

Restoring Justice to the Banking System

by Rehman Sobhan

Is there any scope for restoring justice to our banking system? A democratic society has to reconcile its goal of removing poverty through democratising access to resources and restoring efficiency to the financial system. A system which does not regenerate itself though repayment of loans by its borrowers cannot survive. We, therefore, need to address the problem of justice in the banking system within a more holistic framework of financial sector reform which can effectively integrate the micro-credit and macro-credit system.



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It is arguable that such a concentrated pattern of advances reflects the logic of the market place. The large account holders are deemed to be creditworthy and are likely to be more efficient in their use of such credit. Unfortunately, the contemporary historical record in Bangladesh does not sustain the credibility of this piece of inherited folklore in the banking system. As of 31/12/99, Tk. 24,000 crore or 41% of all outstanding loans made by the banking system of Bangladesh were classified or in popular terminology, were in default. The proportion of classified loans were relatively higher in the NCBs where the ratio stood at 46%. In contrast private bank loan classification covered 27% of their advances whilst only 4% of the loans of foreign banks were so classified. However, within the private banks 7 of the largest banks had over 33% of their outstanding loans classified.

It is ironic that large defaults within the private banks largely originated in the insider-borrowing by the bank owners from their own banks. Part of the logic of bank privatisation lay in the expectation that private bankers, as owners, would be more prudent in the supervision of loan operations compared to managers of the NCBs. In practice, we have observed that a section of private bank owners have committed an injustice on their depositors by using their funds to finance the owner's businesses in violation of both banking laws and best practice. This injustice to the depositors was then compounded by inefficiency whereby the owner-borrowers defaulted on loans taken from their own banks, thereby putting the viability of the bank at risk and violating the trust of their depositors.

In recent years some attempts were made to improve discipline in the banking system. In the early years when the system was taking shape a much higher

and will need careful monitoring to see that they also do not end up in default like their predecessors.

It should be here recognised that not all large borrowers are in default of their financial obligations to the banks. Thus, even within large borrowers there is an element of injustice whereby some borrowers duly service their loans whilst some do not. This arrangement penalises efficient large entrepreneurs, engaged in competition both in the market place and for scarce resources who pay a much higher implicit rate of interest on their loan portfolio than a borrower who defaults on his loan.

Micro-credit and the spread of institutional banking

In the prevailing circumstances of such a high percentage of default amongst affluent borrowers, attention needs to be given to the fact that a new class of micro-borrowers have emerged on the banking scene. These borrowers fall within the category of the rural poor, defined as those owning less than 0.5 acres of land. These borrowers may not be the poorest of the poor but they do belong to those who live below the poverty line. As of 30 June, 2000 it is estimated that 11.9 million households in Bangladesh covering 47.5% of the total population, were deemed to have incomes below the poverty line. 65% of these 11.9 million households are estimated to be recipients of micro credit. The special feature of micro-lending in Bangladesh is the fact that it largely serves poor rural women and that the system is characterised by very low levels of default. Grameen Bank as of March 2000 had outstanding loans of Tk. 12,022 crores to 2.4 million borrowers but only 10.5% of the outstanding loans were overdue. Today Grameen Bank is the world's largest provider of micro-credit with an adequate capital base in little need of recapitalisation.

Apart from Grameen Bank and other MFIs, government agencies such as BRDB and the Youth Resource Development and Employment Project, have between them disbursed Tk. 1508 crores. BRDB has recovered 85% of its disbursed loans which have been extended to 1.65 million borrowers of whom 83% are women. Thus even public sector institutions have demonstrated the efficiency of their low income borrowers.

There is a temptation to romanticise the role of the MFIs who are viewed by some votaries, including aid donors, as the solvent to the problem of poverty and the emancipation of women in Bangladesh. We do not need to indulge in such flights of fancy since poverty in Bangladesh still remains close to 50% in spite of the spectacular growth of micro credit. The real achievement of the micro finance system has been to bring close to 10 million borrowers into the institutional credit market. This figure may be compared to the 6.5 million accounts who received credit from the formal banking system. The MFIs have established that the more deprived segment of the population are now familiar with commercial banking. They know

about their fiduciary obligations, they have to make intelligent market decisions on investment and manage their resources with enough efficiency to be able to service loans, paying market based rates of interest.

Social Injustice in the Banking System

This recognition of the bankability of the poor in Bangladesh which has been established by the widespread coverage of the loan operations of the MFIs has to be juxtaposed against the concentrated nature of lending by the formal banking sector. This inequitable loan structure of the commercial banks has ended up with a loan classification ratio of 41% the bulk of which originate from the large borrowers in both the public and private sector, but mostly in the private sector. It should be kept in mind that such large defaults, particularly in the NCBs have a high opportunity cost *vis a vis* micro-credit borrowers. If all the defaulted loans of the NCBs could, instead, have been channelled by the NCBs to micro-borrowers the remaining 4 million households in need of micro-finance could have been fully covered.

