# Economic Policy Paper on
# REFORM OF FINANCIAL POLICIES FOR ECONOMIC DEVELOPMENT

**Reform Leverage:**

In the financial sector particular, there needs to be a delicate balance between regulation and entrepreneurial freedom. Much of the persistent malaise in our financial sector can be attributed to the fact that we went for liberalization without providing for adequate regulation and supervision. The end 1996 episode of phenomenal boom and bust that did great damage to the country's nascent stock market was mainly created by the machinations of some unscrupulous share-traders who took advantage of the laxity in regulation

It needs to be mentioned that, although the private banks now account for nearly a half of the country's banking business, the state- owned banks still play the major role in rural banking and in providing term loans for industrial investment. The banking sector generally suffers from weaknesses in investment appraisal capability. Although there is a need for reviving the stock market, there is a misplaced belief that the stock market can and should replace commercial banking as the major source of raising funds.

**Fit and Proper Test:**

A "fit and proper test" has been introduced for qualifying to be a bank director in fact, most countries impose restrictions on owning a bank, so as to ensure that the owner-director should have a minimum level of expertise and should not be a person who has a record of abusing trust. Unfortunately political affiliation rather than the professional track record of sponsor-directors has been the criterion for obtainig permission to open new banks.

**Role of Audit:**

Reliable external auditing is supposed to be the main vehicle of independent oversight on management by the company boards. The owner-directors of banks should therefore demand such auditing in their own interest, unless they have things to hide. It seems curious that some bank boards have been rather negligent in ensuring a sound system of internal and external auditing in their banks. Bangladesh Bank(Central Bank) has already made it mandatory for banks to follow International Auditing Standards. Suggestions have now been made to make such auditing even more rigorous. Particularly in providing more in-depth information regarding financial risks and in revealing the so-called "related party transaction" (that is transactions with entities in which bank directors have an interest)

**Need for Financial Reform:**

The financial system of an economy provide the medium of exchange, allocates resources, provides a return on and affects the level of saving , It also pools, transforms, and distributes risks as an important locus of implementation of development policy of a country. Real economic growth goes hand in hand with an increasing amount and diversity of activity of Financial institutions, markets and instruments. The financial structure composed of two sets of element; namely , financial structure financial institutions . In the context of Bangladesh, an efficient and development financial system is essential of transferring capital from severs to investors and to channelize scarce resource to maximize production. In –fact, the financial system's contribution t growth lies precisely in its ability to increase efficiency in financial deepening through viable and effective financial market and financial instruments and profitable interaction with the progressive globalization.

Financial reform is urgently needed because the major goal of the national economy is sustainable economic growth. Income growth is desirable because everyone wants to improve standard of living, full employment and stable prices are also important goals . In an attempt to support sustainable growth, the role of financial inter-mediation is indispensable. Well designed and well-developed financial intermediation program and financial system are essential for both the growth concern and the stability perspective . Unlike the financial system supported by various forms of implicit-government guarantees and intervention, we all need an autonomous, efficient financial system that hinges on a well-functioning market mechanism.

Market competition has the power to distinguish between healthy companies and ailing companies. The market supplies money to high performing companies. Competition causes under-performing companies to exit the market, and keeps well-performing companies in the market. Unless market discipline is continuously emphasized, it will be hard to expects a proper functioning of market mechanism. Market discipline and strengthened prudential supervision are the two pillars of financial stability in globalized environment.

It is generally agreed that the most important means of communication with shareholders is the annual report. The extent of disclosure adequacy in the annual reports may be a major determinant of the quality of investment decision making in particular, and economic resource allocation in general. Although the above arguments are applicable to all kinds of corporations, they have, thus far, received inadequate attention in the case of financial institutions since the thrust of public interest in the past has been the protection of depositors and/or customers rather than stockholders. It is generally agreed that the reporting practices of banks have not yet reached the required/desired level of adequacy.

Reforms of the financial sector have been pursued over the past two decades in many developing countries as part of broader structural adjustment programs that included fiscal consolidation, reforms of the trade and exchange systems, and wide-ranging measures to enhance the supply responsiveness of the economy (notably through price liberalization, deregulation of activities, and other reforms of the incentive system). The reform of the Financial Sector was expected to bring about significant economic benefits, in particular through a more effective mobilization of domestic savings and a more efficient allocation of resources. Reforms of the domestic financial system aimed at strengthening the role of market forces and competition in financial markets through liberalization of interest rates and the introduction of indirect monetary policy instruments, by enhancing bank's financial soundness, and by promoting equity markets. Liberalization of current and capital accounts transactions aimed at better integrating the domestic financial system in to world financial markets.

**Financial Institutions in Economic Development:**

The Financial market is considered as the vehicle for the financial development of a country. The security market segments failed to reflect signs of such depth and breadth. The market remained shallow over the years a the market capitalization in Bangladesh is only 2.42% of GDP against 27.43% in India, 99% in Taiwan and 138% in Malaysia. The informal and quasi-formal sector (NGO) are covering a significant segment of financial market activities. There are 52 Commercial banks in the country now, of which 12 are foreign banks. 29 non-banking financial institutions beside 4 Development Financial Institutions in the country. The number of banks and financial institutions operating in the country now are adequate, but their quality is significantly poor and needs drastic improvement soon.

The banking sector, non-banking financial institutions and foreign exchange transactions controls are the primary areas of operations of Bangladesh Bank and it controls and regulates these institutions through the use of the Bank Companies Act. 1991, Financial Institutions Act. 1993, The Financial Institutions Regulations Rules 1994, Negotiable Instruments Act. 1928, The Money Loan Court Act. 1990, The Money Loan Court Rules 1990, Money Laundering Act. 2002, Foreign Exchange Control Guidelines 1947 and the Amendments thereof as well as through various Administrative Circulars issued from time to time. Apart from these the Capital Market is regulated by the Security and Exchange Commission Act. 1969 and the amendments thereof.

**Corruption Formula:**

The term governance as generally used encompasses all aspects of the way a country is governed, including its economic policies and regulatory framework. Corruption is a narrow concept, which is often defined as the abuse of public authority or trust for private benefit. The two concepts are closely linked, an environment characterized by poor governance offers greater incentives and more scope for corruption.

Corruption formula may be C=M+D-A, Where C stands for Corruption, M for Monopoly, D for Discretionary Power and A for Accountability.

Reversely Anti Corruption (AC) formula may be termed as AC = A-(M+D)
**(Ref: Prof. Feroz I. Faruque - an anticorruption activist)**

**Role of SMEs:**

Economic Development of a country mostly depends on the SMEs. 80% of the Japanese economy depends on SMEs. Due to high lending rate of interest SMEs are deprived of Commercial banks loan. Board of Investment (BOI) set a FDI target of US$ 40 crore for 2003. in a survey of the first 6 months of the year the amount said to be about US$ 25 crores through 328 business units. The FDI targets for 2004 is set at US$ 60 crore, for 2005 US$ 80 crore, for 2006 US$ 100 crore estimating an average growth rate of about 36.42% a year. BOI has planned to attract local & foreign investments in the Agriculture and Agro-Processing Sector too.

Slashing Interest Rate will not yield any significant results for investment in company share unless people have fair confidence in the audited annual report/accounts of the company. In most of the cases statutory audit is a compromise between the Company directors and the auditor(s). In many cases three sets of accounts are prepared in many cases where one set showing loss for the Income Tax, one set showing substantial profit for the bank financing, which are certified by the Auditor(s) of the company/ Chartered Accountants and the third set for the management itself to see the real performance of the company.

**Globalization and SMEs:**

Increase in export does not indicate that the SMEs in particular will be able to survive comfortably under the present WTO regime. There are about 50000 SMEs in the country registered with different trade organizations and factors affecting the SMEs due to globalization are:

- Competition(price, delivery, after sales service)
- Technology(modern, cost saving and quality assurance)
- Policy(competitive with other countries and business friendly)
- Skill(commensurate with technology and techniques)
- Institutional and Infrastructural support(information, communications and business support)
- Market(additional market exposures for existing and new products and services) and
- Good Governance(efficient management with required knowledge and skills)

Trade related Technical Assistance would be provided to Bangladesh by EC to ensure that Bangladesh gets the best advantage out of WTO negotiations. European Commission has already enveloped 49 million Euros for 2002-2006, would focus specially on small and medium enterprises sector of Bangladesh to develop. SMEs contribution in the country's GDP in terms of industrial contribution is about 46 percent. Small enterprises comprise over 98 percent of all industrial units in the country.

**Industrial Reclassification:**

Status of industry has been redefined and the number of thrust sectors now increased to 21 along with the existing 16 named in the industrial policy 1999. The new items are basic chemicals/ raw materials used for industries, dying and raw materials used in the textile industry, optical frame, CNG and Furniture. The new industrial policy changed the definition of an industry based on its capital. Industry having a capital of Tk. 500 million and above will now be termed as large industry, while in the previous policy it was Tk. 300 million and above. A medium industry should have capital between Tk. 250 million to below Tk. 500 million in place of present range between Tk. 100 million and Tk. 300 million. An industry having a capital up to Tk. 250 million will be defined as a small industry in place that of Tk. 100 million in the previous policy. An industry having capital less than Tk. 100 million has been defined as cottage industry, while technology based seed production has been awarded the status of industry. Special incentives will be provided to the export oriented industries and to women entrepreneurs.

**Which Economic Model does Bangladesh Follow?**

Many of us are not sure which economic development model does Bangladesh pursue? We are aware of Japanese model, East Asian model, American model, Swedish model, New Zealand model, Dutch model, German model, Singapore model, Malaysian model etc. Is it a home grown model? May be our Finance and Planning Ministries could answer for us.

**Fate of Savings Certificates:**

Interest rate on savings certificates is going to be further slashed down to 8% p.a from the prevailing 12% p.a and to 9% from 13% respectively by the end of 2003. By this time four government saving schemes have been closed. In most of the cases savings instruments are golden deer these days and banks are seriously reluctant to issue any savings instruments. Six types of savings instruments were in the market having interest rate between 13.5%-18%. Commission to commercial banks now Tk. 20 only in place of 1% of the face value of the savings instruments previously.

**South Korean Experience:**

Prices, like interest rates should be liberalized. Credit and asset management should be liberalized and at the same time regulated, while labor and internal management should be autonomous. Also, there should be freedom. for the implementation of new financial products.

The liberalization of interest rates was not achieved until the early 1990. In the past, in order to provide preferential interest rates to the real sector, interest rates were fixed by the government. In 1991, Korea liberalized its interest rates. Within a short period, the liberalization policy was very successful.

Even though the liberalization of interest rates, service charges, and surcharges took place at a later stage of development, it was successful and efficient. Right now, interest rates are free-floating, meaning the bankers and borrowers determine interest rates, and so the rates differ from bank to bank. However, public fiscal funds, demand deposits, and time deposits shorter than seven days are still regulated by the government. Nonetheless, this is a worldwide trend. No country has liberalized the demand deposit rate. Credit and risk management encompasses asset and liability management. The chairmen and boards of banks decide how the deposited money should be used. The chairmen and boards' strategies should be an autonomous choice. In the early stages of Korean development, government controlled credit and the execution of credit was made selectively. Nowadays, there is no more credit rationing and credit channeling and as a result financial institutions are free to choose the allocation of assets and liabilities. Thus the financial sector has resumed the original role of allocating financial resources to the real sector.

**Institutional Capacity:**

The use of bench marking is becoming common in debt and reserve management. Rationales for currency benchmarks include matching the external debt structure with that of international receivers, exports of the currencies in the basket against which local currency is pegged or managed. In the absence of benchmarks there should be a guideline such as limiting shorter debt, matching foreign currency debt to reserve or limiting floating rate debt. Once benchmark is established, the next question is how much discretion should be allowed to the debt managers to deviate form benchmark.

Available information suggests that management of foreign exchange reserve and management of government's foreign debt are assigned to distinct organization with distinct mandates. This is because reserves and debt need to be managed according to quite different objectives. But the debt manager will typically want longer-term liabilities to limit refinancing risks. Assigning these two different tasks to separate institutions has the advantage of facilitation accountability since each institution can be called to account for its area of responsibility according to specially tailored criteria.

Mechanism of carrying out Risk Audits or Stress tests should be there to evaluate different scenarios for the country economic program contingent to external shock on periodic basis, preferably not less than twice in a year. For example Central Bank of Peru does it twice annually, Mexico monthly, Korea frequently, Thailand regularly sine 1997.

**Importance of Sound Financial Policy:**

The major function of a financial system is to strengthen the saving – investment process of the country. For the matter of economic development, the financial system mobilizes and pools together the financial resources for productive investments. In addition, the financial system influences the economic development process through supporting an active payment mechanism. An efficient payment mechanism helps to active specialization and economy of scale in production and strengthens the development process of a country. Because of this widespread relationship between economic development and financial sector, it is said that a sound, disciplined and efficient financial system is a pre-condition for economic growth. The financial system of Bangladesh is mainly bank dependent Sustainable economic growth for the country can be ensured through proper and careful utilization of this sector .

**Human Resources Development:**

For successful implementation of any reform program, one of the important prerequisites is the skill, experience, and attitude of the officers and employees of the banking institution. None of the previous reform programs were observed to address the HRD issues related to financial sector. Both BRC and CPD Task Force recommendations should be given due considerations in this regard. The CBA issue, employee retrenchment, promotion and recruitment policies, congenial working environment and remuneration structure etc. are required to be addressed in right perspective give for addressing HRD issue. The role of banking automation and information technology is considered very important for expanding the financial market and surviving the competition in this globalized age. Though banking automation has increased recently, yet the ICT penetration in the banking sector still not substantial, because of NCBs slow progress in this regard

**Improvement of Solvency & Efficiency:**

For ensuring overall banking development, the first and foremost requirement is to improve the solvency and efficiency of the NCBs, given their large market share. The market share of NCBs is around 51% in terms of deposit and around 76% in tremens of net assets, according to BB annual Report, 2001-02. As of December- 2002, the capital ratio of NCBs is only 4.06% of total risk weighted assets and classified loans is around 34%. The CPD Task force Report (2001) has emphasized on firm political commitment, non–interference (by government and tread-unions), establishment of rule of law, ensuring internal control mechanism, effective suppression of BB (over NCBs) etc. for the improvement of the situations in NCBs as well as for overall banking development. Considering the huge and multifarious problems of NCBs, Bhattacharya and Choudhury (2002(, proposed to form an autonomous Financial Restructuring Authority for addressing the problems of the NCBs (and other problem banks of the private sector) professionally and efficiently. For the purpose of improving efficiency and reducing loss on the part of NCBs (and DFIs), Bangladesh bank has launched a program in the last year to merge/rationalize continuously (for the last five years) loss incurring branches of NCBs (and DFIs). It was expected that out of 806 loss incurring branches, at least 500 branches would be closed at three phases (June, September, December) during 2002.

Williamson suggested the following make reform feasible and successful:

1. Policy reforms emerge in response to crisis
2. Strong external support is an important condition for successful reform
3. Authoritarian regimes are best at carrying out reforms
4. Policy reform a right wing program
5. Reformers enjoy “honey moon period” of support before opposition builds up
6. Reforms are difficult to system unless the government has a solid based of legislative support
7. A government may compensate for the lack of a strong base support if opposition is weak and fragmented
8. Social consensus is powerful factor impelling reform
9. Visionary leadership is important
10. A coherent and united consensus team is important
11. Successful reforms economists in position of political responsibility
12. Reformers should mask their intention to the general public
13. Reformers should make good use of media
14. Reform becomes easier if the losers are compensated
15. Accelerating the emergence of winners can enhance sustainability

**Introduction:**

Banking sector plays a pivotal role in the economic development of nations. As economies develop, the needs of the users and the providers of financial services change. The German economists argue that the German bank based financial system had helped Germany overtake the United Kingdom as an industrial power, During $20^{th}$ century, the debate expanded to the United States and Japan (Vogel 1994; Porter 1990). Recent debate concentrated on financial system. Should policy marks concerned with promoting growth and poverty reduction focus on developing banks or developing stock markets or depend on state financing. Some argue that banks have advantage over market when complementary institutions are weak (Gerashchenko 1962). Continuing restructuring of the financial sector and focusing more on profitability and improved governance structures are to be the three foremost activities of the financial sector.

Despite all the financial hoopla about the rising level of household debt, the financial market by and large showed resiliency and stability during 1997-2003. Restructuring in the financial service industry in particular has restored stability and made domestic financial institutions more robust, more resistant to economic disturbances and better positioned for growth in the future. However, in terms of overall competitiveness, Bangladesh's financial service industry continues to lag behind that of many leading nations .For instance, the size of assets and profitability of many financial institutions have not yet reached where they should be, to enable them to compete effectively on the global stage. For this objective, we need a continual process of restructuring and some blueprints for the future of the financial industry. Restructuring efforts for the financial industry are expected to bring a competitive edge for the globalized financial environment.

Despite slow progress toward restructuring the financial sector, prevailing conditions are still plagued with nagging problems. If these constraints are not well taken into account, sustained restructuring efforts could be aborted due to substantial backlash. One such constraint are the old fashioned standards of the banking sector. Labor union does not want reform, because they are satisfy with the current inefficient system. They think that if the system is made more efficient, it will be difficult to survive, due to layoffs of unnecessary staff. The chaebols (conglomerates) are also a big problem. The chaebols fear that if resources are allocated efficiently, there will be no financial channeling, financial rationing, credit rationing or credit allocation exclusively directed to them as was seen in the past.

