

# **FINANCIAL SECTOR REFORMS TASK FORCE REPORT**

Dr. Wahid Uddin Mahmud (Chairman)  
Professor, Economics Department  
Dhaka University

Mr. Khondoker Ibrahim Khaled (Co-Chairman)  
Managing Director  
Pubali Bank Limited

Mr. Mohammed Hossain (Member)  
Managing Director  
Al-Arafah Islami Bank Limited

Mr. C. M. Koyes Sami (Member)  
Managing Director  
South East Bank Limited

Mr. Shah Md. Nurul Alam  
Managing Director  
Prime Bank Limited

Dr. Toufic Ahmad Choudhury (Member Secretary)  
Professor & Director  
BIBM, Dhaka.

## **TASK FORCE REPORT ON FINANCIAL SECTOR REFORMS**

1. The major function of a financial system is to strengthen the savings-investment process of the country. For the matter of economic development, the financial system mobilizes and pools together the financial resources from various surplus units, and ultimately channelize all those 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 achieve specialization and economies 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 sine qua non for achieving economic growth. (Banking Reform Committee Report, 1999, page-1).
2. The financial system of Bangladesh is mainly bank dependent. Though in the recent years, a number of non-banking financial institutions (leasing and merchant banks) have been established, yet the banking sector still captures the lion share of the financial market. How far the banking system of Bangladesh is efficient, how far, the widespread reform measures undertaken during the last two decades, to increase the efficiency of the banking sector, were effective, and what measures need to be undertaken by the next democratically elected government in the near future for raising the efficiency are the subject matters of this report. However, first of all let us consider the evolution of banking in Bangladesh.
3. Just after the liberation of Bangladesh, the whole banking system (excepting a few foreign bank branches) was restructured and nationalized. During 1972-1982, the banking system used to operate under a regime of rigid government control and central bank regulations. During the period, the banking system expanded very rapidly, specially for providing banking and credit services in the rural areas. On the other hand, the banks were motivated and directed to channelize credit to national priority sectors such as nationalized industries, small entrepreneurs, farmers etc. It is a fact that because of the rapid expansion of bank branches and services, the financial soundness as well as quality of services to a great extent were adversely affected. Consequently, the government denationalized two nationalized commercial banks (NCBs) whilst a number of private commercial banks (PCBs) were allowed to operate in the banking sector. It was expected that because of competition with PCBs, the overall quality of services of the NCBs would be improved.
4. In 1987 the then government set up a National Commission chaired by Prof. A.F.A. Hussain, with the objective of scrutinizing the banking sector's problems and suggesting remedial measures thereof. However, a wide ranging banking reform measures eventually were undertaken on the basis of the recommendations of a World Bank Consultative Mission which provided the basis for a Financial Sector Adjustment Credit (FSAC) just at the start of 1990s. To implement the reform measures under the FSAC, a Financial Sector Reform Project (FSRP) office was instituted at Bangladesh Bank. The project was terminated in 1996 when a Banking Reform Committee was constituted by the then elected government. The Committee submitted its report to the government in 1999. In the meantime, a number of new PCBs were licensed in the first and last quarters of the 1990s. At this moment (upto December, 2000), a total number of 49 (forty nine) banks operate in the banking arena of Bangladesh.

5. It appeared from various studies that the denationalization and privatization process could not generate expected results because of the absence of firm supervision and effective economic regulations of Bangladesh Bank. Though in some respects (specially for high income urban customers), quality of customers' services improved, yet the overall banking efficiency, specially in the context of credit management, was observed to have deteriorated. The compulsion on the part of banking system to adopt reform measures was not that strong till mid-1980s. Because of inappropriate accounting and reporting systems and non-compliance with international accounting standards, the problems of the banking system were not exposed to public scrutiny, which delayed the formulation and adoption of reform measures in the banking sector of Bangladesh.
6. After a detailed examination of various problems of the banking sector such as bank rate and the refinancing policy of Bangladesh Bank, overdue loans of NCBs and Development Financial Institutions (DFIs), supply of adequate loans to rural and agriculture sector, supervisory problems of Bangladesh Bank and Bank Managements, frauds and forgeries in the banking sector etc., the National Commission On Money, Banking and Credit submitted a long list of recommendations to the government in 1986. Subsequently, a number of steps (such as fixation of recovery targets for NCBs and DFIs, prohibiting defaulters from getting new loans etc.) were taken, yet the deterioration in banking efficiency could not be stemmed.
7. In order to address the issue of increase in efficiency in the banking sector, the FSAC of the World Bank classified the problems of banking into four distinct groups: Economic, Prudential, Institutional and Legal. According to FSAC, the loan rate of interest could not reflect real risk and price because of excessive control. Moreover, directed credit to priority sectors and absence of appropriate loan classification and provisioning led to deterioration in the overall loan management quality. On the other hand, flexibility and forbearance in terms of ensuring effective enforcement of prudential regulations (such as capital adequacy, loan classification etc.) were also observed. Weaknesses in relation to loan screening and supervision were identified among the most important institutional problems in the governance of the financial sector. Another institutional problem owed to the very weak management information system of the banks. Finally, the loan default problem was perpetuated because of the delays and inadequacy originating the legal system. Under the above circumstances, the World Bank, through the FSAC spelt out the following objectives for the financial sector reform program:
  - Gradual deregulations of the interest rate structure with a view to improving the allocation of resources;
  - Providing market oriented incentives for priority sector lending;
  - Making subsidies in the priority sectors more transparent;
  - Adoption of an appropriate monetary policy;
  - Improvement in the debt recovery environment; and
  - Strengthening of the capital markets.
8. Achieving a free and market dependent interest rate structure was the major objective of banking sector reforms. It was expected to bring about improvement in resources allocation as well as enhance market or price competition. Since 1990, the interest rate structure was gradually deregulated. At this moment, there is no ceiling, floor or band for the determination of interest rates for any economic sector, excepting exports. It the bank managements can now fix up their own prices for financial products/services including deposits and credits, guided exclusively by the market forces of demand and supply.