This inequitable dispersal of loans as between households is compounded by the inequity in the geographical spread of the loans. The rural areas as of 31.3.99 received only 17.2% of all loans even though they accounted for 22.3% of deposits. It is significant that the urban areas of just two districts, Dhaka and Chittagong accounted for two thirds of all bank advances. In contrast virtually the entire operations of the MFIs are located in the rural areas.

This disposition of bank loans has derived not from any criteria of efficiency or creditworthiness but from the nature of Bangladesh's political economy where power and influence have been the dominant influence in accessing resources. Had these resources been effectively used whereby big borrowers had serviced their loans and in the process generated sizeable surpluses for reinvestment then at least the inequity in the banking system would have been compensated by the regenerative capacity of such a lending strategy. Instead, an inequitable banking system has ill served the cause of justice or efficiency by misallocating resources which have in no small measure originated from the deposits of millions of small account holders scattered all over Bangladesh.

Political Injustice in the Banking System

The perpetuation of social and economic injustice in the banking system is compounded by the erosion of political justice. Our political institutions have become increasingly dominated by an affluent elite who exercise considerable influence in the major political parties and in the national parliament. Recent research has shown that these political institutions have now come to play an active role in influencing NCB banking operations. More seriously this influence is brought to bear on influ-

encing NCB Boards and management to condone default by repeated rescheduling of defaulted loans. Such politicised interventions in NCBs violate the trust of the citizens of Bangladesh who expect those in positions of political authority to ensure that public banking resources are not used to serve private interests.

This symbiotic linkage between political and economic power perpetuates both economic and social injustice in the banking system and undermines its efficiency and viability. Such a system, perpetuates inequity in the society and denies the deprived majority the opportunity to compete on equal terms in the market. As a result the deprived remain largely excluded from the institutions of representative government where money has emerged as the major criteria for political advancement. In such circumstances, our elected representatives need to sensitise themselves to the importance of directing banking resources to the deprived populations. It is not enough to intervene periodically to seek loan forgiveness for small borrowers.

In discussing the issue of political injustice we should also take account of the political abuse of power exercised by collective bodies of NCB bank employees who use their position within the system to extract rents from both clients and the NCB management. This practice raises the costs of credit whilst compromising the efficiency of the banks. Such rent seeking proclivities within the NCBs have been perpetuated over several regimes because the major parties remain reluctant to discipline these rent-seekers for reasons of political opportunism.

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cle its goal of removing poverty through democratising access to resources and restoring efficiency to the financial system. A system which does not regenerate itself though repayment of loans by its borrowers cannot survive. We, therefore, need to address the problem of justice in the banking system within a more holistic framework of financial sector reform which can effectively integrate the micro-credit and macro-credit system. In this process our MFIs need to graduate from specialised institutions designed to operate outside the formal banking system and should establish themselves as major corporate financial institutions whose shareholders happen to come from the lower income groups. The reconstructed MFIs should be able to compete with

the established commercial banks for rural deposits and to provide loans and other financial services to rural clients hitherto served by the NCBs and agricultural banks. The MFIs should also be able to underwrite procurement of corporate assets by the lower income groups and should accordingly equip themselves to intermediate the linkages of small producers to the national and global market.

In turn, the formal banking system should more readily reach out for the low income groups served by MFIs as well as to small farmers served largely by specialised financial institutions and target the underserved small scale business sector, including small ventures capitalists. The NCBs and specialised banks have already been providing micro-credit to small borrowers and upto June 1998 had provided loans of Tk. 4421 crores. This shows that the NCB's have the capacity to serve this MFI market but have, as yet, only touched the fringe of this market. The present government has also shown that when it commits itself it can deliver resources, at least to the small farmers, as they did in directing agricultural credit to farmers through the NCBs and BKB in the wake of the 1998 floods. This introduced a net inflow of more effectively supervised credit into the rural areas which contributed to the bumper boro crop early in 1999. This experience can be repeated, expanded and institutionalised.

