Financial sector reforms in Bangladesh

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FINANCIAL sector in Bangladesh broadly encompasses (i) banking sector, (ii) insurance companies, (iii) stock market and (iv) non-bank financial institutions. In developed countries, building societies are included in financial sector. In Bangladesh, building societies are not yet formalised and law/rules do not exist to govern or monitor them. Micro Financing Institution (MFI), a new breed of financial institutions, however, has developed and expanded in Bangladesh, though law has not yet been enacted to govern and monitor such institutions. MFIs, because of their prominent existence, can not be ignored.

Reform means gradual rational change. Reform aims at up-dating, adjusting to operating environment and progress. Hence, reform is a continuous process. It is neither static nor one-shot treatment. Reform at micro level often suffers set back due to absence of proper policy support. Hence reform is not isolated and needs to synchronise with operating environment. For effective reform, planned approach is necessary with a broad perspective. This is why reform projects are developed with specific agenda and a time frame. Reform project, if properly developed and implemented, may speed up the process of change. These are targeted reforms.

Financial sector occupies a large portion of economy. But all its components are not equally developed in structure and operation. Banks and insurance companies are widely spread and offer services to large number of people. Stock market in Bangladesh is in its formative stage and yet to attract attention of large number of investors. Non bank financial institutions (NBFI) are new and operate on a skeleton scale. Micro finance institutions (MFI) deal in tiny loans to large number of loanees involving a modest amount.

Banks have been subjected to major reforms. Other financial sectors have not yet witnessed such concerted reform, though changes have taken place in stock market development to mentionable extent. Insurance sector has also witnessed some reform activity. MFI is also receiving attention for rationalisation.

This paper concentrates on banking reforms. Financial Sector Reform Project (FSRP) implemented during the first half of last decade predominantly dealt with the banking sector. Banking sector is widely exposed and widely discussed. Banks have been subjected to basic changes both in objectives and operations. With criticism and appreciation, banking sector stands as the most dominant and sensitive catalyst of our economy.

Like other sectors, banking sector organisations themselves brought about many changes to cope with operating environment. Those are not widely discussed. But targeted reform projects, planned and implemented in the banking sector by expert consultants and committees receive close attention of all segments of the society. The first type represents silent changes and perhaps expresses inherent strength of the sector for gradual and rational evolution. For example, in British India, particularly during the fag end of British rule, emergence and sudden exit/bankruptcy of banks was a common phenomenon. In the process, many people lost their hard earned savings. Reserve Bank of India reviewed the situation internally and decided to enlist the banks for proper monitoring. Enlisted banks were known as 'Scheduled Banks.' Since then, failure of scheduled bank almost stopped. This was a major reform, though it happened in the normal process of working within the central bank.

Commercial banks were operating in the private sector for a long time. Growing public perception of concentration of wealth in a few hands gave rise to the demand of nationalisation of banks in Pakistan. In 1972, banks were nationalised in Bangladesh as well as in Pakistan. This was a major and basic change. The change was well intentioned, but probably not well-planned. Hence, the objectives for which the changes were made, were not achieved. There were growing frustration over the issue and soon started the reversal process. Few banks were denationalised and many more banks were allowed to operate in the private sector. In haste, privatisation process was not properly planned. This explains primary set-back of privatised and new private banks. Nationalisation need not be blamed for non-achievement of desired objectives. Lack of proper planning before nationalisation and failure to undertake proper reforms agenda after nationalisation are mainly responsible for poor performance. Rules, tools and organisation of private banks were not appropriate for nationalised environment. Timely reforms were not taken up to rectify the mismatch. However, after about two decades, problems were analysed for taking corrective measures. Proposed reforms indicated important systemic changes for the short run and reversal to privatisation in the long run, suggesting that nationalisation is not sustainable. The suggestion may be questioned for failure to identify and develop proper reforms regime necessary for nationalised banks.

