only 1.13 percent in case of the branches headed by male manager, whereas the women contributes to the deposit mobilization by 15.71 percent, almost 14 times higher than the access to credit. The actual share of women in deposits and in credits would be much less than shown in the table. This is due to the fact that a very high proportion of ladies branches and branches headed by the lady managers have been taken in the survey sample. Secondly, male members are found to run substantial number of female accounts. Finally, the sample branches are in urban areas, definitely in urban areas number of female accounts are higher than in rural areas.

However, the access to credit figure is likely to increase if we consider the special lending program of NCBs and other specialized financial agencies like Grameen Bank, BRAC, ASA, Proshika etc. In fact, women accounted for 94 percent of Grameen Bank members, 82 percent of BRAC members, and 68 percent of BRDB members (Khandker and Khalily, 1995; Khandker, Lavy, and Filmer, 1994).

The existing literature indicate several factors determining poor accessibility to credit by women. Collateral requirements, high transaction costs, limited mobility and education, and other social and cultural barriers contribute to women's inability to obtain credit (Holt and Ribe, 1991). Saha et. al (1995) finds that the reasons behind

Table 18. Share of Women in Banking Services

Branch Type	Share in deposit						Share of Loans and Advances					
	Total		Female		Share of female (%)		Total		Female		Share of female (%)	
	No. of A/Cs	Amt. (in million)	No. of A/Cs	Amt. (in million)	A/Cs	Amount	No. of A/Cs	Amt. (in million)	No. of A/Cs	Amt. (in million)	A/Cs	Amount
Ladies Branches	22380	519.6	11438	290.3	51.10	55.87	278	25.2	66	5.4	23.74	21.52
Branch headed by Lady Manager	22785	733.7	5358	98.0	23.51	13.35	148	46.3	28	3.1	18.92	6.80
Branch Headed by Male Manager	39896	560.0	8868	88.0	22.22	15.71	1645	1085.8	124	12.2	7.54	1.13
Grand Total	85061	1813.3	25664	476.3	30.17	26.26	1971	1157.3	218	20.7	11.06	1.79

Source: Saha B et. at 1995. Women in Banking , p. 36.

the poor access to credit by women in urban areas are: few women entrepreneurs involved in business, procedural cumbersome, negative attitude of bankers to women as entrepreneurs, collateral, less mobility of women.

VI.I.VII.II. Supply Side

The survey by Saha et. al (1995) observed that both male and female customers hold a positive attitude regarding services rendered by women employees. Nonetheless, the share of women employees in the banking sector (increased form 4.74 percent to 6.23 percent) is still far lower as compared to that of government sector of Bangladesh and banking sector of other countries. The proportionate share of women officers in top management and functional positions in very insignificant, implying a peripheral role of women in banking sector. Although male bankers agree that banking jobs are suitable for women, they do not hold very positive attitudes regarding managerial quality and efficiency of women employees. Many male borrowers are unwilling to work under a female bosses. But the top executives (Governor, Deputy Governor, MDs and DMDs) attitude towards women have been found favorable. Excepting Bangladesh Bank, no other bank groups have been observed to recruit women officers as per government directives. The women employees are placed generally as controlling officers at the head office and regional office, where jobs are less tedious and customers are not being faced. In respect of promotion and training the women employees are less exposed even to their proportionate presence in the banking sector over the period 1983-1993.

Ladies branches (now around 40 ladies branches are working) do not offer any special banking services for women customers. Being unable to become viable by only providing services to women customers ladies branches have opened their doors to male customers also. Still, the level of operation of these branches are below than that of banking sector's average.

Surprisingly, the gender aspect was completely missing in the financial sector reform project. The reason may be that the policy designer left the issue completely on the market forces. The access to credit on the part of women as a whole increased specially in the rural areas just due to the massive expansion of the credit network by the MFIs. This credit services in the rural areas by semi-formal sector remains beyond the policy purview of the SAP designers.

Saha et. al (1995) recommended several policy measures, which are still valid, these are as follows:

a) For monitoring and taking appropriate action in relation to women status in banking, Bangladesh Bank should ask all financial institutions to provide gender based statistics of banking.
b) The Bangladesh bank should ensure the enforcement of the directive regarding the recruitment of the women in the NCBs to increase the share of women in the banking sector.
c) The BB should discourage gender discrimination by the PCBs.

Improvement of internal control and business processes can solve the problem of overstaying which is particularly problematic for the women employees, as they have to devote fullfledgedly in the family. The automation of the banking sector can solve this problem as a byproduct of major improvement in the banking operations.

VI.II. Stakeholders' Perception of Access to Credit

In order to accommodate the political economic aspects of SAP according to SAPRI analytical framework, we have emphasized on the efficient allocation of resources through improved access to credit. Due to absence of data it is impossible to perform the before-after analysis of "access to credit". Several shadow calculations can be done. But nothing can replace the opinion of the stakeholders of the financial sector.

Among the shadow calculations one is the asset concentration ratio (table 19) of different size of borrowers.

Table 19. Asset concentration

Year	Share of largest 1% Borrowers in total advances	Share of lowest 95% Borrowers in total advances
1987	72.36	17.92
1988	72.05	18.19

1990	71.69	18.59
1991	70.29	16.63
1992	72.23	15.96
1993	73.86	14.81
1994	72.52	16.36
1995	72.30	14.98
1996	72.91	14.34
1997	73.61	13.34
1998	75.63	12.80

Source: Bangladesh Bank, SBS, Various issues

The table 19 figures out that the SAP period witnessed the increase in the asset concentration into the hands of privileged few large borrowers, who may not be always very productive. Throughout the period in question the largest 1 percent borrowers availed more than 70 percent of total available funds in the banking sector. Among the rest, lowest 95 percent of borrowers received only one-seventh of the total available funds. Asset concentration of the small borrowers even decreased gradually over time. In 1987 it was 17.92 percent, in 1990 it was 18.59 percent, in 1998 it become only 12.80 percent.

VI.II.I. Rural Financial Market and Access to Credit

In the rural Bangladesh, credit is supplied by the formal, semi-formal and informal sectors. The formal sector includes the regulated financial institutions and agencies while the semi-formal sector includes micro credit and micro finance institutions and programs mostly organized by NGOs. The informal sector covers private transactions falling outside the regulated operations and which includes sources like money lenders, traders and dealers in agricultural markets, shop-keepers, land lords, friends and relatives. The formal sector comprises the public sector banks especially two agricultural banks (BKB and RAKUB) and the rural branches of the nationalized commercial banks, two co-operative networks under BSBL and BRDB and to a very limited extent, private banks (NBL and IBBL). About two-third branches of the commercial banks are located in the rural areas.

The public sector institutions have been disbursing loans to the agricultural/rural sector for various purposes viz., crop production, procurement of irrigation and agricultural equipment, fishery, livestock and poverty alleviation. The formal sector has been able to meet about one-third of the credit needs of the rural sector[Meher B, 1997].

The semi-formal sector broadly includes Grameen Bank and NGOs that are mostly engaged in financing the poverty alleviation programs for the rural poor. BRAC, ASA, Proshika are among the biggest out of about 1000 NGOs in the country offering credit and savings services and most of the NGOs have an explicit social agenda to cater the credit needs of the poor section of non-agricultural population with women making up the majority of the clientele. A major institutional innovation was the establishment of Palli Karma Sahayak Foundation as an apex institution for NGOs to support the poverty alleviation programs. PKSF was established in 1990 as a non-profit autonomous organization under the Companies Act and funded by GOB and it lends funds to NGOs for on-lending. By their presence semi-formal sector organizations meet substantial demand for credit in the rural areas.

Informal market continues to be the primary source of credit for a large proportion of the rural population. t is also lender of last resort to many. Informal sources of credit still play a dominant role in rural financial market as it provides about half of the credit needs of the rural people.

VI.II.I.I. Rural Stakeholders Perception of SAP: Demand Side

Before analyzing the access to credit the general features of the rural stakeholders [borrowers and non-borrowers] may demand attention [Table - 20]. Among the respondents 55.8 percent are marginal farmers, with land holding within 0.49 acres. 21.7 percent respondents belong to the land holding class between 0.50 acres to 1.49 acres. Land holding between 2.5 acres to 4.99 acres comprises 7 percent of respondents. Among the respondents only 6.8 percent are large farmers. By occupation we observe that 71.58 percent of stakeholders depend on agriculture as their primary source of income. The survey finds that 41.91 percent of stakeholders subsist with occupation of wage labor. We observe that for many marginal farmers wage labor also constitutes as an important source of income.

Table 20. Land Ownership Structure of the Respondents

Land Holding Size (in Acre)	Frequency of the Respondents
0-00 – 0.49	55.8
0.50 – 1.49	21.7
1.50 – 2.49	8.8
2.50 – 4.99	7
5.00 and above	6.8

Source: SAPRI Rural Survey

Table 21. Sources of Income of Rural Stakeholders [Economic Agents]

Source	**Frequency [In percent]**
Selling Agricultural Products	71.58
Wage Labor	41.91
Selling Household Animals	10.17
Fishing	12.63
Service	11.83
Selling Plantation	8.30
Selling Milk and Milk Products	5.39

Source: SAPRI Rural Survey, 1999

For the perception of the stake holders (from demand side) regarding the access to formal credit a Symantec model has been used [see figure 2]. For this model five questions have been developed. First, "Did you apply for formal loan ?" If answer is "yes" to this question, the following question is: " What were the sources you called upon?" The following question is: "Did you receive a loan ?" If the answer is "yes", the next question is "Did you receive the entire amount of loan ?" The number of respondents, who answer "yes" to this question, is the proportion of respondents, to whom the access to credit is un-restricted. But, there is another group of respondents, who answer "no" to the question "did you apply for formal loan?" For extracting the reasons for not applying for loan in this model the question is set "Why did you not apply for loan ?" Among the responses of the respondents, one is "no need, enough private money". The number of respondents to this question should also be added to the "un-restricted access" group.

According to the model in the whole rural credit market [including supply form bank. MFIs and money lenders etc.] 52.68 percent of respondents have no access to credit at all. The access to credit is restricted to 47.32 percent of rural stakeholders. Only 40.25 percent of rural stakeholders have unrestricted access to credit market. The unrestricted access is the subset of restricted access. By unrestricted access we mean acceptance of credit in full amount applied for. The restricted access is the sum of acceptance of credit in full amount and acceptance of part of the amount applied for.

VI.II.I.I.I. Sources of Credit

The sources of finance for the rural stakeholders are diverse [Table - 17]. Among the sources, bank, micro finance institutions and moneylenders are prevailing in the rural credit market with a market share of 34.75 percent, 33.16 percent, and 25.19 respectively. The survey depicts that majority of the stakeholders largely depends on the bank credit, thanks to the directed credit policy of the government for the agricultural sector.

Table 22. Market Share of Credit in Rural Area

Source	Share
Bank	34.75
MFI	33.16
Money Lender	25.19
Samity	5.83
Relatives/Friends	0.80
Others	0.27

Market share = (respondents getting credit from a source)/ [total number of respondents getting credit from any of the sources]

Source: SAPRI Rural Survey, 1999

Among other sources, Samity captures a 5.83 percent share of the total market. Relatives or friends are not the major source of funds in the rural area [market share less than 1 percent].

The survey derived some important features of access to credit by stakeholders. If we consider access to individual market of credit [e.g. bank credit market or MFI credit market etc.] we found the following picture. According to the sources of credit, 65.69 percent of stakeholders have no access at all to the bank credit, 46.62 percent of stakeholders have restricted access to the bank credit, and only 31.67 percent of stakeholder have unrestricted access to the bank credit [Table 23]. Bank and MFI's market segments are different in general, bank credit are focused mainly to the agricultural loans, where as MFI loans focused mainly on non-farm loans. MFI emerged as one of the major market participant in the rural credit market with a one third of the market share, but 43.52 percent of stakeholders of that market segment have still no access to this credit [Table 18]. We may guess that a majority of the stakeholders in this group may belong to the hardcore group of poor. This result complies with many research outcomes that hard core poor are out of reach by the MFIs. Nevertheless, MFIs' presence in the rural credit market significantly supplement the bank credit, as a whole helped to improve the accessibility to credit status in rural Bangladesh. Another important finding of the survey is that money lending is still prevalent in the rural area, moneylenders capture one –fourth of the market share. Furthermore, 37.12 percent of the stakeholders does not have any access to this source of finance. The rural credit market is largely unsaturated, the market saturation level is 49.17 percent.

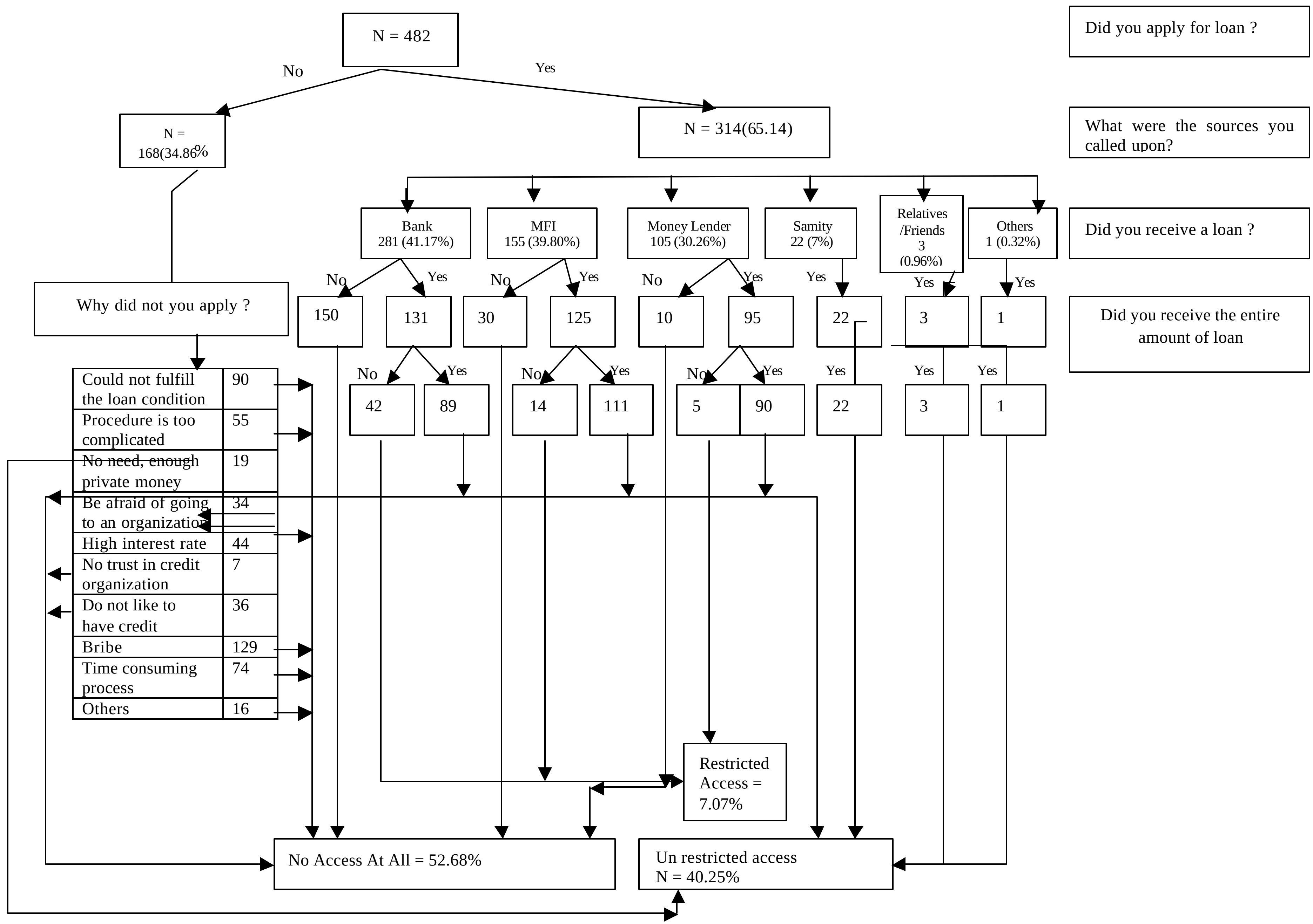


Figure 2. Access to credit: Perception of Rural Stakeholders

Table 23. Access to Credit by Sources

Source	Restricted Access	Unrestricted Access	No Access at all
Bank	46.62	31.67	65.69
MFI	80.65	71.61	43.52
Money Lender	90.48	85.72	37.12
Samity	-	69.09	30.91
Relatives/Friends	-	100	-
Others	-	100	-

Note: Restricted access was calculated as the percentage of respondents who have approached for credit to a particular institution and got credit but with or without some restrictions [e.g. got partial amount applied for]. Unrestricted access is the subset of restricted access, it is percentage of respondents who have approached for credit and got the credit without any restriction [e.g. full amount applied for]. No access was calculated as the percentage of respondents who have been refused and who did not apply for credit for the reason other than financial solvency.

