

CPD Occasional Paper Series

**Financial Sector Reforms in Bangladesh:
The Next Round**

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The present paper titled *Financial Sector Reforms in Bangladesh: The Next Round* has been prepared jointly by *Dr Debapriya Bhattacharya*, Executive Director, CPD and *Dr Toufic M Choudhury*, Professor and Director, BIBM. The paper was presented at the dialogue on *Financial Sector Reforms in Bangladesh: The Next Round* organised by CPD in collaboration with the Federation of Bangladesh Chambers of Commerce and Industry (FBCCI) held on Sunday, April 16, 2002 at Hotel Sheraton, Dhaka.

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Financial Sector Reforms in Bangladesh: The Next Round

I. Introduction

Reform is not a one-shot exercise, but a dynamic socio-economic process. Financial sector reform is also not an exception to this. During the 1970s and 1980s, there had been intense debate in Bangladesh on the need and rationale for financial sector reform. Contrastingly, one does not observe now-a-days any fundamental or conceptual objection to the objectives of reform, though there might be varying perspectives regarding its pace, sequencing, timing etc.

Initiatives to reform the financial sector in Bangladesh may be traced back to the beginning of the 1980s when the denationalisation of the *Uttara Bank* and *Pubali Bank* took place and a number of new private commercial banks (PCBs) were given licences. The *Money, Banking and Credit Commission* was constituted in mid-1980s to define the scope and modalities of the early phase of the reform.

Financial sector reform started in an intensive way in the beginning of the 1990s under the *Financial Sector Adjustment Credit* (FSAC) which Bangladesh contracted with the World Bank. Though the *Financial Sector Reform Programme* (FSRP) ended in mid-1990s, yet the reform measures were continued to be pursued.

After the expiry of FSRP/TA in 1996, the Government of Bangladesh (GOB) formed a *Bank Reform Committee* (BRC), which submitted its recommendations in 1999. While the then government partially acted on some of the recommendations of the BRC, a large part of them remain unaddressed. During the run-up to the last national elections, CPD launched a *Task Force on Financial Sector Reform* which prepared a set of recommendations for consideration by the newly elected government. The new incumbent government, after assuming the responsibility, has undertaken a number of measures for improving the performance of the financial sector.

In this context, the present paper attempts to take stock of the earlier initiatives of financial sector reform, analyse the thrust of the present policy approach and indicate some immediate measures with a view to meet the increasing demand for financial sector reform.

The present paper is not a comprehensive review of the state of banking sector in Bangladesh. Rather it seeks to highlight some of the on-going policy debates to seek guidance for the future.

II. The First Round: A Brief Overview

In order to define the "Next Round" of financial sector reform, one may ask what constitute the "First Round." According to our working definition, the First Round included the reform

initiatives undertaken during the 1980s and 1990s when the financial sector was opened up for private sector participation, operational procedures were partly deregulated and a number of important steps were undertaken which exposed the structural weaknesses of the sector. A set of consolidation measures were pursued during this period with mixed results.

The “Next Round”, as the paper argues, should concentrate on the “unfinished agenda” of the First Round, focusing on “expansion and diversification” of the sector in order to service the basic task of investment promotion in the era of globalisation.

- i) As mentioned earlier, the first reform programme in the financial sector of Bangladesh was initiated in 1982, when the government decided to allow the operation of local private banks and denationalise two out of six nationalised commercial banks (NCBs). The main reason for allowing local private banks was the desire on the part of the government to demonstrate its commitments to encourage the private sector and to create competition in the banking sector. It transpires from various studies that denationalisation and privatisation process could not generate the expected results because of absence of strict supervision coupled with rigid economic regulations on the part of the Bangladesh Bank. Though in some respects quality of customers' services improved, yet the overall banking efficiency, specially in the context of credit management was observed to have deteriorated.
- ii) To diagnose the malaise and identify ways and means for banking recovery, a *National Commission on Money, Banking and Credit* was appointed by the Government of Bangladesh (GOB) in 1986. After a detailed examination of various problems of the banking sector, such as bank rate and refinancing policy of the Bangladesh Bank, overdue loans of NCBs and the development financial institutions (DFIs), supply of adequate loan to rural and agriculture sector, supervisory problems of the Bangladesh Bank and individual bank managements, frauds and forgeries in the banking sector etc. The Commission submitted a long list of recommendations to the then government in 1986. Subsequently, a number of steps including fixation of recovery targets for the NCBs and DFIs and prohibiting defaulters from getting new loans were undertaken, yet the deterioration in banking efficiency could not be stemmed.
- iii) In order to address the issue of increase in efficiency, the FSAC of the World Bank in 1990 determined the following objectives for the financial sector reform programme.
 - Gradual deregulations of the interest rate structure with a view to improving the allocative efficiency;
 - Providing market oriented incentives for priority sector lending;
 - Making subsidies in the priority sectors more transparent;
 - Adoption of appropriate monetary policy;
 - Improvement in debt recovery environment; and
 - Strengthening of the capital markets.