In 1986, the Government of Bangladesh constituted 'National Commission on Money, Banking and Credit' for a deep and detailed study of money and banking sector to identify major problems and suggest remedial measure. The commission submitted a large volume of report containing large number of recommendations on different aspects of money and banking. Observation was made about deep rooted malaise in the banking system and it was suggested to carry out further professional analysis leading to treatment under a reform programme. The government sought professional help from the World Bank in the formulation of a reform programme. In response, a strong WB team worked in Bangladesh for a long time and developed Financial Sector Reform Project (FSRP) which is known as the first planned banking reform project in Bangladesh.

FSRP was visualised as a long term project to be implemented in phases. First phase of the project, covering 5-year period (1991-1995) was financed under IDA financial sector adjustment credit (FSAC) of $ 175 million. Foreign contractors M/s. Booz-Allen & Hamilton and M/s. Nathan Associates, Inc. in association with local counterpart M/s. S.F. Ahmed & Co. worked as project consultants. Bangladesh Bank and four Nationalised Commercial Banks (NCBs) worked as implementing agencies.

Project consultants state, "The main objective of the FSRP were to

- Assist with monetary policy reforms at Bangladesh Bank;
- Help Strengthen bank supervision capabilities at Bangladesh Bank;
- Help improve the quality of training at BIBM and the NCBs;
- Prepare and institute computerisation programmes at Bangladesh Bank and NCBs;
- Help improve the efficiency and financial viability of the NCBs."

The project paper mentions four broad areas where efforts will concentrate. Broad areas are

- Implementation of market oriented central bank monetary policies;
- Improvement of central bank supervision of the commercial banks;
- Expansion of the private banks share of commercial banking, and
- Development of commercially viable NCBs, which may be suitable for privatisation.

Monetary policy was a major area and policy reform was a major objective of FSRP. Following are the major activities and accomplishments in the policy area :

i) **Deregulation of interest rates fixation:** Prior to reform, interest rates on bank-deposit and advances used to be fixed by Bangladesh Bank and it was mandatory for the banks to follow the rates. A major reform under FSRP was to empower the banks to fix their own interest rates, so that gradually interest rates reflect price of money. This change was introduced in phases. Initially interest rate bands were prescribed by Bangladesh Bank. The band was gradually widened and finally withdrawn. During the transition period, banks responses were not uniform. During the first year of introduction of band, banks were inclined to cling to the ceiling rate. Gradually, two cluster of rates emerged - private banks clustered around a higher rate while nationalised banks clustered around a lower rate. No bank significantly moved away from its own group. It took almost a decade for two sets of rates to converge towards one market rate.

ii) **Capital Adequacy:** Prior to reform, capital adequacy used to be calculated in the conventional way. There was no objective method of calculation. Under FSRP, the capital structure was analysed and compared with international standard. There was gross mismatch. As a first step, it was decided to fix capital of bank at 6 per cent of its total time and demand liabilities. Later on, it was decided to redefine capital requirement in line with international practice of calculating capital at 8 per cent of weighted average value of assets. This created huge deficit of capital in almost all the banks. The new policy was not a panacea in itself. But it helped - (a) develop an objective criterion (b) follow international practices, (c) diagnose the disease and (d) calculate the amount of deficit. Greatest achievement of this change is understanding the weakness. After more than a decade, capital deficit stands at a high level even now. Analysis reveals that capital is almost adequate in the private banking sector and high level of deficit persists in the nationalised sector.

iii) **Exchange Rate Policy:** FSRP helped central bank to introduce a method of managing exchange rate, keeping the Real Effective Exchange Rate constant.

iv) **Refinancing Policy:** FSRP recommended to central bank to abolish differential refinance rate policy. Now single bank rate is maintained by Bangladesh Bank.

Another far-reaching change brought about by FSRP is loan-classification norms and procedure. Prior to reform, there existed no objective loan classification system. It was done by personal judgement. The error can be identified from the difference between calculations done by conventional system and the new objective system. In 1989, classified loans, calculated by conventional system, averaged at around 8 per cent while the percentage went over 30 per cent a sample survey applying new objective system. This was alarming. Hence, FSRP devised new classification norms in line with international practice. New system prescribes a time-bound framework which is highly objective and ignores personal judgement. The system is based on the concept that "more the duration of non-operative loan, higher is the probability of non-repayment." If international norm of classification of loans after three months of non-operation would have been applied during project period, classified loans would reach around 60 per cent level. Hence, it was decided to implement international standard in phases. It took eight years to implement it. But soon after full implementation, it was relaxed at the instance of trade leaders. Now, we stay one step behind the international standard.