9. In such a market-driven system, one of the important indicators of competitiveness in the financial markets is the interest rate spread (the difference between lending and deposits rate of interest). The higher the level of competitiveness, the lower interest rate spread. However, in the wake of the deregulation of interest rates it has been observed that the spread is increasing over the years in Bangladesh. This indicates reforms have yet to bring about the expected degree of competitiveness. Rather, market distortions have increased. It is argued that the persistence of loan default is responsible for those market distortions. Such a view is not supported by academic research which shows that loan default cannot alone explain this high spread. Government-led distortions (for example, high interest rates for government debentures) and misconceived price strategies of the bank managements may also be responsible for the unusually high spreads.
10. Interest rate deregulation was sought for not only bringing competition in the banking system, but also for achieving more efficient resource/credit allocation. It was also argued that even PCBs would be motivated to support priority sector lending following interest rate deregulation. However, more efficient resource allocation cannot be measured by growth in credit volume/quantity. Rather, resource allocation according to market demand, the quality of the loan portfolio and from a national economic point of view, credit allocation to the priority sectors also need to taken into account in assessing the efficiency of resource allocation by the banking system. Since competition could not be ensured through a market mediated price mechanism, the natural corollary is that interest rate deregulation could not also lead to more efficient resource allocation.
11. The quality of the loan portfolio of the banks is generally reflected by the volume of classified loan. During the 1990s, the classified loans increased from 27 to 35 percent. During 1994-98, the loan classification norms were changed five times, (in order to raise the norms to an acceptable international standard). Therefore, it is very difficult to compare the status of the classified loans over the years (1994-98). Yet it can be easily argued that a 35 percent of classified loans cannot indicate a “quality” loan portfolio by any standard. Some of the subsequent sections of the report contain detailed analyses on classified loans. In terms of sectoral distribution of credit, it may be observed that the flow of credit to national priority sectors (such as agriculture, small and cottage industries) also declined during 1990-1999. The provision of credit to national priority sectors by PCBs was low at the time of launching the reform program (in 1990). Thus ratio declined further after the reform program. Therefore, from the viewpoint of targeting the national priority sectors, the allocation of credit was not particularly efficient.
12. The relative share of rural banking has declined after the adoption of banking reform measures. The share of the branches in the rural areas has gradually been declining. A substantial number of loss making rural branches of NCBs have been transferred to Bangladesh Krishi Bank (BKB). The provision of credit by the rural bank branches is low as compared to their deposit mobilization. Moreover, closure of only rural branches in the name of branch rationalization, has adversely affected the overall rural banking environment. It is reported in some a very recent studies that the access to credit in the post reform period has not improved at all for rural and small entrepreneurs. For the rural sector, 52.68 percent of eligible borrowers have no access at all to credit, (either formal or informal). Even after taking into account the Micro Finance/Credit Institutions (MFIs) noteworthy contribution, more than half of the rural people are outside the ambit of the institutional credit market. For the small entrepreneurs, it is observed that 50.53 percent of eligible borrowers do not have any access to credit.