However, a review of the outcomes of the FSAC done under the *Structural Adjustment Participatory Review Initiative* (SAPRI) in 2000 indicated that from the viewpoint of implementation, the reform measure were implemented satisfactorily, but from the viewpoint of desired outcome, the results were not very encouraging.

The FSAC failed to address the issue of efficient resource allocation in terms of access to credit by productive sectors. Interest rate deregulation could not instill competition in the sector. Management efficiency in the NCBs could not be perceptibly improved despite implementation of new operational and management/loan quality assessment tools.

Thanks to the newly implemented loan classification system as well as provisioning and capital adequacy standard, it was established that the financial health of the banking sector of Bangladesh is far from the acceptable range. This may be considered a success now that the weaknesses of the banking sector were conclusively exposed, this creating a pressure to accelerate the reform process.

The major criticism of the FSRP points out that it placed more emphasis on economic deregulations rather than on broadening of the prudential regulation and supervision for the sector. It is further maintained that it would have been more appropriate, in the context of Bangladesh, to introduce measures to deal with the "debt default syndrome" and the management of the NCBs, prior to a more general interest rate liberalisation.

- iv) The report of the Bank Reform Committee (BRC) gave highest priority on restructuring of the supervisory and regulatory set up for ensuring strong system of enforceable oversight of banks. At the same time, the BRC also asked for strengthening of legal framework and effective restructuring of the NCBs. For reducing the political interference, BRC proposed not to interfere with the affairs of the Bangladesh Bank Board and to set a clear-cut guideline for deficit financing of the government. The BRC also suggested that the Directors of the NCB boards cannot be Member of Parliament or an office bearer of a political party or a loan defaulter. The BRC also opined that the 'regulatory forbearance' on the part of the Bangladesh Bank has been responsible for the continuing problems with the "problems banks".
- v) The *SAPRI study* (2000), mentioned earlier, besides evaluating, the FSAC, assessed the implications of the BRC proposals and subsequent developments in the banking sector. The SAPRI study maintained the following.
 - In order to achieve the goals of financial sector reform, the first and foremost requirement is ensuring an enabling environment, which requires macroeconomic stability, political commitment and non-interference by the government and vested interest groups.

- The policy framework should be comprehensive (systemic) and should also incorporate both demand and supply aspects.
 - The policy measures should be sequentially arranged and implemented.
- vi) The *CPD Task Force* (2001) on Financial Sector Reform underscored the following aspects in its report.
- Firm political willingness and commitment for establishment of rule of law.
 - Effective and quick enforcement of legal system related to banking.
 - More intensified and effective supervisory system of the Bangladesh Bank.
 - Efficiency of the NCBs must be increased for ensuring competition.
 - Increase accountability and transparency of the financial sector governance.
 - Stop illegal activities of trade unions in the banking sector.
 - Utmost attention to human resource development (HRD), and introduction of information and communication technology (ICT).

III. Recent Policy Measures: An Analysis

i) *Reduction of Bank Rate and Lending Rate*

Immediately after the present government took office in September, 2001, The Bangladesh Bank reduced the bank rate with a view to decreasing the lending rate and, consequently, increase the volume of lending. It has been observed that following the reduction of bank rate, most of the NCBs and the PCBs have reduced their lending rates more or less proportionately. As a result, the actual spread for the banks was supposed to decline. However *the actual spread of the NCBs is not expected to decline because of their simultaneous reduction of deposit rates*. However, the spread has declined for the PCBs. This is also true for the foreign commercial banks (FCBs).

It may be pointed out that there is a weak relationship between bank rate and market interest rates because of the fragmentation characterising the financial market in Bangladesh. With a reserve requirement of 20 percent, the spread between lending and deposit rate should be around 2 percent. However, throughout the 1990s, the spread was almost 7, if not more.