Source: SAPRI Rural Survey, 1999

A portion of borrowers approached to the multiple sources of credit and got it [Table 24]. Most of the respondents [68.97 percent], who have borrowed from more than one source explained the reason as insufficient loan amount from one source. For sudden need 29.31 percent of borrowers took loan from more than one source.

Table 24. Reasons to Borrow from More than One Source

Reason	Frequency
Insufficient Loan From One Source	68.97
For Sudden Need	29.31
Others	1.72

Source: SAPRI Rural Survey, 1999

The non-borrowers mentioned different reasons in order of importance behind their inaction in seeking finance form different sources. In most of the cases the non-borrowers mentioned multiple reasons for not seeking loan. Although the multicollineraity problem exists in the data set [table 25], it derives the severity of the problem of unaccessibility to the credit in the rural area. Among the rural non-borrowers 76.79 percent complained about the rent seeking by the banker as the major reason for not seeking loan. Among the other reasons why the respondents did not borrow the respondents mentioned the following reasons: 53.57 percent of the non-borrowers mentioned inability to fulfill the loan requirements, 44.05 percent did not seek loan due to the time consuming process of lending, 32.74 percent complained against the complex lending procedures. Among the less important reasons the non-borrowers mentioned are: high cost, disliking to have credit, financial insolvency and lack of confidence in credit organization. Now consider the scenario that problem of rent seeking is not in the market. In that case second barrier is inability to fulfill loan requirement. If we take figure of inaccessibility due to bribe and inability to fulfill loan requirements, we can say with the removal of rent seeking access to credit will be increased by 76.79 – 53.57 = 23.22 percent, i.e. 23.22 percent of non-borrowers will get access to credit. The similar logic is applicable for table 27 and table 29.

Table 25. Perception of respondents not seeking access to credit

Reason	Frequency of respondents
Bribe	76.79
Unable to fulfill loan requirements	53.57
Time consuming Process	44.05
Complex Lending Procedures	32.74
High Cost	26.19
Do not Like to Have Credit	21.43
Financially Insolvent	11.31
Lack of Confidence in Credit Institution	4.17
Others	9.52

Note: The frequency is the ratio of number of respondents mentioning particular reason divided by total number of respondents, who did not approach to credit.

Source: SAPRI Rural Survey, 1999

Only 48.8 percent of the respondents have financial savings. Among the savers more than half (53.4 percent) of the respondents have financial savings less than Taka 1000 [Table 26]. Savings ranging from Taka 5000 to Taka 10000 is maintained by only 8.3 percent of the respondent. This is mainly because of the fact that the rural people are very much vulnerable to the sudden events like natural calamity and social events for which they cannot save. This may be the reason that government often has to extend loan forgiveness to the rural borrowers. Moreover, financial schemes in the rural areas are largely focussed on credit/loan, rather than on savings or on both credit and savings.

Table 26. Financial Savings by the Respondents

Range	Frequency
< 1000	53.4
1000 – 5000	34.2
5000 – 10000	8.1
> 10000	4.3

Source: SAPRI Rural Survey, 1999

VI.II.I.I.II. Barriers to Access

The respondents who were refused bank credit mentioned mainly the lack of collateral security. The second important reason was refusal to provide bribe (26.67 percent). It is noteworthy that among the non-borrowers, 76.79 percent of respondents mentioned bribe as a major barrier to credit, while for the loan seekers the frequency of complaining against bribe is much low. One possible explanation may be that most of the borrowers consider bribe as a part of system of lending.

Table 27. Reasons of Refusal from Bank Credit

Reason	Frequency
Lack of Collateral Security	43.33
Bribe	26.67
Insufficient Income	20.00
Others	10

Source: SAPRI Rural Survey, 1999

Collateral was mentioned both by the borrowers and non-borrowers as most serious barrier of access to credit. Bribe is the second important barrier for access to credit for two different reasons. For one group of respondents the bribe acted as a barrier as it increases borrowing cost. For another group, the majority, the ethical side of bribe made them out of credit market.

VI.II.I.I.III. Procedural complexities and Delays

For many respondents procedural complexities keep them out of the credit market (32.74 percent of respondents). The procedural complexities are mainly related with the bank credit. They indicated that the documentary requirements are not made explicit by bankers and are also huge. Borrowers who have direct experience of pursuing a loan application particularly emphasized the huge amount of time required to prepare and follow up on a loan application. 44.05 percent of respondents, who did not apply for loan is due to time consuming process of lending.

Delays in processing loan applications are noted as between 15 days to four months, leading borrowers and non borrowers alike to rank banks as the worst among the available credit sources in this criteria. Both borrowers and non-borrowers indicated that such delays could be extremely damaging, preventing from meeting seasonal demand. The traditional moneylender or trade credit provides the only alternative in such situations.

Table 28. Responsiveness of Credit Sources and Access by Rural Economic Agents [% of Respondents]

Source	Frequency of calling upon	Frequency of getting access
Bank	89.49	41.17
MFI	49.36	39.80
Money Lender	33.44	30.26
Samity	7.01	7.01
Relatives/ Friends	0.96	0.96
Others	0.32	0.32
Note: The frequency of calling upon was calculated as a ratio of number of respondents called upon particular source divided by total number of respondents who approached for loan. Frequency of getting access to credit was calculated as a percentage of respondent who got a credit divided by total number of respondents, who approached for loans.		

Source: SAPRI Rural Survey, 1999

VI.II.II.II. Rural Stakeholders' Perception: Supply Side

The policy level and practicing bankers mentioned several constraints and limitations of formal financial institutions. They emphasized on two important issues for consideration in relation to the banking operations in rural areas:

i) Removing the institutional constraints and improving the capability of PSBs; and

ii) Formulating measures to integrate the financial intermediaries in rural financing.

VI.II.I.II.I. Capability and Constraints of formal sector Institutions

In general the problems facing the NCBs' rural portfolio are similar in nature to that of specialized banks like BKB and RAKUB but probably more severe in magnitude. Their problems are compounded by their limited rural operations, mounting overdues, difficulty in getting right and motivated staffs to work in rural areas since they normally prefer to work in urban areas for better career. The NCBs are in better position to lower and cross-subsidize their cost of operation and hence raise profitability because of their urban and industrial operations. NCBs are more efficient in deposit mobilization in rural areas than in credit delivery probably because their staff are more commercially and security oriented than specialized banks and used to safe lending rather than sound and productive lending. It is observed that the two specialized agricultural banks have been playing a dominant role in agricultural/rural credit in terms of disbursement and coverage although recovery position shows no better performance, considering their specialization.

The major problem with the public sector banks (PSBs) working in rural area seems to be the institutional one because of the fact that a rural bank branch does not always have the required manpower and facilities to undertake an efficient disbursement and recovery of large number of small loans in the rural area. Rural credit has to be closely supervised for ensuring proper end use and timely repayment, but their ability to undertake supervised credit operations is extremely limited. Moreover, there is conspicuous weakness in enforcing the built-in system of credit operations by the bank officials for one reason or the other which leads to poor recovery and low income affecting the profitability of the branch itself. Lack of accountability of the officials and motivational measures are two important factors, which significantly affect the credit operations. Till recently the two specialized agricultural banks did not have reasonable incentive scheme necessary both for proper recovery and disbursement as well as for deposit mobilization.

VI.II.I.II.II. Interest Rate Band for Agricultural Credit

Lending to the agricultural/rural sector involves high risk and high cost of operation. Adequate interest margins to cover cost of funds, cost of operations and provision (for loan losses) are therefore, very relevant for viability of a bank branch. It is however considered that reasonable effective interest rates is one of the important variables for success of rural financial institutions. The bankers have supported the removal of interest rate band from the agricultural sector. The logic behind the support: in any case, as interest rate is determined by the banks themselves for other loans and advances, the interest band on agricultural loan increases lending rate for other sectors.

VI.II.I.II.III. Outside Intervention

PSBs operating in rural areas are basically guided by the government programs and objectives rather than commercial considerations. The autonomy and discretion of the banks especially the specialized agricultural banks is often compromised by the formal and informal intervention. This has the effect of gross distortion in the credit discipline in the rural finance market and a great set back to the financial condition of the banks. The impact on the banks has two dimensions. One is the viability of the banks; another is moral hazard problem due to the expectation of loan forgiveness.

VI.II.I.II.IV. Risk-Coverage Safety net

The rural sector is considered risky for commercial lending due to the frequent natural calamities, which affect the repayment capabilities of the borrowers. Currently, there is no safety net for covering unforeseen risks. This issue should be considered for designing some safety nets like crop insurance, credit guarantee schemes or compensatory funds for agricultural credit. Some mechanism may also be developed by the way of creating a risk fund in the bank branch out of the loan amount since this system has been experimented in various projects or organizations.

VI.II.I.II.V. Fund Constraints

The PSBs also face sometimes the problem of shortage of loanable funds in the rural area. In the past, banks used to get refinance from Bangladesh Bank against their agricultural /rural lending at a concessional rate in case of liquidity problem. This facility has been abolished after the financial sector reform measures are undertaken for NCBs, but continued for BKB and RAKUB at bank rate. So, shortage of funds in absence of good recovery is becoming great problem for the banks. This issue should be addressed to increase the rural credit flow.

Besides the above mentioned problems numerous structural and institutional problems have been mentioned by the bankers. Among them, corruption, fake loans, misconduct, inefficient management capabilities, inadequate control etc are mentionworthy.

VI.II.I.II.VI. Integration

The major driving force of integration of formal, semiformal and informal segments in the rural financial market is that the market is still not saturated and huge fund is required for this purpose.

The line of demarcation between formal on the on hand, and semi-formal and informal segments on the other hand, is generally drawn on the basis of the regulations imposed (on the formal sector) by the central bank in respect of capital, reserve and liquidity requirements, mandatory banking targets and prices (if any), and audit and reporting requirements.

The advantage of the semi-formal and informal sector lies in appropriate screening mechanism of credit worthy borrowers, lower transaction costs and proximity to recover the loans. The institutional structure and lending mechanism of the semi-formal and informal sectors are much more suitable for meeting the financial needs of the rural clients. However, their weakness is inadequate amount to lend. On the other hand, the formal sector enjoys advantage in mobilizing resources for lending but suffers from the disadvantage of lacking in proper lending mechanism and financial products. A rational solution might be a linkage between the comparative advantages of these two sectors (formal on the one hand and semi-formal and informal sectors on the other). A possible integration may create a synergy and win-win situation for each of them. The financial technology of integration have been practiced for long in Indonesia, Philippines, Thailand, Nepal and India.

Many banks started to experiment group lending following the models of Grameen Bank and other leading NGOs. But, the NGO experience suggests that this sort of lending model requires training of field workers with high motivation, social preparation of the borrowers, appropriate incentive structure for the workers, and high effective interest rates, which are not present in the context of PSBs. This indicates that instead of adopting an "alien" lending culture, it is better on the part of PSBs to go for linkage with semi-formal and informal sectors for ensuring desired financial and economic results.

The linkage may take different forms: institutional linkage and financial linkage. The institutional linkage is collaboration between two institutions and financial linkage is link between savings and credit.

The models of linkage are as follows:

A. FI $\rightarrow$ FI $\rightarrow$ RC: One surplus financial institution (FI) provides fund to another FI for on-lending to rural customers (RC).
B. FI $\rightarrow$ SFI $\rightarrow$ RC: Surplus FI lends to Semi-formal financial institution (SFI), then SFI lends to rural customers, or, SFI makes the customer bankable and FI provides the funds.
C. SFI $\rightarrow$ SFI $\rightarrow$ RC: One apex SFI or surplus SFI may provide fund to other SFI for on-lending.
D. FI $\rightarrow$ SFI $\rightarrow$ IL (SHG) $\rightarrow$ RC: FI provides funds to money lender, trader-creditors or to self-help group (SHG) for on-lending to individual customers.

E. FI $\rightarrow$SFI $\rightarrow$ IL/SHG $\rightarrow$ RC: FI provides funds to SFI, which lends to SHG or IL for ultimate on lending to rural customers.

As opposed to traditional individualistic approach (of PSBs) to rural banking, the linkage approach is far more promising in creating a viable rural banking structure. Despite a number of weaknesses, the linkage schemes have so far given us a message that rural banking is not unprofitable and rural poor may also be made bankable (Choudhury, et. al. 1996. p- 18).

VI.II.II. Stake holder's perception about Access to Credit: SMEs

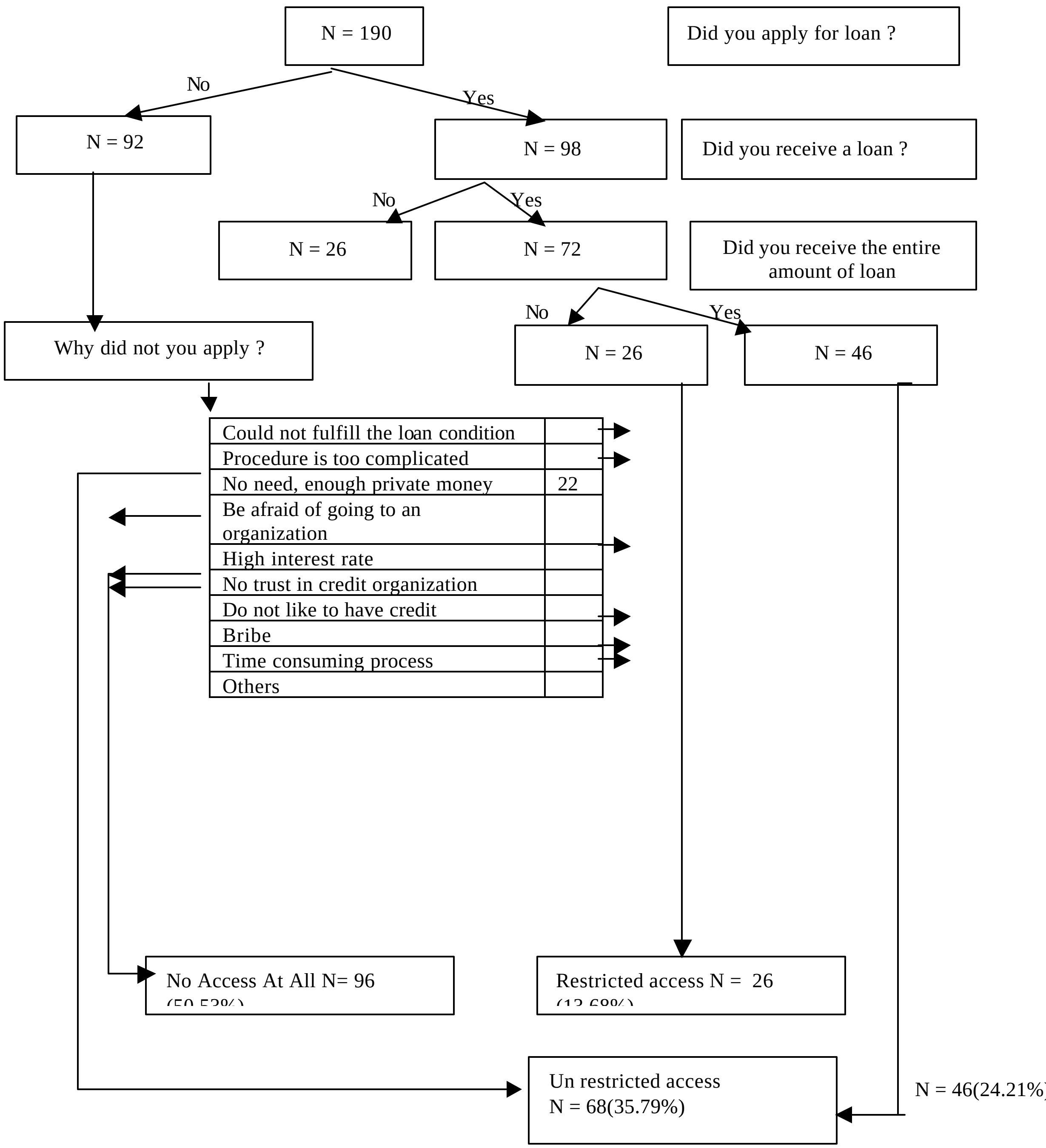
VI.II.II.I.I. Stakeholders' Perception: Demand Side

SMEs are considered as one of the priority sectors of Bangladesh economy since independence. Economic history conveys that healthy economic structures are usually based on a complex network of large, medium-size and small enterprises. The intensity and quality of relationships that exists between different size of companies -the input and output they give and receive, the exchange of experiences and ideas - largely determine the dynamism and the sustainability of economic development. Very small, small and medium enterprises form the seedbed of the national economy. This sector also offers the best chance of achieving two objectives that have been mutually exclusive in the past : economic growth and fairer distribution of opportunities.