13. For access to credit, the constraints from the demand side include: the need to bribe, time consuming and complicated procedures, lack of collateral, the inability to fulfill loan covenants, the high incidental costs etc. On the other hand, the supply side constraints (from the viewpoint of bankers) include: high risks and transaction cost, the role of outside influence, inadequate collateral, ineffective and inappropriate legal structures for collecting default loans etc. For such reasons, flow of credit to rural and small entrepreneurs remains inadequate to their needs. Unfortunately, the banking reform program did not take any effective measures towards removing all those demand and supply constraints of credit allocation to the weaker borrowers. Rather, through interest rate and portfolio deregulation, emphasis was placed on enhancing competition as well as, efficient resource allocation. However, in order to correct the failure of banking reform measures in achieving their predetermined objectives, there is no rationality in arguing for reimposition of interest rate and portfolio controls. Rather, it is suggested that concerted efforts be made to address the demand and supply side constraints of the weaker borrowers in addition to interest and portfolio decontrol, for ensuring more efficient as well as more democratic allocation of resources by the banks.
14. For strengthening the banking system, a number of accounting, supervisory and management oriented reform measures were undertaken. Among them, loan classification and capital adequacy are most important. These two measures are important preconditions for ensuring safety and soundness of the banking system. It has been mentioned that the loan classification norms have already been raised to international standard. At the same time, minimum capital requirement of the banks was also fixed at 8 percent of risk weighted assets since 1996 according to international standard practice. Till 1998, both NCBs and PCBs were suffering from capital inadequacy. However, as on June, 2000, the capital of NCBs further reduced to 5.08 percent, whereas that of PCBs improved substantially to 11.29 percent and for the overall banking system, it stood at 7.54 percent. An off-site supervision technique has been added long ago with the existing on-site supervision for strengthening the supervisory system of Bangladesh Bank. In the context of off-site supervision, Bangladesh Bank used to determine a composite rating for each bank, known as CAMEL rating, based on the respective bank's capital, asset quality, management capability, income and liquidity level. Based on CAMEL rating, Bangladesh Bank used to identify the problem banks and if necessary also provide Early Warning Signal (EWS) to any bank. Moreover, Credit Information Bureau (CIB) and Large Loan Review Cell (LLRC) were also established in Bangladesh Bank, with an aim to improving the quality of loan portfolio of the banking system. Even after adopting new loan accounting norms and supervisory techniques, there was no worthmentioning improvement in classified loan, provisioning requirements and capital adequacy of the banking system until the end of third quarter of 1990s. (The subsequent improvement in the above mentioned issues has been discussed later). It indicates that during the above time period, Bangladesh Bank was not fully successful in enforcing effective supervisory system and in raising firm protection against unsound banking practices. For enforcing effective and meaningful supervisory system, Bangladesh Bank needs two additional supports: autonomy (free from the influences of political and vested interest groups) and appropriate manpower. In the recent days, the autonomy of Bangladesh Bank is badly felt for enforcing effective supervision on NCBs.
15. Under the banking reform programme, the management efficiency of NCBs was thought to be achieved through introduction of a number of new management and operational tools such as Lending Risk Analysis (LRA), Management Information System (MIS), New Loan Ledger (NLL), Performance Planning System (PPS) etc. These tools were

introduced with the active support of FSRP. The impact evaluation of FSRP-TA project itself recognized that though many of the operational building blocks needed to permit NCBs to function soundly had been provided successfully by FSRP, yet effective incorporation of new operational procedures required leadership and vision on the part of senior management, which was not ubiquitous in the NCBs. This may also be argued that the above management and operational tools were mainly focussed on improving the credit screening and monitoring process of the banks, for which adequate knowledge, skill and willingness of the credit officer are very essential. This all depends on the adoption of appropriate manpower development strategy by the banks.

16. For proper enforcement of financial contract, what is most necessary is the establishment of a quick and effective legal framework. A weak legal infrastructure is largely responsible for non-recovery of default loan and thus for deterioration in the quality of overall credit management in Bangladesh. A number of steps such as enactment of Money Loan Court Act, 1990 and its subsequent amendments, Bankruptcy Act, 1997, Bank Company Act, 1991 and its amendments etc. have been taken for improvement in the debt recovery environment of the country. At present, there are ninety (90) Money Loan Courts (MLC). Yet the performance of these courts are not satisfactory, only 9.41 percent of total litigated amount has been able to be recovered until the end of 1999. Another noteworthy point is that most of the settled loan cases of MLC are small loan defaulters, indicating that the big and influential defaulters are still outside ambit of legal framework. Two (2) bankruptcy courts are established - one in Dhaka and another in Chittagong - under Bankruptcy Act of 1997. Unfortunately, the performance of this court is frustrating. Upto December 2000, the Bankruptcy court at Dhaka settled 97 cases, out of 177 lawsuits. Again, out of all these settled cases (97), only 44 individuals and companies were declared bankrupt, but so far 10 government nominated receivers have not yet been able to recover the decreed money, even in a single case. The receivers have failed to enforce court decree because of unholy alliance between administration and influential defaulters. This reflects overall lawlessness and sheer poor governance of the country. For such a situation one may held following factors responsible: paucity of judges (as compared to number of cases), frequent stay-orders and undue delays of the courts, unethical support of administration, influential defaulters and a class of corrupt bank officers.
17. The World Bank driven reform measures of 1990s could not generate expected results. However, it is a fact that the banking reform program had been successful in exposing the banking sector problems to general public and raising their consciousness. One of the most important reasons for not getting expected results was the overemphasis on economic deregulation without broad basing and consolidating the prudential and supervisory regulatory framework. It would have been more appropriate in Bangladesh to introduce measures to tackle loan default and management problems of the banking system, prior to embarking on wide spread interest rate deregulations. The final report on FSRP TA states that without introducing efforts to overcome the structural weaknesses (huge bad debt, lack of competition etc.) of the banking system, interest rate reform efforts alone are not sufficient to address the banking problems. The performance audit report (PAR) of the World Bank related to FSAC also admitted that “the project was not successful”. According to the PAR, the causes of the failure are various: government ownership of the reform program and a strong political will to make it succeed were absent. Moreover, the reform program was aimed at achieving some unrealistic and over-optimistic objectives. There were flaws in the design and sequencing of the reform agenda. The demand constraints (as discussed earlier) were not at all considered in the