Though the magnitude of non-performing asset (NPA) is largely responsible, yet it cannot fully explain the high interest rate spread prevailing in Bangladesh. *In addition to high NPA, collusive behaviour and misconceived price strategy, high operational costs and over staffing (of NCBs) are also responsible for high interest spread*. On the other hand, NCBs account for 75 percent of total classified loan of the commercial banking sector. Moreover, their operational and overhead costs are also high as compared to PCBs and FCBs. Under the circumstances, *it is imperative to reduce the NPA level and operating costs of the NCBs in order to bring down lending rates in a sustainable manner*.

The share of the PCBs in total lending is around 27 percent, and along with the FCBs it is around 33 percent. The rest of the lending market share (67 percent) belongs to state-owned banks. It is observed that the net interest spread on the part of the FCBs is very high (as compared to local banks). Although, the high interest spread by the FCBs is usually justified by their efficient and quality customer services. The FCBs have therefore, been asked to reduce the interest spread (by reducing lending rate), which they can accommodate because of their very low NPA. It is expected that the lowering of lending price by the FCBs would force other market participants (NCBs and PCBs) to reduce their lending rates, if they want to survive the competition. This may not happen given the very small market share (6%) of the FCBs. *Having such a small share, the FCBs cannot play the role of price leader.* Rather, the FCBs are price-followers, whatever prices are determined in the market, the FCBs are accepting it. Therefore, if the objective is to reduce high interest spread of FCBs, then high lending rates of NCBs (because of high NPA, operational costs etc.) need to be reduced. In that case, the FCBs will be forced to follow the low lending rates of NCBs. Otherwise, within a market framework, administering a lower interest rate on FCBs will not be sustainable, rather will create distortions in the lending market. Moreover, given the customer structure of the FCBs, the beneficiaries of lowering of interest rate will only be a select group of multinationals and big local customers.

In fine, the bank rate driven lending rate reduction approach is going to have very limited results.

ii) Linking Classified Loan Level to Large Loan Sanctioning

The Bangladesh Bank has recently (January, 2002) revised the “Large Loan Rules” with respect to classified loan of the banks. The new rule prescribes that the banks with net classified loan of upto five per cent will be allowed to sanction a maximum of 56 percent of the total loan and advances as “large loans”.¹ Earlier, with a comparable classified loan (<5 percent), a bank could lend up to 80 percent to large loan category. The banks with net classified loans between five percent and ten percent can now lend 52 percent of their portfolio as large loans against the previous allowable limit of 70 percent. The banks with net classified loans between 10 and 15 percent can lend up to 48 percent as against the previous 60 percent of their portfolio. For the next slot of up to 20 percent, the allowable large loan is 44 percent instead of the previous 50 percent.

Surprisingly, the worst-performing slot with over 20 percent net classified loans does not suffer because of the new policy. They retained their current 40 percent loan limit. This has given rise to the apprehension that the new rule will effectively restrict the lending growth of the banks. While the good banks with low classified loans have been punished, the worse performer have been left untouched by the new rule.

¹ Although the concerned circular does not provide a definition of “large loan”, it is generally understood that a large loan deal with an amount above Taka 10 million.

The Bangladesh Bank has also directed the commercial banks to reduce their amount of large loans to fit into the new slab. According to the existing rules, banks have to seek permission of the central bank for approval for any loan exceeding 15 percent of their capital.

The new rule is expected to contain the credit risks of a bank within a reasonable range, prohibit the tendency of concentrating bank resources in a few hands and encourage a bank to give loans to small and medium sized projects (SMEs) for diversified industrial development.

Though from the point of view of limiting the credit risk exposures of the banks having a higher level of classified loan, the new rule is justified. However, to consider large loans as risky loans (by the new rule) is not reasonable. Moreover, for the matter of increasing the volume of lending to the SME sector, this sort of supply-side policy is not adequate. As various studies have indicated that for efficient resource allocation to productive sectors (e.g. SME and agriculture), the demand-side problems such as collateral requirement, procedural complexity, high sunk cost, inability to fulfill loan conditions, etc. must be adequately addressed in the reform programme. In fact, under both directed lending (before 1990) and deregulated lending (after 1990) regimes, the demand-side factors were not considered, consequently resource allocation suffered.