Small businesses are numerous in Bangladesh and form a large majority in the domestic markets. According the estimate of BSCIC there are about 523 thousands of small enterprises including cottage industries in the country employing about 2.3 millions of people, which is around 82 percent of total industrial labor forces [Khan, 1999]. Different definitions of SMEs emerge in different countries. In Bangladesh, an SME is having 10 or less number of workers. According to the BSCIC a company with Tk. 10 Crore or less assets or employing not more than 50 is considered as SME.

For the perception of the stake holders from demand side regarding the access to formal credit a Symantec model has been used [see figure 3]. For this model four questions have been developed. First, "Did you apply for formal loan ?" If answer is "yes" to this question, the following question is "Did you receive a loan ?" Again, if the answer is "yes", the next question is "Did you receive the entire amount of loan ?"

Figure 3. Perception of the SME Stakeholders: Access to Formal Credit



The number of respondents, who answer "yes" to this question, is the proportion of respondents, to whom the access to credit is un-restricted. But, for rest of the respondents (who applied for loan), the access to credit is restricted, degree varies from hundred percent (applied for loan, but not received) to less than 100 percent (applied for loan but received less than entire amount). Yet, there is another group of respondents, who answer "no" to the question "did you apply for loan ?" For extracting the reasons for not applying for loan in this model the question is set "Why did you not apply for loan ?" Among the responses of the respondents, one is "no need, enough private money". The number of respondents to this question should be added to the "un-restricted access" group.

According to the model the access to formal credit is not available at all to 50.53 percent of the stakeholders. Only 35.79 percent of SME stakeholders enjoy unrestricted access to the formal credit. The rest (13.68 percent) of them have restricted access to the formal credit.

The SMEs respondents mentioned several reasons of failure to receive loan from formal source (Table 29).

Table 29. Reasons for failure to receive the Loan : Applicants' Perception

Reasons	Percentage of Respondents
Could not fulfill the loan covenants Bribe	58.3 43.5
Left trying for loan, procedure is too complicated	41.7
Banker's disinterest	39.1
Left trying for loan, time consuming process	34.8
Lack of collateral security	30.4
Insufficient income	17.4
High interest rate	17.5
High sunk cost Lack of information	4.3 4.3

Source : SAPRI SME Survey, 1999.

VI.II.II.I.I. Sources of Credit

Most small entrepreneurs finance the main portion of their businesses using a combination of their own savings and loans from family and friends. Many SMEs use trade credit arrangements to supplement this. Bank credit is used by small percentage of entrepreneurs and provides financing of generally less than 20 percent of their total outlay. Majority of the SMEs (59.6 percent) seek finance for their working capital needs from banks, although only a half-of them get loan from banks. Trade credit is second most important source to many small entrepreneurs with relatively little problem, although provided at a much higher rate of interest than banks, it is available when most needed. Family and friends provide much of the financing of small business but are unable to provide much of the financing of small business (21.3 percent) and often take time to mobilize the funds and that's why, are not helpful in times of emergency. Money lenders are not excluded from the source list of SMEs, they only use moneylenders in emergency situations.

Table 30. Sources of Loans sought and received by SMEs

Source	Percentage of Respondents sought loan	Percentage of Respondents received loan
Bank	59.6	53.57
Trade Credit	27.7	100
Relatives/friends	21.3	100
Money Lender	6.4	100
Samity	6.4	92.31
Others	2.1	100

Source : SAPRI SME Survey, 1999.

VI.II.II.I.II. Dissatisfaction with bank credit

Most of the borrowers (58.1 percent) expressed their dissatisfaction with "bribe", as it becomes pervasive in the banking sector. Complex procedures were mentioned as second most acute problem in bank credit. Almost half of the borrowers expressed dissatisfaction for collateral requirements of banks. Borrowers also complained of the long delay and guarantees required in sanctioning loans [45.2 percent]. The other sources of dissatisfaction as expressed by the borrowers are: high interest rate (32.3

percent), inadequate volume of credit (22.6 percent), high sunk cost (19.4 percent), and harassment (12.9 percent).

Table 31. Factors of Borrower's Dissatisfaction [In Descending Order]

Factors	Percentage of Respondents
Bribe	58.1
Complexities	54.8
Collateral	48.4
Delays	45.2
Guarantees Required	45.2
High Interest Rate	32.3
Inadequate Volume of Credit	22.6
High Sunk Cost	19.4
Harassment	12.9

Source: SAPRI SME Survey, 1999.

VI.II.II.I.III. Barriers to Access

Collateral was mentioned both by the borrowers and non-borrowers (79.4 percent) as most serious barrier of access to credit. The second most important barrier is bribe (66 percent). In regard to the perception of dissatisfaction (only of borrowers) we found bribe was in the first position. If we link these two responses, we can say that SMEs are ready to pay extra to the price of loan, even in form of bribe. Logically bribe is the part of sunk costs. But only 8.2 percent of the respondents (both borrowers and non-borrowers) mentioned high sunk costs as barrier of access to credit. It implies that most of the SMEs generally do not consider bribe as extra cost of loan.

Table 32. Barriers of Access to Credit : Overall Perception of Demand Side [In Descending Order]

Barrier	Percentage of Respondents
Collateral	79.4
Bribe	66
Delays	54.6
High Interest Rate	39.2
Banker's Disinterest	27.8
Guarantees Required	27.8
Inadequate Volume of Credit	22.7
Harassment	11.3
High Sunk Cost	8.2

Lack of Information	6.2

Source: SAPRI SME Survey, 1999.

Most non borrowers indicated that the requirement for "excessive collateral' was a major barrier for them to access bank loans. Borrowers all noted that raising sufficient collateral had been a problem for them. The kind of collateral usually considered by banks as appropriate security is land or buildings [Table 33].

These securities must be exclusively owned by the borrower i.e., the title documents must be in the borrower's name. This poses a particular problem for women, who rarely have property in their name and for young entrepreneurs who may stand to inherit property but do not have present title.

Table 33. Security Provided by SMEs for Loan

Type of Security	Percentage of Borrowers
Land	55.2
Building	6.9
Security Papers	3.4
Deposit or Insurance Certificate	13.8
Others	20.7

Source : SAPRI SME Survey, 1999.

The SME respondents indicated that bankers are generally not interested in taking farm land as collateral indicating that they would only consider land owned within the municipal area. Borrowers complained that where land ownership is accepted by the bankers, they insist that a wall should be erected around the land. This extra expense is objected to by the borrowers. It is a general complain by the borrowers that bankers undervalue the collateral presented. A further problem is the insurance required for property put forward as collateral. Borrowers feel that the insurance cover is purely for the benefit of the bank and the bank should be responsible for the premium. Banks always identify the insurance company that the borrower should use (for commission). Borrowers complained that the value of the security for insurance purposes is always inflated in contrast to the collateral value that is always deflated.

Many small entrepreneurs work from rented property. According to a World Bank study [WB, 1994] 60 percent of more than 350 firms studied operated from rented premises without disturbance of land lords and there was no evidence that they would have been better businessman if they had owned their own premises. Furthermore, renting was considered to be a sound strategy for conserving capital.

VI.II.II.I.IV. Procedural complexities and Delays

All SME respondents noticed that a major barrier to accessing bank credit is the complexity of the procedures which leads to delays. They indicated that the documentary requirements are not made explicit by bankers and are also huge (documentary requirements). Borrowers who have direct experience of pursuing a loan application particularly emphasized the huge amount of time required to prepare and follow up on a loan application [Table 34].

A borrower has to visit a bank on average 15 times to pursue a loan with a maximum number of 60. Trade credit take minimum number of visit, average 1.67 times. However, most of the borrowers have to visit 8-15 times to pursue a bank loan [Table. 34].

Table 34. Number of Times A Borrower Visits the Lender [In Descending Order]

Source of Loan	Minimum	Maximum	Mean
Bank	3	60	14.70
Money Lender	1	4	3.00
Samity	1	5	2.50
Relative Friends	1	7	2.25
Trade credit	1	5	1.67

Source : SAPRI SME Survey, 1999

Table 35. Percentage of Borrowers According to Number of Times Visiting Banks and Other Sources of Credit

Number of Times	Bank, %	Money Lender, %	Samity, %	Relatives/Friends, %	Others, %
1 - 7	20	100	100	100	100
8 - 15	55	-	-	-	-
16 - 30	20	-	-	-	-
31 - 60	5	-	-	-	-

Source : SAPRI SME Survey, 1999.

Table A-8 provides an example of documents, which are 19, required for a small loan as survey singled out. NCB requirements are higher - twenty two documents are described as the basic requirement and certain types of loan require additional documents.

Delays in processing loan applications are noted as between two months and one year, leading borrowers and non borrowers alike to rank banks as the worst among the available credit sources in this criteria. Both borrowers and non borrowers indicated that such delays could be extremely damaging, preventing the business from meeting seasonal demand, stocking at low season prices, expanding a business at a critical time and meeting deadlines of orders. The traditional moneylender or trade credit provides the only alternative in such situations.

Potential borrowers are rarely given written guidelines clarifying the eligibility and terms and conditions for different loan schemes, which should also indicate the supporting documents required. If a potential borrower is given incomplete information, then he would spend a lot of time gathering the documents apparently needed, but the ones presented might be inadequate or incorrect, or at worst, even their eligibility might be questioned.

Banking language is often difficult for the laymen to grasp and potential borrowers felt that they often make mistakes on the application forms and in interpreting requirements because they do not get advice and guidance from the bankers.

According to borrowers' estimate it takes two to three months for a potential borrower to collect the necessary documents for a loan application through personal visits to a variety of offices. Each office generally requires a bribe to provide the services and demonstrates the power of delay to ensure it.

According to the survey estimates bribe to income tax officer takes first position, 34.70 percent of sunk cost is spent on income tax documents. Potential borrowers particularly noted the difficulty in accessing C/S, R/S and S/A documents, although 8.64 percent of sunk cost is spent on collection of these documents (table - 31).

Since the modern property documents are based on the old documents anyway, they found the necessity for the old British and Pakistan period documents, which are the most difficult to locate.

Another irritation noted by the borrowers was the requirement to collect no objection certificates from all the local banks. Again 'service charges' are usually required for this. The borrowers felt that review of the banking record of a potential borrower should be the job of the bank. In fact it should not be a bank policy to ask borrowers to collect their own 'no objection certificates', rather the bank should reject such certificates if there are collected by the borrowers, since they can be easily obtained illegally.

Most banks require a guarantor for sanctioning a loan. This person must be well placed, must operate a substantial savings account and not be a borrower itself. Some banks require two guarantors. Many borrowers noted that they had difficulties finding a guarantor acceptable to banks, mainly because they did not have a network of contacts, including influential people, particularly ones who themselves did not have bank loans. Furthermore, a guarantor must not guarantee more than one loan, further reducing the chances of finding such a person.

Table 36. Sunk of Cost of Loan

Expense Item	**Average Amount in Taka**	**As % of Total Loan**	**As % of Total Expenses**
Bribe to income tax officer	17750	4.61	34.70
Bribe to Banker	11425	2.97	22.33
Preparation of security documents	9535.71	2.28	18.64
Commission of Banker	3200	0.83	6.26
TIN	1567	.41	3.06
Commission of Broker	1150	.30	2.25
Transportation	875	0.23	1.71
Own "Away from home" fooding cost	840	.22	1.64
Income statement from banks	800	.21	1.56
Account opening	750	0.19	1.47
Trade license	650	0.17	1.27
Assistance in preparation of documents	480	0.12	.94

Stamp	238	0.06	0.46
Loan Application Form	87.50	0.02	0.17
Nationality Certificate	50	0.01	0.10
Others	1760	0.46	3.44
Average sunk Cost per loan		5.89	
Maximum Sunk Cost per loan		21	

Source : SAPRI SME Survey, 1999.

As bank managers have generally quite low sanctioning powers, the papers need to be sent to higher sanctioning authorities. The documents have to be examined at the branch office, the regional office the principal office and the head office. The higher authority often requests further examination of the application and physical verification of the site. The final decision on the loan may be given six to twelve months after initial application.

VI.II.II.I.V. Bribes

'Service charge', 'commission; 'percentage', 'subscriptions', 'contributions/donations' are all euphemisms for bribe as described by the borrowers and non borrowers alike. Nobody had experienced a bribe free formal loan sanction although private banks are recognized as requiring less bribes than NCBs.

Many respondents feel that many bankers intentionally delay the loan application in order to frustrate the applicant and ultimately providing bribes to facilitate the process. The bribe component of sunk cost comprises 22.33 percent of total costs. The p/c, i.e., a percentage of the sanctioned loan is ranged from 10 to 20 percent of sanctioned amount. Sometimes p/c is required in advance of loan sanction. Even where overt requests for 'p/c' are not made, charges are levied under the head of 'service charge' or 'commission'. Such charges are not official bank policy. In addition, donations for entertainment expenses of the bank (closing functions, entertaining visiting officials, picnics, farewell etc.) are requested. Many banks insist that a borrower signs an authorization that enables the bank to debit their account directly up to a fixed monthly figure to 'cover expenditure incurred in servicing the loan account'.

Arrival of a new bank manager is viewed by current borrowers with trepidation. They fear that renewal of loans will be denied in an attempt to extract further bribes. New borrowers fear that the whether application process will have to start from scratch, with new p/c and service charge expectations.

To the customers advantage, bankers can be bribed to overlook a number of procedural difficulties e.g. land documents which are not actually in the borrowers' name, arranging guarantors and over valuation of collateral, hypothecated or pledged property and stock.