Bangladesh's financial sector has been devastated by its strong reliance on bureaucracy, which also places limits on the extent of sector wide reform. The business sector criticizes the bureaucrats for the lack of freedom of choice, but even when freedom of choice is given to the business sector, they still ask bureaucrats for advice. The traditional attitude of Bangladeshi bankers still prevails. A deep coalition between businessmen and politicians has been created in Bangladesh society and this is the main reason for the inefficient banking sector. The collusion has also undermined the competitiveness of Bangladesh's society.

Some firewalls have already been installed in weaker parts of the financial system, so that those small disturbances in the non- banking sector do not spread into the economy. Pre-packed bankruptcy procedures would also allow a more speedy resolution of trouble firms in future. Restructuring ailing banks involves closures of ailing and/or nonviable insolvent banks, government recommendations for capital increase, the collection and distribution of fiscal funds for the rescuer of non-viable banks, government investment in banks, strong support to healthy banks and strict prudential regulations. Financial boundaries can be divided into three types: traditional banking business, securities business, and insurance business. But even still, there are many hybrid bank function like deposit taking by non –bank intuitions. The classical system stresses that financial operations should be strictly separated. In contrast, the universalistic view suggests that a bank can sell and buy securities, and participate in the insurance business.

To obtain a sustainable economic growth and development, most of the developing nations of Latin America, Asia, Africa as well as Ex-Centrally controlled and planned Economies of the world have been adopting Structural Adjustments and Stabilization Program since 90's. The reforms of the financial sectors in the industrially advanced countries were triggered to a major extent by the phenomenon called " Globalization of Bank and Financial Markets" which again was influenced by factors like restrictive regulations in domestic banking development of Euro-Dollar market, collapse of " Breton Wood System" and Adoption of Floating Exchange Rate system, Abolition of Capital Control resulting in Cross-Border Exchange and Trade, Technological Development, Debt crisis of early 80s leading to a series of finical crisis etc.

Reform requires austere policies, which respect budget constraints. Reform also precludes compromising with the narrow special interest groups those have been the beneficiaries of the pernicious policies of the past. Harbierg (1993) termed policy markets as the heroes of economic profession those who have courageously pursued market oriented economic policies by following reform process. Government become austere, uncompromising, and unpopular if follows reform for economic recovery.

Research on the origins of banking crisis strongly suggested causes leading to banking crisis, in general, are as follows:

a) External and domestic macroeconomic volatility.
b) Lending booms, asset prices collapse and surges on capital flows.
c) Increasing bank liabilities with large maturity/currency mismatch.
d) Inadequate preparation for financial liberalization.
e) Heavy government involvement and loose control on connected loans.
f) Weakness in accounting; disclosure and legal framework.
g) Distorted incentives.
h) Exchange rate regime.
i) Poor Corporate Governance.

# CHAPTER -I

**FINANCIAL REFORMS: INTERNATIONAL FRONT**

**Cross Border Banking Crisis:**

Banking crisis in the developing countries have been far more severe during the past 15 years than those of industrial countries. Capiro and Klingebil (1996) from their 15 years comprehensive data base revealed that the most sever banking crisis was of Spain (1977-85) where estimated losses reached 17% of GDP. In descending order, the next came Finland (1991-93) at 8% of GDP. Sweden (1991) at 6% and Norway (1987-89) at 4%.Capiro and Klingebil identified more than a dozen of episodes in which losses or resolution costs exceeded 10% of GDP, including the recent cases of Venezuela (18%) Bulgaria (14%), Mexico (12-15%) and Hungary (10%).

In several cases Argentina, Chile, Cote d'lvorie losses are greater or equal to 25% of GDP. Concern about banking crisis is hardly surprising because these difficulties generated serious negative externalities for the rest of the economy. In case of re-capitalization weak banks cut back lending and widening spreads, the lower availability and higher cost of bank credit undermine the real economy. Particularly for small and medium sized firm which have fewer alternative sources of financing. In general decline in economic activity precedes the outbreak of a banking crisis. Nevertheless, there is widespread agreement that a banking crisis is likely to amplify a downturn ( Kaminsky and Reinhaart 1995; Mishkin 1994; and Sheng 1996; Lindgren(1996). Johnston and Pazabasipglu 1995; and Beranke 1983). In addition, the worsening of information and adverse selection problems that typically occurs during a financial crisis the least creditworthy borrowers will be prepared to pay high interest rates means that the quality of investment is likely to suffer, that is saving will not flow to its most productive uses (Gregory and Guidotiti 1992; and Mishkin 1994).

**Management of Forex Reserve:**

A crucial aspect of liquidity management is the level international reserve. In the Asian crisis the economies with largest reserves were able to hold their exchange rates steady (China and Hong Kong) or suffered only relatively modest depreciation (Singapore and Taiwan) while most other emerging economies in the region suffered severe devaluations. A recent poll of reserve managers supports Fischer's supposition that " it is very likely that countries seducing to draw lessons of international financial crisis will decide to hold much large reserves than before (Weller). There are of course costs of holding reserves. Their assessment is complicated by the alternative opportunity costs used to Calculate them. Building up and holding excessive reserve may also give rise to other types of costs, such as excessive monetary expansion, particularly, when underdeveloped financial markets limit the effectiveness of sterilization operations that high reserve allowed to be maintained for longer. In the days when the balance of payment was dominated by trade, holding the equivalent of three month's import was regarded as useful rule of thumb. Some countries still to some extent apply such rules. The Czech practice is over 3 months, now 5-6 months, Poland: from existing 3 to 6 months, India: 12 months . An alternative rule of thumb for today's environment where capital flows to dwarf trade, was brought to public by Greenspan. It is often called " Guidootti rule." as a form as it was proposed by Guidotti . The rule states that usable foreign currency reserves, including any available through contingent credit lines, should be sufficient to meet all repayments and interest on foreign debt falling due over the following year (Greenville). For example, the Korean authorities have strictly limited foreign currency maturity mismatches. For residual maturity of seven days and less, assets must exceed liabilities; for residual maturity of three months or less assets must represent 80% of liabilities; for loans of three years or more, 50% of the funding must be at three or more year's maturity. Banks in Indonesia intending to borrow from abroad must submit their annual plan three months in advance and the central bank will allocate a ceiling to each bank based on its past performance. Banks are also required to limit external borrowing under two years' maturity to less than 30% of their paid up capital and use at least 80% of it for export credits.

**Responsibility for Ethics:**

The Board of Directors and senior management are responsible for promoting high ethical and integrity standards, and for establishing a culture within the organization that emphasizes and demonstrates to all levels of personnel. It is the ethics that management must display in their business dealings, both inside and outside the organization. All personnel at a bank need to understand their role in the internal control process , ethical practice and be fully engaged in the process.

**Morality in Banking Business:**

Banking business is inseparable from the society. It is the vein, artery and blood of business. In Greece business persons were severely punished if found guilty of immoral business practices. Individual ethics my be influenced by:

- Family influences
- Situational Factors
- Values and morals
- Experience
- Peer influences

**Obligations of Banks:**

William Frankena has analyzed obligation of banking business into three components of (a) avoiding negative impact on the society, (b) preventing such harm and (c) positively promoting social good.

**Basle Capital Accord:**

Proposed reform to the Basle Capital Accord, which seek to link the amount of capital banks have to hold more closely to the credit worthiness of their loans, overstate some of the risks while underestimating the collateral. This means that banks might be forced to hold more capital than they would otherwise reasonably require, raising the cost of compliance with the accord and making them less competitive, particularly against financial institutions not subject to the regulations. New rules designed to reduce the risk of bank failures are too conservative and costly and could impair the competitiveness of large banks. Government proposed a Monetary and Fiscal Policies Coordination Committee to cut the Finance Ministry's lone authority over fiscal and monetary maters. But no measures for ethical matters/issues. Permission should be sought from Bangladesh Bank before granting big loans.

**Basel Committee on Banking Supervision:**

1. In June 1999, the Basle committee on Banking Supervision issued a new Consultative paper on New Capital Adequacy Framework. The paper is now Pone for discussion and the final accord will come into effect by 2005. The proposals once finalized , will replace the 1998 capital adequacy framework.

Strengthening financial management and commitment to ethical conduct. All employees of the bank must adhere to a specialized code of ethical conduct containing all the elements of a code of ethics. All bankers should annually sign a code containing all the elements of the code of ethics and deliver it t the board or to the board designated committee with copy in the personal file of the respective employee. Oath should be conducted by touching the Holy book of the employee concerned. His pledge to ethical conduct must be renewed every year. This exercise may be administered during the customer service month the banks usually celebrate. Rebuilding confidence in financial reporting, the accounting industry and the effectiveness of the audit process. Banks should actively promote ethical behavior and provide employees with the means to report perceived violations of ethical standards without fear of reprisal. Statutory auditors without having adequate banking knowledge should not be appointed auditor of the bank. Banks
must have disclosure of corporate governance practices and code of ethics in their annual report

**Sources of Unethical Practices:**

Unethical practices may occur from various sources such as : For opening of letter of credit, encashment of cheques, discounting of bills, early receipt of treasury challan, sanction of loan, assessing value of fixed assets/co-lateral, foreign exchange transaction, money laundering through credit card, export proceeds repatriation, recovery of loan, reducing rate of interest, helping hundi/money laundering, helping over invoicing, allowing undue cash incentives, under invoicing, waiver of interest, remission of principal, name lending, forged land documents inconnaivance with the land related agencies of the government, appointment of auditors, legal advisors, project evaluation, evaluation/appointment of various external service providers, over profiteering motive etc.

**Principles for the Assessment of internal Control Systems:**

All members of the Basel Committee agreed the principles set below should be used in evaluating a bank's internal control system:

**Management Oversight and the Control Culture:**

**Principle # 1:** Defining the Board of Directors Responsibilities
**Principle # 2**: Defining the Senior Management's Responsibilities
**Principle # 3**: Defining the joint responsibility of both the Board of Directors and the Senior Management for Promoting high Ethical and Integrity Standards.

**Risk Recognition and Assessment:**

**Principle # 4**: Recognition of Material Risks

**Control Activities and Segregation of Duties:**

**Principle # 5**: Recognition of Control activities as an Integral part of Daily Banking Activities
**Principle # 6**: Clear Division of Labor

**Information and Communication:**

**Principle # 7**: Availability of adequate Internal and External data
**Principle # 8**: Reliable Information System in place
**Principle # 9**: Effective Channels of Communication
**Monitoring Activities & Correcting Deficiencies**

**Principle # 10**: Monitoring of Key Risks as a Part of Daily Activities
**Principle # 11**: Comprehensive Internal Audit Reporting directly to the Board of Directors/ Audit Committee and Senior Management.
**Principle # 12**: Internal Control and any other deficiencies must be reported immediately to appropriate authority.

**Evaluation of Internal Control Systems by Supervisory Authorities:**

**Principle # 13:** An Effective System of Internal Control for all Financial Institutions.

**WTO and Financial Services Agreement (FSA) & General Agreement on Trade in Services (GATS):**

The FSA and GATS concluded in December 1997 under the auspices of the World Trade Organization(WTO) represented one of the hallmark achievements of the Uruguay Round. The largest service sector, including all banking and other financial services, and all insurance and insurance related services, is now fully subject to multilateral trade rules. Services make-up about 60% of the global economy and is the fastest growing sector of international trade. Per WTO agreement all countries will be required to open their market fully by the year 2015. It covers 160 services sector. Under the GATS services are broken in to four modes of supply:

1. Cross-border supply (internet, overseas telephone calls)
2. Consumption abroad (tourism)
3. Commercial Presence (banks, insurance)
4. Presence of Natural Person (Nurses, IT Person)

Internationalization of Financial Services is an important issue for strengthening and liberalizing of financial systems in developing countries. The elimination of discriminatory treatment between domestic and foreign financial services providers and the removal of barriers to the cross boarder provision of financial services opens the door to the entry of foreign suppliers. There has been considerable support for the view that this favors the building of financial systems that are more stable and efficient by introducing international standards and practices. At the same time, there have been concerns about the risks that internationalization may carry for some countries , particularly in the absence of adequate regulatory structures.

**Financial Sector Reforms Experience in some Selected Countries:**

**Financial Sector Reforms in India**

Banking Sector Reforms:

The deregulation of banking system in India is characterized by the following features:

1. Prudential norms introduced for income recognition, asset classification, provisioning for delinquent loans, and capital adequacy. In order to reach the stipulated capital adequacy norms, substantial capital has been provided by the Government to public sector banks.
2. Government pre-emption of banks' resources through statutory liquidity ratio(SLR) and Cash Reserve Ratio(CRR) brought down in stages
3. Interest rates on deposits and lending sides almost entirely deregulated
4. New private sector banks allowed to promote competition
5. Private Sector Banks encouraged to approach the public to raise resources
6. Recovery of debts due to banks and the Financial Institutions Act, 1993 passed and special recovery tribunals set up to facilitate quicker recovery of loan arrears
7. Bank lending norms liberalized and a loan system to ensure better control over credit introduced
8. Banks asked to setup asset liability management systems. Reserve Bank of India(RBI) guidelines issued for risk management systems, in banks encompassing credit , market, and operational risks
9. A Credit Information Bureau is being established to identify bad risks
10. Derivative products such as forward rate agreements and interest rate swaps introduced

**Capital Market Development:**

1. The capital issue (control) Act.1947 repealed, office of the controller of capital issues abolished and initial share pricing decontrolled
2. The SEBI- the capital market regulator established in 1992
3. Foreign Institutional investors allowed to invest in Indian capital markets after registration with the SEBI
4. Indian companies permitted to access international capital markets through Euro issues.
5. SEBI regulations governing substantial acquisition of shares and takeovers, including conditions under which disclosures and mandatory public offers are to be made to shareholders.

6. Private mutual funds permitted
7. Dematerialization of stocks encouraged for paperless trading
8. Companies required to disclose all material facts and specific risk factors associated with their projects while making public issues.
9. To reduce the cost of issue, underwriting by the issuer made optional subject to conditions
10. The practice of making preferential allotment of shares at prices unrelated to the prevailing market prices stopped and fresh guidelines issued by SEBI.
11. Buy back of shares allowed
12. SEBI insists greater corporate disclosures and better Corporate Governance
13. Detail employee stock option scheme and employee stock purchase scheme for listed companies
14. Companies given the freedom to issue dematerialized shares in any denomination
15. Derivatives trading started with index options and futures
16. A system of rolling settlements introduced
17. SEBI authorized to register and regulate venture capital funds
18. Issue of license to new credit rating agencies and the introduction of a code of conduct for all credit rating agencies in India.
19. SEBI introduced capital adequacy norms for brokers and rules for making client/broker relationship more transparent including separation of client and broker accounts.

**Three Maghreb Countries(Algeria, Morocco and Tunisia):**

As in many developing countries this reform was part of an overall strategy toward establishing a more market based , open, and private-sector led economy. The key conclusions are: (1) the policy reform agenda has been wide-ranging (2) the sequencing of reforms has been broadly appropriate, which helped avoid financial instability and disruption (3) the reforms helped to strengthen savings in the three countries, thereby enhancing the sustainability of growth and (4) the process, while still incomplete, is gaining in depth and credibility. Differences in the experiences of the individual countries largely mirror differences in the initial stage of development of their banking, and financial systems, but also in their macroeconomic policies.

While much progress has been made in recent years in financial sector reform in all three MAGHREB countries, the reform agenda needs to be accelerated in order to support increased investment and high growth rates. In all three countries, competition among banks needs to be enhanced and the role of the private sector in financial intermediation strengthened. A deepening of secondary markets for government paper will be required to establish meaningful yield curves to better guide inter-temporal investment decisions and provide the central banks with a basis for open market operations, complemented by well-functioning equity markets. Moreover, enhancing the mobilization of long term contractual savings(insurance companies, pension funds) would help promote investment and growth. Strengthening of the financial system, combined with a further consolidation of macroeconomic stability, would allow further liberalization of capital account transactions and thus help integrate the MAGHREB economies into world financial markets.

**Money Laundering:**

The Financial Action Task Force on Money Laundering (FATF) is the International body responsible for setting anti-money laundering and anti-terrorist financing standards recommended 40 measures to fight against abuses of global financial system. The recommendations are winged over many aspects including the legal system, provisional measures confiscation, measures to be taken by financial institutions, non- financial business and professions, customer due diligence and record keeping, reporting of suspicious transactions and compliance, measures to be taken with respect to countries that do not or insufficiently comply with the FATF Recommendations, ratification and implementation of UN instruments, freezing and confiscating terrorist assets. Non profit organizations are considered to be vulnerable for terrorist financing. The focus areas are Financial Transparency(financial accounting, bank accounts), Programmatic verification(solicitations, oversight, field examinations, foreign operations), Administration, Oversight bodies(Government law enforcement, and security officials, specialized government regulatory bodies, government banks, tax, and financial regulatory authorities and private sector watchdog organizations)

# CHAPTER -II

## FINANCIAL SECTOR REFORMS: NATIONAL FRONT

### Overview of Banking Sector in Bangladesh:

### Nationalized Commercial Banks (NCBs)

Recently the NCBs and DFIs share in bank deposit declined from 68 in 1991 to 61 percent in 2001 and bank advances came down from 74 percent to 61 percent during the same period. In the absence of rationalization of unviable branches contribution to losses increased .The NCBs currently account for 79 percent of total bank branches (6100) in the country. A Program of rationalization on loss-making bank branches was initiated recently by the Government.