The new *Large Loan Rules* of the Bangladesh Bank seems to be similar to what we call “narrow banking”², which has been suggested as a solution to the problems of high non-performing assets. While, on the one hand, the long-term measures aimed at improving the viability of problem banks (having a high level of NPAs) should be initiated, as an interim measure to arrest any further deterioration in asset quality such banks could be placed under narrow banking regime. This would imply restricting the incremental resources of these institutions only to investments in high quality marketable securities of nominal risk with matching maturity and liquidity needs of their deposit liabilities. *From the above point of view, the Bangladesh Bank’s rules linking between NPA and size of loans is not appropriately designed as the large loans are mostly illiquid. It is also to be mentioned that the narrow banking only addresses the issue of increment, it does not tackle the problem of “overhang” (i.e. advances which have already become NPA)*

iii) Rationalisation/Merger of Loss Incurring Branches of NCBs and DFIs

For the matter of running the banks on commercial basis, the concerned authorities have decided to merge/rationalise continuously loss incurring branches of the NCBs and the DFIs. It has been decided that the branches which are incurring losses continuously for the last five years and having no potentiality of becoming profitable in future, will be merged with another nearby branch. At this moment, there are 806 branches (of the NCBs and DFIs) which are incurring losses continuously for the last five years. The merger/rationalisation programme of the loss incurring branches will be conducted at three phases (June, September and December, 2002). However, it has also been decided to keep at least one branch within five kilometer radius of the present branch location, giving preference to *intra-bank merging*,

² The term “narrow bank” refers to a bank which only invests deposits in highly marketable liquid assets such as treasury bills.

and in case of *interbank merging* – BKB and RAKUB should be preferred. Importantly, the surplus manpower of the merged branches would be absorbed in other branches of the same bank. It is estimated that around 200 branches cannot be merged because of non-existence of any other branch within five kilometer radius. *After the successful implementation of the branch rationalisation programme, it is expected that at least 500 branches of the NCBs and DFIs would be closed down.*

From the perspective of improving efficiency and reducing loss, the branch rationalisation programme is definitely a step in the right direction. However, this is also true that in a branch banking system, it is not the “profit and loss” of individual branches, rather the aggregate financial viability of a bank which matters most. If profit making is the only criteria for keeping a bank in business, then possibly we need to close down most of the state-owned banks which are effectively in red for the last so many years. Admittedly, the state-owned banks do not operate strictly within the market-based principle given the large set of welfare activities they are induced to pursue-thus, we do not usually support that they wind up their business altogether

The position paper on branch rationalisation programme indicates that the branches which have been selected for merger have no potent of becoming viable in future. However, it is not clear how the decision that the loss incurring branches (which they are going to be merged) will never be viable in future has been arrived at. Was there any attempt to improve the viability of those branches? What was the nature and scope of that effort? *Rather, what we have observed that the rural branches (most of which are loss incurring) have not been given appropriate attention since the inception of the First Round (1991) of financial sector reform, which may be considered as one of the reasons for their gradually becoming non-viable.* In case of the “problem banks” of the private sector, we have observed that because of intensive care and control of the central bank, most of them have already graduated from the problem status. In fact, this sort of nursing and care was not taken in case of loss incurring rural branches of the NCBs.

As of July, 2001 there were 3612 and 1296 branches of the NCBs and PCBs respectively, the ratio of (PCB and NCB) being 1:2.8. Because of closure of 500 branches, the proportion of branches between PCBs and NCBs would stand at 1:2.4. The merger/rationalisation of the identified branches will reduce the financial/branch network of NCBs and DFIs by 10 percent. The *CPD Task Force Report (2001) on Financial Sector* observed that *the proportionate share of rural banking has declined after the adoption of banking reform measures. The share of rural banking is expected to further decline because of closure of 500 loss incurring branches, as most of these are expected to belong to rural areas.* The government must have taken into consideration the impact of winding up a significant portion of its financial infrastructure on its other economic objectives.