VI.II.II.II. Stakeholder's Perception: Supply Side

The commercial banking sector has not looked upon small enterprises as an important part of its loan portfolio. Government intervention through subsidized credit or specialized "development banks" has not solved the problem. It has made it even more difficult for small enterprises to gain access to formal credit, as all commercial banks have thought that for the SMEs there is "specialized" institution, so they do not have to think about SMEs.

The banks have generally no interest in promoting new markets with higher perceived risks and relatively high information costs. There is too little market pressure on them to develop banking services for small businesses. The small businesses tend to be much less dynamic and less competitive because technical and administrative standards are generally inferior. Most of them subsist on the informal sector and have no access to loans through formal channels. On the one hand, there is massive potential in terms of entrepreneurial talent and initiative; on the other hand, too little of this potential is actually realized in the form of investment, competitiveness and growth.

The supply side determinants of access to credit for SMEs are as follows:

- Profitability of purpose
- Interest willing or able to pay by a small borrower
- Risks involved

- Size of loan
- Prior business relation
- Quality of collateral
- Cost of information
- Monitoring and supervision cost

As the margin between costs and benefits narrows, the bank's interest in granting such credit dwindles. The factors affecting the cost and benefit represent the "natural" reasons why bank discriminate the SME borrowers.

The higher the potential profit from the use of loans, the higher the interest rate a borrower will be willing to pay. A higher interest rate gives a bank a wider margin to cover the cost of granting the loan. So, a removal of control over the interest rate [removal of floor rate or ceiling rate] was thought to motivate the banks to extend credit to the SMEs. But the observation of the practice does not support the perceived intention. Even after decontrol of interest rate the commercial banks were reluctant to extend credit to this sector [Table 6: credit allocation index for SME]. As the rate of return data are absent for the sector, it was difficult to comment on the greater profit margin of the SMEs.

The administrative cost of lending to SMEs is considered higher. The administrative costs arise from the processing of loan application, the bank's internal accounting controls, and the collection of information to have accurate profile of customer. The banks must also defray the administrative cost for monitoring of loans once granted. Since most of the costs are relatively independent of the amount of the loan requested, certainly the economies of scale in lending tip the balance in favor of the large companies, not SMEs.

In view of their informal nature, few SMEs keep credit records or the formal accounts that would provide clear picture of their profitability or the value of assets. Sales figure shown on the tax returns submitted by small companies are generally lower than actual earnings. The poor quality of data provided by the SMEs results in the perception of greater risk in SMEs lending.

In order to ensure their employees' compliance with bank practices and to maintain the quality of their loan portfolios, commercial banks generally compile manual of banking norms and procedures. Among other things, these handbooks stipulate procedures for the processing of new loans, follow-up of existing loans, and non-performance. They also set out guidelines for deciding about allocation of various types of loan and discretionary powers assigned to each decision level. The discretionary power of allocating loans should have been increased after the reforms. But the discretionary power of the operational level managers decreased after reform.

Standardized banking norms and procedures are usually applied very strictly and as a result SMEs are deprived of funds. Among the reasons why the SMEs did not receive the loan applied for, among the reasons, non-fulfillment of loan condition [58.3% of applicant], lack of collateral securities [30.4 percent], insufficient income [17.4 percent] are directly linked to the strict lending rules.

Financing SMEs became further difficult by the policies of prudential and supervisory regulations adopted because of financial reforms measures, which are similar for all categories of borrowers. Requiring by banks to provide detailed financial statements, emphasizing on solvency and liquidity ratios as well as projected cash-flow statements, equity declarations, and income tax declarations for each client hindered the access to credit by the SMEs. These are the direct result of financial sector reforms.

In the last quarter of 1980s, BB asked all the commercial banks to set aside at least 5 percent of total demand and time liabilities for providing finance to small and cottage industry sector. In addition to that, there was one special credit program for small and cottege industries (SCI) and one small loan scheme (for which banks used to set aside 2 percent of total demand and time liabilities (TDTL) for providing fund to small business). However, all these "directed credit" programs have been discontinued after financial reform. Therefore, now banks do not set aside any funds for providing as loans to SMEs, rather they are treated on residual basis. This is also the implication of financial reform.

Legal provision regulating the recovery of default loans may also have a negative effect on access to formal credit on the part of SMEs. Not only the judicial recovery process is slow and costly, lack of collateral on the part of SMEs make the banks to think that there is no guarantee to recover the loan. As it is known that collateral is not always possible to be provided by a small borrower. Thus, collateral becomes a barrier to access to credit. Because the few fixed assets that small firms possess generally consist of used machinery that too of little value, the banks perception are that small firms are riskier borrowers. Fixed legal fees for judicial recovery sometimes make ironous to attempt to recover the SMEs small loan amount. Further, the time consuming process of recovery often makes the initial lending amount discounted to a ridiculously small amount.

The SAPRI investigation on the supply side derived the opinion of bankers at different levels of management.

Policy level bankers were unanimously optimistic about loans to SMEs. Most felt that the repayment rate for such loans would be high and there would be good opportunity for the banks to earn profit on such services. From the investigation, as mentioned earlier, SME entrepreneurs are found ready to pay higher interest rate for loans as they are paying in the form of bribe and other sunk costs. Only 6.8 percent of the borrowers mentioned high sunk cost as a barrier to access the credit market. The bankers are also positive about the chance to broaden the clientele base and diversify credit portfolios. They feel that provision of credit to this sector would contribute greatly to increasing employment and ultimately to economic development. Their reservations focused mainly on the high cost of service and particularly problems with monitoring and supervising large numbers of loans. But they are also confident that these problems are not insurmountable and expected to be outweighed by the advantages involved the bank in providing such services.

The investigation found that almost half of the respondents (48. 4 percent) did not seek institutional loans. Policy level bankers indicated that the most likely reason behind the reluctance of the small entrepreneurs in approaching the formal institutions are the complex and lengthy procedures. The survey investigation of demand side also found the reason as important for the SMEs, although there are some other reasons like failing in meeting the collateral requirements. According to their opinion, low literacy level of many entrepreneurs make the understanding of the forms and procedures more difficult. Some bankers indicated that these customers might feel that bankers are not interested in providing small loans and consequently perceived as unfriendly.

Besides the above mentioned reasons the bankers also mentioned the following reasons:

- High level of default

- Shortage of manpower and logistics
- Unfair punitive measures for bankers
- Lack of bankable clients
- Liquidity Constraints.

Most operational level bankers pointed to the suitable borrowers according to the banks' existing criteria. They thought that most applicants lack business experiences. In regard to the delays in loan sanctioning they attributed to the unnecessarily strict procedures and low sanctioning power of the branch manager. "Default culture' and shortage of manpower are also mentioned as reasons why the bankers are not interested to provide small loans.

In relation to the above mentioned reasons the bankers suggestions are as follows:

- Increase sanctioning power of branch managers to Tk. 500000
- There should be stipulated (published) periods for sanctioning loans and bankers should be held responsible for delays beyond that period.
- Fewer documents should be required for loans up to Tk. 500 thousands
- Provide clear information (reader friendly) to customers regarding the requirements by banks.
- Determine a specific (optimum) numbers of borrowers to be provided services by each bank officer to ensure proper monitoring and supervising.
- Establish up-to-date data bank for small enterprise information which bankers can tap.

Bankers did not directly subscribe to bribe taking but admitted "malpractice in sanctioning loans" as a prevalent problem. Policy level bankers agreed that bribery is rampant although it is not everywhere. They also questioned about the readiness of the borrowers to provide bribes and also mentioned that sometimes borrowers themselves offer bribe because they wanted to pursue weak proposals. They noted that bankers deliberately capitalize on the ambiguities in the procedures. The key to minimizing the opportunities for bribery would be to supply bankers and customers with clear information on the documents required, the processing stages and the maximum time required for each step. Bankers would not then be able to harass customers by asking repeatedly for documents or delaying the procedures.

All the bankers recognized that small borrowers have difficulties raising collateral and felt there is too much emphasis on collateral requirements. Many bankers indicated that a small entrepreneur who comes with good references and whom they feel trustworthy is more valuable than the evidence of collateral, which may be falsified, over valued and which will not be possible to dispose of following seizure anyway. Bankers opined that most of the existing classified loans have sufficient security mortgaged in favor of the banks. It is clear that one can not infer the repayment potential of a borrower from the ability to raise collateral. Furthermore, banks find it very difficult to sell out mortgaged property. At present, collateral is the only security required by law and an alternative would have to be approved. Policy level bankers suggested group guarantees, personal guarantees by "good network of individuals" or life insurance guarantees as alternatives to collateral but remained conservative about the upper limit under such arrangements. Some bankers also proposed land owned in the village as collateral.

Policy level bankers confirmed that bankers do not have sufficient knowledge and experience of different sectors on which to base loan sanctioning decisions. However, the breadth of knowledge required is mind boggling. The bankers need to be able to tap into a central database and share experiences with other bankers more widely.

The bankers expressed much concern about the prevailing rates of default and mentioned that it has enormous effect on their willingness to process loans. They attribute the default phenomenon" to a number of factors:

- Loan forgiveness
- Malpractice in loan sanctioning
- Ineffective punishment for defaulters
- Poor project planning by the borrowers
- Limited experience and skills of borrowers
- Poor supervision by banks.

The bankers blame the loan forgiveness arrangements of the previous governments as contributing enormously to the present high rate of default. The Ershad regime waived all interest payments on loans up to Tk. 10000, BNP regime once made a similar gesture for the loans upto Tk. 5000, and again, waived both the principal and interest amounts on loans up to Tk. 5000, which costed Tk. 30 billion for the country. The bankers noted that "malpractice in sanctioning loans" is largely a result of political pressure and Trade Union pressure, which contributes to the high rate of default. They explained that local politicians pressurize bank managers into sanctioning loans for their direct benefit and the benefit of their associates. Refusal to cooperate leads to social harassment, physical or mental abuse or transfer. Trade union members offer brokerage service for potential borrowers. They pressurize bankers into providing loans using threats of physical violence or transfer. Trade unions operate under the protection of local political parties and so can exert tremendous pressure at local offices.

Policy level bankers proposed the following measures to solve the above mentioned problems:

- Abolish trade unions in the banking sector
- Protect bank officials from the political interference
- Abolish loan forgiveness which promotes a 'loan default culture'
- Establishment of a mechanism of speedy trial of loan defaulters. Some suggested that branch mangers are to be given magistracy powers to deal with default at the branch level.
- Abolish system of holding bank official accountable for classified loans where the documentation and supervision have been made satisfactory.
- Ensure sufficient bank staff and transport facilities or transport allowances to enable proper loan supervision

Some of the policy level bankers in the Central Bank are very critical about the loan recovery situation. According to one of Deputy Governors of the BB, debt-equity ratio is comparatively low for those borrowers, who regularly repay their loan installment. Low equity makes the entrepreneurs highly risk taker, which they can afford because they know that they do not have to repay the loan. According to him, in our country bargaining agents are numerous, real entrepreneurs are few in numbers, specifically in case of large borrowers. Proper loan screening has become impossible because the bankers do not have the required skill, as well as the mentality. Corruption in the banking sector reaches such a peak; it appears folk-tale that a loan proposal is appraised without bribe. In the name of encouraging industrialization a minimum of 20 percent equity was made as requirement for obtaining a loan. This policy made the fund wastage process rampant. With the collaboration of bankers, a borrower is over-invoicing the purchase of capital goods by 25 percent. With equity of 20 percent that entrepreneur actually earns a 5 percent extra from the bank. In loan screening process he proposed to emphasize not only on the project itself, but also on the entrepreneurship. According to him, a very few banks provide loan within the range of Tk. 100,000 to Tk. 500,000. FSRP took the reform measures for improvement of banking system. The idea was that an improved system could increase the efficiency of the banking system. But, if the man behind the system, who ought to implement the system is corrupted, it is bound to fail.

According to the Managing Director of a commercial bank, tracking the account relationship of an entrepreneur may be an important loan-screening tool. A borrower of a DFI in most cases does not have an account in that particular bank. According to him, loan proposal and appraisal can be manipulated, but entrpreneurship can not be manipulated. The know-how of "how to penetrate an established marketing chain?" is one of the most important aspects of loan screening. To manufacture is comparatively easy, but to grab the market is difficult.

The demand for higher volume of working capital is observed now in the financial market. He identified the reasons:

- credit sale;
- high inventory keeping for hartal; and
- Providing rent to different types of rent-seekers.

Law and order situation is an important determinant of good repayment rate by the SMEs. He opined that most of the bankers are seeking excuse of political influence for poor loan screening. A banker may waste 100 percent assets in the name of political influence, for another banker the rate might be 10 percent. So, the motivation and integrity of a banker is an important factor for the financial health of banking system.

According to the Managing Director of MIDAS, the legal framework in Bangladesh is pro-bad borrowers. This legal framework protects the defaulters, not the lenders. The Money Loan Court Act failed to play its due role. The overall moral degradation is the main reason behind the failure of system. Whatever reform measures we will take, all will go in vein, if the system does not work. According to him, the repayment performance is much better for small borrowers.

The operational level bankers said that the policy helps the acceleration of default loan, by forgiving interest, and sometimes-even principal. One Deputy Governor opposed it and said that the BB and government did not have any policy pressure for loan forgiveness, it is the bank's internal policy. The individual bank should be careful of it. The reason why the bank is forgiving the loan, is the failure of the bank to collect it (for negligence or unwillingness due to corrupt involvement).

VII. REVISITING SAP AND FUTURE POLICY DESIGN

The earlier discussion on implementation and outcome of financial sector reform measures (like interest rate deregulation, discontinuation of directed credit measures, adoption of prudential measures, entry of new PCBs, etc.) indicate that reform objectives are still remaining largely unfulfilled. For the non-fulfillment of the objectives, one might consider that either I) the designing of the reform framework (in terms of adequacy, justification and sequence) was not appropriate, or, ii) the banking problems might not be identified correctly (wrong diagnosis of the problem). In order to look into it, prevailing banking situations, reforms instruments and expectation are required to be revisited.

All the FSAC related documents of the World Bank viz. project paper, implementation completion report and performance audit report have indicated that the financial sector reform agenda was determined following the economic and sector work by the Bank and the recommendation of a GOB task force, National Commission on Money, Banking and Credit (NCMBC) with a mandate to improve the efficiency of financial intermediation in Bangladesh. But, in reality, it is observed that the recommendations of NCMBC was rather ignored while designing reform framework under FSAC. It is therefore, pertinent here to look into the priorities of the NCMBC report.

The Commission's recommendations were basically focussed on fundamental problems of the banking system rather than giving priority to economic deregulations. Specifically, the commission was concerned with the problems of overdue loans of DFIs (BSB and BSRS) and agricultural credit, capital adequacy requirement of NCBs and DFIs, supervision and inspection of financial institutions including DFIs and legal framework affecting loan recovery and overall banking. As a tool for improving allocation of resources to priority sectors, instead of complete dismantling of controlled lending rates, the commission rather suggested to channelise the flow of credit from local private and foreign banks to agricultural and rural sectors at least to the extent of 15 (fifteen) percent of their loaning operation. They may either lend the funds directly or through any NCB or BKB. Banks which would fail to attain the target should be obliged to deposit the required fund with the Bangladesh bank. (NCMBC Report. p-34).

In regard to interest rate deregulation, the commission admitted that proliferation of lending rates arose because of concessional rates prescribed for target groups under the priority sector lending reflecting social concerns and considerations. The commission also observed that no scheme of rationalization relating to interest rate structure should ignore these social concerns and considerations. Moreover, in the context of the present stage of development of the financial markets in Bangladesh, it would not be desirable to leave the determination of interest rates entirely to market forces, which may result in wide fluctuations in interest rates and may cause excessive uncertainty in the financial market. Therefore, the commission suggested a fair degree of regulation of interest rates. (NCMBC Report, p-82).