reform measures. Consequently, resource allocation specially to national priority sectors was badly affected. Though the World Bank driven reform measures were basically supply-led, yet it is undeniable that the supply aspects were not also adequately covered in the supply-led measures, specially the concerns of implementation stakeholders were largely bypassed. The knowledge, experience and skill of bank executives and employees, their attitude towards market based actions, their accountability and incentive structures, internal control mechanism of the banks, undue influence of CBA and employee union leaders in banking decision making etc. were largely bypassed in the reform program. It is also to be mentioned that all the FSAC related documents of the World Bank indicated that the financial sector reform agenda was determined following the economic and sector work by the bank and the recommendations of a GOB task force, National Commission On Money, Banking and Credit (NCMBC) formed in 1986. But, in reality it has been observed that the recommendations of NCMBC was rather ignored while designing reform framework under FSAC. According to the opinion of the Task Force on Financial Sector, formed during the regime of interim government in 1991, restoration of “financial disciplines” was adjudged as the most urgent requirement in the financial/banking sector. The task force report (1991) said, “banks and financial institutions cannot grow in the absence of (i) autonomous decision making on economic and commercial considerations; (ii) strict enforcement of contractual obligations between the financial institutions and their clients; and (iii) effective authority of their management over personnel. Absence of these elements manifests in inefficiency as well as indiscipline in the financial sector.”

18. After the expiry of FSRP in 1996, the GOB formed one Banking Reform Committee to evaluate the situations arising in the banking sector and place recommendations to GOB in regard to improving debt recovery environment of banks, strengthening supervisory capacity of Bangladesh Bank, increasing income and reducing expenditure, and improving the personnel quality of the banks. (It may also be mentioned here that in May 1997, a Commercial Bank Restructuring Project - CBRP funded by the World Bank was also undertaken). In December - 1999, the BRC submitted its report alongwith the recommendations to GOB. The present task force formed by the civil society of the country has placed special significance to BRC report and considered the report as their “point of departure,” because the BRC report is a recent analytical banking document. In addition, the experiences of past reform measures and present banking conditions should also be given due consideration in any banking analysis. The main recommendations of BRC have been discussed below keeping in mind the above point of view.
19. BRC argues that the supervisory and regulatory forbearance of Bangladesh Bank (BB) has been one of the main reasons for the accumulated banking problems. Therefore, BRC seems to put highest importance on supervisory and regulatory enforcements for ensuring financial discipline in the banking sector. In addition to Bangladesh Bank autonomy, BRC emphasizes on coordination among different departments (of BB) engaged in bank examination, coordination between on and off-site supervision, rationalization of small branch and good banks (problem free or less problematic) examination, formulation of an action plan for implementation of examination findings, formation of a Bank Supervision Committee etc. It is a fact that in the mean time the intensity and quality of supervision have improved substantially, which one can discern simply looking at the level of classified loan. In 1994, the classified loan was 35 percent and remained at the same level in December - 2000, even after making loan classification norms stricter (in between 1994-2000) in order to raise it at international standard level. During 1995-98 the classified loan of the PCBs reduced to 33 from 39 percent. On the other hand, during the same time period, the classified loan of NCBs increased to 40 from 31 percent. Since the

classification norms have been made stricter over the years, therefore, the real deterioration of loan portfolio quality of NCBs may not be so much as indicated here. The same logic also indicates that the loan quality status of PCBs might have been much better. However, it is to be noted that for the improvement in the loan quality of PCBs in the post-1995 period, the PCBs established during 1990s deserved more appreciation than the PCBs established during 1980s. A number of old PCBs, like NCBs, are encountering the same level of classified loan. A class of sponsor directors, who have received a huge amount of unauthorized financial facilities, are mainly responsible for poor loan status of old PCBs. It thus reflects that the government should not have started the process of licensing PCBs to start operation at the instance of donors before ensuring the enforcements of legal and regulatory system.