The network of private domestic banks, consisting of 1273 branches, and private foreign banks, with 38 branches, grew substantially in last decade. The manpower strength of the NCBs today is 79,000 compared to 81,000 in the early nineties. The NCBs employ 79 percent of this manpower. The private banks, on the other hand, employ 27000 employees. The domestic private banks account for 95 percent of this total.

In the absence of an independent evaluation according to International Accounting Standards(IAS) the true quality of loan portfolio has been constrained and the proportion of classified loans in NCBs' portfolio rose noticeably from 31 percent to 46 percent during 1995-1999. The proportion of classified loans of the bank under reported their classified loans in the past. A special evaluation of portfolio, capital and financial position of NCBs carried out according to International Accounting Standards ( IAS) in 1996 found the proportion of various categories of classified loans to be much larger than reported by NCBs. The Audit found the classified loans of NCBs at end- 1996 to be Tk. 102 billion or 48 percent of the loan portfolio which was considerably higher than the proportion reported by NCBs at that time of TK 71 billion or 33 percent of all loans.

### Central Bank (Bangladesh Bank:)

Reforms within the central bank of the country are essential part of banking reforms. As a part of reform process numerous countries provided greater legal independence from the governments in the 1990s Cukierman- 1996 listed 25 countries in various parts of the world, which strengthened the independence of their central banks between 1989 and the beginning of 1996. The concrete reasons for institutional changes to central bank structures vary county to country. Kock (1973) described the changing role of central banks since the formal start with limited operation of Bank of England (1694), Riksbank of Sweden (1897) and Federal Reserve System in the USA (1914) at different phases of economic development . Evaluation of central bank objectives indicate that ultimate objective of modern central bank is to foster economic growth by promoting factors of production, promoting full utilization of resources, avoiding harmful effects of business circles and economic crises and minimizing the risk premium of a country. Price stability assumes priority among the goals of central banks as historical evidence suggests, high inflation rates are detrimental to economic growth, are socially disruptive and are associated with political and social disorder inflation (Fischer, 1996). Recently, central banks are committed to maintaining both domestic prices stability and exchange rate stability faced with severe financial crises. Examples are Swedish crises in 1992. Mexican crisis in 1994, and East Asian in 1997.

### Private Commercial Banks (PCBs):

The minimum required paid-up capital of a bank has been raised from Taka 20 crore to Taka 100 crore (the comparable figure for Pakistan for example, being Rupee 100 crore). The logic of such a measure along with ensuring capital adequacy is not often well understood. In addition to other regulatory measures, it is a mean of indirectly influencing the incentives or motivations of owner directors. The larger are their investments in the bank, the higher are their stakes in seeing that the bank is run profitably.

**Classified Loans Of NCBs, PCBs and DFIs (1990-2000)**

A ten year comparison of classified loans of NCBs, Private Commercial Banks (PCBs), foreign Commercial Banks (FCBS) and Development Financial Institutions (DFIs) indicates that classified loan is 39.70% accounting for much higher and alarming compared to neighboring India and Pakistan. This is much above the 15% bad loans crossing the limit of which banking system of a country is graded as distressed. Further, share of bad loans (Year 200) in NCBs: 44.62% PCBs: 25.76%, FCBS: 3.74% and DFIs: 60.14% of their total loan portfolios.

| Year | NCBs | PCBs | FCBS | DFIS | %of classified Loans as a whole |
|---|---|---|---|---|---|
| | **% Classified Loans** | **% Classified Loans** | **% Classified Loans** | **% Classified Loans** | |
| 1990 | 27.59 | 23.73 | 20.65 | N.A | 26.09 |
| 1991 | 26.30 | 24.20 | 11.87 | N.A | 25.00 |
| 1992 | 31.86 | 31.10 | 12.64 | N.A | 30.67 |
| 1993 | 32.23 | 44.42 | 10.46 | N.A | 34.86 |
| 1994 | 32.12 | 44.53 | 8.89 | N.A | 34.85 |
| 1995 | 31.00 | 39.43 | 5.4 | N.A | 32.04 |
| 1996 | 32.55 | 34.77 | 4.72 | N.A | 31.49 |
| 1997 | 36.57 | 31.42 | 3.58 | 65..72 | 37.49 |
| 1998 | 40.38 | 32.72 | 4.14 | 63.15 | 39.18 |
| 1999 | 45.62 | 27.09 | 3.80 | 65.02 | 41.11 |
| 2000(As on June 30 | 44.62 | 25.76 | 3.74 | 69.14 | 39.70 |

Source: Banking Regulation and Policy Department (BRPD) Bangladesh Bank 2000.

**Trend in Classified loans:**

There is trend of decline in classified loans since June 1999, which is an improvement and is particularly noticeable for 2000. It reveals that the proportion declining sharply by 7 Percentage points to 39% percent by December 2000. The decline has slowed down since then, the proportion declined to 37 percent by December 2001, but roses to 38.1 percent by March 2002. In the case of DFIs. The proportion of classified loans declined noticeably, by almost 4 percentage points in 2000, but the pace of decline has slowed down since then . This is not clear to what extent the reported improvement for NCBs and DFIs since June 1999 has been due to better loan recovery, as opened to loan rescheduling and /or write-off. The reasons for the sharp improvement in 2000 for both NCBs and DFIs, and a slowdown in the pace since then are also not fully understood.

The current ratio of non-performing loans continue to be significantly worse for DFIS (61%) compared to the NCBs (38%), while the absolute amounts of classified loans are much larger for the latter .Policy makers have justified that there has been an improvement in the quality of new loans disbursed because of improvements in the loan sanction process in recent years. This will take time to show up in the proportion of classified loans, depending on the extent of improvement of the new loan quality. Bangladesh Bank has been examining trends in loan recovery performance, based on improved reporting format. Its analysis should provide a better understanding of the factors underlying the reported improvements in the proportion of classified loans since June 1999 and the recent slowdown. The much lower ratios of classified loans for Private sector banks PCBs (18%) and FCBs 3% suggest that improvements are possible with determined efforts even under more rigorous classification standards. The private domestic banks have been able to lower their ratios significantly since 1995. The foreign banks have also improved their already low ratio, marginally. The regulatory supervision of Bangladesh Bank appears to have contributed to this improvement.

**Capital Adequacy Requirement:**

Before introduction of FSRP our banking sector was unconcerned about Minimum Capital Requirement . Although it was mandatory in the Bank Companies Act, 1991 to provide 4% of total demand and time liabilities as capital , very few of our banks could fulfill the condition. Almost all the banks were under capitalized and because of provision shortfall and deteriorating condition of asset quality, further erosion of capital was faced by the banking sector . Hence in order to safeguard the interest of depositors and bring about a universally accepted status of our banking sector, risk weighted capital adequacy requirement has been revised from deposit base to credit based and accordingly credit risk based system has been introduced from January' 1996 and it is now mandatory for the banks to maintain capital to a minimum of 9% of the risk weighted loans and advances. Banks are strictly advised to maintain the adequacy element of capital and Bangladesh Bank is constantly motioning the status of commercial banks in this regard.

Capital inadequacy of NCBs has been deteriorating since the mid- nineties and now stands at TK. 55 billion for shortfalls in loss provisioning for non-performing loans. The capital position reported by NCBs to Bangladesh Bank reflects only partial loan loss provision, with much of the loss provision not actually charged to their income as reported in their income statements. As a result, NCBs reported capital shortfall has been systematically understated since long. In 1996, for instance, the capital shortfall reported by NCBs was just TK 5.6 billion. If short provisioning of loan loss is taken into account, the adjusted capital shortfall on account of classified loans was TK. 24 billion. The NCBs' report to Bangladesh Bank, based on incomplete accounting, showed a positive capital balance of Taka 14.9 billion and a capital shortfall to be 12.7 billion as on June 2002. The absolute capital and its shortfall are understated because accumulated shortfall in loan loss provisioning for NCBs has risen to the level of Tk. 43 billion by June 2002. Consequently, the adjusted capital shortfall of the NCBs, taking the short provisioning of loan loss into account, stood at Tk 55 billion, more than twice the level of 1996. This raises a question about the credibility of NCBs reported accounts . A special audit of NCBs in 1996 had identified the problem of underreporting of capital shortfall .

| Reported and Adjusted Capital Shortfall of NCBs on Account of Classified Loans (billion Taka) | | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002-4 |
| Required Capital | 18.4 | 19.0 | 19.3 | 24.6 | 25.8 | 27.7 | 27.6 |
| Reported Capital | 12.8 | 15.7 | 12.6 | 16.1 | 14.0 | 1.7 | 14.9 |
| Reported Capital Surplus/Shortfall | -5.6 | -3.2 | -6.7 | -8.5 | -11.7 | -13.0 | -12.7 |
| Accumulated Loan Loss | | | | | -35.5 | -38.38 | 42.5 |
| Provisioning surplus/Shortfall | -18.4 | -22.2 | -31.6 | -37.9 | | | |
| Adjusted Capital Surplus / Shortfall | -24.2 | -25.5 | -38.4 | -46.4 | -47.2 | -51.9 | -55.2 |
| Source: Bangladesh Bank | | | | | | | |

**Probable Reason of Capital Shortfall:**

Total capital shortfall of the NCBs is likely to be larger than the shortfall due to classified loans resulting from other possible bad investments and liabilities. The above table shows partial estimates of capital shortfall of the NCBs, related to only classified bank loans. There is other bank assets as well as liabilities related to which losses and capital shortfall may arise. The total capital shortfall of the four NCBs was estimated on the basis of an audit according to IAS to be around TK.83 billion in 1996 .This was considerably higher than the capital shortfall of Tk. 55 billion in mid-2002 based on just the loan loss-provisioning shortfall reported by NCBs. An assessment of the true total capital shortfall of the NCBs related to their loans as well as non-loan under international accounting standards.

Source: Special Evaluation of Portfolio, Capital, and financial position of the Nationalized Commercial Banks 1996

**Financial Performance of NCBs and DFIs (Billion Taka )**

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Rerouted Profit/Loss of NCBs | -0.4 | -1.7 | -0.3 | 0.2 | 1.1 | 0.3 | 0.2 | 0.1 | 0.1 | 2.0 | 2.0 |
| Accumulated Profit/Loss of NCBs | 0.3 | -1.8 | -0.9 | -3.2 | -3.1 | -2.9 | -2.1 | -2.8 | -3.1 | -4.9 | 1.0 |
| Cumulative Provisioning | -0.1 | -3.5 | -1.2 | -3.2 | -1.9 | -2.6 | -1.9 | -2.7 | -3.0 | -2.8 | 3.0 |
| Shortfall of NCBs | -0.1 | -3.6 | -4.8 | -3.0 | -9.8 | -12.4 | -14.3 | -17.0 | -20.0 | 22.8 | -19.8 |
| Cumulative Provisioning | -1.2 | -7.5 | -6.6 | -7.9 | -16.3 | -18.4 | -22.2 | -3.16 | -37.9 | 35.5 | -38.8 |
| Shortfall of DFIs | n.a | n.a | n.a | n.a | n.a | n.a | -2.0 | -3.6 | -2.0 | -0.7 | -0.4 |
| Cumulative Provisioning | -1.2 | -7.5 | -6.6 | - 8.4 | -16.3 | 18.4 | -24.2 | 35.2 | -39.9 | -36.2 | -39.2 |
| Shortfall of NCBs | | | | | | | | | | | |
| Cumulative Adjusted PFI Profit/Loss | -1.3 | -11.1 | -11.4 | -16.3 | .26.1 | -30.8 | 38.5 | -52.2 | -59.9 | -59.0 | -59 |

Source : Bangladesh Bank and staff estimates.

**Trends in Proportion of Classified Loans in total Loan Portfolio (Percent)**

| | Dec'95 | Dec'96 | Dec'97 | Dec'98 | Dec'99 | Dec'00 | Dec'01 | Dec'02 |
|---|---|---|---|---|---|---|---|---|
| NCBs | 31.0 | 32.6 | 36.6 | 40.4 | 45.6 | 38.6 | 37.0 | 38.1 |
| DFIs | | | | 66.7 | 66.4 | 62.6 | 61.8 | 60.5 |
| PCBs | 39.4 | 34.8 | 31.4 | 32.7 | 26.5 | 22.0 | 17.0 | 18.0 |
| FCBs | 5.4 | 4.7 | 3.6 | 4.1 | 3.9 | 3.4 | 3.3 | 3.0 |

Source: Bangladesh Economic Survey and Bangladesh Bank

**Legal Environment:**

In most cases, Bangladesh legal infrastructure becomes a barrie r instead of being helpful to recover bank dues. The commercial law dealing with loan recovery overwhelmingly favors the delinquent customers. "The legal system makes if difficult for the NCBs repossess and sell many securities."(LRA Manual P.1-2) Enforcement of loan contracts in default is too slow to have much disciplinary effect on borrowers. For enclosure and other legal actions involve a cumbersome legal process that may take years to complete at huge cost to the banks .There are more than 30 Acts and Rules affecting banking and financial systems of Bangladesh but are very much ineffective in enforcing creditors right .

The borrowers know that even if the bank decides to resort to legal remedies, they (borrowers) would not be touched for at least 10-154 years due to cumbersome, inefficient and time consuming procedural law, over burdened judges and most of all ingenuity of their lawyers in adopting dilatory tactics. One research report suggests. "The legal system allows defaulters to delay lenders' recourse process indefinitely, making the enforcement process a virtual mockery" (Islam et. al 1999, p 31) our legal system provides, for an elaborate system of appeals, references, reviews and revisions, which causes abnormal delays in the legal process.

Let us now we analyze the performance of different courts by determining the rate of settlement, rate of recovery, difference between the average number of filing new suit and average number of settlement of case in a particular time period, etc. Table in dicates the rate of settlement according to Bank Group as on 30th June 2000.

| Year | % of Settled Case | | | |
|---|---|---|---|---|
| | NCBs | DFIs | PCBs | FCBs |
| 1997 | 36.09 | 26.83 | 25.58 | 55.88 |
| 1998 | 37.98 | 28.68 | 31.74 | 66.39 |
| 1999 | 43.13 | 30.92 | 38.48 | 68.86 |
| 2000 | 42.95 | 42.34 | 42.94 | 70.39 |

Source: Banking Regulation and Policy Department (BRPD). Bangladesh bank 2000

In all 4 types of Banks, the rate of settlement is showing an increasing trend over the years. The increasing trend of the rate of NCBs is comparatively lower. In the year 2000, the rates of NCBs and PCBs are almost the same. One remarkable thing is that the performance of FCBs is much better than all other banks and financial institutions.

**Non Bank Financial Institutions (NBFIs):**

With the liberalization of financial system in the late 1980s NBFIs have been taking increasing role. At present19 NBFIs are working with about total investment of Tk 2700-3000 crore. The NBFIs found it profitable to borrow from banks and lend the proceeds through the modalities of hire purchase and bill discounting to firms that have difficulty in borrowing from banks. Their basic operations are loans of 3 (three) to 7 (Seven) years for commercial or industrial equipment , particularly vehicle. Although no firm data is available, it can be estimated that the share of non-performing assets in the larger NBFIs is between 2 - 4 percent. In addition larger NBFIs have updated computerized system. Wide branch networks, better-trained staff who operates under an incentive system to make sound loans and to ensure recovery. The NBFIs have expanded in scope and now carry on a wide range of funded and un-funded activities. They are permitted to take deposits of one year or more.

**Reform Matrix:**

Healley and Ilieva constructed a reform matrix with nine parameters in a one to four point scale for Central Banking in Transition Economies. Comparisons of parameters are matched with the position of Bangladesh. The

Results indicate that Bangladesh can be ranked 4 in only one parameter i.e. privatization of all small enterprises .In case of liberalization of price, trade and foreign exchange system, Bangladesh can be tanked in 3 .In all other parameters, the position of Bangladesh is at the bottom. Therefore, policy makers should reexamine their position in terms of reform and take necessary action to go ahead with the reform agenda.