Refinance by Bangladesh bank constitutes an important step for ensuring adequate flow of credit to the priority sectors. [However, in order to have effective monetary control, the commission prescribed that there should be matching between quantum of refinance and reserve money creation]. Instead of stopping refinance by Bangladesh Bank, the commission asked to link refinance with recovery performance of the banks, specially agriculture credit providing institutions.

The banking commission report dealt elaborately with the problem of DFIs (namely BSB, BSRS and BKB), specially their default problem. But surprisingly, DFIs were dropped in the broad reform measures prescribed by IDA and adopted by Bangladesh Bank. Not only that, the restructuring measures for BSB and BSRS as suggested by ADB and other donors (in 1985) were also not incorporated in adopted reform actions.

According to the opinion of the Task Force on Financial Sector (1991), formed during the regime of interim government in 1991, restoration of “financial discipline” was adjudged as the most urgent requirement in the financial/banking sector. The Task Force report said, “Banks and financial institutions cannot grow in the absence of (i) autonomous decision-making on economic and commercial consideration; (ii) strict enforcement of contractual obligations between the financial institutions one the one hand and their clients on the other, and (iii) effective authority of their management over personnel. Absence of these elements manifests in inefficiency as well as indiscipline in the financial sector.” SAP financial sector reform measures were obviously inadequate to bring back financial discipline in the financial sector (UPL, 1991).

The performance audit report (of the World Bank) related to FSAC admitted that "the project was not successful (p.12)". According to the PAR, the causes for this failure are various: government ownership of the reform program and a strong political will to make it succeed were absent. Debt recovery environment did not improve. The laws are in place to improve bank supervision, bank operating practices and methods of debt recovery, but commitment to enforce these laws has been dilatory and lacked resolve. Expectations regarding bank operating practices and the central bank supervisory practices through training and technical assistance (FSRP TA) were unrealistic and overly optimistic. Finally, there were flaws in the design and sequencing of the reform agenda. The PAR also rated the sustainability of the financial sector reforms operation as "unlikely", given the implementation experience and lack of progress after the completion of FSAC (pp. 12-14).

The success of reform largely depends on its ownership by the government. If we track the background of FSAC, we find that the World Bank had fixed several conditions before releasing particular tranche under SAP. The fixation of the tranche conditions and subsequent compliance of those conditions by GOB imply that the reform is not owned by the GOB. But, for successful reform, the role of government cannot be played by the Bank. Not only the ownership by the government, but also public consensus or majority public acceptance is required. However, in our country, the stakeholders of the reform process are not found to be aware about the reform measures and their anticipated outcome.

The analysis of the backdrop of FSAC and FSRP TA shows that the financial sector was in distress in all fronts: by failing to maintain the philosophy of market economy, where market forces ought to be the pivotal elements in determining the interrelationship between the economic agents, financial repression was massive. Prudential regulations were not enough and not working at all even to maintain minimum financial discipline. Financial institutions were in chaos. Furthermore, the lack of and loopholes in the legal framework accelerated the indiscipline. The major problem was 'from where to start", because everything was felt as immediate necessity and seemed required immediate action. Another major problem was to fix sequence of reform. As a whole, initiative of reforming financial sector was justified.

But sort of reform agenda along with its sequence was not appropriate as was required by Bangladesh financial sector.

If we observe closely the objectives and specific measures conditioned (prior to release of particular tranche of credit) by the FSAC, we can trace the thread of anti-state paradigm, where government intervention was found as main culprit of the problems. The policy measures like interest rate decontrol, withdrawal of interest rate subsidies, abolishing directed credit are the elements of that essence. The state ownership of banks also was found as major element of market distortion.

Therefore, in the reform agenda more emphasis was placed on economic deregulations rather than broadening of prudential regulation and supervision. The experience of many other countries shows that wide economic deregulation in the presence (or absence) of weak prudential enforcement create moral hazard problems on the part of the banks already having a lot of problems and thus further deteriorates their overall financial health, instead of improving. The same result has also been experienced in Bangladesh during post-reform period. The incorrect sequencing of reform measures as adopted in Bangladesh has been recognized by PAR of the Bank, when it said, "for fundamental financial sector reform, the sequence of reforms is critical for the overall success of the reform effort and to avoid detrimental side effects. Interest rate liberalization with a banking structure characterized by oligopoly, public sector ownership, inadequate central bank supervision and a poorly functioning debt recovery system will not necessarily improve resource allocation or the efficiency of financial intermediation. As was shown, real interest rates simply rose as financially weak banks sought to cover higher costs of provisioning for past bad lending decisions. It would have been more appropriate in Bangladesh to introduce measures to deal with the "debt default culture" and the management of the NCBs, prior to a more general interest rate liberalization.

The final report on FSRP TA also states that without introducing efforts to tackle the structural weakness of the banking sector, such as its bad debt and their source and the lack of adequate competition, interest rate reform efforts alone are not sufficient to address banking problem (P-8). The report also recognizes that non-performing loans, which in turn have an impact on lending rates and capital adequacy, are one problem that the FSRP was unable to ameliorate(p-2).The Capital adequacy and other regulatory requirements have generally not been enforced nor have changes in the interest rate flexibility created the kind of competition desirable among NCBs and PCBs. Indeed the reforms in interest rate may have contributed to a decline in the financial viability of the PCBs as higher permissible lending rates and related factors may have contributed to more risky lending practices.

It was expected that the reform measures like interest rate deregulation, discontinuation of directed credit and refinance facility, allowing a sizable number of PCBs and rationalizations of branches of NCBs would generate competition in the banking sector and ultimately improve the efficiency in allocation of resources. At the same time, a number of prudential and legal reform measures were undertaken like classification and provisioning of loans, minimum capital requirements, prevention of insider lender, enactment of MLC Act and Bankruptcy Act, amendment of BCA etc. for bringing back safety, soundness and discipline in the banking system. The safety and soundness measures were expected to ensure financial stability and thus contribute towards competitiveness and sustainable improvement in resource allocation. But, we have already shown that neither competitiveness nor resource allocation improved in the banking system of Bangladesh. The failure in this regard should be discussed both from supply side as well as demand side. The supply side problems such as overemphasis on economic deregulations, ignorance to prudential requirements specially enforcement aspects, ineffective legal system, lack of commitment on the part of government etc. have already been mentioned. To look into the demand constraints, our primary investigation shows that more than 50 percent stakeholders (borrowers) belonging to rural and SME sector do not have any access to formal credit. Again, a substantial portion of borrowers, who have access to credit, have access in "restricted" sense. The major barrier of access to credit as identified by the borrowers are : bribe, time consuming and clumsy procedure, lack of collateral, inability to fulfill loan conditions, high cost etc. From the point of view of practicing and policy level bankers, high risk, high transaction cost, outside interference, quality of collateral, ineffective legal framework for debt recovery, institutional constraints, complicated procedure etc. have been cited as major barriers of access to credit. Unfortunately, SAP financial reform measures were not directed towards addressing the above problems. Instead, it was thought that removal of interest and portfolio control would bring competition and improvement in allocation of resources. Because of this mismatch between demand side constraints and supply response (in the sense of implementing certain financial reform measures), the objective of FSAC/SAP financial reforms could not be achieved. However, it does not necessarily mean that re-imposition of interest rate control and directed credit would ensure efficient allocation of resources. Being forced/directed to achieve a higher level of disbursement does not indicate allocative efficiency. Removal of above mentioned barriers faced by the stakeholders (borrowers as well as bankers), in addition to interest and portfolio decontrol, would ensure sustainable improvement in allocation of resources by the banks.

After the expiry of FSRP TA in 1996, the GOB formed one Banking Reform Committee to evaluate the situations arising in the banking sector and place recommendations to GOB in regard to improve debt recovery environment of banks, strengthening supervisory capacity of the BB, increasing income and reducing expenditure, and improving the personnel quality of the banks (BRC Report, Preface). In May 1997, a Commercial Bank Restructuring Project (CBRP) funded by the World Bank (WB) has also been undertaken to take stock of progress on key issues and identify urgent actions that need to be taken for the development of commercial banks in Bangladesh. By this time two (2) World Bank Mission visited Bangladesh, one in May 1997 and the other in November 1997 and made a number of recommendations to the government, based mostly on the then BRC's on-going work. The Mission suggested a "paradigm shift" for the banking sector of Bangladesh and proposed following programs and actions: an aggressive institutional renewal program for Bangladesh Bank, fundamental reforms of NCBs, strengthening of the legal process and institutions for expediting recovery of debt, better internal governance both in NCBs and PCBs, compliance with capital standards, penalties for insider and imprudent lending, announcement of banking policy statement, etc.

Since its formation in October 1996, the BRC submitted a number of reports alongwith recommendations on various issues like amendment of Bangladesh Bank Order, 1972 to give Bangladesh Bank legal autonomy over its affairs, reforms of supervision system of Bangladesh Bank to bring back financial discipline, reforms of Bangladesh Banks (nationalization) order, 1972 to give autonomy to NCBs' Boards so that they can run NCBs on commercial consideration, Deposit Insurance Scheme to protect depositors interest, amendments to Bank Companies Act, 1991 to effectively handle problem banks, precluding crony (insider/connected) lending and ensuring credit discipline and so on. Finally, in December, 1999, BRC submitted its detail report combining the earlier individual reports. Now, we try to focus in the following on some of the well deserved aspects of BRC/CBRP recommendations with a view to discern future policy directions.

1. Supervisory and regulatory framework: BRC considers weak supervisory and regulatory framework as largely responsible for existing banking problems. The committee is of the opinion that without ensuring the enforcement of regulatory requirements, GOB should not have allowed to establish PCBs at the instance of donor agencies. On the other hand, NCBs cannot be brought under effective control of the BB. Therefore, BRC/CBRP has given highest importance on supervisory and regulatory restructuring for ensuring a strong system of enforceable supervision on banks. In addition to BB autonomy, BRC emphasizes on coordination among different departments (of Bangladesh Bank) engaged in bank examination, coordination between on and off-site supervision, rationalization of small branches and good banks examination, formulation of action plan for implementation of examination findings, stopping of approval and rescheduling of large loans (by BRPD), strengthening of Problem Bank Unit and to convert it into a Problem Bank Division, enforcement of MOU on problem banks, creation of a separate special Investigation Division, formation of an expert group under Bank Supervision Committee to suggest amendments time to time and posting of qualified bank examiners and imparting training to them.

For ensuring a sound and safe banking system, the question of BB autonomy cannot be bypassed. In this regard, the BRC has also proposed not to interfere with the affairs of Bangladesh Bank Board and to set a clear-cut guideline for deficit financing on the part of the government from Bangladesh Bank. The necessary amendments for the above are required to be made in Bangladesh Bank Order, 1972. Since supervision and examination of the banks are vested with Bangladesh Bank, therefore, it should also be entrusted with the handling of "entry policy" of new banks, instead of by an MOF-appointed committee. The BRC has proposed to ensure accountability of Bangladesh Bank by way of keeping informed the government and general public through publication of its (Bangladesh Bank) quarterly policies in regard to monetary management, exchange rate policies and supervision of banks and non-bank financial institutions. The Governor of Bangladesh Bank shall also brief from time to time, the Prime Minister and Finance Minister on the state of the economy with special reference to money supply, growth of credit, balance of payment, price movements etc.

While fully agreeing with the BRC notion of Bangladesh Bank autonomy in regard to bank supervision and all other aspects, we should not be forgetful about breaking the dilemma of subordination of regulators (Bangladesh Bank) to owners (Government owning NCBs). When regulator is subordinate to owner, in that case it is very difficult on the part of regulators to enforce regulations on the owners. In one Top Management Conference on Contemporary Banking Issues, bankers unanimously voice to make the post of Governor, a constitutional one.

The efficiency and skills of the personnel of the BB are an important determinant of vesting and sustaining autonomy on the part of the BB. The BRC has observed that the existing personnel policy of the BB has failed to create an appropriate personnel structure suitable for running a modern central bank. The BRC has suggested a number of important measures for improving human resource quality of Bangladesh Bank which are given below: retrenchment and rationalization of Bangladesh Bank staff, complete prohibition of CBA, drastic change in "direct-promotee" composition in the structure of officer, preference of merit and qualification (to seniority) in case of promotions, appropriate training and incentive packages for the officer, formation of a human resource development (HRD) department at Bangladesh Bank etc.

The above measures for improving personnel quality of the BB are not questionable, but their implementability are really doubtful. These require strong government and political support and cooperation of all stakeholders. In the existing political environment of Bangladesh, a strong political support is very much unlikely.

The BRC also calls for coordination among different departments engaged in supervision, rationalization of examination work and formulation of an action plan for implementing examination findings. In a deregulated financial environment, the responsibility of financial supervisors is increased manifold. In order to face that challenge, BRC calls for adopting above measures. It is really doubtful whether only coordination and rationalization would be able to bear the increased burden of supervision. D'Souza (2000) advocated one concept of "structured supervision" in order to reduce the heavy reliance on supervisory authority and at the same time without compromising the quality of supervision. In this form of structured supervision banks with high CAMEL ratings or capital levels may be subjected to minimum supervisory action and those below some minimum CAMEL ratings or capital levels may be subjected to rigorous supervision or intervention, if required. The framework may have a range indicating banks with strong financial position and those with weak ones.

In order to strengthen banking supervision, the BB has formed one Bank Supervision Committee. The Committee usually meets once in a month (BB Annual Report, 1998-99, p.32). In India, one independent Board for Financial Supervision (BFS), which acts as the supervisory authority for financial supervision, has been formed under the aegis of RBI. The main supervisory issues, which are being addressed by the BFS are: on and off-site surveillance system for banks, prudential norms of BFIs and NBFIs, strengthening internal control and MIS of the banks.

Handling of problem banks by the BB is one of the most thorny issues at this moment. It has been argued that not only "sheer negligence" on the part of the problem banks but also "regulatory forbearance" on the part of the BB are responsible for the continuing problem of the problem banks. The flexible attitude of BB is because of the fear that any stern action like closing down or liquidation will have adverse impact on the depositors. On the other hand, the "fear" of the BB is being capitalized by the problem banks owners and management (that the BB can not or will not take any stern action) for which their financial health are not improving. Not only that, this attitude of the BB is rather contagioaning other good banks for engaging in corrupt/unlawful activities.

By any standard, all the NCBs and DFIs are problem banks. But these banks are not considered as problem banks by the BB, which again indicates the lack of "effective" control by the BB on those banks. However, in view of further deterioration of NCBs financial health, the BB recently formed one NCB monitoring cell.

The BRC has suggested according to the existing legal framework either to cancel the Boards of those problem banks at least for two years, which are to be replaced by the BB appointed directors for running the affairs of Problem Banks ; or to take-over all those Problem Banks by Bangladesh Bank. In addition to above, BRC also provides other alternatives such as: prohibition of providing large, long-term and risky loans, restriction of taking new deposit or opening of new branch, imposing high CRR on new deposits, removal of Chief Executive, appointing Bangladesh Bank nominated director in the Boards of Problem Banks, etc.

The practice of handling Problem Banks on the part of the regulators of some other countries take the form of automatic prohibition of undertaking certain transactions (by the Problem Banks) and submission of a plan (along with a time-schedule) to the regulators for overcoming their problems (namely insolvency, provisioning shortfall etc.). In order to handle the increasing as well as sensitive affairs of problem banks, the suggestion of BRC of raising the status of existing Problem Bank unit to a Problem Bank Division is noteworthy. The birth of problem banks can be best checked at the entry level, through adoption of rigorous and impartial screening mechanism. From that point of view, BRC's suggestion of transferring the authority of approving new banks from MOF to BB is appreciable, provided BB enforces impartial and rigorous screening process complying all financial, prudential, ethical and professional requirements of licensing a new bank. At the same time , a well designed exit policy from the banking system should be formulated and enforced also by BB , which will prevent the banks from taking excessive risk or being indifferent for complying prudential norms. However , in some countries (like Indonesia, Thailand and Malaysia) one financial sector restructuring agency has been formed to handle the problems of problems banks for bringing back financial discipline and ensuring confidence of depositors and investors. Considering huge tasks of handling all these problem infested NCBs and PCBs, GOB should also think of establishing such an agency for Bangladesh banking system, which would be exclusively dealing with problem banks and thus helps BB to strengthen its regulatory and supervisory framework for the rest of the banking system.