The position paper on branch rationalisation also argues that the banking business should run on the basis of commercial viability and guided by sound and prudent policies. No one will

contest this proposition, though we know that under different circumstances in the 1970s and 1980s, the NCBs and DFIs were asked to expand branches having total disregard to their commercial viability. Furthermore, even at the time of denationalisation of *Uttara* and *Pubali*, the BKB was forced to take over the loss-incurring branches of these two banks. *Unfortunately, now the NCBs and DFIs are being blamed for having so many loss incurring branches. It is too often forgotten that efficiency is to be judged in relation to objectives set of management, not in relation to objectives (such as profit maximisation) that are believed to be desirable in themselves.*

What is most interesting that while the branches are being closed down, the surplus manpower is being retained. This is possibly being done to reduce the resistance to the proposed measure. *One wonders whether such an approach will at all have any sobering impact on the aggregate financial viability of the concerned banks.*

It may be recalled that in 1993, another branch rationalisation programme of the NCBs was undertaken. To this end a committee was formed headed by a Deputy Governor of the Bangladesh Bank with the MDs of the NCBs as members. The committee decided to close/merge 106 NCB branches out of 997 loss incurring (consecutively for three years) branches. The rest 891 branches were not to be closed for either socio-economic reasons or for the need to run treasury operation of the government. Some of them were targeted for improving their financial viability. *The experience of 1993 rationalisation programme has not been adequately analysed.* Specially, it would have been very useful for us to know the current status of those 106 merged branches (if they are at all merged!). What happened to those 891 branches, whether they could be upgraded to commercially viable position.

Financial loss of the branches is the "effect", not the "cause". *Since the Bangladesh Bank has categorically denied any sort of external pressure for the branch rationalisation programme, one is curious to know whether it has gone by the revealed priority, consulted the earlier branch rationalisation experience (1993) and adopted some revival programme (like the problem bank approach) before straightway closing/merging so many branches at a time.*

iv) Measures for Loan Recovery

At this moment, the biggest problem of the financial sector in Bangladesh is huge loan default. Because of default in repayment, it is not only putting adverse impact on profitability and liquidity, 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. Huge default constitutes a demotivating factor on the part of banker for making loans on their own. International banking operations of the domestic banks are at stake because of their erosion of capital base due to loan default. *Therefore, in terms of priority, NPA problem should have been given most importance, instead of any other thing.*

Diverse factors have precipitated the loan default problem in Bangladesh: lack of loan screening skill, lack of supervision and accountability on the part of bank management,

malinfluence of political and other vested group, high loan price, volatile economic environment, corruption and unethical activities on the part of concerned stakeholders etc. For the recovery of default loan, the main hindrance at this moment is existing legal framework and its lengthy procedures. The *CPD Task Force Report (2001)* argued that the *problem of loan recovery cannot be addressed only by undertaking legal reform, issues like ethical standard and accountability of the concerned individuals, the overall law and order situation and quality of politics of the country are also involved in the process.*

For the matter of resolution of problem loans, CPD in 1997 and subsequently the BRC in 1999 have recommended to articulate and implement a sound "Recovery Policy" by the NCBs, form an *Asset Management Company (AMC)* and establish specialised loan work-out department in each bank. Very recently, the Ministry of Finance (along with the Bangladesh Bank, NCBs and DFIs) has initiated a move to set a guideline to write-off bad loans of the banking system. Possibly the process is yet to be completed. In the meantime, the Bangladesh Bank has announced a uniform incentive package for recovery of classified loans for the four NCBs.

According to the new incentives package, an NCB staff will receive *seven percent* of the loan for helping the bank to recover it, which remained unrealised for *seven years* or more and has already been labeled as "bad debt". In case of recovery of bad debts that remained unrealised for *three to seven years*, the staff would get *six percent* of the amount, while (s)he will receive *five percent* of the amount as incentive for realising *other bad loans*. Besides, a bank staff would get *four percent* in case of realisation of "doubtful loans". The incentives would be given on yearly basis upon closure of a loan account. The incentive packages would not be applicable if a branch fails to slash five percent of classified loans of the previous year.

As a policy measure, incentive schemes for loan recovery should be thought of only as an interim/short term measure. *In the medium term, the incentive schemes is fraught with "moral hazard" problem.* To evolve a sustainable policy package in this respect the government may think of the proposals put forward by the BRC mentioned earlier (e.g. creation of AMC and loan work-out department).

v) *Revision of Delegation of Power and Responsibility between Board of Directors and the Management*

In February, 2002, the Bangladesh Bank has issued a circular delineating the responsibility and accountability of the members (including the Chairman) of the Board of Director and Managing Director (MD) of the NCBs and DFIs. In fact, this sort of guidance was in place for both NCBs and PCBs since 1996. However, *the further amendments and reallocation of power between the Board and the Managing Director (through issuance of a new circular) indicates the seriousness on the part of government/Bangladesh Bank to run the NCBs efficiently.*