20. The classified loan was 41.11 and 35 percent in 1999 and 2000 respectively. The quality of loan status has definitely improved in 2000 as compared to 1999. The PCBs were having classified loan amounting 27.09 and 22.01 percent in 1999 and 2000 respectively and at the same time, the NCBs were having 45.62 and 35.56 percent classified loan. Purely from the point of view absolute amount, the classified loan of NCBs reduced from Tk. 12,992 crore in 1999 to Tk. 11,734 crore in 2000. On the other hand, at the same time, the classified loan (absolute amount) of PCBs increased from Tk. 4,525 crore to Tk. 4,621 crore. In case of PCBs, the rate of growth of loan was much higher than that of classified loan and as a result, the classified loan in terms of percentage reduced during 1999-2000. An analysis into the causes of decline in classified loans of NCBs indicates that only bad and loss part of their classified loan has been reduced by around Tk. 500 crore, out of which Tk. 200 crore has been reduced in government sector and the rest Tk. 300 crore has been recovered from private sector. It reflects that given a favorable debt recovery environment with full-fledged cooperation of the government, recovery of default loan is possible. The recovery of Tk. 300 crore bad loan from private sector further indicates that a bad loan does not necessarily lead to bankruptcy. It is possible to recover even the bad loan provided an appropriate debt recovery environment is created through imposing adequate administrative, financial and psychological pressures on the defaulters. One should also note that because of introducing loan rescheduling facility in 1996, a considerable amount of loans have been avoiding classification status. In India, all rescheduled loans are considered as sub-standard. However, this is undeniable that loan default problem is very acute and at this moment, is the biggest problem of Bangladesh banking. In April 2001, the Parliament of Bangladesh has changed the definition of loan defaulter by amending Bank Company Act, 1991. The amendment says, an individual or institution will be considered a defaulter only if its loan becomes overdue by six months. Before the amendment, the time limit was three months for current or demand loan and 6 months for term loan. The amendment also stipulates that a public limited company will not be considered as a business concern related to a defaulter unless the defaulter is a director or holds more than 25 percent shares in that company. On the other hand, a private limited company will be considered as a business concern of a defaulter only if he holds over 20 percent shares in it. The introduction of such a flexibility in terms of defining a loan defaulter, after attaining international standard of loan classification norms does not bear the testimony of firm commitment on the part of the political parties representing in the parliament for resolving loan default problem of Bangladesh. The amendment has also created some scope for theoretical contradiction. Because, on the one hand, the loan will be classified but on the other hand, the loanee cannot be treated as a defaulter (upto six months after overdue). Almost 80 percent of classified loan is bad/loss loan. As a result, though there will be no immediate adverse impact on the volume of classified loan, yet because of changes in definition (of

defaulter), a defaulter cannot be barred from taking new loan upto six months. Consequently, there is a possibility that classified loan may increase in future instead of declining. There is another illogical aspect of the amendment, virtually no one has 25 percent share in a public limited company.

21. There are various reasons for loan default problems: lack of loan screening skill, lack of accountability on the part of bank officials, high loan price, risky economic environment etc. Among all these, corruption and lack of ethics on the part of concerned stakeholders are also important. So far, there is no exemplary evidence of awarding legal (including filing criminal cases) and severe punishment against the concerned individuals even after their involvement with financial corruption and frauds are exposed. It is also not clear which agency of the government is responsible for initiating legal actions against frauds and forgeries in the financial sector. But it is a natural and normal practice of taking such punitive actions against the fraudulent and corrupt practitioners in those countries where the standard of financial management practice is at advanced level. The default culture of Bangladesh has created multidimensional problems. Because of default in repayment, it is not only putting adverse impact on capital and liquidity management, but also raising the cost of lending substantially. Again, due to increase in cost of lending, good borrowers are affected and in some cases, they have been influenced not to repay bank loans. International banking operations of the domestic banks are at stake because of their erosion of capital due to loan default.
22. For the recovery of default loan, the main hindrance at this moment is existing legal framework and its lengthy procedure. It has already been mentioned that for bringing dynamism in the enforcement of legal framework, a number of new Acts have been enacted and old Acts have been amended. The noteworthy additions are: Bank Company Act, 1991; Bankruptcy Act, 1997; and Money Loan Court (MLC) Act, 1990. However, the progress in relation to recovery of default loan is not significant even after formulation of new Acts and formation of new courts that too only for recovery of default loans. The poor progress might be because of gaps between formulation and application of legal frameworks and/or between application and effectiveness of legal system. For the delay in settlement of cases, the law itself is not responsible. For example, there is a provision in the MLC Act that a loan default case is to be settled within six months, but it is not becoming effective. When there was no such provisions relating to time limits for settlement of loan cases during 1960s, yet the cases were then used to be settled within one to three months. But, now even after having legal provisions, the time limits for settling loan cases are not being maintained. Banks become completely helpless because of stay orders of the courts. It is a fundamental right of the citizens to seek justice from courts. There should not be any objection against the unfavorable verdicts of the courts, if the cases cannot be probed. It is observed that in many cases, the right of prosecuting default suits are impeded through stay orders, is it not obstructing the application of legal process? If the higher courts give unfavorable verdicts, then automatically the verdicts/proceedings of lower courts will be annulled, in that case what is the need of stay orders? On the other hand, the time which is lost for such stay orders cannot be made good by the higher courts. These issues cannot be resolved by formulating new laws. Rather, while applying discretion for stay orders, the judges should be guided by wisdom, ethics and reality, which can resolve the problems associated with stay-orders. Sometimes, the legal processes have been observed to be delayed because of lack of cooperation of bank officials and legal advisers. The parties which are involved in lawsuits are: plaintiff or complainant, defendant, lawyer and judges. Without having proper ethics, cooperation and sincerity of the involved parties, not only the legal process

will be delayed, but also to be obstructed. However, it can also be argued that the problem of loan recovery cannot be addressed only by undertaking legal reforms, at the same time the issues like ethical standard and accountability of the concerned individuals and the overall law and order situation of the country are also involved.