To reach out to this large and more creditworthy clientele of small borrowers the NCB's will not only have to be backed by new policy guidelines but they will have to equip themselves to deal with their more democratic clientele. This will demand a major restructuring in the institutional structure of the NCBs, in their banking culture and in the mechanisms of accountability which guide their operations. Regrettably the programme of financial sector reforms put in place by the World Bank failed to address itself to such a restructuring of our financial institutions. Correspondingly the banking and monetary policy of the government will have to provide the bank-economic signals to the banking system necessary to redirect their lending targets to the creditworthy poor. At the same time the government will need to realise institutional reforms in the corporate owner-

ship of public and private banks so as to take account of the logic of efficiency and the principle of justice as the guiding philosophy of its public policy.

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Conclusion : An agenda for action

In order to give substance to any move to redirect banking policy I present below some specific suggestions for building the foundations of a more just banking system in Bangladesh.

1. In order to ensure that our NCBs and specialized institutions target the deprived segments of the population in their lending programmes we should find ways to make these institutions publicly accountable. Such an approach may consider divesting part of their shares to their own depositors with accounts below a certain ceiling. This would convert millions of citizens of modest means into prospective owners of public institutions. Other stakeholders in the way of prospective borrowers such as small farmers, small entrepreneurs, micro-credit borrowers could also be given an equity stake in these public institutions. NCB bank employees should also be given an equity, stake in the banks so that they become stakeholders in the prosperity of these banks rather than rent seekers who prosper at the expense of both the institution and its depositors.

2. Public financial institutions should observe complete transparency in their transactions. Where necessary, banking secrecy laws should be amended to enable the banks to make full public disclosure of their transactions. This would involve, for example, publishing the identity and loan particulars of all loan recipients above Tk. 1 crore, as

well as records of the servicing of such loans, their defaults if any, and all rescheduling of debts where this takes place. The Finance Minister should be instructed to report this information to the Parliament at the time of placing the budget.

3. NCBs and specialised banks should be insulated from political pressure. This commitment should be made public on the basis of a political consensus amongst the major political parties. All such patronised loan applications should be penalised. All such acts of external pressure should be reported to Parliament and made public.

4. The Finance Minister should report to Parliament on all loans made to small beneficiaries i.e. small farmers, business, micro-credit. An appropriate definitional ceiling should be developed for this system of reporting.

5. Private banks should also be encouraged to democratise their ownership. For those private banks with large loan classification ratios and which are in consequence under-capitalized, their capital inadequacy should be made up by the government through an equity injection. This new equity inflow to these banks should be distributed among a large cross section of the deprived classes. These prospective equity holders can be financed by NCB loans which can be repaid from the future dividends paid to these new equity owners by the private banks. Private banks should be completely transparent in their accounting and remain fully accountable to both their shareholders and depositors.

6. The new private banks should, as part of their licence conditions, have to distribute say 25% of their equity to this category of deprived stakeholders. The private banks should also be persuaded, as with public institutions, to give an equity stake to their low income depositors.

7. Under no circumstances should a private bank owner, defined as a member of the Board of Directors, be permitted to borrow from their own bank.

8. Members of Parliament should be disqualified from borrowing from public financial institutions on the same principle applicable to directors of private banks. NCBs are custodial owners of the MP's on behalf of the real owners, the citizens of Bangladesh. Thus any conflict of interest between an MP's responsibilities as a public representative and as a claimant on the resources of public institutions should be avoided. MP's should however be at liberty to borrow from private banks. All current defaults of MPs should be reported to Parliament on a regular basis. At the time of the next general election no defaulter should be permitted to contest elections. The Finance Minister should commit to the people that no new rescheduling of defaults will be permitted on the eve of the election as was done on the eve of the February 1996 elections.

9. A number of new banks, with low income groups as their equity owners, should be incorporated as commercial banks targeted to serve the deprived as owners and clients. These banks should compete in the open market with NCBs and private banks for deposits, and clients on the basis of their performance.

10. Bangladesh Bank should extend its regulatory and custodial functions to protect the interests of depositors as well as clients from the deprived classes. To this end it should encourage all banks to serve these constituencies and should promote institutional reform to equip banks to deal with a new client base.

The above suggestions are merely illustrative of an agenda for democratising Bangladesh's financial system. A more definitive agenda should emerge out of a process of extensive and intensive public consultation. To this end a Citizen's Task Force on Financial Sector Reform may assemble a body of distinguished experts and citizens to work out the architecture of such a reform. In preparing their report the Task Force may draw upon the valuable work of the Wahiduddin Mahmood Committee and other studies, as well as initiate a process of public dialogue with Government, legislators, bankers, clients and deprived citizens. The report should be exposed to wide public debate around which a public consensus may emerge to underwrite the reform process, which would have to be discussed and approved by Parliament.

The article is based on the Third Nurul Matin Memorial Lecture on Ethics in Banking delivered by the author on 5 June, 2000.