**Comparison with Bangladesh**

| Rank ▸ Parameters ▾ | 4 | 3 | 2 | 1 | Bangla desh |
|---|---|---|---|---|---|
| Large Scale Privatization | More than 50% of large enterprises are privatized | More than 25% of large enterprise are privatized | Privatization scheme of large enterprises have been introduced | Little or nothing done | 2 |
| Small scale privatization | All small enterprises privatized | Most small enterprises privatized | Significant port of small enterprises privatized | Litter or nothing done | 4 |
| Enterprise restructuring | Corporatization of state Enterprise completed | Corporatization in progress but incomplete | Legislative reforms passed, but not fully implemented | Few reforms passed | 1 |
| Price liberalization | Complete price liberalization and antimonopoly control | Substantial price liberalization | Price controls remains for significant number of products | Most prices still controlled | 3 |
| Trade and foreign exchange system | No import or export quotas or controls, convertible exchange rate | Few quotas, near full convertibility of exchange | Few quotas, but exchange controls still force | Widespread import/export quotas and / or exchange controls | 3 |
| Competition policy | Signification antimonopoly enforcement | Some enforcement to control abuse of market power | Basic competition policy rules and institution are set up | No competition policy rules or institutions | 1 |
| Banking reform | Well functioning banking system | Substantial progress towards competitive banking system | Interest rates main mesa of allocating credit | Little or no progress | 2 |
| Capital Markets | Functioning, liquid capital market, with legal teamwork approaching international standards | Substantial issue of shares by private firms on capital market | Establishment of capital market and limited trading | Little or no progress | 2 |
| Legal reform index, rules on pledge bankruptcy and company law | Comprehensive legal rules, independently and consistently enforced | Legal rules exists but enforcement patchy | Legal rules are limited or contradictory hard to enforce | Legal rules very limited in scope, unclear and not consistently enforced. | 2 |

**Brief History of Banking Sector Development in Bangladesh**

Reforms in the financial sector are not needed for itself, rather for facilitating the real sector activities through fulfilling the regula tory prudential requirements as well as maintaining its own viability. The banking system of Bangladesh was evolved, in fact, through reforms in terms of nationalization and reorganization of the banks operating in Bangladesh in 1972. during 1972-82, the banking and other financial institutions were operated under the ownership and regulatory control of the government of Bangladesh (GOB), As the policy of the GOB regarding the private sector had changed since long ( and also for increasing banking)efficiency), the need for allowing local private banks was keenly felt,. Therefore, the reform measures in terms of privatization and denationalization of banks were taken in

1982. Before liberation of Bangladesh, the banking and finance industries in erstwhile East Pakistan was owned and controlled by erstwhile West Pakistan owners. After liberation of Bangladesh in December' 1971, it inherited a narrow and thin financial sector with six commercial banks which were nationalized, a few foreign banks and two Government owned Development Financial Institutions.

**Global Trend:**

Followed by a number of regulatory reform measures taken under Financial Sector Adjustment Credit (FSAC) of the World Bank basically for restoring banking efficiency in the beginning of 1990s. In 1986 ,the GOB also formed a commission-National Commission on Money, Banking and Credit (NCMBC) with the objective of scrutinizing the banking sector's problems and suggesting remedial measures thereof. The financial sector reform project (FSRP), which was instituted at Bangladesh Bank for successful implementation of reform measures under FSAC, ended in 1996. It was followed by the formation of a Banking Reform Sector (BRC). The BRC submitted its report along with recommendations in 1999. During the last interim government (2001), CPD launched a Task Fore on Financial sector Reform which prepared a set of recommendations for consideration by the government.

A number of financial sector reform measures have already been initiated. The important among those reform measures are: guidelines for sanctioning large loans, loan rescheduling and write-off; rationalization/merger of loss incurring branches of NCBs and DFIs; delegation of power and responsibility between the board and management; guideline for the formation of audit committee and its functions; amendment of Bank company Act, 1991 incorporating new minimum capital requirements of banks and changes in the composition of board and the tenure of its member; enactment of new Artha Rain Adalat Act,2003 etc. The initiative of the Government has been the formation of an expert committee (henceforth to be considered as the reform committee) for addressing the problems related to non performing loans (NPL) of the banking system. A number of recent reform measures have been undertaken based on the committee's recommendations.

Through an amendment of the Bank company Act, 1991 in the last March 2003, the level of minimum capital requirement (comprising of paid up capital and reserves) has been raised to TK. 100 crore from TK.40 crore for all categories of banks operating in Bangladesh. The objectives of raising the level of minimum capital requirement are to ensure the financial soundness through removing the capital inadequacy of the banks. Bangladesh Bank (BB) in a subsequent circular has asked the banks to fulfill the 50% of capital shortfall within a year form the date of enactment of amendment of the Bank Company Act and rest of the shortage by the following 2 years. The banks are not allowed to declare cash dividend before fulfilling the capital shortfall. Increase of reserves through retaining profits after tax, offering of primary or right shares, and merger of more than one banks- are the means suggested by Bangladesh Banks for addressing the capital shortfall of local banks. For the foreign banks, the capital shortfall is to be fulfilled within the assigned time either through non–repatriation of profit or bringing additional capital from foreign sources.

**Need for Financial Sector Reform:**

The demand management aspect of macro economic variable was not taken care of. The loanable fund at the disposal of the banks were disbursed mostly in publicly directed sectors without commercial consideration . The internal control system of commercial banks was weak, the books of accounts did never reflect the actual financial health of the banks, the quality of assets of the banks was never evaluated on strict accounting principles, the MIS was virtually non-existent in the banking sector, profitability and liquidity aspect of portfolio management was unfamiliar concept among the management personnel, the elements of capital adequacy for banking operation were never given due weightage. The pervasive weakness in money market was observed in the capital market also. The only stock exchange of the country- Dhaka Stock Exchange was almost inoperative with only a few enlisted companies. Bangladesh Shilpa Bank (BSB) and Bangladesh shilpa Rin Shangstha (BSRS) were mainly bridge financing projects out of loans from IDA, ADB credit lines to projects which were hardly appraised from the point of view of cost benefit analysis. Cumulative effect of mismanagement on money and capital market led to huge accumulation of non performing loans for our financial sector. The total scenario of financial sectors was in a state of disarray. Hence the need for overhauling of the financial sector was felt and in order to bring about structural , institutional and policy sector changes in the fragile financial sector, a National Commission of Money , Banking and Credit was constituted in 1984 .

The Commission submitted report to the Govt. in 1986 identifying the problem areas in our financial sector. The specific recommendations to bring about the structural, institution policy and legal reforms, Accordingly, the Financial Sector Reforms Project (FSRP) was launched in 1990 under financial Sector Adjustment Credit of IDA the 1st phase of which was completed in June 1996, The financial sector reform has become a continuous process, which is now being carried out , in its second phase the Commercial Banks Restructuring Project .

**Privatization of Banks:**

One of the important objectives of the FSRP was opening up of financial sector for private Banks. This policy has been aimed at are bringing about efficiency through competition in the banking sector and gradual privatization of the 4 NCBs which still hold 60% of the total bank deposit. Under the present policy of liberalization, scope exists for operation of more indigenous private sector banks and foreign owned banks keeping a very cautious watch over overall performance of the economy in the years to come

**Liberalization of Interests Rate:**

A major policy change introduced in a key policy variable was in the area of interest rate policy. In place of arbitrarily fixed interest rate, Bangladesh Bank introduced a flexible market oriented interest rate structure from January 1990. Interest rate bands were abolished except for export, agriculture, and rates of interest on the basis of risks attached to and also on term loans on the basis of maturity period. At present, banks are free to fix up their deposit rates on the basis on market forces.

**Centrally Credits Monitoring:**

To strengthen the credit discipline and to provide adequate reliable credit information among banks to facilitate loan sanctioning, a credit Information Bureau (CIB) has been created in Bangladesh Bank in December 1992 to achieve the flowing objectives:

a) To collect all credit information of the borrowers having outstanding loan of TK. 1.0 lac and above from all the banks and non-banking financial institutions.
b) To provide credit information to all banks and financial institutions to facilitate loan sanctioning, renewal and rescheduling from the computer database.
c) to prepare credit reports for use of the Government and international financial institutions and to provide relevant data on bank credit for research and studies .
d) To prepare and provide Credit Risk Rating of the borrowers.

**Loan Classification Guideline:**

Before introduction upgraded loan classification guidelines in 1989 by Bangladesh bank, the commercial banks did not follow any norm to classify their bad and non-performing loans. Banks did not keep provision for their poor quality assets , hence there was huge provision short-fall and capital inadequacy.

But now, Bangladesh bank is constantly monitoring the bank’s performance and improvement on the issue of provision and capital shortfall. Now the loan classification criteria has been made more stringent. Accordingly provision requirement have also been raised to 20% for substandard and 50% for doubtful and 100% for bad/loss.

**On-site and Off-site Supervision:**

Under FSRP, major change has been made in the on –site and off-site inspection areas of Bangladesh Bank. Evaluation of performances of banks are being made thorough "CAMEL RATING". The CAMEL RATING system is based upon an evaluation of 5 crucial dimensions that are to be evaluated are Capital Adequacy, Asset Quality, Management, /Earning & Liquidity. Each of these dimensions is to be rated in a. scale of 1 through 5 in ascending order of performance deficiency. Thus, " 1 represents the highest, '5' the lowest level of operating performance.

1) Banking Companies were being guided under Bank Companies Ordinance, 1962 and has been replaced by Bank company; Act, 1991 which provides with wide range of power to Bangladesh Bank to deal with banking sectors monitoring, regulation and supervision.
2) The financial Institutions Act. 1993 was formulated to deal with the affairs of Non-Banking Financial Institutions (NBFI). As per provision of this Act, cautious approach is taken to issue license for new NBFIs and monitor and supervision of the existing NBFIs are being made to ensure their sound operation
3) The Bankruptcy Act was enacted in 1997 and 2 Bankruptcy courts have been set up in Dhaka and Chittagong and deal with delinquent big defaulters. Adequate number of money loan courts have also been created to deal exclusively with bank loan default.

**Foreign Exchange Management:**

Bangladesh follows a managed float types of exchange rate arrangement under which market sets the exchange rate instead of Bangladesh Bank . Banks give forward cover for their own foreign exchange transaction. An important landmark in the exchange rate regime has been the convertibility of Taka for all Current Account transactions from March 24 1994. Phasing away of exchange restrictions gained momentum in the "90s . The official and secondary exchange market rates were unified at the end of 91. Major relations in exchange control area included waiver of Bangladesh Banks' prior permission for routine current transactions such as foreign exchange for visits abroad, medical treatment, education, interest and principal payment on loans, remittance of profits, dividends, royalties. Exporters and other earners relaxed requirement of surrender of foreign exchange by residents allowing partial retention.

The allowing of the operation about 400 money changers or exchange house all over the country to deal with buying & selling of foreign exchange in addition to the Authorized Foreign Exchange Dealers further facilitated the foreign exchange availability in the Foreign Exchange Market.

In the FY 2002-2003 export increased by 9% making a total of US$ 649 crore 20 lac. On the other hand import cost increased by 13% making a total of US$ 869 crore 90 lac during the same period. Trade deficit during the FY 2001-2002 was US$ 176 crore 80 lac and in the FY 2002-2003 it increased to US$ 220 crore 70 lac and the NRB's remittance increased by 22%. Foreign exchange reserve now stands at US$ 246 crore, which is enough for 3 months import bills and is ideal for a country like ours. Out of this reserve World Bank and IMF have released a substantial amount of their total pledged loan amount of US$ 102 crore 60 lac.

Bangladesh maintains a unified exchange rate. The rate is anchored to a basket of currencies of 15 important trade partners under a system known as Real Effective Exchange Rate(REER) rules. The exchange rate of taka should theoretically be adjusted from time to time on the basis of changes in the real effective exchange rates. SWIFT is now widely used in the banking sector to safeguard against any fraud and forgery.

**Capital Market:**

The Capital Market of Bangladesh is still in a rudimentary stage, The Investment Corporation of Bangladesh (ICB) and Dhaka stock Exchange (DSE) are playing active role in the capital market .The

ICB nourishes the equity segment while DSE provides opportunity for trading in shares & equities .A number of reforms have been adopted to promote growth of capital market . These include fiscal incentives, regulatory matters, updating and rationalization of securities & Exchange Commission (SEC) and establishment of SEC as a statutory regulatory body. More liberal policies have been put forward to issue licenses to new merchant banks and NBFIs. An allocation of 5% of new IPO has been earmarked for non –resident Bangladeshi investors. Banks can finance loans against share/debentures to the extent of 60% of average market value of preceding 6 months following the bankers-customer relationship and other banking norms as per prudential guidelines issued by Bangladesh Bank .But the stock Exchange has yet to regain shape from the collapse happened due to irresponsible speculative bubble during November, 1996. The continuous bearish tendency and the declining price index has shaken the confidence of the investors in the share market .As a result the prospect of the growth of capital market to meet the capital needs of the industrial development through attracting booth domestic and foreign portfolio investors seems to be nipped in the bud . The lack of expertise and professionalism in the SEC to regulate and promote the stock Market opened the opportunity to the market players to manipulate and exploit the emerging market to make windfall gains.

The Capital Market reforms and the liberalization of exchange control regime to attract foreign investment in the market friendly environment of the economy could hardly make any mark in the flow of foreign direct and portfolio investment. Mere financial and fiscal reform are not enough to attract and retain foreign capital in the country Appropriate legal Socio- political commitment, law and order, rule of law and good governance are essential to create confidence of local and foreign investors.

**Ethics in Bangladesh Banking Sector:**

Inefficiency and Injustice

Rampant inefficiency and injustice are prevailing in the banking sector due to the unethical practices going on in the whole society where bank is a great party to it. Political domination on the baking sector and unethical top executives are the most horrifying chapter in break ethics culture which is again the foundation of loan default bad habits (culture?) of the country.

Risk recognition and assessment should cover all risks- such as credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk. Certain changes in a bank's environment should be the subject of special consideration to see whether accompanying revisions are needed in the internal control system. These changes include (1) a changed operating environment, (2) new personnel (3) new or revamped information systems, (4) areas/activities experiencing rapid growth(5) new technology (6) new lines , products, activities (7) corporate restructurings, mergers and acquisitions and (8) expansion.

Management is one person that is top person to me and Ethical conduct by top management is almost nil in Bangladesh. No one should be employed if he faces criminal charges and name lending. Country is suffering from lack of efficient management and accountability, wrong feasibility, certification of creative accounts by auditors, lack of ethical and proper follow-up, shortage of adequately qualified and professionals, due to expansion of bank inefficient and miss massed managers are in the top, knowledge generation gap prevailing in banking and there are idle capacity in the government banks. Political influence and rampant corruption by bankers. Background checking of Managing Directors are not effective.

**Cost of Corruption in the Financial Institutions of Bangladesh:**

Recent Tk. 3000 million irregular loan of Om Prakash Chowdhury from 5 private banks. Loan default in the private sector now 20%, while it is 35 in the Nationalized sector. Private banks are more profit oriented than good house keeping, while government banks are neither profit oriented nor care for house keeping.

Industrialization in Bangladesh is seriously hampered by over-profiteering of the banks. Corruption costs financial institutions US$ 666 million annually. This is as high as 1.42% of the county's GDP of US$ 46934 million at current market price. Inefficiency, corruptions add up this amount annually to the product costs of financial institutions. Had there been no such corruption and inefficiency depositors would get more attractive rates while the customers would get loans at a cheaper rates. Simply tax payer are being panelized/punished for the inefficiency and corruption of the bankers. Operational costs in the banking system are staggering 3.13% of the net assets against an internationally accepted practice of 1% only. In India it is 2.5%. The substantial excess cost therefore stands at 2.13% of net banking assets, which translates to 0.56% of the current GDP. Statutory capital adequacy requirements needs are 3.20% of GDP. The annual cost of servicing the re-capitalization, therefore stands at 0.32% of GDP. Based on other studies the re-capitalization financing would reach 0.62% of GDP. Consequently the total annual cost of the banking sector inefficiency would stand at 1.18% of GDP. If the inefficiency of DFI and specialized banks are added to the list the cost of refinancing only in this particular segment stands roughly at around US$ 1.17 billion or an additional 0.24% of GDP. In India the refinancing cost is roughly 0.75% of GDP. One would think that our financial system is riddled with people who have little or no knowledge of modern banking system. In the FY 2000-01 858 Textile mills received Tk. 6930 million as cash incentives, of which mostly was through forged documents in connivance with the bankers. Although there is no Islamic Banking Law in the country, but they are operating in full swing.

**Commercial Audit Objections:**

Since liberation of Bangladesh Government Commercial Audit has raised 121000 audit objections under 19 categories, of which 108000 were for Tk.2-15. Interestingly there were no significant objections, while the country has been suffering from chronic loan default bad habits (as it can not be a culture, I do not call it culture deliberately). The Commercial Auditors are not competent in banking and they themselves are mostly corrupt. This kind of silly ineffective audits do more harm than good. It rather gives license to the fraudsters and unethical corrupt bank officers. The audit objections are based on 17-25% sample checks only. A total of 771 audit objections were raised involving Tk. 6.63 billion for the period 1993-2001. In the FY 2001-2002 commercial audit raised 7538 audit objections valuing Tk. 22650 million. Bangladesh bank only in April, 2000 mandated application of IAS-30 disclosures for banks to have true and fair view of their financial status. External Audit fails due to compromised independence and failed quality control procedures and lack of Banking knowledge of the auditors.

**Default Loans:**

As of April 30, 2002 default loan amount has reached at Tk. 243430 million including Tk. 210490 million of bad loans. Interest exemption, rescheduling and transferring the loan into block account are the bad things the country needs to change immediately. In last 6 months default loan has increased by Tk. 6810 million.

**Control Break-down in Problem Banks:**

There were seven problem banks in the country, two have now come out of the problem bank list. The types of control breakdowns typically seen in problem bank cases can be grouped into five (5) categories:

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank.
- Inadequate recognition and assessment of the risk of certain banking activities, whether on or off balance sheet.
- The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliation's, and reviews of operating performance.
- Inadequate communication of information between levels of management within the bank, especially in the upward communication problems.
- Inadequate or ineffective audit programs and monitoring activities.