23. In order to ensure financial discipline and soundness of the banks through the resolution of problem loans, BRC has recommended to formulate and implement a concrete “recovery policy” by the NCBs. The committee has also suggested to verify the feasibility of forming one Asset Management Company (AMC) for resolving the problem of default loans. The experiences of banking reforms in different countries show that some of the countries followed centralized approach, while others followed decentralized approach for addressing their problems of loan default. The centralized approach handles the problem loans of all banks through a centrally controlled institution, and the decentralized approach allows each bank to handle its own default loan problem, might be through a specialized department (loan workout department). There are some advantages and disadvantages associated with both centralized and decentralized approaches. The centralized strategy suggests to transfer the bad loans from the balance sheet of respective banks to the company engaged in resolving default loan problems. As a result, the banks will not only be cleaning up their own balance-sheet, they will also be relieved from engaging themselves from enterprise restructuring. Some of the authors have highlighted the superiority of centralized approach over the decentralized one in handling the restructuring of defaulting enterprises. On the other hand, some others opined, lack of manpower having specialized knowledge and experience (for handling problem loans) and bureaucratic control might lead to ineffectiveness of centralized approach. The proponents of decentralized approach feel that the centralized approach cannot help to get rid of the reasons contributing towards creation of problem loans. Rather, there is always some scope of generating new problem loans through the process of carving out problem loans (from the balance sheet of banks) under centralized approach. Though BRC incorporates both centralized and decentralized measures in its recommendations, yet it appears that BRC prefers decentralized to centralized approach.
24. To strengthen the supervisory framework of Bangladesh Bank, BRC has recommended to upgrade the problem bank unit (of BB) to a division. It is to be noted that out of seven(7) problem banks, two have been successful to breakthrough their problem status. It is also to be specified that by any standard, all the NCBs and development financial institutions (DFIs) are to be considered as problem banks, though officially they are not considered so. This is an evidence indicating the lack of effective control of Bangladesh Bank over NCBs. In case of licensing new banks, decisions should not be taken hurriedly. After analyzing carefully the business track records, honesty and experiences of sponsors-directors rather than their political affiliations, new banking licenses should be provided. Unless the sponsors are honest in their objectives, the new bank will be destined to be a problem bank. Therefore, the creation of problem bank should be obstructed at the very beginning (that is, at the time of licensing) through a very strict, influence- free and neutral analysis of a new bank application. From the above point of view, the suggestion of BRC in regard to transfer of authority from Ministry of Finance (MOF) to Bangladesh Bank for providing new banking license, is very correct, provided Bangladesh Bank is capable of handling neutral and influence-free analysis of new bank applications. In this case, the political commitment of the government is more necessary than the willingness of Bangladesh Bank. At the same time, a concrete “exit policy”, to be governed by Bangladesh Bank, should be in place, which will help to restrict establishment or conduct of banking business with ulterior motive.