One of the important functions of a modern central bank for the matter of discharging its supervisory duties is to protect the interest of depositors. One way of doing it is the institution of deposit insurance scheme. Such a scheme has been instituted by the government in 1984 through the enactment of an ordinance, 1984. The BRC in its report has suggested some amendments in the present Bank Deposit Insurance Ordinance, 1984 which comprises: increase of yearly premium from Tk. 0.05 to Tk. 0.08 and formation of a 5-member "Board of Trustee" with the Governor, Bangladesh Bank as Chairman for profitably investing the fund in approved securities. The cross-country experiences show that state guarantee on bank deposits, in a situation of weak bank supervision and enforcement and absence of concrete exit policy, would create massive problems of moral hazard on the part of bank managements and owners and laxity (by not looking at the affairs of banks) on the part of bank depositors. Therefore, we should rather put all-out effort for installing a very strong and effective supervisory, regulatory and legal system as well as enforcing and ensuring good governance on the part of bank managements. That way we can better ensure protection to depositors interests. Even if we go by the idea of deposit insurance, in that case there are two methods of limiting the moral hazard practice of the bank managements: one by charging "risk-based premium" and the other by arranging "co-insurance", covering only a part of deposits by deposit insurance.

2. Restructuring NCBs: By any standard measure, the NCBs of Bangladesh are insolvent for a long time. The SAP financial sector reform measures could not break-through the insolvency problems of the NCBs. The question of overcoming insolvency on the part of NCBs is directly related with the improvement of the quality of loan portfolio, supported by the effective internal control and management, professional skills of the officers for credit management as well as overall asset-liability management, cost control, effective MIS, congenial environment (free from political and CBA influence), etc.

However , for the matter of restructuring NCBs ,the BRC (and CBRP) places importance on autonomy to the NCB boards, aggressive branch and staff rationalization programs, improvement of loan management including loan workout skills, automation program, solving union problems, revamping compensation package (with sound personnel policy and human resource development), formulation of recovery policy, formulation of an Asset Management Company (for carving-out bad loans), appointment of recovery agent, financing large loans through syndication/consortium, increase of fee-based income, etc. The BRC is of the view that the directors of NCB boards cannot be an M.P. or an office bearer of a political party or a loan defaulter and would be nominated by the Banking Sector Management Section Committee (BSMSC). The boards are to be empowered with the formulation and approval of short and long-term realistic and risk adjusted business plans. Moreover, the boards are also proposed to formulate personnel, credit, fund management, and internal control policies.

The issue of giving autonomy to NCB boards is not questionable. But what is not clear in BRC's proposal is the accountability of the boards. Moreover, the cross-country experience shows that it is the operational management who used to formulate business/Asset-Liability plans, not the boards. The board is the approving authority. Moreover, the question of separation between management and board – an important requirement of a well run big business-is also not touched. For the matter of cleaning up the balance sheets of the NCBs, the proposals of formation of an Asset Management Company (AMC) and appointment of recovery agents have been put forward by the BRC. These are one sided from the point of view of "loss sharing " (only by the GOB as owner of AMC). Consequently, the borrowers (because of moral hazard problem) may not be willing to repay the bank money. Though this (loss allocation) is the most difficult part of restructuring, yet the exclusion of borrowers from bearing the cost of restructuring will not guarantee sustainable bank restructuring. Loan default in the case of Bangladesh banking is substantially of willful nature. Therefore, to break –through this willful loan default culture, the question of borrowers' involvement in the form of loss sharing should be considered seriously before the formation of AMC. In addition, NCBs may think of establishing loan work out/NPA management department, recovery branches and cells etc. for improvement in loan recovery situations.

The GOB should be very active and provide all sorts of support to eradicate the loan default problem of the country. In the mean time, the government has already declared that it would not politicize and interfere with the loan decision process of the banks and would handle the loan defaulters with strong attitude irrespective of their political affiliations. All concerned would expect that govt. will maintain its commitment. At the same time , govt. should try to absolve itself from the blame of being a loan-defaulter. Otherwise, govt. will not be able to contribute towards eradication of loan-default problem.

The BRC has also suggested to increase the base of non-fund/ fee based income on the part of NCBs. This is really a very good step , because it would not only help to increase solvency and profitability, but also release the pressure on increasing capital base. Not only the expanding of fee based income base of NCBs, they should also think of expansion and diversification of existing asset product base for the matter of maintaining and ensuring financial discipline. Nobody would disagree that in case of traditional cash mode of lending (by commercial banks), accountability on the part of borrowers' as well as lenders' recourse on borrowers are minimum. Therefore, they should think of introducing new asset products like leasing, consumer product financing, merchant banking, etc. which would not only diversify asset product base (and thus reduce credit risk of banks) but also would help to reduce loan default attitude of the borrowers and increase lenders' recourse, ultimately leading to ensuring financial discipline.

3. Strengthening of Legal Framework: In this regard, amendments to Money Loan Court Act, 1990 and Bank Companies Act, 1991, enactment of Bankruptcy Act, 1997 have been already mentioned. The BRC has also mentioned arranging training programs on basic accounting, banking and bankruptcy procedures for the judges of

the MLCs and BCs. For the matter of restraining connected lending, specially by PCB directors some new amendments have been proposed by the BRC , most important of which are: the directors who are to be removed earlier for being loan defaulter will not be reinstated before loan repayment; rescheduling of directors loan for more than two times without the permission of Bangladesh bank has to be prohibited ;and interest waiver not only for directors but also for other parties has also been suggested to be prohibited. The violations of provisions of Bank Company Act, 1991 in regard to interest waiver and providing loans to directors have been proposed to be adequately penalized by the BRC. Some sort to medium term measures have been suggested by CBRP for making improvement in the legal framework for debt recovery through amendments to existing laws and enactment of new laws. These include: overhauling of Negotiable Instruments Act, Transfer of Property Act, Evidence Act and enactment of new Money Loan Court Act, Debt Recovery Agencies Act and Financial Institutions (Security of Loans) Act, It has been observed that in addition to existing weakness of the legal system, cumbersome court procedures constitute another important factor for delaying debt recovery process. Therefore, for quick disposal of default loan cases, special tribunals having simplified procedure may be established.

The BRC has suggested to allow banks to open their own subsidiary for undertaking non-banking business. In line with developed countries' banking laws , some proposals have been made to be incorporated in the Bank Company Act, 1991 to facilitate BB in regard to takeover, merger etc. of existing problem banks. The penalty structure for non-compliance of the existing BCA-1991 provisions by the banks have also been suggested to be raised significantly.

The new proposals of BRC/CBRP have been proposed possibly to build strong disincentive in the legal system. Disincentives alone will not ensure financial discipline. Neither free-riding nor strong disincentive is desirable. Rather strong disincentives for non-performers should be matched with appropriate incentives for performers.

An overall impact study of the proposed recommendations of BRC (and CBRP) is not possible , because these are yet to be adopted by BB and GOB, however, in course of our discussion we tried to focus on the probable impacts of the different proposed recommendations and also put forward some alternative measures. At this moment, it can be reiterated that unlike the previous reform measures, especially of SAP/FSRP, the current BRC measures are not narrowly focused. However, the focus of BRC is not also completely broad based. Like the previous SAP/FSRP, BRC also did not include the DFIs, as if there is no problem with the DFIs (BKB, RAKUB, BSB, and BSRS). It is to be remembered that the problem of our financial sector is "systemic" in nature, therefore, it should be looked into very comprehensively not partially. Moreover, like FSAC / SAP measures, the BRC proposals also have not taken into cognizance the “demand constraints” and supply side problems (at the field level) in order to ensure better allocation of resources.

VIII. CONCLUSION

The principal hypothesis contains two major components to verify through the analysis:

1. Efficient allocation of resources in terms of access to credit
2. Market mediated equilibrium price for credit

The analysis shows that the FSAC/SAP failed to achieve efficient resource allocation in terms of access to credit by productive sectors. The credit allocation index (see table 6) deteriorated in the post reform period. In agriculture, credit allocation index steadily fell from 1987 to 1998, in 1987 the index was 0.677, whereas in 1998 it stood at 0.428. For SME the index fell more than twice for the period in question, from 0.859 in 1987 to 0.398 in 1998. From the survey of stakeholders perception we could not compare pre-reform and post-reform situation, but the prevailing situation regarding the access to credit by the priority sectors was derived as unsatisfactory. For the rural sector, 52.68 percent of stakeholders have no access at all to credit (either formal or informal). Only 42.25 percent of stakeholders enjoy unrestricted access to credit. It is noteworthy here, in the rural economy MFI emerged as one of the major sources of credit encompassing 33.16 percent of the whole rural credit market. Even considering the MFIs' contribution, more than half of the rural people is beyond the credit market. For the SME, 50.53 percent of the stakeholders do not have any access to the credit. Only 35.79 percent of the stakeholders enjoy unrestricted access to credit. Thus, both from empirical analysis and analysis of the stakeholders' perception, efficient allocation of resources through improved access to credit was not achieved following the FSAC/ SAP.

The FSAC/SAP failed to achieve also competitiveness in the financial market following the interest rate deregulation. In this regard, the analysis of the authors coincides with the confession of the PAR of the World Bank that the underlying assumption was wrong regarding the market structure, which resulted in increase in real lending rate rather than reduction of interest rate through competition (see section VI.I.I).

In line with the broad areas of investigation, we can summarize the policy outcomes as follows:

1. The expectation form the interest rate deregulation was that it would increase competitiveness. The SAPRI analysis shows using the interest rate spread criteria that the objective was not achieved, competitiveness is still absent in the financial market of Bangladesh. The analysis found that government led distortion, NPA, collusive behavior, misconceived price strategies are main reasons of failure to reach the desired outcome. It would not be exaggerating to say that the interest rate deregulation was a premature step.

2. For controlling lending risk and improving management efficiency, FSAC took a lot of measures. From the view point of implementation the reform measures were implemented satisfactorily, but from the view point of desired outcome the result is not very optimistic, the financial discipline is still in disarray. By the newly implemented loan classification, provisioning and capital adequacy standard the financial health is far from the acceptable range. It may be a success that now the weaknesses of the banking sector are completely exposed, which may create a pressure to quicken the reform process. The management efficiency in the NCBs could not be achieved despite implementation of new operational and management/ loan quality assessment tools. The reasons are: sheer negligence of the banks, supervisory and regulatory forbearance, ineffective legal system, lack of leadership, expertise and motivation, mismatch between loan

classification requirement and improvement in loan screening and monitoring skill, mismatch between economic deregulation and enforcement of prudential regulations.

3. The objective of restructuring rural banking was to ensure the viability of rural banking. After the reform, rural branching policy was changed, PCBs virtually did not open new branch in rural area and NCBs tried to consolidate their branch network. BKB was entrusted with all losing rural branches of DNCBs (nationalization of losses). The net credit flow was negative in many post reform years. Poor recovery, withdrawal of refinance and interest rate band aggravate the negative flow. The other reasons of inefficient rural banking are: faulty borrower selection, over-staff, inefficient staff, complex procedure, low volume of business, wrong marketing and institutional policy.

4. It was expected that the policy reform will encourage the PCBs to create competition. Although the market share of the NCBs was decreased due to intervention of PCBs and new FCBs , but the dominance of the NCBs is still in place. Moreover, the PCBs failed to improve resource allocation among the productive sectors.

5. The most severe problem of the Bangladesh financial system is NPA. The FSAC correctly identified the policy agenda. But the outcome is not desirable, NPA did not reduce. The reasons found in the study are: ineffective publication of default list, slow MLC, influence of vested interest group, collusion between political parties and defaulters and overall lawlessness.

A credible future policy design should aim at rectifying and preventing the recurrence of unacceptable trends and at the same time ensuring sustainable financial sector development. In order to achieve that goal **first and foremost requirement is ensuring an enabling environment**, which require macroeconomic stability, political commitment and non-interference by the GOB and vested interest groups.

As it is observed, though macroeconomic environment has been somewhat favorable, yet political support (especially in the sense of government ownership of reform) for effective implementation of reform measures has been absent. The fixation of tranche conditions implies that the reform was owned by the Bank, not by Bangladesh government. But, for successful reform, the Bank can not play the role of government. The stakeholders of the reforms were not also aware about the reform measures and their anticipated outcomes. The very inception of SAPRI confirms the argument that reform process should not only be owned by the government, but also by the stakeholders. Without government ownership and public consensus, a reform must fail. In Bangladesh, the lack of commitment on the part of the government is not only because of ownership conflict (with the WB and donors) but also because of the peculiar characteristics of our power structure. The democratic culture is weak in Bangladesh and its government is hostage to different kinds of vested interest groups. The survival in power on the part of the government is largely dependent on how well they can satisfy those groups. It has also been observed that sometimes government becomes uncommitted to those reform measures, as the reform issues conflict with the interest of the vested groups. This lack of spirit in the implementation of reform measures becomes a major cause of unacceptable outcome of the financial reform measures.

At the same time, we have found that the GOB has also been responsible for interest rate distortion, deteriorating loan recovery environment by announcing loan forgiveness, directing banks to provide loans to particular sector or customers, becoming itself a loan defaulter, etc. These sorts of interference by the GOB should be stopped for ensuring enabling environment for successful implementation of financial sector reforms.

Secondly, the policy framework should be comprehensive (systemic) and should also incorporate both demand and supply aspects. The policy framework of SAP was not comprehensive in the sense that it did not incorporate all banks, DFIs were missing. Even BRC recommendations also did not cover DFIs issues. In fact, the problem of Bangladesh banking system is systemic, though commercial banking occupies significantly large part, yet deliberately dropping a part (DFIs), though small, would not help in the creation of a sustainable, sound and robust banking system. Another important drawback of the reform framework that it completely ignored the demand constraints, especially for improving resource allocation. The demand side problems for efficient resource allocation (to productive sectors) such as collateral requirement, procedural complexity, high sunk cost, inability to fulfill loan conditions, etc must be adequately addressed in the future reform policy. In fact, in both the directed lending and deregulated regimes, the demand side factors were not considered, consequently resource allocation suffered.

Even the supply aspects were also not adequately covered in the supply-led SAP measures, specially the concerns of "implementation stakeholders" were largely by-passed. Their expertise in handling and implementing the reform measures, particularly the loan screening and monitoring capacity, their attitudes towards accommodating market based actions, their accountability and incentives structures etc. should be seriously considered in future policy framework. Another very important supply side problem is the undue influence of CBA and employee union leaders in banking decision making. BRC/CBRP have considered this aspect very seriously. One GOB formed committee also submitted one report on banking sector CBA, which deserves special attention of the policy makers. Therefore from the supply side, not only efficient policy formulation, but also efficient policy implementation is required to be ensured in future policy framework, which would led to achieve overall management efficiency.