**Money Market Scenario:**

The Second monitoring and Evaluation mission of the IMF came to Dhaka to evaluate the Floating Exchange Rate since it was first introduced in Bangladesh in June 2003. Under the umbrella of the Floating Exchange Rate System Authorized Dealers themselves decide the rate of exchange between Taka and Other Foreign Currencies in place of previous practice of deciding the rate of exchange by the Bangladesh Bank. Many people were apprehensive of drastic fall of Bangladesh Taka as soon as the Floating rate was introduced, but to their surprise that did not happen. Even after 6 months of introduction of floating exchange rate Bangladesh Taka value remained stable and call money rate swings between 5.5%-7% even in this peak season of festival compared to 51% call money rate at this time last year.

Capita Market should be fair, but not too much through unfair means, which turns to be scam and ultimately a Black Monday situation. Former Malaysian Prime Minister Dr. Mohathir Mohammed said, " currency trading and speculation in stocks as conducted today serves very little purpose. Currency trading is said to be 20 times bigger in money term than the world trade in goods and services, but what benefits do we derive from it? Apart from a few people making huge sums of money, it has created to increase in employment, no growth in business, in the wealth of nations and people." A proverb goes that ' Every time a share is bought or sold , somebody some where has made a mistake'.

**Call Money Market:**

We have also broken all the previous records of call money rate as it went upto 51% -ever highest for all ages and all races. Questions were raised while mountain like hip of money/liquidity remained in the Nationalized Commercial Banks, why call money rate shooted up like this? Bangladesh Bank supplied about 505 crores taka as short term loan to 9 private commercial banks to rescue them/bailout from the liquidity crunch/crisis. As a result call money rate came down to 35% instead of previous ever highest 51%. In November 2001 M1 increased by 1.16% while M2 increased by 3.68%and the bank rate remained at 6% a decrease of 1%. Of late-10 years after Bangladesh has realized to set up a WTO cell in the ministry of commerce to protect the business interest of Bangladesh. The delay has happened as Bangladesh has utterly failed to understand the intrinsic meaning and objectives of Liberalization, Privatization and Globalization (LPG) since 1991.

Bangladesh Bank has now engaged itself in the open market operation very actively and has introduced its own securities, such as 90 days Bangladesh Bank Bill since 1990. Later on 30 –days Bangladesh Bank Bill has also been introduced in 1995 alongwith 90 days, 180 days and one year maturity Treasury Bill with active participation by commercial banks. Repo and Reverse Repo has already been placed there in the Market.

**Interest Rate Regime:**

During the last three years time bank rate of interest has been reduced by 6-7% in the major economies of the world, while it has been reduced by only 1% in Bangladesh. On November 5th 2003 the Managing Directors of the Commercial Banks have assured the Governor of Bangladesh Bank that they would reduce the rate of interest by 2-3% by January 2003. On the other hand Bangladesh Bank has slashed bank rate from 6-5% i.e. by 1%. After 1992 it is the first time to reduce the Statutory liquidity Requirement (SLR) from 20%-16%-a reduction by 4% of which Cash Reserve Ratio (CRR)?? would be 4% in liquid(cash) form and the rest 12% would be in the form of Treasury bill and bonds etc. This change in SLR requirements will not affect the Islamic Banks, they will continue with the previous 20% SLR rate. A process is under way for them to introduce a kind of Islamic bond. Previously it was 16% in form of Treasury bills and bonds and 4% CRR in Cash/liquid form. As a result of the current measures additional liquidity of Tk 4000 core is available in the market, making a total surplus of Tk. 12000 crore. The NCB's are the worst sufferers from excess liquidity. In other words loan-able fund has expanded by Tk.40 billion making a total of 120 billion taka. According to Bangladesh Bank statistics the banks had Tk. 19754 crores stashed with the central bank as SLR and cash reserve ratio(CRR) on October 16 2003. The banks also had Tk. 8099 crore in excess liquidity on the same date—Tk. 2272 crore with the NCBs, Tk. 3838 crore with the PCBs and Tk.1673 crore with the foreign banks. A year before call money rate went upto 51%, which was probably the ever highest in the contemporary economic history of the world, leaving aside Bangladesh. Although loanable fund/ liquidity position has significantly (33%) improved but the banks are worried about with this huge amount of liquidity as the demand for loan is significantly low and there is no immediate sign of improvement.

Bangladesh bank expects that there would be no more liquidity crisis in the country atleast in the foreseeable future. The existing high rate of interest seriously putting hindrances in the economic development of the country. The rate of interest in Bangladesh is the highest in the world as well as significantly higher compared to the neighboring countries. On the 30th June 2000 the average lending rate of interest in Bangladesh was 13.86% (15.86%)??, while on that date average lending rate of interest in Pakistan was 14.02%. On the 30th June 2003 the average lending rate of interest in Bangladesh plummeted to 12.80%%)??, while on that date average lending rate of interest in Pakistan plummeted to 7.58% and on the same date the average lending rate of interest in Thailand was only 6%. Still the rate of interest in Bangladesh is not at all comfortable. Although rate of interest is a significant factor for investment, employment generation and Economic growth, but law and order, bureaucratic constraints, low profile commitment of the politicians is not less important.

Lending rates also shriveled by 6-7% in India, Nepal and Sri Lanka. Interest rates on treasury bills have also been decreased by 2-3% and call money rate is hovering around 2-3% due to certain steps taken by the Bangladesh Bank.

**Interest Rate Dilemma:**

On one hand the government claims that under the prevailing interest rate principles the commercial banks enjoy full autonomy in determining their deposit and lending rate of interest. But on the other hand Bangladesh Bank has again instructed the commercial banks not to have discriminatory rate of interests among the customers. They have threatened the commercial banks to punish if discriminatory rate of interest is practiced. Despite the Bangladesh Bank's instructions some commercial banks are practicing the discriminatory rate of interests and making the competition uneven. NCB's rate of interest for term deposit varied between 6.50%-7.25% in October, while PCB's rate for term deposit was between 6.5%-13%, but most of the PCB's offered 8.5%-10% for term deposits. Foreign banks offered between 5%-11% interest for term deposits. Bangladesh bank has been aiming to reduce the commercial banks' rate of interest to one digit(9%).

NCBs' and state owned Development Finance Institutions have been asked in the World Bank report on 'Bangladesh review of public sector enterprise performance and strategy' to squeeze their lending to check the flow of default loans. The quality of bank loan portfolio in Bangladesh is considered to be significantly worse than that of many developing countries in the world.

A new guideline issued by the Ministry of Finance said that Government, Semi-government and Parastatals can have 25% deposits of their annual development budget allocation amount and 25% of their own fund in PCBs provided they are of atleast 10 years and 5 years old respectively.

Despite many positive steps by the Bangladesh Bank lending rates of interest declared by the commercial banks in November 2003 are significantly high and ranges between 13-118%, while BRAC bank declared between 13-24%. For export it is 7-10% in all banks.

**NCB/SoE Reforms:**

International Finance Corporation (IFC), and Small Enterprise Development Fund (SEDF) and DFID will jointly provide US$ 445 million for reforming the NCBs and SoEs. US$290 million will be spent for voluntary retirement, US$ 38 million for banking reform, US$ 10 million for enterprise growth, US$ 20 million for refurbishment of assets, US$ 4 million for institutional strengthening and US$ 5 million for retraining and counseling of retrenched staff.
As a condition of reforming the NCBs' Bangladesh received US$ 104 crores loan from IMF. Against the loan Agrani Bank will have 6-7 consultants, Rupali Bank will have 7 consultants, for a period of 3-4 years for the purpose of making these banks ready for privatization, Sonali and Janata bank each will have 7 consultants for 3-4 years to make them more dynamic. The total employment size of these 4 banks is about 61000, while World Bank recommended golden handshake for upto 50% of the total employment strength making about 30000 in number. Employees above 25 years of experience are scared of golden handshake and demotivated.

**Loan Default Culture!!**

Banks were stacked with Tk. 20,736 crore in default loans at the end of last FY, Finance and Planning Minister told the Parliament recently. The colossal amount of classified loans belongs to 77805 customers who took Tk.50000 to above each. The 4 NCBs were burdened with Tk.11798 crore. Sonali bank accounted for Tk.5066 crore, followed by Agrani bank tk.2836 crore, Janata bank Tk. 2618 crore and Rupali bank Tk.1269 crore.

Sonali Bank-an NCB claimed that borrows with more equity in the business default less and are more professional in their business operations compared to the borrowers with less equity in their business

**Anti-Money Laundering Act-2002:**

Bangladesh has enacted Money Laundering Act 2002 to prevent illegal financial transactions. Although the law is wider and deeper than the American Money laundering Law but the enforcement is not effective. Money Laundering is now a serious issue and has become more organized, sophisticated, technical and increasingly international in nature. Money laundering is a process whereby proceeds, derived from criminal activities, are transported, transferred, transformed, converted or intermingled with legitimate funds for the purpose of concealing or disguising the true nature, source, disposition, movement or ownership of those proceeds.

An estimated US $500 billion of dirty money is placed into world financial systems each year or roughly 2% of global GDP. IMF estimated that the aggregate size of money laundering in the world could be somewhere between 2-5% of world GDP. Accordingly our estimated amount of money laundered in a year is about US$ 950 million about Tk.5500 crores(2% of our GDP). A study has revealed that 40% of our foreign remittances are sent through unofficial channels, which supports illegal trade in goods, gold, arms, drugs. Hawala or Hundi is widely practiced between India, Pakistan and Bangladesh.

**Global Competitiveness Index and Bangladesh:**

The world economic forum study report stated that Bangladesh is losing out in global competitiveness index having slipped to 79$^{th}$ position in 2003 from 77$^{th}$ position a year before. The survey identified corruption as the most inhibiting factor of doing business in Bangladesh. Inefficient bureaucracy, inadequate infrastructure, poor law and order, policy instability, poor access to financing also affect the countries business environment.

In one estimate of the newspaper that about Tk. 10 million per day is transacted through hundi in Chittagong area alone. It is also reported that a strong net work has been established in the Middle-East for the purpose.

**Islamic Banking !! Is there any Law for it??**

Although there is no Islamic Banking Law in the Country, but brisk business is being done in the name of Islamic banking. Due to this sentimental opportunity/ issue Islamic banking along with other traditional banks are expanding their self breed type banking rapidly. What they term Islamic that is not Islamic in the true sense. As the Sharia is not changeable there is no need to have a Sharia Council in the Islamic Banking Concept.

**Capital Market Scenario:**

The capital market was never been booming in Bangladesh. What we saw in 1996 was an artificial market for some opportunists, rumor mongers unethical and unscrupulous people. That was a super abnormal behavior of a CAPITAL market which can be compared with a black Monday only. A group of people gained enormously at the cost of enormous loss of other group. Lowering the interest rate for government savings instruments will not yield a significant improvement in the capital market as long as the people have less or nil confidence in the audited balance sheet, government and regularitory bodies efficacy. Security and Exchange Commission has sent recommendation to the body on companies act amendment seeking separate bench for stock market cases. To safeguard the interest of the small investors an independent director outside the shareholders and atleast 20% directors in the board of a company proposed to come from minor investors.

**Role of Insurance in the Financial Sector:**

There are 45 Insurance companies in the country now, compared to 21 in 1996. insurance as a whole is not popular in Bangladesh. By and large it is taken under some kind of compulsion or so except a few cases. Risks can be minimized through the purchase of insurance policy, while insurance companies can turn risks into opportunities in a careful calculative exercise/manner. Experts opined that due to certain government decisions like banning commission and credit system and imposing ceiling on establishment cost to 20%, charging VAT on deposit premium against open cover note executed between the importer and the insurer, which claimed to have violated the Insurance Act.

Experts opined that cost of management should be raised from existing 35% and agency commission should be reinstated. Framing Code of conduct for the development officers and strictly follow the uniform tariff rate claim settlement of the re-insurer through the central bank/Bangladesh Bank causing unusually delay and that results in loss of confidence in the local insurance companies by the re-insurer. Delay in genuine clam settlement by some insurance companies also contributing towards loss of public confidence in insurance.

**Lease Finance:**

The first Leasing company was set up in 1985 followed by a second one in 1989. At present 17 financial institutions are offering lease financing in Bangladesh. The industry's rate of investment in Bangladesh is estimated around 17.2% of GDP. It needs to be accelerated to reach about 25% in the next 5 years time and 30% in the following 5 years if a rate of growth of 6.7% is to be sustained, assuming capital output ratio of around 4. A 5 years leasing business table is appended below and the trend is quite encouraging too:

| **Year** | **No. of Leasing Co.** | **Growth Rate** |
|---|---|---|
| 1997 | 14 | 24.46 |
| 1998 | 16 | 2.65 |
| 1999 | 16 | 30.12 |
| 2000 | 17 | 30.89 |
| 2001 | 17 | 24.09 |

**Micro-Credit Dilemme:**

According to a study of CARE and DFID the chronically poor households owe 167% of the net asset value while the non poor owe only 15% of the net asset in the south eastern region. The people who are always under pressure of poverty use most of their credit on basic needs like food and healthcare while the non poor households use it primarily for agriculture and off-farm investments. Over 33% poorest households use credit. As the interest rate depends on the sources of credit, the poor households pay about 45% interest, while the non-poor pay about 11% mainly because the poor mostly depends on the money lenders. As the micro credit is in almost every part of the country and going on unchecked/uncontrolled establishment of a micro credit regulatory commission to institutionalize micro credit banks in the country where over 10 million poor borrowers are reached by mcbs each year. Regulations in this sector would not only help smooth functioning of NGOs, but also protect the money of the micro depositors of around Tk. 3900 crore. People borrow from one lender to re-pay another. To me Credit is not a right, rather a privilege as opposed to Prof. Mohammad Yunus.

As of now Grameen Bank has disbursed US$ 3 billion in micro credit loans and US$ 185 million in housing loans. Currently it serves 2.35 million customers, 94% of the are women covering 40000 villages. Grameen Global Network – a coordinating body of Grameen Bank now conducts 80 micro credit programs in 30 countries around the world.

Palli Karma-Shahayak Foundation (PKSF) the largest funding agency of its kind in the world has lent about US$ 300 million to 210 micro finance institutions in Bangladesh covering more than 3.8 million customers, more than 90% of whom are women. A researcher of BRAC said that the micro credit was not meant for the extreme poor because of its severe commercial nature who constitute 10-15% of the total population of the country. An economist claimed that 40% of the bank deposits come from rural areas, but they enjoy a little over 13% of the national distribution. Another expert claimed that around 3.1 crore poor people are under the micro financing program in the country. The rate of interest hovers between 20-30% and the loan recovery rate is 92.92%.

The fundamental difference between micro credit and micro finance ideas are (a) profit motives and (b) the means of operation. By definition the micro credit programs are NGOs', for which they cannot run their operations with the objectives of making profits. This in turn suggests that they must depend upon external financing. The microfinance o the other hand , is a profit making private venture, which must aim at operating its activities without external help, because profit making and public objective do not go hand in hand. For both intellectual clarity and sound policy formulation , the current practice of using the micro credit and microfinance terms synonymously demands critical evaluation. It is obvious that they are very different kinds of organization that attract very different kinds of people. Therefore for the sake of sound policy making these terms ought to be used in their proper context. The excess liquidity of the commercial banks are now being used for micro credit though NGOs. About 45% of the micro credit is going to small business, 17.73% to livestock sector, 12.74% to agriculture,, 4.84% to Fisheries, 3.39% to food processing, 2.81% to small industry and 2.15% to transport sector. Of the total credit delivery of Tk. 51670 crore, the outstanding credit is about Tk. 9376 crore. The recovery rate of Grameen Bank is about 86%, while other NGOs' about 97.93%. Central bank of Bangladesh is supposed to monitor Tk. 6000 crore micro credit business, but virtually there is little or no control.

**Central Bank Reorganization Project:**

Bangladesh Government has received a loan of US$ 3 crore 70 lac from the World Bank for reorganization & strengthening of Bangladesh Bank. The total budget for this project is US$ 4 crore 61 lac 30000 and the duration of the project is upto 2007. About 40 numbers of foreign consultant will be engaged in this project including one foreign consultant as the Private Secretary of the Governor of Bangladesh Bank. The lions share of the expenses will be used for the salary of these consultants. One IT consultant is already drawing Tk 2 million equivalent salary/p.m. One Consultant from the US Treasury department is already there for last one year.

**Summary of the Constraints in the Banking Sector of Bangladesh:**

- NCB's are creaking under the dead weight of 28%
- Wrong choice of loanees
- Fictitious feasibility study report
- Compromised attitude of the bankers
- Political Influence
- Money Laundering of the loanees
- Heavy CBA influence
- About 35% of loan default of which 31.37% for industrial sector alone.
- Inadequate guidance from the relevant government ministries/departments
- Rampant corrupt practices
- Lack of professionalism
- Inadequate knowledge of the bankers
- High lending rate of interest
- Managed annual/audit reports
- Lack of Accountability
- Tk. 250 billion(US$ 4.30 billion) default industrial loan under process of writing off
- Up to June 2002 Commercial banks distributed industrial loans for Tk.790 billion(US$ 13.62 billion)
- The largest NCB-Sonali Bank spends Tk. 99.71 for earning each Tk.100
- Other NCB's income/expenditure ratio is also almost similar to Sonali Bank.