25. An effort was taken to bring competition in the banking system by giving licenses to more and more new PCBs and thereby increasing their market share and reducing the share of NCBs. Though the market share of NCBs has reduced because of entry of old (established during 1980s) and new (established during 1990s) PCBs, yet the NCBs still occupy a very large share of banking. At this moment, the NCBs shares in total deposit and credit are 60 and 50 percent respectively. In spite of their (NCBs) large share, they are suffering from multidimensional problems. It is quite impossible to ensure competition in banking without removing the problems and increasing the efficiency of NCBs. Unless the efficiency of NCBs is increased, loan prices will remain high and government subsidies in the name of the recapitalization of banks will continue year after year. The increase in efficiency of NCBs through removing their problems will not only ensure competition in banking, moreover in future it might lead to merger, takeover, acquisition etc., which are considered as “necessary evil” of modern banking system.
26. NCBs suffer from numerous problems: political influence in loan decision, bearing the burden of losses of state owned enterprise (SOEs), lack of accountability of bank officials, defective promotion policy, excess manpower, poor salary and other incentives, unauthorized activities of CBAs etc. The experiences of many countries regarding the operation of state owned banks show that these are being used for distribution of financial facilities on political considerations. It is very difficult to check this sort of tendency even after having good intentions by the policy makers. For obtaining financial facilities on political considerations, there might be competition and contentions among the pressure groups within a political government. Bangladesh is no exception to it. But we know that even if the five(5) percent of financial sector reform measures are affected by ill political motives, then the rest ninety five(95) percent will also lose credibility.
27. BRC argues that without widespread reforms, the problems of NCBs cannot be solved. The immediate requirement is to reorganize the NCBs on commercial considerations through extending autonomy to them. The NCBs should not be used as sources of finance for loss incurring SOEs, rather the losses of SOEs should be borne out from the government budget. The necessary steps should be taken to write-off the unidentified and irrecoverable loans of the NCBs. The consequences arising out of inadequacy of efficient officers at all levels of NCBs are becoming severe day by day. One of the significant inconsistencies is that the existing rules and regulations do not empower Bangladesh Bank to enforce its control in all respects of NCBs, consequently in many respects the NCBs are beyond the effective control of Bangladesh Bank. While delegating adequate power to the boards of NCBs, the question of fixing up their liability and accountability is also important. Only those individuals should be nominated to the boards of NCBs, whose (board members) social recognition and efficiency are beyond question and under their leadership the bank officials will be encouraged to discharge their duties with utmost honesty and sincerity.
28. Now it is recognized that only interest deregulation or increasing the number of PCBs cannot ensure competition and efficiency in the banking sector. The foremost necessity is to resolve the accumulated problems of NCBs and PCBs, for which we require firm political commitment and noble intention. In order to be successful in banking sector reforms, one firm commitment must be made by the government that the banks shall not be used for distributing political benefits nor be used as sources of fund for political parties. However, in the meantime, there has been a lot of improvement in regulatory and supervisory framework of Bangladesh Bank, but what we need further is the effective enforcement of the above framework. At the same time, the regular exposure of banking irregularities to general public is also essential in order to ensure the stakeholders

accountability and transparency, which is expected to increase public consciousness and banking efficiency. In regard to transparency, one American judge said, “sunshine is the best disinfectant.” The loan defaulter should not be kept unexposed in the name of secrecy, when the depositors protection is at stake (because of loan default). It is observed that in many occasions, the general customers do not come across many essential and sensitive information, because of weak publicity by the banks. For example: the common depositors do not even know that their deposits are insured only upto Taka 1 lakh. In addition, the indicators relating to financial health of the banks (such as capital, classified loan, profit after provision) should be made public through publication in newspapers, exhibiting in some conspicuous places of branch, regional/zonal and head offices. As a result, the depositors will be careful in selecting banks and on the other hand, banks will also be serious for improving their efficiency in order to survive competition. This is to be considered that in view of existing widespread banking weaknesses and irregularities, if all corrective measures are taken simultaneously, then the stability of the banking system might be endangered. On the other hand, unless some firm actions are taken, the credibility of the banking system cannot be restored nor rule of law can be established in banking. This deserves serious consideration that through neutral and objective analysis of banking problems and realizing their (banking problems) significance followed by corrective action can only ensure restoration of credibility of banking.

29. For successful implementation of any reform programme, one of the important preconditions is the skill, experience and attitude of the officers and employees. BRC argues that the existing personnel policy of Bangladesh Bank is not helpful for creating an appropriate manpower structure required for a modern central bank management. That is why, BRC, with a view to improving the manpower quality of Bangladesh Bank, has recommended for rationalizing the number of existing employees, prohibition of CBA, thorough restructuring of “direct - promotee” mix in the structure of officers, giving promotion on the basis of merit instead of seniority, establishing HRD division etc. Almost the same recommendations have been given by BRC for the NCBs. However, the CBA problem is more acute for NCBs. In this context, the recommendations of the Task Force on Trade Unions of the banking sector, formed by GOB in 1998, deserve special attention. There is no disagreement in relation to above measures with an aim to increasing the efficiency and accountability of the officers and employees, however, the implementation of those measures are not so easy. The firm political commitment and cooperation of all quarters essential for enforcing the above measures, are very difficult to obtain in the present political and social context of Bangladesh.
30. BRC has recommended to increase the non-fund/fee based services, the income from which will increase the overall income of NCBs. Undoubtedly, this is a very good suggestion, because it will not only increase the profit but also will reduce the pressure on capital. At the same time, banks may think of expanding and diversifying their assets base through introducing new products or services like leasing, consumer product financing, merchant banking etc. These products/services will not only introduce diversification, but also motivate the defaulters to give up their default attitudes. In addition, the banks may consider introducing asset securitization, instead of depending on traditional deposit products for increasing the inflow of fund in the banks. As a result, undue competition in the deposit market will be reduced and security market will be deepened and broadened.
31. The role of banking automation and information technology is considered very important not only for human resources development (HRD) but also for surviving the competition and expanding the financial market. Information and Communication Technology (ICT) penetration in the banking sector is very poor. Only 19 percent branches of NCBs, 38

percent branches of PCBs and 97 percent branches of FCBs are computerized. Overall computer density is only 1.64. ICT can contribute towards the improvement of supervisory and prudential standard of Bangladesh Bank through its own and interbank network which will ultimately raise the overall efficiency of the banking system. In Bangladesh, there is no Automated Clearing House (ACH), which is a prerequisite for development of ICT based banking products. Credit information Bureau's (CIB) data collection and dissemination is not ICT based and consequently time-consuming, which hinders efficient credit decision by banks.