Creation of Credit Information Bureau (CIB) at Bangladesh Bank is a contribution of FSRP. It was a new idea and took a long time to implement in phases. CIB collects individual credit information from all banks and on request provides relevant information to the requesting bank for checking of borrower record. Now borrowers cannot conceal their loan liabilities at different banks. CIB helps the banks to check sanction of loans to defaulting borrowers of other banks.

FSRP initiated large scale legal reforms. Important legal reforms include the following:

i) Bank Company Act, 1991 was enacted.

ii) Financial Institutions Act, 1993 was enacted, facilitating operation of Non-Bank Financial Institutions.

iii) Loan courts (Artha Rin Adalat) Act was passed and loan courts were established to expedite cases of bank loans.

iv) Bankruptcy Act, 1997 (*Deolia Bishayak Ain*, 1997) replaced Insolvency Act 1920 to facilitate loan recovery. Due to legal complexities Bankruptcy Act is yet to deliver desired result. A number of cases, however, remain in the process.

FSRP identified low level of expertise in banks to evaluate loan proposals. To improve the level of expertise, FSRP introduced an instrument called Loan Risk Analysis (LRA). Large number of loan officers were trained in LRA. Bangladesh Bank made it compulsory to apply LRA to large loan proposals of one crore Taka and above. This is an improvement over the previous situation, but did not yield desired result.

Introduction of New Loan Ledger (NLL) was a desk level reform. It provided a convenient format for loan accounting. Due to low level of computerisation in banks, NLL introduction was slow.

FSRP attempted to rationalise information system of the banks. Number of statements and returns produced by the branches was reduced considerably. MIS was also developed for top management. After the project period, MIS seems to have moved in back gear. Probably banks could not internalise new MIS.

Strengthening of bank supervision was a major agenda of FSRP. Study revealed that banks' poor performance and anomaly are, to a large extent, due to inadequate supervision capabilities at the central bank. Hence, FSRP concentrated on improving capabilities of Bangladesh Bank by restructuring supervision portfolio, introducing modern techniques and systems and providing training. Accomplishments of FSRP are summarised here:

i) Department of Bank Inspection (DBI) was strengthened by increasing number of inspectors so that increased number of bank branches may be inspected at a reasonable frequency. Inspectors were exposed to intensive training for their skill development. Code of ethics have been developed and prescribed for the inspectors.

(ii) A new mechanism has been introduced for off-site supervision of banks. Suitable information system has been devised for this purpose.

(iii) A new department named as 'Problem Bank Monitoring Department' has been created to intensively guide and supervise the operations of weak banks. As the hospitals offer intensive service to critical patients, the central bank decided to provide intensive care to the ailing banks so that they get cured and safety of depositors' money is ensured. Study reveals that after being entered as problem bank, no bank's position deteriorated further. It was also gathered that health of all problem banks have been improving constantly. Two banks have already returned to normalcy and others are in the process.

iv) Under FSRP, rating of banks was introduced. Prior to this, no standard rating system existed. The new system is known as CAMEL Rating, widely practiced in the international banking arena. Each bank is rated on five counts namely, (i) capital, (ii) assets, (iii) management, (iv) earning and (v) liquidity. Rating is done by Bangladesh Bank on quarterly basis. This is a confidential exercise, because publicity of low rating may adversely affect the banks business. Instead, any weakness identified is taken care of by the central bank.

(v) Under FSRP, all banks' supervision activities were exclusively brought under a Deputy Governor. The arrangement has provided focussed attention of top management of central bank on supervision of banks.

FSRP (1st phase) was over by the end of 1995. The project was evaluated by USAID in 1997. A number of professionals and academic persons evaluated the project in different aspects for different purposes. Conclusions do not differ widely. One report concludes, "The project has been implemented successfully -- but results fall far short of expectations". Does it indicate that formulation of project was not proper? Reform, however, is not a one-shot game. Moreover, it presupposes change of culture. Hence, realisation of reform objectives is not a short-run outcome.