- PCB's classified loan slightly fell from 16.98% to 16.65% from December 2001 to December 2002.
- FCB's classified loan fell from 3.33% to 261% from December 2001 to December 2002
- DFI's classified loan fell from 61.80% to 56.19% from December 2001 to December 2002
- BSRS's 82.80% loan is default while
- BSB has 67.54% default loan
- RAKUB has 54.30% default loan and
- BKB has 51.86% default loan

**BANGLADESH INSURANCE SECTOR:**

Among the various institutional investors who provide finance in a number of development projects of a country, particularly for industrial finance, insurance companies as a matter of fact play a very vital role in arranging and mobilizing the required finance for long term. Amongst other things, by means of insurance, insurers attempt to tap the infinite number of small sources of capital available from the man in the street , create a pool and the aggregate net sums after meetin g the claims and other administrative expenses are continuously made available for investment to the best advantage of the nation. Insurers are therefore custodians of the vast sums they receive which they naturally invest to earn interest in the capital market.

Jiban Bima Corporation (Life Insurance Corporation) (JBC) of Bangladesh lost about half of its business compared to previous year. After liberation JBC took over the responsibility of 37 Life Insurance Companies of the country having an accumulated liability of Tk. 15.70 crore. JBC started facing stiff competition since 1995 after the inception of several Private Insurance Companies in the country.

Several steps like rectification of faulty rules and regulations, establishment of transparency and accountability, collection of outstanding dues, credit control procedures, hiring of talents, removal/replacement of corrupt and inefficient officials etc. have been taken up as a part of the reorganization measures. After Bangladesh Shadharan Bima Corporation (General Insurance) received Tk. 240 million by fraudulent means from its foreign re-insurer there prevails distrust about Bangladesh among the re-insurers of the world.

**RED ALERT SYNDROM FOR FINANCE:**

Conflicting Trade Marks Registration-Breaking of TRIPS: The significant issues relating to TRIPS agreement are of the following:

1. The TRIPS agreement includes nuclear energy, methods of agricultural ad horticulture and biological processes and products for patentability
2. It provides for granting products patent to food, medicine, drugs and chemical products.
3. The duration of patents will be for 20 years of both for product patents and process patents.
4. There is no specific provision for licenses of right or revocation of patents
5. there is a provision for protection of plant variety by individual countries and to have an effective sui generis system of their own

Violating the Agreement on Trade Related Intellectual Property Rights(TRIPS) and out of bribe Trade Marks Registration office under the ministry of Industry has been registering any brand and name and trade marks of the world. Per Bangladesh Trade Marks Act. 1940, Section 10 no trade marks can be registered if it resembles by name, appearance and pronunciation with any other products or services. Per Article 6 of the Paris Convention no registration can be given to any one other than the original owner of the brand. American businessmen recommended Bangladesh to be black listed for the violation of international agreement on trade marks registration. If not deregistered these violators Bangladesh may face billion of dollars worth fine due to this after 2005.

**CORPORATE GOVERNANCE:**

All 6 Governance Indicators for Bangladesh

| Governance Indicator | Year | Percentile Rank (0-100) | Estimate (-2.5 to+2.5) | Standard Deviation | Number of surveys/polls |
|---|---|---|---|---|---|
| Voice and Accountability | 2002 | 29.3 | -0.57 | 0.17 | 8 |
| Political Stability | 2002 | 26.5 | -0.61 | 0.22 | 7 |
| Government Effectiveness | 2002 | 35.1 | -0.53 | 0.16 | 7 |
| Regulatory Quality | 2002 | 13.9 | -1.05 | 0.18 | 7 |
| Rule of Law | 2002 | 26.3 | -0.78 | 0.14 | 10 |
| Control of Corruption | 2002 | 7.7 | -1.12 | 0.16 | 8 |

Source : D. Kaufmann, A . Kraay , and M Mastruzzi 2003 : Government Matters III : The World Bank Group ( WBI Themes )

It is believed that the following factors may have contributed to the problems observed in the areas of Corporate Governance, Ethical Management, Financial reporting and External Audits:

- Lack of Ethical Conduct and Inappropriate 'Tone at the Top'
- Failure of Effective Board Oversight
- Lack of Financial Expertise on Audit Committees
- External Audit failure due to compromised independence and failed quality control procedures
- Opaque Financial reporting
- Emphasis on form over substance in applying accounting standards

**Investment Financing: Capital Market vis-à-vis Banks:**

Banks continue to remain the main providers of long term investment finance in Bangladesh, direct issues of equity and debt in the capital market playing only a minor role. New issue through private placements and public offerings in the capital market in FY 02 amounted to Taka 0.55 billion, against long term bank loan disbursements of Taka 35.05 billion. The Taka 65.52 billion market capitalization of listed stocks in the Dhaka Stock Exchange as of end-June, 2002 likewise looks small, when seen against Taka 166.80 billion outstanding term loans of banks

**Activities of the Dhaka Stock Exchange (DSE)**

| | End June | | |
|---|---|---|---|
| | FY 2000 | FY 2001 | FY 2002 |
| No of listed Securities | 239 | 244 | 257 |
| Issued equity & debt (billion Taka) | 30.52 | 32.23 | 34.97 |
| Market capitalization (billion Taka) | 54.00 | 72.17 | 65.52 |
| Turnover (billion Taka) | 27.70 | 49.09 | 34.94 |
| All-Share price index | 561 | 716 | 793 |

The present limited role of the capital market in investment financing would expand only gradually as the infrastructure of corporate governance, financial disclosure and credit information improves, instilling higher confidence of savers on the information resented by issuers seeking equity or debt. Transparent trading rules, and safeguards against price manipulations are also important in sustaining the interest and confidence of savers in the capital market.

**Industrial Term Loans by Banks**

| | End June | | | |
|---|---|---|---|---|
| | FY 99 | FY 2000 | FY 2001 | FY 2002 |
| Disbursement | 13.30 | 16.27 | 30.57 | 35.05 |
| Recovery | 10.93 | 16.53 | 27.95 | 32.15 |
| Outstanding | 121.52 | 136.63 | 153.79 | 166.80 |

**Activities of the Chittagong Stock Exchange (CSE)**

| | End June | | |
|---|---|---|---|
| | FY 2000 | FY 2001 | FY 2002 |
| No of listed Securities | 163 | 171 | 184 |
| Issued equity & debt (billion Taka) | 26.66 | 28.42 | 30.81 |
| Market capitalization (billion Taka) | 46.50 | 62.80 | 56.19 |
| Turnover (billion Taka) | 9.55 | 14.71 | 15.84 |
| All-Share price index | 1174 | 1502 | 1316 |

**Measures for Capital Market Development:**

The major steps taken in FY 02 by the Securities and Exchange Commission (SEC), the capital market regulatory authority, towards improvement of the issuance and trading environment in the capital market were as under:

- The central Depository Bangladesh Ltd. (CDBL) a depository for paperless, electronic issuance and trading of securities, was accorded registration.
- Direct listing in the stock exchanges was made permissible for public limited companies with capital of Taka 30.0 million or higher;
- Rules were prescribed for Over-The - Counter (OTC) trading of securities of unlisted companies with capital of Taka 10.0 million or higher, and for securities of Companies de-listed from the stock exchanges;
- Registration was accorded to the Credit Rating Information and Services Ltd. (CRISL), a company to be engaged in the rating of companies and their securities issued in the capital market;
- To prevent abuse of the securities of poorly performing (Z-group) companies for price manipulation in the market, the stock exchanges were required to exclude the securities of such companies in working out and publicizing the index of shares prices;

- Adoption of decisions on dividends and on dates for holding annual general meeting simultaneously with board approved audited financial statements was made mandatory for companies listed in the stock exchanges.

**Secondary market activities:**

Secondary trading in the two stock exchanges at Dhaka and Chittagong remained generally subdued in FY 02, amidst slowdown in overall economic activities. Fluctuations in market prices, mainly reflecting local conditions, were of modest magnitude, in contrast with the precipitous falls in major markets abroad. The DSE Index has moderately improved in recent months.

**Non-resident portfolio investment**

There was a net Taka 0.29 billion non-resident portfolio disinvestment outflow in FY 02, with inflow of only Taka 0.03 billion against gross outflow of Taka. 0.32 billion. The FY 01 net disinvestment outflow was much smaller at Taka 0.06 billion, with inflow of Taka 0.32 billion and outflow of Taka 0.38 billion. The outflows were apparently caused by investor disappointment with steep losses suffered in the major world stock Market, too strong to be neutralizing by the relative stability in the small capitals market of Bangladesh.

**Equity and Entrepreneur ship Fund (EEF)**

The Bangladesh Bank for equity support is administering a Taka 1.00 billion Equity and Entrepreneur ship Fund (EEF) provided by the government to new ventures in the information technology and agro-based products sectors. The disbursement of equity support in FY 02 from the EEF was a modest Taka 0.05 billion, but have increased substantially afterwards in the first quarter of FY 03. The government has announced enhancement of the Fund to Taka 3.0 billion in the FY 03 budget.

**Housing Finance:**

A broad range of financial intermediaries including specialized housing finance organization, bank, other financial institutions, and micro credit lenders are active in housing finance in Bangladesh. All housing loan providers excepting the micro credit lenders extend housing loans for well-built pucca houses or apartments mainly in the urban areas. The Grameen Bank and some other micro credit NGOs on the other hand extend housing loans only for low cost basic shelters in the rural areas. The government's Taka 0.5 billion Grihayan Tahbil provides some refinance support for shelter housing loans through NGOs.

Loans of the state-owned House Building Finance Corporation (HBFC) for houses and flats in Dhaka and Chittagong City are at market interest rates (13-15 percent). but its loans for houses and flats in other areas at 10 percent interest has some element of concessionality.

**Housing loans: by lender/lender Group**

(Billion Taka)

| | Outstanding as of | |
|---|---|---|
| | 30 June'01 | 30 June'02 |
| a. Lenders specialized in housing finance: | | |
| HBFC | 28.08 | 28.34 |
| Delta-Brac | 1.46 | 2.14 |
| National Housing | 0.57 | 0.82 |
| b. Banks | | |
| Ncbs | 15.36 | 17.23 |
| Other banks | 11.33 | 13.94 |
| c. Other Financial institutions | 0.23 | 0.54 |
| d. Micro-credit lenders | | |
| Grameen Bank | 1.98 | 2.36 |

The two private sector housing finance organizations ( the Delta Brac Housing and the National Housing Finance) and the banks and other financial institutions extend housing loans at non–concessional interest rates reflecting market cost of funds. Housing loans of the Grameen Bank, available to its harrowed members, are at a concessional 8 percent rate of interest. Repayment periods of housing loans extend over several years, and these loans require a stable base of long term funds for the lender. Banks and the private sector financial institutions fund their housing loans with the deposits and borrowings they mobilize, which are of shorter maturities than the loans. The maturity mismatches are sources of possible liquidity risk and interest rate risk. Activation of a secondary market in housing loans and/or in securities backed by the housing loans, reoccurs to floating rate lending , and contractual loan term saving schemes for future housing loan borrowers are the usual means for mitigating liquidity risk and interest rate risk. These approaches are yet to take root in the housing finance market in Bangladesh.

# CHAPTER -III

## CRISS- CROSSING THE NATIONAL & INTERNATIONAL FRONTS

### Grading of Bangladesh Banking System:

Carriage (19908) conducted a study of banking system of the Latin America and the Caribbean and constructed a grade sheet of comprising of 10 Characteristics of Effective Banking System and found 3 at lower end. 4 medium, 2 mixed and 1 incomplete. Matching these characteristics with that of Bangladesh it is found that 8 are the lower end and 2 at medium position. This indicates nature and extent of weak banking system of Bangladesh. Bangladesh Banking Graded with 10 Characteristics of Effective Banking System

| Characteristics | Bangladesh | Latin American countries |
|---|---|---|
| Banking services | Low | Low |
| Financial Markets | Low | Medium |
| Wide ownership | Low | Low |
| Level playing field | Medium | Mixed |
| Money and capital market | Low | Medium |
| Payment system Legal framework | Low | Mixed Low |
| Banking Supervision | Medium | Medium |
| Independent central bank | Low | Medium |
| Deposit Insurance | Low | Incomplete |

### Financial Performance: Overdue Loans:

The Quality of bank loan portfolios in Bangladesh has been significantly worse than that of many developing countries. The proportion of overdue bad loans in total portfolio was 50 percent in Bangladesh around the mid-nineties. This was significantly higher than in a number of countries in the region and East Asia. The NCBs accounting for 61 percent of bank credit, and with much high proportion of classified loans than private banks have contributed most to the overall low quality of bank loan portfolio (WB, November 2002). The actual quality of the portfolio has been worse than reported for Bangladesh, an audit of the NCBs carried out in 1996 found their proportion of classified loans based on international classification standards , to be considerably higher than reported by the banks .

### Cross Country Reference:

Ghana was able to embark on a path of macroeconomic adjustment after 1983 with substantial external aid. The success of its fiscal reforms generated a primary surplus that together with external aid, allowed a carve-out to be executed in the banking system to remove bad debt from the banks without generating any monetary pressure. Chile and Colombia both suffered from the effects of rapid liberalization in the financial sector, resulting in overloading and the shocks of the cutoff, of external resources after the 1982 debt crisis. Colombia was able to maintain growth and absorbed the losses within the central bank. The shock to Chile was significantly larger, and the carve-out imposed an extremely large burden on the central bank that has yet to be eliminated despite the restoration of strong growth.

Cross Country Comparison of Overdue Loans
(As percentage of total loan portfolio)

| Bangladesh | Pakistan | India | Indonesia | Thailand | Philippines |
|---|---|---|---|---|---|
| 50 | 35 | 7 | 10 | 15 | 20 |

Source: Bangladesh: Key Challenges for the New Millennium , April 1999

**Conditions for Successful Bank Restructuring:**

The choice of appropriate restructuring mechanism depends on several key factors & size. Sheng identified nine conditions for successful bank restructuring.

a. Clear links with enterprise restructuring.
b. Stable macroeconomic environment.
c. Strong political will.
d. Effective restructuring agency.
e. Transparent accounting standards.
f. Legal framework favoring financial discipline.
g. Incentives favoring private sector growth and competition.
h. Effective bank supervision and enforcement.

**Preparing for Reforms:**

The following steps must guide bank and enterprise restructuring efforts :

a) Determine the size of losses –the stocks and flows.
b) Choose a centralized or decentralize debt restructuring solution.
c) Reduce flow losses resulting from continued exposure to loss-making enterprise and thereby improve intermediation.
d) Determine where the write –off of enterprise debts will be done by banks or by the state.
e) Determine where to restructure banks before privatization and restructuring of enterprises.
f) Determine the appropriate role of banks in enterprise restructuring.
g) Determine the appropriate role of banks enterprise restructuring.

While the process of bank restructuring will vary from country to country depending on initial conditions and financial structure, several principles and objectives should guide the design of bank restructuring programs:

**Centralized and Decentralized Approaches of Bank and Enterprise Reform**

| Centralized | Decentralized | Combination |
|---|---|---|
| I. Bad debts transferred to one agency<br>II. Focused approach-restructuring skills are concentrated.<br>III. Ideal where bad debts are concentrated in few larger borrowers or enterprises or sectors:<br>IV. Frees banks to concentrate on serving healthy customers;<br>V. Legal change required to transfer property rights to agency<br>VI. Budget bears burnt losses, and<br>VII. Could create a bureaucratic bottleneck. | • Banks responsible for bad debts:<br>• Bad debts resolution integrated with banks normal operations :<br>• Scale of enterprise problem can not be divorced from normal bank operation crave out would have banks as empty shells.<br>• No legal change requited – banks operate under debt recover law<br>• Banks are more likely to be more careful in debt recovery, since their funds are involved ;<br>• Banks could be paralyzed because the size of bad debts overwhelms their capacity. | Depend banks capacity to absorb bad debts, depends on skill levels in banks<br><br>Transfers of claims to agency could be legally problematic and information could be lost transfer of debts.<br>Neither solution may have a hard budget constraint as long as ownership rights are unclear.<br>Incentive structure must be clear-enterprise management, banks, and budge must find a solution that is practical and entails the least social cost. |

**Managing the Banking Reform**

The effective bank-restructuring program should be guided by several principles:

a) A bank's operations must be premised on sound banking principles.
b) Every bank must have profit maximization as its objective, since meeting its social objective and responsibilities as a corporate citizen depends on its solvency and profitability.
c) Any public sector credit should be transparent and funded through the state budget.
d) The board and management of each bank should be accountable and independent of outside interference, irrespective of band ownership, Accordingly, the board and management must have the requisite experience, intension, ethical standards, skills, and knowledge to fulfill these obligations.
e) There should be effective regulation and supervision to foster safe and sound banking.
f) Public confidence must be sustained through a responsive legal environment that guarantees transparency and due process and eliminates difficulties associated with the foreclosure of collateral. Banks should operate under the discipline of the market. The implementation team for the restructuring program closely coordinated policy decisions among the Ministry of Finance, the Central Bank, and the banks concerned. The team has four components:
   1. An oversight committee to decide on policy issue on behalf of the government.
   2. A technical committee, which reported to the oversight committee, to monitor and execute the restructuring program .
   3. Consultants to develop the general framework of the restructuring program and bank-specific plans .
   4. Turnaround managers for each bank, supported by foreign experts or through twinning arrangements with international banks, to manage the institution-building and restructuring process.