32. Since NCBs are the biggest market players, therefore, ICT penetration is most crucial for them. All NCBs should have financial freedom to invest in ICT. Bangladesh Bank may fix up a time limit for implementing ICT in the NCBs. Bangladesh Bank can also make it mandatory to recruit new entrants with compulsory IT education.
33. Legal infrastructure is also important for implementing IT based banking services. The existing legal infrastructure is not capable of supporting online authorization and settlement of E-Commerce transactions. The digital signature law and dispute settlement law are not in place. Many B2C E-Commerce ventures cannot bring their money into Bangladesh due to the legal impediments. Bangladesh Bank alongwith other concerned agencies can work out a plan to develop and enact necessary legal and regulatory system.
34. Bangladesh Bank has set up Equity and Entrepreneurship Fund (EEF) for some priority sector including software industry. This positive step (alongwith others such as reduction of interest rate to 10% for ICT by a number of banks) does not bring any fruitful results. Basically, ICT industry requires working capital. As the industry structure is different from others, the financial products to support ICT industry should be tailored made. (This part of the report has been prepared based on the Task Force Report related to ICT).
35. **Recommendations:**
  - For the meaningful reforms in the banking sector and its continued progress, first and foremost requirement is firm political willingness and commitment and establishment of rule of law in the country.
  - For effective and quick enforcement of legal system related to banking, the requirements are:
    - Improvement in overall law and order situation.
    - Finding out means for stopping frequent stay-orders by the courts
    - Making provisions to allow only large loans (Tk. One crore) to make writ applications to special bench of High Court.
    - Extending cooperation to loan defaulters by the administration should be stopped.
    - Providing severe punishment to corrupt bankers.
    - AMC should be given the responsibility of receivership
    - Ensuring ethical standard and effective cooperation among bankers, legal advisers and Judges
  - For making the supervisory system of Bangladesh Bank more intensified and effective, the requirements are:
    - Keeping Bangladesh Bank free from all sorts of influences and rationalizing and increasing the efficiency of the manpower
    - Ensuring effective supervision of Bangladesh Bank over NCBs
    - Bangladesh Bank may be given the responsibility of awarding new banking licenses.

- Not only entry policy (for newentrants), exit policy (for existing banks) should also be formulated.
  - Political considerations should not be given importance while awarding new banking licenses.
- For ensuring competition in the banking sector, the prime necessity is to increase the efficiency of NCBs, for which the requirements are:
- Delegate adequate power to NCB Boards, stop interference of MOF and the executives to work free from any interference.
  - Nominate those in the board of NCBs, who have social acceptability and efficiency beyond any doubt.
  - Rationalize and increase the efficiency ( specially in terms of credit management) of manpower and prevent illegal activities of trade unions.
  - Strengthen and ensure internal control mechanism in NCBs.
- To further increase the efficiency of PCBs:
- Bank Managements should be protected from illogical interference and influence of sponsors.
  - Bangladesh Bank to ensure such an environment in PCBs where boards will formulate credit policy and bank management will be concerned with credit decision, disbursement and monitoring.
- For increasing accountability in the banks the requirements are:
- Publication of the list of defaulters
  - Cancellation of parliament membership, if he/she turns out to be a loan defaulter after election.
  - Rescheduling should not be allowed for more than two times.
  - Publication of the banks' financial statements in at least two widely circulated Bengali Newspaper
  - Expose sensitive banking indicators to general public
  - All employment in the banks should be gradually made contractual.
- For recovering default loan, the requirements are:
- Quicken legal process
  - AMC should be given the responsibility of receivership and loan collection
  - Formation of Loan Workout Department or Problem Loan handling department in the individual banks.
- In order to increase the flow of credit to priority sectors:
- Reforms should be demand oriented
  - Make provision for Wholesale finance
  - Prior fixation of a portion of total loan portfolio for priority sectors
- For preventing the illegal activities of the trade unions in banking, the requirements are:
- Firm commitment of the political parties not to patronize the trade unions
  - Ensure that trade union activities in banks are governed by national and international rules and regulations.

- Urgent emphasis must be placed on HRD, which requires:
  - Drastic change in the direct recruitment - promotee mix in the structure of officers
  - Ensure promotion based on merit, not seniority
  - Arrange appropriate training and ensure adequate competitive compensation levels and a congenial working environment particularly for
  - Rationalize excess manpower
  - Gradually make all jobs contractual
  - Establishment of effective HRD division in all banks
  
- For reducing risk and increasing income of the banks, expansion and diversification of product base (such as leasing, merchant banking, asset-securitization etc.) should be thought of.
  
- For the matter of survival in the competitive world market, the expansion of banking automation and ICT based product market are very necessary.