FSRP has been able to set standards by implementing loan classification system, providing CAMEL rating for banks and prescribing a system of bank supervision by the central bank. These steps have yielded results to some extent. These steps will continue to yield better results in future.

FSRP contributed towards intensive training of bank personnel but failed to work on recruitment and placement of right person at the right desk, particularly at the top management level. FSRP study reveals that around 70 per cent officers are underqualified and promoted from clerical rank. Hence, deficiency cannot be covered by training alone.

Nationalised banks are large organisations. For example, Sonali Bank employees over 30,000 employees to run over 1300 branches. It requires high level of management skills to run such a large organisation. Banks failed to recruit and retain competent officers and executives due to poor compensation package and personnel policy. FSRP consultants brought out this point in their deliberation and did not include it as project agenda.

Another important issue of the FSRP deliberations was trade union activities in the banks. It was observed that a large number of employees under the banner of trade union are engaged in corruption and activities detrimental to the interest of the bank. At one stage, FSRP donor agencies suggested to put a ban on trade unions in the banking sector. In their opinion, any thing short of this, will not serve the purpose. FSRP felt that trade union activities were grossly interfering with reform objectives.

Government of Bangladesh constituted a Task Force to study the issue of trade union in banks and submit its recommendations. The Task Force report submitted to the government on 19 February 1998 reveals that, (i) trade unions occupy sizable space at bank offices (in two banks, 27,500 sqft each), (ii) around 25 per cent trade union members do not attend to their duties (in one bank absentee workers exceed 40 per cent of employee strength) (iii) violating TU law, more than prescribed number of unions have been registered and (iv) unions have opened offices even at regional and branch level, violating norms. The report further reveals that - (i) T.U. leaders run parallel administration in large NCBs, (ii) T.U. leaders grossly interfere with placement in particular and promotion and recruitment in general in consideration of bribe, (iii) T.U. leaders keep liaison with large loanees and extract money from them and (iv) T.U. leaders misuse banks' vehicles and properties and extract money from contractors of purchase and repair. The report presents representative and glaring cases of such dishonesty and misconduct.

Task Force report observed that trade union activities are major obstacles towards realisation of bank reform objectives. For facilitating implementation of reforms, either the T.Us in the banking sector are to be banned or they may be reorganised under a T.U reform project. The proposed T.U reforms may be summarised here:

i) CBA will maintain one office at the Head Office. T.Us shall not maintain any office at regional/branch level.

ii) T.Us will have one committee at Head Office and they will not form any regional or branch committee.

iii) One trade union should exist in each bank. CBA executive committee be limited to 20 members.

iv) T.Us should be delinked from politics and T.U. will not be affiliated with any political party.

v) Term of CBA should be one year and election should be held every year regularly.

vi) Any employee not accepting promotion will be barred from contesting election for five years from the effectual date of proposed promotion.

vii) No T.U. member should be eligible to be CBA President or Secretary for more than two years.

viii) No group/T.U other than CBA shall frame and present any demand.

ix) To facilitate T.U. reforms, necessary amendments of laws are to be enacted and T.U activities be suspended for three years.

After first phase of FSRP was over, attempts were made to articulate second phase agenda. A team of consultants worked on the issue at the initiative of World Bank. They identified deficiencies of the first phase project and attempted to add complementary measures. Draft proposals may be summarised as:

i) Chief Executives of NCBs should be searched out from open market by a Blue Ribbon Committee, comprising eminent national personalities.

ii) Chief Executive should be appointed on contract basis to achieve given goals. He should be properly compensated.

iii) Banks shall have a strong and effective 'hiring and firing` mechanism in respect of personnel.

iv) Branches incurring loss shall be closed down.

v) Central bank be given autonomy. Power exercised by Ministry of Finance be transferred to and vested in the central bank.