Efficiency and Justice in the banking system

The spread of the banking system spearheaded by the NCBs had the positive effect of not only widening the network of the banking system but thereby exposing a large number of clients of modest means to the formal banking system. Today (31/3/99) there are 26.3 million bank accounts held in all banks of Bangladesh; of these 18.5 million or 70% are held in accounts below Tk. 5000. Indeed today there are 25 million accounts with deposits below Tk. 50,000 which add upto 95% of all accounts and account for 21.5% of all deposits. If we were to incorporate the clients of the micro-credit financial institutions (MFI) who today add upto 7.8 million borrowers, then the spread of banking services covers over 75% of the population.

It is this very spread of the banking system to encompass a large proportion of the households of Bangladesh which brings the issue of justice within our discourse on ethics. Today the banking system is no longer the exclusive preserve of a narrow urbanised elite but involves a very large proportion of households. If we also include clients of the MFI system, this large banking clientele, in numerical terms

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is mostly made up of people with modest means who have now come to look to the banking system to provide a secure home for their deposits and also as a source of credit. This large and growing constituency now has to be recognised and accommodated by the banking system.

Unfortunately, this need to democratise the banking system has not been recognised by Bangladesh's banks both public and private. Whilst the NCBs and specialised banks do indeed have a much broader coverage than the private banks, their lending operation remain highly concentrated in spite of their very large base of depositors. 94% of NCB account holders, with accounts below Tk. 50,000 receive 10.6% of NCB advances whilst 6659 or 0.1% of account holders, holding accounts of over Tk. 1 crore, receive 51% of NCB advances. It is to be noted that amongst account holders below Tk. 50,000, whilst 11.9 million deposit money in the NCBs only 2.6 million of these depositors have access to bank advances. It should also be noted that the NCBs serve not just the public sector but a larger constituency of private borrowers. Private sector borrowers as of March 1999 accounted for 90% of all loans to industry which includes 78% of all working capital loans and 85% of all term loans. It is to be noted that whilst private banks have emerged to serve the private sector, the specialised banks and NCBs still provide 78% of all term loans and 58% of working capital loans drawn by the private sector from the banking system. The private banks, as may be expected, also have a highly concentrated pattern of bank lending. As a result, with the spread of privatised banking the access to bank loans at large

proportion of loans were classified. Thus, upto the end of 1990 in relation to outstanding loans, 76% of the NCB loans, 65% of private banks loans and 89% of specialised bank loans were classified. Following the introduction of financial sector reforms in 1990 the situation improved but not significantly. Of all loans sanctioned between 1-1-91 and 31-12-95, classified loans of the NCBs amounted to 62% of outstanding loans, whilst 61% of outstanding loans of private banks were classified. The improved classification ratio of loans between 1996 and 31-12-99 of 16% shows some improvement in banking discipline. But such new loans need to stand the test of time since these new loans are not likely to mature so soon

The state of the nation is symbolised or reflected by the way our Dhaka metropolis is being governed, as it is visible, compared to the invisible working of the offices and agencies in other places. The foundation cannot be seen, but the fluttering flag of indolence atop the tall structure is very much visible. It is a red flag danger signal!

The macro problems have been voluntarily encouraged, although inadvertently, due to mega failures as a result of indifferent administrative and management lapses. Things were allowed to drift in a slipshod manner (like floating kochuripana), and attention was drawn when the problems developed into macro dimensions. We export galdra (prawn); why not octopus?

We have developed management deafness, and do not listen unless the noise level (of criticism

Our Macro Fixation

by Alif Zabr

Emergency administration is different from routine, noiseless administration. Working quietly takes time to learn, each one doing his part of the job, to keep the system going. Rajuk and DCC come to mind, with their ad hoc and sporadic decisions and instant cures, which do not last (go for the mosquito kill or its environment?). Is there a discipline called administrative ecology?

Another bug is political nepotism, which is misuse of power and influence. Professional processing is discouraged in developing countries by the bosses above, and the priorities are changed suddenly and frequently by the powers that be, introducing chaos and frustration. Nothing can be predicted; and mayhem rules the day. Is there a method in the madness, or madness in system? What is the third

choice? The public servicing sector is always under pressure, due to extraneous over-lording by the overlords. The politician-professional equation is warped, as the latter is frequently not allowed to use his professional judgement in public interest. This abnormal stress pattern gets embedded into the system, overloading it into unstable equilibrium note how the DCC, Rajuk and PDB are run.

We need mega leaders to solve the mega problems, but what we get are mega egos bursting with self-righteousness. This syndrome is extended to the election time during the polls, creating the justification for 'neutral, caretaker government'.

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TOM & JERRY