**Distribution of Responsibility for Successful Reform:**

Boris and Negate (1998) constructed a table of reform ingredients in their study on restructuring the Distressed Banks in Transition Economies of Central Europe and identified responsibilities for success of banking sector reform on 10 different ingredients. Banks Reformers in Bangladesh need to examine these ingredients and match these within to assess the current positions of reform process.

**Distribution of Responsibility for Successful Banking Reform**

| Ingredient | governments | Banks |
|---|---|---|
| Macroeconomic environment | Provide sound monetary fiscal and exchange rate framework to contain inflation rates, limit fiscal deficits and maintain stable current and capital account | Respond with efficient, well managed, diversified operations as net interest margins shrink |
| Link to markets | Encourage linkage across markets products | Should be focused on feasible "universal" options |
| Recapitizalizaton | Should have little or no adverse macroeconomic impact | Should be one-time, up-front linked to privatization timetable and focused on strong governance and management to attract strategic domestic and/or foreign investment |
| Enabling environment | Build on stable macroeconomic framework with open markets, well-functioning institutions for oversight, an supportive infrastructure | Take advantaged of opportunities, including joint ventures with experienced specialists; be innovative stress open information and recognize that markets are subject to constant change |
| Political commitment | Sustained commitment to reform with loan-term vision, rejection of short-term political pressures | Sustained commitment to marketplace competitiveness based on global standards, not interim distortions. |
| Stakeholder incentives | Better banking performance strengthens macroeconomic | Rewards (financial and otherwise) for improved performance |

| | | |
|---|---|---|
| | fundamentals | |
| Technical assistance and training | Assistance and training essential for policy markers and regulators for safe and sound banking in support of a stable macroeconomic framework | Training to professionals standers and personnel; correspondent links with prime-rated banks formalize competitive systems |
| Sequencing of reforms | Institutional capacity and financial sector infrastructure need; limns between macroeconomic framework and stridulate issues should be recognized from the start; should included liquidation | Restructuring should be as rapid as is feasible within the context of prudential standards fore safety and soundness |
| Governance and Management | Incentives need to emphasize global standards for sustainability, accountability safety and soundness; should reinforce enabling environment efforts | Should be focused on share appreciation and long-term competitiveness based on global standards |
| Privatization | Institutional capacity and financial sector infrastructure needed; inks between macroeconomic framework and structural issues should be recognized from the start | Privatization should be as a rapid as is feasible within the context of prudential standards for safety and sounds and the ability to attract strategic investment |

Adopted: Michael Borish and Fernando Montes-Negret (1998), Restructuring Distressed Banks in Transition Economics: Central Europe and Ukraine in preventing Bank Crises; Lessons from Recent Global Banks Failures EDI Development stages world bank Washington DC.

**Bank Restructuring Models:**

Like financial sector liberalization banking sector reform is a process, not an event. The techniques of reform process are well defined, their application varies across countries depending on individual condition. Sheng suggested the process to bank reform may be distilled into main phases some of which may overlap: (1) Diagnosis (II) Damage Control (iii) Loss Allocation and (iv) Rebuilding Profitability and (V) Creating Incentives.

Available Models of Bank Restructuring

| UK: Life boat Fund (1974) | USA: Deposit Insurance (until1989) and Resolution Trust Corporation (after 1989) | Spanish : Bank hospital and Crave out mechanism | Chile: Variation |
|---|---|---|---|
| a) Funded by large clearing banks and the Bank of England;<br>b) Initial liquidity support for viable secondary banks;<br>c) Filed bank liquidated<br>d) Bank of England to took over failed banks that was subsequently privatized; and<br>e) Losses were born by the central bank. | Federal savings and Loan Insurance Corporation (until 1989)<br>a) Acquisition or merger<br>b) Income maintenance program;<br>c) Accounting forbearance<br>d) Phoenix and bridge banks;<br>e) Management consignments<br>Resolution Trust Corporation (after 1989)<br>f) Concentration of failed assets RTC<br>g) Liquidation or sale of banks to private sector | (a) Accordion principle<br>(b) Joint funding by commercial banks and Bank of Spain;<br>(c) Deposit Guarantee Fund buys bad assets<br>(d) Provide banks with guarantees and long-term soft loans;<br>(e) Sales of Banks to the privateer sector; and<br>(f) Nationalization of | (a) Central bank issues bonds to buy bad assets with buy back schedule;<br>(b) Central Bank loans to banks converted into equity and<br>(c) Sale of banks to private sector. |

| | | | |
|---|---|---|---|
| | h) Losses borne by RTC (funded by Federal Guarantee). | the Rumasa Group. | |

The United States has the most complex and comprehensive deposit insurance scheme. the scheme, which is market funded but government guaranteed, was established in the 1930 after the massive bank failures of the Great Depression .

The Spanish Guarantee Fund created in 1980-was major institutional improvement over the U.S. and U.K. models since it embodied explicit intervention by the government with a recognized "carve-out" technique. Instead of intervening at the margin through liquidity support (as in the U.K model) or purchase, assumption, and resale through the deposit insurance fund (as in the U.S. model). The fund operated as a bank hospital, the larger commercial banks, and the Bank of Spain, but the supervision shared, Funding, was shared by the larger commercial banks and the banks to the hospital was left to the Bank of Spain.

The Chilean technique was quite successful. The banking system stabilized and the economy recovered after massive structural adjustments in the fiscal and trade sectors.

The Philippines also successfully applied the bad debt carve out in relieving the Philippines National Bank and the Development Bank of the Philippines. In Malaysia, Thailand, and the United Kingdom the bad assets were retained in to banks books and Central Bank assistance was provide in the form of loans (Thailand and the United Kingdom) or equity (Malaysia). Banking Sector Reform committee in Bangladesh, without delay should make a choice among the alternative models or a mixture of those compatible to Bangladesh.

**Corporate Governance:**

There has been a great deal of attention given recently to the issue of corporate governance. Banking supervision cannot function well if sound corporate governance is not in place and, consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance at every banking organization. The primary responsibility for good corporate governance rests with the board of directors and senior management of the banks. Modern banking organizations have become fairly complex and need close supervision and effective directions from well constituted boards. Given the nature of the tasks, the full board may not be able to meet more frequently to devote its close attentions to the operations of the banks . It is therefore essential to get some of the board functions performed through specially constituted board committees. Among such committees, the audit committee has a very important role to play. (Three other board committees that have also very useful roles are: Risk Management Committee, Compensation Committee and Nomination Committee).

**Audit Committee:**

Bangladesh Bank issued a guideline for the formation of audit committees of the board of directors as part of its " best precut". Principles of corporate governance suggests that the audit Committee should be independent and its independence can be enhanced when it is comprised of external board members (independent) that have banking and financial expertise. The Reserve Bank of India (RBI) advisory group on Corporate Governance has recommended that the audit committees are to be comprised solely of independent directors, who are financially literate or become financially literate within a reasonable period of time. However, the Bangladesh Bank guideline has asked to select the audit committee members from the directors of the board. Obviously, they are not independent directors and in fact, the practice of the existing banks in Bangladesh. Without ensuring the presence of independent directories in the boards, the formation of audit committee with independent directors cannot be materialized and without which it would be very difficult to achieve the objectives of formation on audit committee, as expected in The Bangladesh Bank guideline.

From the point of view of corporate governance, the board (and senior management) is ultimately responsible for the desirable performance. Therefore, the issues like composition of board, competence of the directors and their duration are also very important. Following the recommendations of the reform committee, the GOB has amended the Bank Company Act. 1991, making provision for nomination of two depositors' representative in the boards of the banks. The objective of the amendment is to protect the depositors interest. The practice of nomination of depositors' representative in the board is very rare . In India, the government constitutes the board of directors of the nationalized banks. The boards comprise of two whole time directors representing Government of India and the Reserve Bank of India, nominees of workmen and non-workmen union, and a Chartered Secretary/Chartered Accountant. Besides these, six non-official directors with specialized knowledge in agriculture and rural economy, banking, cooperation, economics, finance, law etc. are appointed. In case of private sector banks in India, while appointing the directors, the area of interest is considered to be the most important criteria. The RBI advisory group on corporate governance has suggested that the bank boards should have a specified proportion of non-executive independent directors. OECD principles of corporate governance says that majority must be independent members. The Sri Lankan Code of Corporate Governance for banks and other Financial Institutions also suggests that there should be a strong and independent non-executive element in the Board. In fact, the independent directors can protect the interest of all stakeholders, including depositors . In Bangladesh, depositors representative are to be nominated by Bangladesh Bank. The protection to depositors interest is basically the responsibility of central bank, which can be ensured through strengthening of Central Bank's supervision over the banks board and management. The Bank Company (Amendment) Act. 2003 has also stipulated that the tenure of a director cannot exceed six (6) years in consecutive two terms.

**Transparency:**

Transparency can reinforce sound corporate governance. Therefore, Public disclosure in relation to board structure, organizational structure, dealings with affiliates and related practices, senior management structure, incentive structures etc. is desirable. In regard to above, the reform committee has formulated a detailed list of recommendations to be incorporated in the annual/financial reports of the banks . It includes not only compliance of IAS-30 (which has already been adopted) but also related party transactions, disclosures relating to loan and investment quality, audit committee's activities, highlights of key banking –financial variables and their changes over the years. The committee has also recommitted to-publish financial statement of each bank at least in one national level daily Bengali and one daily English newspaper, make financial statement available for customers at all branches as well as in the bank's own web-site exhibiting the banking highlights and balance-sheet at visible places of each branch etc. In addition to above, the banks should also be asked to incorporate a statement relating to its corporate objectives and goals in the part of their annual/ financial reports, so that a stakeholder can compare the financial performance of a bank with its corporate objectives and goals. In promoting transparency, supervisors and other policy makers need to take into account the potential drawbacks that public disclosure can have in certain circumstances. In particular, when the market become aware that a bank is having a weak position, it may react more harshly than is desirable. Sometimes, the market's lack of confidence in a bank may spread to other bank leading to a systematic disturbance. The fact that disclosures may cause problems when a bank is in a weak condition does not refute the proposition that disclosure provide incentives for healthy banks to continue their operation in efficient manner , Moreover, disclosure well likely cause corrections of problems at an earlier stage .

**Loan Rescheduling:**

The reform committee argues that the existing loan rescheduling arrangement is creating " hindrance" in recovering default loan. Therefore, following the recommendations of the reform committee, Bangladesh Bank has issued a circular (BRPDF circular no. 1 of 2003) describing detailed guidelines for loan rescheduling. The guideline has asked the banks to review a reschedule application to assess whether the defaulter is a " habitual" one or has siphoned off funds from his bank-financed project to elsewhere. Such defaulters (habitual or fund diverted) can not be entertained for rescheduling and the banks would go for legal actions against them. Before rescheduling a loan, a bank is required to examine the defaulter liability with other banks and his ability to repay rescheduled installments and liabilities (through analyzing the financial statements of the borrower). After being satisfied, a bank can reschedule a loan for a minimum rational time period. No additional funded/non-funded loan facility would be provided to the borrower, until one year or repayment of all dues, whichever is earlier. To qualify for consideration of rescheduling a term loan, the borrower is required to make a down-payment of either 15% of defaulted installments or 10% of total outstanding (whichever is lower ) for the first time rescheduling, either 30% of defaulted installment or 20% of the total outstanding (whichever is lower) for the second time rescheduling and a lower amount between 50% of defaulted installment and 30% of total outstanding for the third time rescheduling . For the defaulted volume of demand and continuous loans, the rate of down payments are 15% for upto Taka 1 crore, 10% (but not less than Taka 15 lakhs) for Taka above 1 crore upto 5 crore, and 5% (but not less than Taka 50 lakhs) for Taka 5 crore above. The circular does not specifically indicate whether a demand or continuous loan can be rescheduled for more than one time, however, it (the circular) specifies that the rules for 2nd and 3rd time term loan rescheduling will be applicable for rescheduling a demand or continues loan which has been converted to a term loan. Since the circular is silent regarding the status of a loan after rescheduling, it implies that a rescheduled loan will be considered as standard/unclassified loan.

**Large Loan Guidelines:**

Bangladesh Bank has issued a prudential guideline (though BRPD circular no . 08 of 2003) to be followed by the banks . A loan exposure equivalent to 15% or more of the total capital of bank is to be considered as a large loan, according to the guideline. It further prescribes that the banks with net classified loan of upto five percent, five to ten percent, ten to fifteen percent fifteen to twenty percent, and above twenty percent will be allowed to sanction a maximum of 56 percent, 52 percent, 48 percent, 44 percent and 40 percent respectively of total loans and advances as large loans. Moreover, Bangladesh Bank has made it mandatory for the banks to undertake lending risk analysis (LRA) while sanctioning or renewing a big loan. Though from the point of view of limiting the credit risk exposure of the banks having a higher level of classified loan, the new rule is justified . However, to consider large loans as risk loans (by the new rule) is not reasonable (Bhattacharya and Choudhury, 2002). In regard to LRA practice, though the banks are supposed to undertake it (LRA) before sanctioning or deciding about a big loan, yet in many cases, the banks do it other way round, they first take loan decisions and then do LRA. This might be one of the reasons for which there is no improvement in loan quality, even after making LRA mandatory since mid –1990s. It is also a fact that credit risk management is not only a function of " credit sanction", it is the risk of whole lending process (including credit monitoring, reviewing and ensuring repayment) which is to be covered. for that matter, the real initiative must come from the bank management's and boards, only central bank guidelines would not help that much .

**Artha Rin Adalat Act. 1990(Amendment 2003):**

Another significant step taken by the GOB is the enactment of a new Artha Rin Adalat Act, 2003 to set up courts for the speedy recovery of long pending bad loans. The new act has the provision of disposing of a case within 90 days after submission of written replay by the accused . However, the court may get another 30 days if there is " proper reasons". According to the new act, the financial institutions will not file any case with the Artha Rin Adalat without selling off the mortgaged properties of the accused on which they have legal control. The new act has also kept alternative means for settling the money suits. One alternative is "settlement conferences," which implies that the court can dispose of a case through settlement conferences, where both the parties and their lawyers will be present under the chairmanship of the Judge. However, the judge cannot press the parties to accept his or her proposal at such conferences. The second alternative is "arbitration or mediation" by an independent lawyer or retired judge, or retired bank official or any other appropriate persons to be appointed with the mutual consent of the parties to money suits. However, in case of both the alternatives, the cases are to be disposed of within 60 days from the date the cases have been referred for alternative settlements Another 30 days may be granted for settlement under alternative methods, if both the parties are requesting for it or there are some valid reasons for time extension. On the basis of the agreed settlement under alternative methods, the judge will give his or her verdict or order. The alternative approaches are not basically out of the court " compromise settlement" (which has played a significant role in reducing NPL in India), these can be better termed as " quasi-legal/court" settlement. Nevertheless, the new act is much better than earlier one (Artha Rin Adalat Act,1991) in many respects and it is expected that the enforcement of the new act would help to reduce the recovery problem of Naples. The Honorable High Court has the authority to stay the matter if so desired by the borrower.

**Measurement of Disclosure Adequacy:**

This procedure resulted in the final choice of thirty items of information to be used to construct weighted disclosure index. In general, the items fall into two categories: items that may facilitate investment decision making by providing information more conveniently and those that may provide more insight into the quality of expected future earnings, thus reducing investors' risk.

**Disclosure Requirements:**

IAS Requirements: Disclosures in Financial Statements by Risk Category

**Management Commentary:**

Although some banking risks may be reflected in financial statements, users can obtain a better understanding if management provides a commentary describing the way it manages and controls these risks, as follows:

Commentary about average interest rates, average interest-earning assets, and average interest-bearing liabilities for a given period. Information about effective periods and about the way the bank manages and controls risks and exposures associated with the different maturity and interest rate profiles of assets and liabilities.

**Financial Risks:**
Balance Sheet Structure (including off-balance-sheet activities and items).
The basis on which a distinction is made between those transactions and other events that result in the recognition of assets and liabilities and those that only give rise to contingencies and commitments.

**Solvency Risk:**
For Financial assets carried in excess of fair value; Carrying amount and fair value, individually or for appropriate grouping of those assets. Reasons for not reducing the carrying amount, including evidence-supporting recoverability of the amount.

**Credit Risk:**
The basis for determining loses on loans and advances and the writing off of uncorrectable loans and advances.

**Liquidity Risk:**
Group Assets and Liabilities in the balance sheet according to their nature and list them in an order that reflects their relative liquidity.