Thirdly, the policy framework should be sequentially arranged and implemented. The sequencing of reform measures is really very important. In many countries, because of sequential problems, appropriate outcome of financial sector reform measures could not be achieved. In Bangladesh, we have done well on the arithmetical side, especially, in the context of adopting a number of prudential norms such as loan classification and provisioning, minimum capital requirements etc. and also raising them at internationally accepted level but we have still a long way to go in terms of enforcing all those prudential norms. Without ensuring enforcement of prudential regulations and also lenders' recourse on borrowers (because of ineffective legal system), we should not have gone for wide ranging economic deregulations, which created moral hazard practices on the part of different stakeholders namely bank management, owners, unscrupulous borrowers etc. The sequential mismatch was also observed between easy entry and lack of exit policy and tightening of loan classification norm and absence of loan screening skill. In the context of removing the mismatches or bring back the sequence of reforms in order, we do not suggest withdrawal or suspension of economic deregulation till the strict enforcement of prudential regulations is in place, rather we advocate to quicken the process of enforcing the prudential norms, without disturbing the economic deregulation so far implemented. However, In order to ensure strict enforcement of regulatory, legal and prudential norms, the legal and supervisory system of Bangladesh financial system cannot anymore afford to show forbearance to the non-compliant banks as well as borrowers, rather they should be extra careful as all the key players may not play their due role towards creating and maintaining a sound financial/ banking system. In this regard Greuming and Brotanovic (1999) argue, "to the extent that any key player (say, customers) does not perform its function and responsibility in the risk management chain, other key players have to compensate for the gap created by enhancing their own role. More often than not, it is the bank supervisor that has to step into the vacuum created by the failure of certain players' (p. 31). This argument is especially true for Bangladesh, in view of prevailing indifferent attitude and accountability of the bank officials and low level of conscious on the part of customers. We can also quote here Jalan (2000): "bank depositors have no other security except that banks are well regulated".

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Appendix Tables

Table – A1. Reorganization of Commercial Banks of Bangladesh in 1972

Existing Bank	Reorganized Bank
The National Bank of Pakistan The Bank of Bhawalpur Ltd.	Sonali Bank
The Premier Bank Ltd. The Habib Bank Ltd. The Commerce Bank Ltd.	Agrani Bank
The United Bank Ltd. The Union Bank Ltd.	Janata Bank
The Muslim Commercial Bank Ltd. The Standard Bank Ltd.	Rupali Bank
The Australasia Bank Ltd. The Eastern Mercantile Bank Ltd.	Pubali Bank
The Eastern Banking Corporation Ltd.	Uttara Bank
Agricultural Development Bank of Pakistan	Bangladesh Krishi Bank
Industrial Development Bank of Pakistan	Bangladesh Shilpa Bank
Pakistan Industrial Credit and Investment Corporation	Bangladesh Shilpa Rin Sangstha

Source: Report of NCMBC, P.13, 1986.

Table A-2. List of Commercial Banks in Bangladesh, Updated till 1999.

Commercial Bank	Foreign Bank	Specialized Bank	Development Bank
Sonali Bank	Credit Agricole Indosuez	Bangladesh Krishi Bank	Bangladesh Shilpa Bank
Janata Bank	ANZ Grindlays Bank Plc.	Karmashangstan Bank	Bangladesh Shilpa Rin Sangstha
Agrani Bank	American Express Bank Ltd.	Samabaya Bank Ltd.	
Rupali Bank	Bangladesh Standard Chartered Bank Ltd.	Ansar-VDP Bank Ltd.	
Pubali Bank Ltd.	Citibank N.A.	Grameen Bank	
Uttara Bank Ltd.	State Bank of India		
Arab Bangladesh Bank Ltd.	Habib Bank Ltd.		
National Bank Ltd.	Muslim Commercial Bank Ltd.		
United Commercial Bank Ltd.	National Bank of Pakistan		
IFIC Bank Ltd.	Hongkong Sanghai		
Bank of Small Industries &	Banking Corporation		
Commerce Bangladesh Ltd.	Faisal Islami Bank of Bahrain		
Bangladesh Commerce Bank Ltd.			
The City Bank Ltd.			
Al-Baraka Bank Ltd.			
Eastern Bank Ltd.			
National Credit & Commerce Bank Ltd.			
Southeast Bank Ltd.			
Dhaka Bank Ltd.			
Prime Bank Ltd.			
Dutch-Bangla Bank Ltd.			
Al-Arafah Islami Bank Ltd.			
First Security Bank Ltd.			
Standard Bank ltd.			
Primier Bank Ltd.			
EXIM Bank Bangladesh			
One Bank Ltd.			
Mercantile Bank Ltd.			
Trust Bank Ltd.			
Bank Asia			

Source: Bangladesh Bank

Table –A3. Financial Sector Adjustment Credit – Matrix of Policy Actions

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
A. Macro-Financial Policy Issues			
I. Deregulate deposit and lending interest rates	Lending interest rate policy implemented based on calculated "shadow market rates" for each lending category with a 3-5 percent band within which banks may set their lending rates.	Implement new lending interest rate policy in accordance with the agreed methodology with semi-annual reviews and adjustments in structure as needed.	This has been implemented.
	Floor and ceiling established within which scheduled banks may set term deposit and saving rates.	Implement new deposit interest rate policy in accordance with the agreed methodology with semi-annual reviews and adjustments in structure as needed.	This has been implemented.
	NCB lending rates raised to at least shadow market rates for most categories in the initial adjustment of rates.	Raise BSB long-term interest rates for medium and large scale industry to at least shadow market rates.	This has been done
	Technical unit established in BB with responsibility for interest rate and monetary program in analysis and recommendations.	Amend new interest rate policy to allow banks to change interest rates at least monthly.	This has been done. Interest rates have been gradually liberalized. At present, Interest rates on lending are freely determined by the banks themselves, except export sector (sector of national priority), for which banks can determine and change their own rates within the prescribed bands. The floor limits on deposits have recently been abolished. Overall interest rates are thus Overwhelmingly determined by market forces.

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
A. Macro-Financial Policy Issues (Continued)			
II. Make costs of subsidized interest rates transparent and reimburse costs to banks.	Remaining administered subsidized lending rates have been made transparent and GOB has agreed to reimburse cost of subsidy to banks.	Reimburse banks for cost of interest rate subsidies due to some administered rates below shadow market rates from January 1, 1990.	At present subsidy @3.0% is allowed on term lending to small and cottage industries only. GOB is regularly reimbursing eligible subsidies to banks on a quarterly basis. MOF to provide latest position of reimbursements. Thus, subsidies were made transparent.
III. Protect banks on large loans to poorly performing parastatals made at Government request.	Government had taken steps to reschedule BJC and BJMC advances and to protect banks against non-payment.	Require banks to report regularly on loans and debt servicing status for their public sector borrowers.	This continues as part of the normal reporting requirements.
IV. Replace direct credit ceilings with indirect monetary instruments and open market operations.	IMF has sent an advisory mission to assist in setting up procedures for implementing monetary programming and policy. Existing refinance program replaced with a general rediscount facility at bank rate	Strengthen BB capacity and procedures for monetary programming, policy formulation and regular review of interest rates.	Improvements in Monetary programming capability is continuing.

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
	for commercial banks.		
	BB Act amended to give Central Bank legal powers to issue debt instruments.	BB debt instruments to be issued at market determined yields; a tendering mechanism should be developed.	BB is issuing its own instrument to banks at market determined yields through tendering mechanism.
	Credit ceilings have been abolished.	Implement the 1990/91-1992/93 PFP program so a sound macroeconomic framework is in place.	The 1990/91-1992/93 PFP implemented successfully and a satisfactory macroeconomic framework achieved with lower inflation rate, improvement in BOP and increase in revenue ratio-GDP ratio.
B. **Strengthening Central Bank Supervision**			
Central Bank	Central Bank has combined its four supervision functions under two departments, almost doubled the number of bank inspection personnel, and extended their normal rotation period to five years.	Established bank supervision as a continuous process based on submitted reports. Inspection and follow-up of identified problems.	Substantial number of measures were undertaken to improve BB's supervisory function. Following introduction of the system of report-based supervision as a continuous process and reorganization of BB's inspection and supervision departments, a series of measures have been taken for skill development and strengthening of supervisory activities. A large number of inspection and supervision personnel have been imparted training. The reporting formats have been rationalized and updated with the technical assistance of an IMF expert and consultants under the FSRP-TA project. An upto date manual has been prepared for on-site inspection which incorporates, interalia, various ratio analyses and CAMEL rating techniques. New rules of loan

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
B. Strengthening Central Bank Supervision (Cont'd)			classification and provisioning were phase-wise implemented, which made conforming to international standard. Strict supervision and verification have been enforced to ensure correct classification and provisioning as per the new rules. As a result classification and provisioning errors have come down significantly. A "Problem Bank Unit" has been opened in BB for identifying problem banks on the basis of CAMEL rating, getting Memorandum of Agreements (MOAs) from the problem banks for solution of the problems and putting a BB observer in the Board of Directors of each problem bank. Supervisory activities of BB have thus been strengthened. For ensuring optimum use of trained personnel, the normal rotation period of 5 years are being adhered to, except in very unavoidable circumstances.
	IMF TA arranged to assist with establishing bank supervision as a continuous process and rationalizing and streamlining bank reporting requirements.	Rationalize and streamline bank reporting requirements.	The existing bank reporting requirements are still inadequate in the context of the existing stage of development of the banking sector.
	New stem of loan classification established which shifts primary responsibility to the banks.		
	New accounting policy requirements established for		

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
	provisions and suspension of interest.		
B. Strengthening Central Bank Supervision (Cont'd)		Establish and staff supervision unit for non-bank financial institutions.	A full-fledged department has been established in BB with adequate number of staff for supervision of the activities of non-bank financial institutions.
		Design and conduct major training effort for Central Bank supervision and inspection personnel.	Training arrangements for BB supervision and inspection personnel had been done. Bangladesh Bank Training Academy conducted a number of courses of different durations on techniques of bank super-vision and inspection as well as loan classification and provisioning procedures during 1992-1996, in which a total of 1819 BB officials took part.
	New BB credit information unit established within the supervision function.	Design credit unit input as part of regular bank reporting. Provide on-line credit reports to banks.	Credit Information Bureau continues to operate although on-line facilities has not yet been put in place.
	BB Audit Committee established to set criteria for bank external audits and review audit reports.	Establish criteria for bank external audits and review of audit reports.	NCB external audit and review of audit reports continues to be guided in accordance with standard criteria set for the purpose.
C. Strengthen the National Commercial Banks			
1. Recapitalize the		Reclassify December 1989 portfolio based	This has been done.

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
NCBs.		on new BB loan classification requirements.	
C. Strengthen the National Commercial Banks (NCBs) (Cont'd)		Make new provisions and suspend interest in accord with new accounting policies.	This has been done.
		Issue special Government bond to recapitalize each NCB to a level equal to at least 5 percent of deposits after provisions have been taken. Maintain NCB capital at 5 percent of deposits.	This has been done. This has been done. Moreover, in January, 1996 BB introduced a new system of asset based capital adequacy measurement in line with BIS standards replacing the previous liabilities based capital adequacy requirement. According to the new system, banks are required to maintain minimum 8% capital adequacy ratio to their total risk weighted assets. Capital position of banks as per the new system are being reviewed.
II. Strengthen NCB management and accounting system.	USAID technical assistance for NCB TA to strengthen management, accounting and training progress was approved.	Sign USAID Project Agreement.	USAID financed TA component of FSRP-TA project was completed in June, 1996.
		Technical Assistance in place.	

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
		Establish Tripartite Review process for TA.	
C. Strengthen the National Commercial Banks (NCBs) (Cont'd)		Make satisfactory progress on implementing NCB TA and computerization.	This has been done.
	One NCB has reconciled its inter-branch accounts and the others are working on it. All NCBs have made progress in identifying unmatched items.	Reconcile inter-branch and write off or fully provide for unmatched accounts and uncollectible items, and eliminate suspense accounts more than six months old in 1989 accounts.	This has been done.
	NCB's Boards of Directors have been permitted to decide on personnel policy, including rotation of NCB staff.		
	GOB has adopted policy that NCB managing directors will normally be appointed for periods of more than three years, subject to satisfactory performance.		Normally NCB managing directors are appointed on the basis of senioritis and experience. But appointment for a three years term could not be strictly adhered to due to retirement and other administrative reasons.
		Develop satisfactory NCB capacity to set interest rates within the scope allowed.	Interest rates are currently being set by the NCBs themselves.
	A GOB-established task force	Implement selected NCB management	

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
	has submitted a report to Cabinet with recommendations for additional NCB management reforms.	reforms approved by Government (to be identified after Cabinet decisions on recommendations).	
III. Improve NCB debt recovery.	NCBs have initiated special programs for improving debt collection.	Identify large borrowers requiring restructuring.	Banks identified a number of borrowers for gradual restructuring. The process incomplete.
	Monitorable targets have been established for a collections and resolution of legal cases for 100 largest defaulters and for new loans approved by NCB head offices.	GOB will take necessary steps to cause NCBs to achieve satisfactory collection performance against monitorable targets for 100 largest defaulters and on new loans over Tk 1 million approved by NCB head offices. Collections will be closely monitored.	
		Require the banks not lend to defaulters identified by credit unit without letters of no objection form the lender who holds the defaulted loan.	Banks are required to obtain clearance from the Credit Information Bureau (CIB) in sanctioning loans of Tk. 50 lacs and above.
D. Miscellaneous Objectives			
	Allow NCBs to select legal counsel of their choosing form panels for debt recovery cases.	Status unknown	
I. Strengthen the legal framework for debt	Parliament has enacted a new Financial Loan Courts Act and GOB has issued satisfactory	Review with IDA implementation of Law Court Law and agree on recommended actions, if any, to improve implementation	Financial Loan Courts Act 1991 has been enacted and subsequent amendments made providing for establishment of more financial loan courts,

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
recovery.	rules and regulations for implementing it.	of the law.	appointment of more judges and vesting more powers with the courts for effective recovery of defaulted loans.
D. Miscellaneous Objectives (Continued)	GOB has issued directive establishing loan recovery courts in Dhaka, Chittagong and Khulna effective September 30, 1990, and calling for their adequate staffing.		
II. Revise regulations affecting banks	The Ministry of Law has cleared a new Banking Companies Ordinance.	Enact a satisfactory Banking Companies Ordinance.	The Bank Companies Act, 1991 has been enacted and subsequent amendments made to make it more effective.
		Delete references in national Industrial Policy-1986 which impose lending requirements on financial institutions for repayment schedules, terms, etc.	This has been done.
	BB has authorized public enterprises to place up to 40 percent of their deposits with private sector banks.		
		Set limits as percent of capital for private bank loans to individual borrowers and in aggregate to their directors.	This has been done. The Bank Companies Act, 1991 has been amended and necessary circulars issued by BB setting prudential limits on individual borrowers as well as to bank directors.
	GOB has amended income tax requirements to make Central		

Policy Objectives	**Pre-Board Actions**	**Further Actions Under Credit**	**Status Of Implementation**
	Bank required provisions and interest suspension tax deductible.		
D. Miscellaneous Objectives (Continued)	GOB has given banks freedom to set bank fees individually to allow increased competition.		
III. Strengthen capital markets.	GOB has established a Capital Market Development Committee with Ministry of Finance and private sector participation.	Implement committee recommendations with respect to adjusting underwriting fees and increasing flexibility in pricing new public issues.	Actions are being taken by SEC in this regard. SEC-Securities and Exchange Commission.