Second phase programme was not accepted by the government. Hence, FSRP virtually ended at the end of first phase. The government, however, constituted a "Bank Reforms Committee" on 23 October,1996 to place recommendations on (i) loan recovery, (ii) improvement of profitability and quality of service (iii) recruitment, promotion, placement and training of personnel, (iv) strengthening of central bank's supervision and (v) any other issue considered important by the committee. Initially the committee was headed by Mr. Kazi Fazlur Rahman, who was later on succeeded by Professor Wahiduddin Mahmood. The committee submitted its report by the end of December, 1999.

Bank Reform Committee, in its report, deliberated on - (i) restructuring of Bangladesh Bank, (ii) strengthening of bank supervision, (iii) management of nationalised banks, (iv) management of private sector banks, (v) amendment of Bank Company Act, (vi) amendment of Artharin Adalat Act and (vii) other relevant issues.

After recording detailed analysis and observations, Bank Reform Committee presented 188 recommendations to the government. This is an extensive work voluntarily done by local experts. It has attracted attention of all concerned and a few propositions have already been examined and implemented by the authority. Much, however, remains to be done. Some important recommendations are mentioned here:

i) To ensure autonomy of the central bank, necessary amendments are to be made in Bangladesh Bank Order, 1972.

ii) Bangladesh Bank Governing Board should be redesigned so as to include not more than two govt. officials.

iii) A 'National Banking Advisory Committee' should be constituted. The committee will be entrusted with the responsibility of selecting right type of persons as members of the Board of Bangladesh Bank and other Govt. owned banks.

iv) Governor, Bangladesh Bank, should be appointed for a non-extendable 5-year term. Governor/Deputy Governors shall not be removed before expiry of term except on specific charges.

v) Authority to issue bank licence be vested on the Bangladesh Bank Board.

vi) In the recruitment of 1st and 2nd class officers of central bank, 70 per cent and 50 per cent posts be reserved for direct officers. Officers should be promoted on the basis of merit and educational qualifications.

vii) Central Bank should introduce a reasonable pay-scale to attract meritorious officers.

viii) Trade Union activities in the central bank be banned.

ix) Prudential guidelines be developed for dealing large loans. BB should not approve large loans - - it may only oversee.

x) Governance and superindence of nationalised banks be vested in the Board of Directors. Powers of the govt. in this respect be restricted.

xi) Managing Director (CEO) of NCBs be appointed on contract for a specific term. Powers to remove him without specific charges be withdrawn.

xii) No loan defaulter and political person be appointed as a Director of any bank's Board.

xiii) About one-third of total number of employees appear to be in excess of requirement in NCBs. Employee strength be reduced through golden handshake.

xiv) Branches incurring loss continuously be closed down under an action plan.

xv) Capital shortage of NCBs exceeds Tk.2500 Crore. Govt. may issue long term bond to meet the deficit.

xvi) In case of large loans, banks may share risk through syndication.

xvii) Asset management companies may be developed as subsidiary of banks or as independent company.

xviii) Paid-up capital of local banks as well as foreign banks operating in Bangladesh should be raised to Tk.40 crore.

xix) Loans given to government organisations should be covered by government guarantee.

xx) Law should be so amended as to enable Bangladesh Bank to take over any bank, if activities of the bank is presumed to be detrimental to the interest of the depositors.

xxi) Number of Directors of Board in a bank should be limited to 11.

xxii) Board of bank should not interfere with the normal work of management. To ensure this, duties and responsibilities of Directors should be articulated by Bangladesh Bank.

xxiii)For the purpose loan classification, same procedure be adopted for both private and govt. sector loans.

Recommendations of Bank Reform Committee are considered from time to time for implementation. At present, the government is seriously considering the proposal for closing the continuously losing branches of nationalised banks. Banks have drawn up action plan for the purpose. Closed branch will be merged with nearest good branch of closing bank or any other bank.

Since reform is a continuous process, it is never over. Though Financial Sector Reform Project ended in 1996, the reform process continues. FSRP put a thrust and provided a planned approach towards reform. Hence success of FSRP is not limited to achievement of results within the project period alone. We visualise extensive reforms in general, and technological reform in particular in financial sector during the present decade to cope with emerging global market.

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