**Unethical Practices in Banks:**
The basic malaise in the business and banking has been caused by non-adherence to the golden rule of consistency which makes no scope for making exceptions even unto oneself. A banking executive must not indulge in any kind of unfair activities. Unethical practices in banks are due to some non professional, immoral and shallow knowledge of the bankers, political pressure over ambitiousness to get rich quick and get at the top quick attitude. Some kinds of unethical practices are as under:

1. Discriminatory treatment
2. Taking kickback from customers
3. Having direct and/or indirect shares in customers' business
4. Unrealistic appraisal of loan proposals either due to lack of knowledge and/or purposefully
5. Bad practice, laziness, inefficiency as many bankers have come from government sector banks.
6. Improper record keeping
7. Inadequate Audit and Inspection
8. Lack of blessings from the higher management for proper audit and inspection
9. Private banks' higher management's motivated choice to put their henchmen in the strategic points/ divisions/ departments of the bank having little or no respect for professionalism
10. Lending Risk Analysis (LRA) not done religiously

**Audit Rating:**

The existence of a reliable system of internal control can be a great help, because the objectives of the system should be:

a) ensuring that the records are complete, accurate and properly authorized
b) detecting errors and frauds

**Management Responsibility for Internal Control:**

It is the responsibility of management to decide the extent of the internal control system which is appropriate to the enterprise. The nature and extent of controls will vary between enterprises and also from one part of an enterprise to another. The controls used will depend on the nature, size and volume of the transactions, the degree of control which members of management are able to exercise personally, the geographical distribution of the enterprise and many other factors. The choice of controls may reflect a comparison of the cost of operating individual controls against the benefits expected to be derived from them.

The Audit Rating has been planned to have designed in such a way so that its correct implementation identifies both the strengths and weaknesses of our day to day operations. It therefore provides an invaluable user friendly and measurable evaluation and control system of the organization's efforts. Another important aspect is that the use of this program, when incorporated with the associated audit and grading system, provides for both employers and employees to receive visible recognition for their overall standard and achievements. The Audit Rating system shall highlights the overall basic criteria which need to be addressed in the short and long term. Ongoing and progressive control procedures and risk management is the result of the implementation and maintenance of an effective Health Check program. The foundation rests on commitment to team-work and participative management techniques. Dividends will be an improved standard of operations, international approval by overseas countries according to their criteria for Audit Rating standards, compliance required. Audit Rating shall be introduced to judge the annual performance of the branches and payment of annual incentives shall be linked with the audit rating and would be a part of the performance measuring rod of the branch.

**Lending Risk Analysis (LRA):**

Lending Risk Analysis (LRA) is one of the new management and operational tools for improving the credit risk calculation initiated by FSRP in 1993. It is calculated primarily from two angles- Business Risk and Security Risk.

Business Risk: It consists of a) Industry Risk and b) Company Risk. Industry Risk consists of: Supplies Risk and Sales Risk. Company Risk consists of : Company Position Risk, Performance Risk, Resilience Risk, Management Risk, Management Competence Risk and Management Integrity Risk. Security Risk consists of : Security Control Risk and Security Cover Risk. The risk levels are classified as Low Risk, Average Risk, High Risk and Excessive Risk. Total score is again classified under any one of the 4 risk levels viz. Good Risk, Acceptable Risk, Marginal Risk and Poor Risk. A FSRP Consultant said that about 90% of lending officers do not know how to analyze a set of accounts, although there is little faith in the audited accounts of the prospective borrowers.

# CHAPTER -IV

## CONCLUSION

A review of the policy and institutional environment in which banks operate is a good start for the diagnostic process. After diagnosis of policy and institutional environment for assessing the risk of bank failure in Bangladesh the following appears to be apparent.

### Policy Environment:

a) There is significant financial repression
b) State own a large stake in the financial sector
c) There is no liberal entry into and exit from financial sector
d) Non-bank financial sector is growing rapidly with weak supervision
e) Credit allocation and forced lending policies hurting banks' autonomy in credit decisions
f) Banks and Financial Institutions are being taxed considerably higher(45% of profit) than non –banks
g) Banks substantially owned by large enterprise groups and known defaulters;
h) Most private bank Directors and sponsors have connected loans;
i) In service and retried Bureaucrats including politicians with no business experience sit at the board and run bank, are busy to support their patrons and party managers;
j) Central Bank is not independent and governor is generally appointed on political consideration;
k) All Chairman of NCBs are appointed on political consideration not based on professional excellence;
l) Nearly 60% of the Parliament members and politicians are bank defaulters; and

### Institutional Environment

a) Legal framework and judicial processes are not conducive for enforcement of debt recovery
b) Non-compliance to domestic and internationally accepted accounting and auditing standards
c) Transparency and accountability is rare commodity in Bangladesh Banking sector
d) Information on credit and borrower performance, NCBs in particular, are not reliable and transparent.
e) Supervision and monitoring capacity of banks and supervisors are very weak
f) Lack of sufficiently trained bank management staff in place. For example, new generation banks are employing retired bankers mostly from NCBs as their CEOs.
g) Bureaucrats of regulating agencies keep close contact with their clients promoting banks and financial institutions for a position after their retirement and this impairs independence of regulating agencies.
h) Promotions of executives in the NCBs and DFIs are done on political affiliation and in PCBs based on family relationship.
i) Politicians sitting at the board of NCBs, and directors of private Sector Banks (PSBs) are very much interested to process credit to their relatives and , if possible in benami account .
j) Transfer to foreign branches of NCBs are done not based on merit but based on political affiliation and personal relationship other than business interest.
k) Parliamentary Committee on Banks and Financial Institutions does not have professional expertise on the relevant area and the members remain busy in processing loans for themselves or where the members of the committee have vested interest.
l) Terms of Reference for the government nominated directors of NCBs and DFIs are designed in such a way that does not cover reward and punishment system. For example, there is no evidence that directors of NCBs and DFIs were punished for (current 44.62%) classified loans.
m) Directors of PCBs, and private sector NBIs do not have requisite qualification and experience to evaluate normal banking business and make business decisions in the competitive banking system

**Requirement of Enabling Environment:**

Legal and regulatory reforms are necessary, but not sufficient for banking reform . Also needed are court and out –of court processes that are effective in resolving debt disputes; property registries that provide needed information related to prospective collateral, properties, effective supervisory enforcement of prudential regulations, credit rating agencies that provide needed information and risk assessment, analysts who review bank operations for investment purposes, banking associations that help to professionalism and maintain status, accounting firms that audit, and financial media that actively cover financial sector issue for the public . Having an enabling environment for competitive, market-based banking includes equal treatment on issues of enter (licensing) and exit (liquidations, consolidation).

**Short Sighted PCBs Senior Management:**

Most of the Senior Bankers in the Private Banks have been drawn-up from government banks and they have less respect or no respect for audit report and accountability. Many under qualified officers with bad track records are now occupying important positions in the private banks. Slashing Interest Rate will not yield any significant results for investment in company share unless people have firm confidence in the audited annual report/accounts of the company. In most of the cases statutory audit is a compromise between the Company directors and the auditor(s). Three sets of accounts are prepared in many cases where one set showing loss for the Income Tax, one set showing substantial profit for the bank financing, which are certified by the Auditor(s) of the company/ Chartered Accountants and the third set for the management itself to see the real performance of the company.

# CHAPTER-V

## RECOMMENDATIONS

Recommendations have been grouped under two broad heads- **General and Specific**, which have again been placed under sub-heads for clarity and consistency.

**A) General Recommendations:**

1. Know Your Customer (KYC) and Due Diligence of Customers Giving due Importance on Relationship Banking
2. Improve Quality of Accounting and Auditing System to ensure reliable information.
3. Extending cooperation to loan defaulters by the politicians and bank management should be stopped
4. Rationalize and increase the efficiency to prevent illegal activities of trade unions.
5. Further Reduction of Lending rate of Interest without any more delay
6. Financial Institutions should enhance their financing portfolio to SMEs and Cottage Industries as they are the main engine for economic growth of Bangladesh.

**B) Specific Recommendations:**

**1. Legal Aspects:**

1.1 There should be financial punishment for financial corruption
1.2 Severe punishment provision should be in the banking law as well as in country's law to punish the corrupt land officials in the government departments who engineer false land documents for submission to the bank as collateral.
1.3 Law should be enacted to repossess the leased equipment by the Lessor if the Lessee defaults the payment of lease installment

**2. Commercial Banking Aspects:**

2.1 Allow international Credit Rating Agencies to work in Bangladesh and determine the required number and size of banks needed customized to the size of Bangladesh economy for atleast 20 years ahead from now.
2.2 Internal Auditor must not be in the credit committee of the financial institutions
2.3 Internal Audit in the Financial Institutions are mostly neglected and the senior management has little or no respect on the internal audit reports and is made weaker than other departments by dumping weaker officers. Experienced and adequately qualified officers must be deployed in the Internal Audit Department.

**3. Ethics & Good Governance Aspect**:

3.1 Ensuring ethical standard and effective cooperation among bankers, legal advisers, and Judicial Authorities
3.2 Adoption of code of ethics for all bankers
3.3 To have high powered ethics bound committee comprising of members having high morality and respect for ethics as a supervisory body for financial institutions
3.4 Ethical and moral conduct must be practiced by the top management first
3.5 There should be reward and punishment for ethical conduct and non-ethical conduct respectively for individuals/team and institutions
3.6 All statutory returns to Bangladesh bank and to other regulatory bodies must be sent regularly under the joint signatures of senior officers
3.7 Regular generation of MIS including exception report with all relevant information, which must be read by senor officers at all levels and must put comments, if no observation that must also be written as no observation.
3.8 Not appointing any one beyond vice president level having anticorruption case against him either pending/sub-judice or convicted for any amount or any period whatsoever.
3.9 Submitting asset and liabilities statement, foreign travel, gifts received during the period, bank statement, travel by wife, children, to Bangladesh bank by all senior executives in a format specifically designed by Bangladesh bank under oath, apart from such submission for income tax and these must be cross-checked by a special cell in the Bangladesh bank and to be forwarded to Income Tax authority. Similarly Tax authority shall also send similar information to Bangladesh bank for cross-reference

3.10 Adopt written Code of Conduct for all employees
3.11 Create supervisory /oversight body to justify the activities of the Statutory Auditors
3.12 Exemplary Punishment for the External auditors who failed to Discharge his Statutory Responsibilities Adequately
3.13 The Independent Auditor must not provide audit clients with Internal Audit Services, Consulting Services, Tax Advisory Services, and Computer Systems etc. (ref: Enron Scam).
3.14 Restrict hiring of Personnel from the External Auditors(ref: Enron Scam)
3.15 Continuing Professional Education for Audit Committee Members
3.16 Periodic Rotation of Audit Committee Chairperson
3.17 Disclosure of Corporate Governance Practices certified by the Company Secretary and Audited by a Chartered Secretary NOT by Chartered Accountant.
3.18 Mandatory Internal Audit/Control department and audit committee in all financial institutions and limited companies having paid-up capital beyond Tk. 1 million irrespective of the size and nature of business
3.19 Mandatory appointment of atleast one Chartered Secretary/ Chartered Accountant/Cost & Management Accountant in all Limited Companies having paid-up capital for more than Tk.500000 to ensure good corporate governance
3.20 Mandatory Company Secretarial Audit by Chartered Secretary to protect investors Interest
3.21 Provision should be there for Secretarial Compliance Certificate under the Companies Act. as a part of corporate governance of the Financial Institutions
3.22 All Financial Institutions including BIBM/Institute of Bankers etc. should teach Banking Ethics in their Training Institutes and the trainer must be a man with high ethics, otherwise the ethics training will turn to be a futile exercise.
3.23 Core Banking ethics and Business Ethics Chart must be displayed in several places of the bank branches.
3.24 Ensuring Strict Adherence to IAS-30 and IAS-17 by the Banks and Financial Institutions respectively.

**4. Insurance & Capital Market Aspects :**

4.1. Reform of Insurance Act, Capital Market, SEC, DSE and CSE to suit the needs of the Modern Business

**5. Institutional Development & Capacity Building:**

1. Banking wing of Ministry of finance need to be strengthened with independent professionals for research and development and for Standard Operating Procedures for Monitoring and Compliance
2. Form independent Financial Services Supervisory Commission (FSSC) in line with emerging global trends and local requirements
3. Establish Corporate Debts Restructuring Committee
4. Bangladesh Bank should be free from political pressure and Trade Union
5. Ensure Legal and Operational Independence of Bangladesh Bank
6. Emphasis on Training and Development of Human Resources for coping up with modern banking concepts and Automation
7. Ensuring effective supervision of Bangladesh Bank over NCBs and PCBs.
8. No nomination of politicians and non-professional government officials in the Bangladesh Bank and NCBs
9. All employment in the banks above the rank of Vice President should be gradually made contractual.
10. Ensure promotion based on merit not on seniority only.
11. Higher Salary Scale for Bangladesh Bank and NCB employees and Banking jobs must be considered as a technical job
12. Rationalize excess manpower in the NCBs' and Bangladesh Bank
13. There should be a supervisory board to supervise the activities of central bank, financial institutions of the country free from all kinds of bureaucracy and government influence.

14. A complaint cell should be in Bangladesh Bank, Ministry of Finance, Income Tax Department, Anti Corruption Department, Prime Minister’s office so that public can lodge any complaint against the bankers. But unnecessary harassment must be avoided. All genuine complaints must be resolved within 3 months of lodgment. A black list must be prepared on the basis of the investigation and judgment. List of such bank officials must be circulated among the banks and Bangladesh bank so that every body becomes alert of such persons and they become unemployable in all financial institutions for the rest of their life.
15. There is no need of Sharia Council and special Murakib Position in the Islami banking
16. system which is a drainage and misuse of public resources as the SHARIA is not
17. changeable.
18. Banks must stop charges from the customers restricted by the Bangladesh Bank.

# ANNEXURE

**IMF Recommended Good Transparency Practices for Central Banks and Financial Agencies:**

I. Clarity of Roles Responsibilities and Objectives of Central Banks and Financial Agencies for Monetary policy:

1.1 the ultimate objectives and institutional framework of monetary policy should be clearly defined in relevant legislation or regulation, including where appropriate a central bank law and financial agencies law
1.2 the institutional relationship between monetary and fiscal operations should be clearly defined
1.3 agency roles performed by the central bank and financial agencies on behalf of the government should be clearly defined

II. Open Process for Formulating and Reporting Monetary Policy Decisions

2.1 the framework, instruments, and any targets that are used to pursue the objectives of monetary policy should be publicly disclosed and explained.
2.2 where a permanent monetary policy making body meets to assess underlying economic developments, monitor progress toward achieving its monetary policy objectives and formulate policy for the period ahead, information on the composition, structure and functions of that body should be publicly disclosed.
2.3 changes in the setting of monetary policy instruments should be publicly announced and explained in a timely manner.
2.4 the central bank should issue periodic public statements on progress towards achieving its monetary policy objectives as well as prospects for achieving them. The arrangements could differ depending on the monetary policy framework, including the exchange rate regime.
2.5 for proposed substantive technical changes to the structure of monetary regulations there should be a presumption infavor of public consultations, within an appropriate period.
2.6 the regulations on data reporting by financial institutions to the central bank for monetary policy purposes should be publicly disclosed.

III. Public Availability of Information on Monetary Policy

3.1 presentations and releases of central bank data should meet the standards related to coverage, periodicity, timeliness of data and access by the public that are consistent with the IMF data dissemination standards.
3.2 the central bank should publicly disclose its balance sheet on a pre-announced schedule and after a pre determined interval, publicly disclose selected information on its aggregate market transactions.
3.3 the central bank should establish and maintain public information services.
3.4 text for regulations issued by the central bank should be readily available to the public.

IV. Accountability and Assurances of Integrity by the Central Bank and Financial Agencies.

4.1 officials of central bank and financial agencies should be available to appear before a designated public authority to report on the conduct of monetary policy, explain the policy objectives of their institutions, describe their performance in achieving their objectives, and as appropriate exchange views on the state of the economy and the financial system.
4.2 the central bank should publicly disclose audited financial statements of its operations on a pre-announced schedule
4.3 information on the expenses and revenues in operating the central bank should be publicly disclosed annually
4.4 standards for the conduct of personal financial affairs of officials and staff of the central bank and rules to prevent exploitation of conflicts of interest, including any general fiduciary obligation, should be publicly disclosed.

V. Where there are deposit insurance guarantees policy-holder guarantees, and any other client asset protection schemes, information on the nature and form of such protections on the operating procedures, on how the guarantee is financed, and on the performance of the arrangement, should be publicly disclosed.

**IMF Code of Good Practices on Fiscal Transparency:**

Clarity of Roles and Responsibilities

1.1 the government sector should be distinguished from the rest of the public sectors and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.
1.2 there should be a clear legal and administrative framework for fiscal management

II. Public Availability of Information

2.1 the public should be provided with full information on the past, current and projected fiscal activities of government
2.2 a commitment should be made to the timely publication of fiscal information

III. Open Budget Preparation, Execution and Reporting.

3.1 the budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget and identifiable major fiscal risks
3.2 budget information should be presented in a way that facilitates policy analysis and promotes accountability
3.3 Procedures for the execution and monitoring of approved expenditure and for collecting revenue should be clearly specified
3.4 There should be regular fiscal reporting to the legislature and the public

IV. Assurance of Integrity

4.1 fiscal data should meet accepted data quality standards.
4.2 fiscal information should be subjected to independent scrutiny( by the selected experts from the civil society- Prof. Faruque)

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