Source: World Bank. 1997. Performance Audit Report

Table –A4. BANK RATE & INTEREST RATE STRUCTRE OF THE BANKING SECTOR IN BANGLADESH

	Particulars		Jan 85 to 16.1.87	17. 1. 87 to 31.12.89	1.1.90 to 30.6.90	1.7.90 to 31.12.90	1.1.91 to 30.6.91	1.7.91 to 30.11.91	1.12.91 to 31.3.92	1.4.92 to 2.6.92	3.6.92 to 22.1.93	23.1.93 to 23.2.93	24.2.93 to 23.493
1	**A. Bank Rate**		10.75 from 1.7.87	10.75	9.75	9.75	9.75	9.75, 9.25 (w.e.f. 17.11.91)	9.75, 9.00 (w.e.f. 15.3.92)	9.00	8.50	8.00	7.00
2	**B. SBs' Interest Rates on Deposit**				4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
3	a. Cal Deposit												
4	b. Special Notice A/C	Special Notice A/C											
5	i) Withdrawable at 7 to 29 days		4.50	4.50									
6	ii) Withdrawable of 30 days or over		4.50	4.50									
7	c. Saving Ban A/C (Checking facilities)	Saving Bank A/C	8.5 for Urban & 10.5 for Rural	8.5 upto June 87, 9.00 from July 87, 10.5 for R upto June 87, 10.00 fro R from July 87	8.50 - 12.00	8.25 - 11.75	8.00 - 11.50	8.50 - 12.00	8.00 - 11.50	7.50	6.00	5.5 (min)	5.00
8	d. Savings Bank A/C (Without CF)		11.00 for Urban & 11.00 for Rural	11.00, 11.00 for R									
9	e. Fixed Deposit	Fixed Deposit			10.00 - 10.25	10.00 - 13.75	10.00 - 13.75	10.00 - 13.75	9.00 - 13.00	8.50	7.50	7.00	6.50
10	1. 3 months & over less than 6 months		12.00	12.00									
11	2. 2 months & over but less than 1 year		13.00	12.50									
12	3. 1 year & over but less than 2 years		14.00	13.25									
13	4. 2 years & over but less than 3 years		14.50	13.75									
14	5. 3 years and over		15.00	14.25									
15	**C. SBs' Lending Rates**			-									
16	a. Normal lending rate	1. Agriculture		16.00	16.00	16.00	16.00	12.00 - 16.00	11.00 - 15.00	11.00 - 15.00	11.00 - 15.00	11.00 - 15.00	11.00 - 15.00
17	b. Adv. for jute goods & others	2. Large & Mid .I. (T.L.)		-	13.00 - 17.00	12.50 - 16.50	12.50 - 16.00	12.00 - 17.00	11.00 - 16.00	*	*	*	*
18	c. Export credit other than jute, jute goods & tea	3. W. Capital Jute		-	9.00	9.00	9.00	9.00 - 11.00	8.50 - 11.00	*	*	*	*
19	d. Agriculture + Forcotsy + Fishing	4. W. Cap (Other than Jute)		12.00	12.00 - 15.00	12.00 - 15.00	12.00 - 15.00	12.00 - 15.00	10.00 - 14.00	*	*	*	*
20	e. For industry	5. Jute trading		14.50 10.0 wef 1.7.86	16.00	16.00	16.00	13.00 - 16.00	12.00 - 15.00	*	*	*	*
21	1. Large	6. J & J goods Exports		13.00	8.00 - 11.00	8.00 - 11.00	8.50 - 11.50	8.00 - 12.00	7.50 - 11.00	7.50 - 11.00	7.50 - 10.50	7.50 - 10.50	7.50 - 10.50
22	2. Small & cottage	7. Other Exports		12.00 9.00 wef 1..86 9.00	8.00 - 11.00	8.00 - 11.00	8.50 - 11.50	8.00 - 12.00	7.50 - 11.00	*	*	*	*
23	f. Industry of less dev. area	8. Other Comm Lending		13.00	18.00 (max)	18.00 (max)	18.50 (max)	13.50 - 18.50	12.00 - 17.00	*	*	*	*
24	g. Non-trade	9. Urban Housing		5.00	12.00 - 15.00	12.00 - 15.00	12.00 - 15.00	12.00 - 15.00	11.00 1400	-	-	-	-
25	h. loan for socio economic dev.	10. Special P											
26	i. Construction of houses in R.A.	i) Small In		16.00 - I Tk 1 Lac 18.00 ex Tk. 1 Lac	10.00	10.00	10.00	9.00 - 12.00	8.00 - 13.00	8.00 - 13.00	8.00 - 13.00	8.00 - 13.00	8.00 - 13.00
27	j. Adu for inter .... trading	ii) O.S.P		20.00	8.00 - 13.00	8.00 - 13.00	8.00 - 14.00	8.00 - 15.00	7.50 - 1400	*	*	*	*
28	k. Adu Ag. FDR	iii) Others		18.00 upto 23.3.87, 17.00 from 24.3.87	12.00 - 20.00	12.00 - 20.00	12.00 - 20.00	12.00 - 20.00	11.00 - 18.00	*	*	*	*
29	l. commercial Import												

Table –A4. BANK RATE & INTEREST RATE STRUCTURE OF THE BANKING SECTOR IN BANGLADESH (Concluded)

	24.4.93 to 17.9.93	18.9.93 to 2.3.94	3.3.94 o 24.4.94	25.4.94 to 9.9.95	10.9.95 o 6.10.95	7.10.95 to 31.01.96	1.2.96 to 30.10.96	31.10.96 to 18.2.96	19.2.96 to 18.5.97	19.5.97 to 23.11.97	24.11.97 to 28.8.99	29.8.99 to on wards	
1	6.50	6.00	5.50	5.50	5.75	6.00	6.50	7.00	7.00	7.50	8.00	7.00	
2	4.50	*	*	*	*	*	*	*	*	*			
3													
4													
5				*	*								
6											*	*	
7	5.00	4.50	4.50	5.00	5.25	6.00	6.50	*	*	*		-	* Deposit and Lending Rates would be decided by the banks a. The maximum rates of interest on deposits would be decided by the banks themselves.
8													
9	6.00	5.50	5.00	5.00	5.50	5.75	6.25	6.75	*	*	*	-	Note: For large and medium scale industry bank may fix a slight higher interest rates for a term loan of more than five years over the term loans up to five years. This interest rate should not be more than five years.
10													
11													
12													
13													
14													
15													
16	11.00 - 15.00	11.00- 15.00	11.00- 15.00	10.00 - 14.00	10.00 - 14.00	10.00 - 14.00	10.00 - 14.00	10.00 - 14.00	10.00 - 14.00	10.00 - 14.00	10.00 - 14.00	10.00 - 14.00	
17	*	*	*	*	*	*	*	*	*	*	*	*	
18	*	*	*	*	*	*	*	*	*	*	*	-	
19	*	*	*										
20	*	-	-	-	-	-	-	-	-	-	-	-	
21	7.50 - 10.50	7.50 - 10.50	8.00 - 10.00	8.00 - 10.00	8.00 - 10.00	8.00 - 10.00	8.00 - 10.00	8.00 - 10.00	8.00 - 10.00	8.00 - 10.00	8.00 - 10.00	8.00 - 10.00	
22	*	*											
23	*	*	*	*	*	*	*	*	*	*	*		
24	-	-	-	-	-	-	-	-	-	-	-	-	
25													
26	8.00 - 13.00	8.00 - 13.00	9.00 - 12.00	9.00 - 12.00	9.00 - 12.00	9.00 - 12.00	9.00 - 12.00	9.00 - 12.00	9.00 - 12.00	9.00 - 12.00	9.00 - 12.00	*	
27	*	*											
28	*	*	*	*	*	*	*	*	*	*	*	-	
29													

Table A-5. Implementation of New Loan Classification System

Phases	1st Phases	2nd Phases	3rd Phases	4th Phases	5th Phases	
Length of Overdues	Length of	Length of	Length of	Length of	Length of	International
	Overdues	Overdues	Overdues	Overdues	Overdues	Standards
	31-12-94	31-12-95	31-12-96	31-12-97	31-12-98	
A. Classification Status :						
Unclassified	Less than 12 months	Less than 9 months	Less than 9 months	Less than 6 months	Less than 3 months	2 months or less
Sub Standard	12 months or more but less than 36 months	9 months or more but less than 24 months	9 months or more but less than 24 months	6 months or more but less than 12 months	3 months or more but less than 6 months	3-5 months
Doubtful	36 months or more but less than 48 months	24 months or more but less than 36 months	24 months or more but less than 36 months	12 months or more but less than 24 months	6 months or more but less than 12 months	6-8 months
Bad / Loss	48 months or more	36 months or more	36 months or more	24 months or more	12 months or more	9 months or more
B. Provision-Requirements :						
Unclassified	1%	1%	1%	1%	1%	1% -5%
Sub Standard	10%	10%	15%	15%	20%	10%-25%
Doubtful	50%	50%	50%	50%	50%	50%-75%
Bad / Loss	100%	100%	100%	100%	100%	100%
C .Frequency of Classification	Annual	Half-Yearly	Half-Yearly	Quarterly	Quarterly	Atleast quarterly, usually monthly

D. Eligible Securities: Merchandise in the effective control of bank (ii) Gold and jewelry (iii) FDR , Cash certificate, govt. securities etc. (iv) Loans guaranteed by the govt. (v) 50% Market value of the land and building mortgaged to secure the loans.

Note : In respect of short term agricultural credit, classification rules as contained in BCD Circular No. 34 of 1989 will continue.

Sources: BB's BCD Circular No.20, dt ,December 27 ,1994 and BCD Circular No-12,dt. September 04, 1995 and FSRP literature.

Table A-6. Sectoral Distribution of Advances by NCBs (% of Total)

Sectors	1987	1988	1990	1991	1992	1993	1994	1995	1996	1997	1998
Agriculture +Fishing +Forestry	21.26	17.83	17.37	13.05	14.1	14.64	15.23	14.3	12.97	12.56	13.39
Large and Medium Scale Industry	21.69	20.61	30.85	30.55	30.35	30.51	25.95	29.31	30.25	30.53	31.42
Small Scale & Cottage Industry	4.59	4.38	1.21	1.42	1.53	1.44	1.71	1.71	1.3	1.54	1.64
Working Capital Financing	4.59	4.24	10.66	11.73	10.51	10.19	15.63	10.83	14.32	13.75	13.09
Large and Medium	4.18	3.92	9.37	10.33	9.25	9.09	13.92	9.03	12.38	11.93	11.18
Small Scale & Cottage Industry	0.42	0.31	1.29	1.41	1.26	1.1	1.71	1.8	1.94	1.82	1.91
Construction	2.78	2.85	4.04	4.72	4.85	4.9	5.54	5.83	6	5.76	5.74
Electricity, Gas Water and Sanitary	0.96	0.83	0.29	0.48	0.04	0.05	0.35	0.14	0.36	0.04	0.02
Transport and Communications & Storage	1.66	1.77	1.55	1.94	1.83	1.67	2.19	1.86	2.37	2.31	2.04
Trade	37.17	43.19	29.6	31.08	31.71	31.62	27.4	27.95	25.45	25.01	25.42
Export	7.14	7.63	6.94	5.89	6.86	7.21	6.65	7.29	6.34	6.51	6.93
Import	3.97	5.79	4.62	3.16	3.49	3.29	3.78	4.44	3.86	5.15	4.42
Miscellaneous	4.89	3.94	4.43	5.04	5.09	4.99	6.09	8.06	6.98	7.19	7.24

Source: Bangladesh Bank. Scheduled Bank Statistics, Various Issues

Table A-7. Sectoral Distribution of Advances by PCBs (% of Total)

Sectors	1987	1988	1990	1991	1992	1993	1994	1995	1996	1997	1998
Agriculture +Fishing +Forestry	3.2	3.38	2.62	2.97	2.07	2.52	3.03	2.03	1.58	1.76	1.57
Large and Medium Scale Industry	13.36	13.57	16.58	16.11	15.43	17.65	16.07	19.42	16.63	16.38	14.72
Small Scale & Cottage Industry	1.25	2.33	1.49	1.16	1.04	1.08	1.68	0.17	2.15	1.4	1.85
Working Capital Financing	7.15	7.06	7.75	7.66	8.55	9.17	6.64	9.09	10.77	9.77	8.92
Large and Medium	6.99	6.86	7.34	6.78	7.7	7.92	5.74	8.16	9.69	8.97	8.14
Small Scale & Cottage Industry	0.16	0.19	0.41	0.87	0.86	1.26	0.9	0.93	1.09	0.8	0.78
Construction	8.34	8.49	6.9	9.22	9.5	9.65	9.82	8.61	7.83	8.82	8.67
Electricity, Gas Water and Sanitary	0.23	0.2	0.02	0.01	0	0.01	0.05	0.04	0	0.01	0.01
Transport and Communications & Storage	1.8	2.51	2.38	1.77	1.98	1.76	7.76	2.9	3.1	2.14	2.78
Trade	58.8	60.23	58.65	56.41	56.23	52.33	53.52	49.94	50.01	2.53	51.57
Export	6.24	5.35	5.78	5.22	5.56	7.6	9.15	6.2	0.04	7.01	8.25
Import	22.63	22.06	13.65	16.87	16.61	13.12	14.81	13.75	12.91	13.6	13.18
Miscellaneous	2.55	2.18	3.6	4.6	5.19	5.83	7.43	6.49	9.05	8.45	10.01

Source: Bangladesh Bank. Scheduled Bank Statistics, Various Issues

Table A - 8. List of Documents Required for Small Loan

Sl. No.	Described by Borrowers
1	Trade License
2	TIN
3	Income Statement form the bank where the entrepreneur maintains a current account
4	Land Purchase Deed
5	Via Deed
6	C/S (Cadestral Survey) Record
7	S/A (State Acquisition Survey) Record
8	R/S (Revised Survey) Record
9	Non-incumbrance certificate
10	Mortgage registration
11	Land valuation certificate
12	4 copies of loan applications
13	project profile
14	CIB report of BB
15	Certificate of ability to provide equity
16	Land map (from sub-registry office)
17	Building plans
18	Clearance certificate from the electricity office
19	Nationality certificate from the Up chairman

Source: SME Survey

Table A – 9. Summary Table of Policy Measures Evaluation under SAPRI Investigation

Measure	Objectives	Criteria	Reasons of failure to reach target
1) Interest Rate Deregulation	Competitiveness	Interest spread	Government led distortion, NPA, Collusive Behaviour, Misconceived Price Strategies.
2) Interest Rate Deregulation and decontrol of credit	Improved Resource Allocation	Loan-Deposit Ratio, Sectoral Allocation and Credit Allocation Index, loan Quality	High Perceived risks and Costs. High Capital Requirement
3) Strengthening FIs	Risk Control in bank lending Management Efficiency of NCBs	Loan classification and provisioning; capital adequacy New Operational and Management Tools/Loan Quality	CL$\uparrow \rightarrow$ Upgradation of classification standard CL Suppressed $\rightarrow$ Evergreening, classification based on loan repayment Sheer negligence of the banks Supervisory and Regulatory Forbearence $\Rightarrow$ Lack of autonomy and quality of supervisor. Ineffective legal system Lack of Leadership, expertise and Motivation Mismatch between loan classification requirement and improvement in loan screening and Monitoring skill Mismatch between economic deregulations and enforcement of prudential regulations

Measure	Objectives	Criteria	Reasons of failure to reach target
4) Restructuring Rural Banking	Viable Rural Banking	Increased Flow of Credit, Deposit and Loan Quality	Change of rural branching policy PCBs did not open any new branch NCBs tried to consolidate BKB was entrusted with all losing rural branches of DNCBs (Nationalization of Loss). Negative Net Flow of Credit⇒ Low recovery and withdrawal of refinance and subsidized interest rate. Political influence Faulty Borrower Selection, Over-staff Inefficient staff, complex procedure, low volume of Business Wrong Marketing and Institutional Policy.
5) Role of PCBs 6) Improving Debt Recovery Environment	Competition Reduce NPA	Increase in the share of PCBs Decrease the share of NCBs Reduce NPA	Could not break-through NCBs dominance Share of business between old and new PCBs Ineffective publication of default list Lawnessness Slow MLC Influence of vested interest Group Collusion between Political Parties and Defaulter.