The new policy has endowed the Board with the responsibility of formulating and approving the business goals, target, strategies, income-expenditure policies, loan policy etc. as well as monitoring the progress of implementation of the policies periodically (at least quarterly). *One very significant departure of the new policy relates to delegation of loan sanctioning power to the MDs to the extent of 7.5% of capital without taking approval from the Board.* However, the Board is also responsible for approving the banks' budget (within government stipulated framework), employment and transfer policy, training policy, business risk management policy etc. The Board is also empowered to monitor the internal control system of the bank and constitute a special audit team. The Board is required to submit an analytical report on the business performance of the bank for the government's consideration. The Managing Director will perform his duty within the financial and administrative authority as delegated by the government and the Board. The MD will also ensure compliance of *Bank Company Act* and other regulatory frameworks and remain accountable for achieving the business targets.

With a view to increasing the management efficiency of the NCBs, both the BRC and CPD Reports have underscored the need for delegating adequate power to the Boards, stopping the interference of the Ministry of Finance and strengthening the internal control mechanism in NCBs. In case of the PCBs, the CPD Task Force highlighted the need to protect the management of PCBs from the illogical interference and influence of their Board Members.

The new policy of delegation of power to the management should be viewed in the context of the broader framework of corporate management structure. In such a structure, both responsibilities and accountabilities of all management tiers (like Board, top management, middle management etc.) are determined. *From that point of view, the accountability of the Board is not explicitly determined in the new policy.* According to the new rule, the MD will be accountable to both Government and Board, i.e. the CEO of the NCBs will continue to suffer for "dual loyalty". *In spite of delegating a lot of power to the Board, the Ministry of Finance still holds sufficient power for the matter of controlling the NCBs (in terms of budget approval, purchase policy, construction, accountability of MD etc.).* It can only be expected that in course of time, gradually the other essential powers will also be devolved to the Board.

Considering the composition and quality of the Board members of the NCBs, one may draw attention to their capability of formulating a well designed banking policy and strategy, specially risk management policy, keeping in mind the challenges emanating from competitive globalised banking sector. The CPD Task Force argued for nomination of those in the NCB Boards, who have social acceptability and efficiency beyond doubt. The BRC has suggested to form a Banking Sector Management Selection Committee (BSMSC) for proposing the names to the appointing authority, for posting them to key banking positions including Chairman and Board Member. The present government till date has decided to do without it (i.e. BSMSC) with consequent implications for the recent appointments to the NCB Boards.

vi) Decision on Cash Reserve Ratio Requirement

The recent (February, 2002) liquidity crisis of the banking system which manifested in the *call money rate* going up as high as 50 percent has adversely affected the PCBs – especially the “third generation” PCBs, i.e. those licensed in the last quarter of 1990s. Before the liquidity crisis, the present government questioned the viability of the new PCBs and asked all government offices to withdraw their deposits from these PCBs, which are not yet five years old. Because of this government decision, the new PCBs were already under liquidity pressure.

In this context, the central bank’s decision of keeping the *Cash Reserve Ratio* (CRR) only in local currency (that too just before Eid, when normally huge deposits are withdrawn by depositors) instead of local and foreign currency, put the PCBs under heavy liquidity pressure, resulting in steep rise in call money rate. The concerned Bangladesh Bank officials are inclined to look at the phenomenon as the weakness of the fund management system in the PCBs. However, the market participants maintain that they were neither consulted nor given adequate time to deal with the revised regulatory decision. *In this connection, it may be noted that the timing and extent of tightening of prudential regulations will have to take into account the cyclical factors in the economy. At the same time, adequate notice would need to be provided to market participants to enable them to be fully prepared to meet the changing prescriptions. Finally, intense consultations process in detailing the prudential regulations would be necessary so that prudential regulations are introduced at an appropriate pace in order to reach the desired objectives.*

The unviability of the newly established PCBs (“third generation”) is yet to be established; according to the published data, they are performing well. The present government might be thinking that the number of licensed commercial banks has exceeded the “optimal” number, which might lead to turn some of the new PCBs into problem banks. Possibly for this reason, the present government has declared that no further license would be provided for establishing new banks. It is true that the creation of problem banks should be preempted at the very beginning (that is, at the time of licensing) through a very strict, influence-free and neutral analysis of the new bank applications. *From the above point of view, suggestion of the BRC in regard to transfer of authority from Ministry of Finance to Bangladesh Bank for providing new banking license, is very correct, provided the central bank is capable of undertaking professionally competent and influence-free analysis of new bank applications.* The present government can take necessary action in this regard.

Concurrently, *a concrete “exit policy”, to be governed by the Bangladesh Bank, should be in place as early as possible. This will not only help to restrict establishment or conduct of banking business with ulterior motives, but also facilitate restructuring of the financial sector through merger, acquisition, and liquidation.*

IV. The Way Forward: Some Immediate Measures

The recent policy measures seem to have focused on improving both "quantity" and "quality" of banking investment (lending) through reduction of bank rate and lending interest rate (for quantity) and revision of large loan lending rules (for quality). Concurrently, the concern for profitability/efficiency has possibly prompted the government to undertake policies like branch rationalisation and functional demarcation between the Board and the management. For the stability of the financial system, the government has also expressed concern regarding the status of the *third generation* PCBs.

However, it appears that the policy measures are yet to address many of the priority issues of financial sector reform. It is reckoned that without creating an "enabling environment" and strengthening of "prudential and supervisory structure", functional/ economic expansions and efficiency gains of the banking system cannot be sustained. Both the aspects, may be addressed simultaneously, but the latter (i.e. economic and efficiency gains) in the absence (or inadequacy) of the former (i.e. prudential and supervisory structure) would be an "accident waiting to happen". Though the former, in the absence of latter, may be acceptable from the safety and soundness point of view of the banking system, but cannot be afforded by an economy like Bangladesh because of its retarding impact on economic growth.

The policy measures taken so far are tilted towards economic expansion and efficiency gains, nothing tangible has been done, till date, towards strengthening the prudential and supervisory structure and hastening the creation of enabling environment. The issue of ensuring competitive market has been approached in an administered manner, rather than increasing the efficiency of NCBs. The NCBs have not been brought under effective oversight of the Bangladesh Bank. There is no headway in regard to solving the perennial problems of huge NPA, provisioning and capital shortfall. The issue of enhancing the efficacy of the legal enforcement system remains unattended. The inactions or delay in actions in this regard may be construed as political foot-dragging. Under such a situation, the economic and efficiency measures will not ensure a competitive and robust banking system, even it may not stop back-sliding of the sector.

Therefore, remaining mindful of the reform experiences of the *First Round*, taking note of the recent policy measures and being cognizant of the unattended weaknesses of the system, the *Next Round* of the reform actions should have dual focus:

- (i) addressing the "unfinished agenda" of the *First Round*, and
- (ii) developing the next generation reform measures relating to expansion and diversification of the financial sector.

In this connection, some of the immediate measures which may constitute the *Next Round* of financial sector reform in Bangladesh have been presented below.

i) Strengthening the Regulatory-Supervisory Base of the Bangladesh Bank

- Like the PCBs, the NCBs must also be made accountable to the Bangladesh Bank for regulatory and business compliance.
- Both the Board and the MD of the NCBs should remain accountable to the Bangladesh Bank.
- The dilemma of subordination of the “regulators” (the Bangladesh Bank) to the “owners” (the government in case of the NCBs) needs to be removed.
- Introduce "Exit Policy". Both *Entry* (licensing of new banks) and *Exit* policies are to be handled by the Bangladesh Bank in a free, fair and transparent manner.
- Increase the oversight capability of the Bangladesh Bank.
- Develop a time-bound programme for adoption of "Core Principles for Effective Banking Supervision", as suggested by the *Basle Committee on Banking Supervision*, by the Bangladesh Bank.

ii) Improving the Financial Viability of the NCBs

For ensuring competitive banking, the first and foremost requirement is to improve the efficiency of the NCBs, given their large market share. In this regard, the NCBs are required to improve their capital position, reduce NPA and operational costs. As of December, 2001, the NCBs were suffering from huge capital shortfall – to the tune of Tk. 1303 crores. In terms of percentage, their capital ratio is only 4.24% of total risk-weighted assets. Among the PCBs, only a few first generation PCBs and two privatised NCBs are burdened with capital shortfall.

- If fresh capital cannot be injected by the government to the NCBs, then they may be allowed to raise capital (supplementary) by issuing security paper in the market.
- The fixed assets of the NCBs may be also reassessed to reflect their current market price.

iii) Addressing the Problem of Debt Overhang

By any standard, debt overhang problem of the banking system in Bangladesh, specially for the NCBs, is very severe. The total classified loans, as of December 2001, amounted to about Tk. 23,600 crores. While classified loan of the banking system has as a whole reduced over the last six months (June - December, 2001), but the same for the NCBs, albeit marginally, has increased (from Taka 12,202 to 12,227 crores). The classified loan of PCBs has been reduced by Taka 450 crores during this period. In terms of percentage, by the end of 2001, the classification rate of the loan portfolio of the whole banking system (including the DFIs) stood at about 31.5% as against more than 37% recorded for the NCBs.

The following measures may be suggested for addressing the problem:

- *Asset Management Company* should be immediately launched.

- Review the experience of the *Bankruptcy Court* and *Money Loan Court* for necessary expeditious amendments.
- Create "Loan Recovery Policy" as an integral part of Loan Policy of the banks.
- Create "Problem Loan" handling department in all banks.
- Bad debt of the state-owned enterprises (SOEs) to the NCBs should be settled through direct budgetary allocations (as was partly done in case of jute industries and other "sick industries").

iv) Dealing with the Provisioning Shortfall

The provisioning shortfall for the whole banking system increased from Taka 3,887 crores to Taka 4425 crore over the period June-December, 2001. The NCBs account for about 88% of this shortfall. The private banks which are suffering from provisioning shortfall belong to the *first generation* PCBs.

- A clear policy needs to articulated for the NCBs with a view to meeting the provision shortfall through appropriation of pre-tax profit. Strict application of the proposed policy may also act as a stimulus for loan recovery.

v) Creation of a Financial Restructuring Authority

The problems of the NCBs (and the DFIs) are huge and multifarious. There are a number of problem banks in the private sector as well. As without addressing these problems, the efficiency of the banking system cannot be ensured, it is proposed an autonomous *Financial Restructuring Authority* may be formed for professionally and efficiently addressing the problems of the NCBs and other problem banks.

vi) Measures for Increasing Corporate Efficiency

A number of measures may be considered for increasing corporate management.

- Nominate members and top executives of the NCBs through a credible *Selection Committee*..
- Remove "indirect" control of the government over the NCB Board Chairman and members.
- Regularly publish updated financial statements of the NCBs and the PCBs to increase accountability and frequency of their performance.
- Protect PCB Managements from illogical interference and influence of the sponsors.
- Ensure adoption by the Bangladesh Bank:
 - a) *Framework for Internal Control System in Banking* and
 - b) *Principles for Management of Interest Rate Risk* by the managements of both NCBs and PCBs.
- Consider contract appointment of top management team.

vii) Enhancing Efficacy of the Legal System

For effective and quick enforcement of legal system related to banking, the requirements are:

- Improvement in overall law and order situation

- Receivers must receive all sorts of cooperation from the administration
- Find means to deal with frequent stay-orders issued by the courts
- Improving ethical standard and effective cooperation among bankers, legal advisers and judges.

viii) Creation of Secondary Market for Bonds and Loans – Capital Market Link-up

Liquidity is the source of confidence of the customers on banks and banking. In a banking system with huge provisioning and capital shortfall, all precautionary measures must be taken for guarding the liquidity, otherwise the system is bound to collapse. In order to increase the liquidity, the banking system may resort to "securitisation" and creation of secondary markets for government bonds (Repo market), loan sales etc. Securitisation would not only be an important source of fund for the banks, but also help the security market to develop through ensuring enough supply of good scripts. This will help deepening the interface between money market and capital market.

ix) Dealing with the Illegal TU Activities

Trade union activities in NCBs is a very big barrier for increasing the efficiency of NCBs and DFIs. For preventing the illegal activities of the trade union in banking, the requirements are:

- Firm commitment of the political parties not to patronise the trade unions.
- Ensure ideal trade union activities in banks according to national and international rules and regulations.

In conclusion, two issues may be particularly emphasised.

First, most of the above issues are "systemic" in nature, many of which are contingent upon general improvement of economic governance in the country. For adoption and implementation of appropriate measures concerning the above mentioned issues, *what we require is the demonstrated commitment of the political authorities towards developing a modern financial sector in this country*. The government has to identify discrete and implementable measures, effective perusal of which would generate public confidence in the overall reform package.

Second, it must be remembered that in the absence of a reasonably well functioning financial system in the country, all other policy overtures (e.g. fiscal incentives) provided by the government for investment promotion will be of marginal value. *Thus, in the sequencing of structural reforms, financial sector reform should occupy the foremost position*. Thus, it is expected that during the period leading to the announcement of next national budget, the government will find it advisable to implement a number of the measures mentioned above.