**Acronyms and Abbreviations**

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ADAB</td>
<td>Association of Development Agencies in Bangladesh</td>
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<td>ADB</td>
<td>Asian Development Bank</td>
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<td>AGB</td>
<td>Agricultural Bank</td>
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<td>ASA</td>
<td>Association for Social Advancement</td>
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<td>ARGF</td>
<td>Agricultural and Rural Credit Guarantee Fund</td>
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<td>BAAC</td>
<td>Bank for Agriculture and Agricultural Cooperatives, Thailand</td>
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<td>BB</td>
<td>Bangladesh Bank</td>
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<td>BKB</td>
<td>Bangladesh Krishi Bank</td>
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<td>BSBL</td>
<td>Bangladesh Sambaya Bank, Limited</td>
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<td>BRAC</td>
<td>Bangladesh Rural Advancement Committee</td>
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<td>BRDB</td>
<td>Bangladesh Rural Development Board</td>
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<td>BRI</td>
<td>Bank Rakayat Indonesia</td>
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<td>BSERT</td>
<td>Bureau of Socio-Economic Research and Training of BAU</td>
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<td>CDF</td>
<td>Credit Development Forum</td>
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<td>COOP</td>
<td>Cooperative</td>
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<td>DTW</td>
<td>Deep Tube Well</td>
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<td>FAO-CP</td>
<td>Food and Agriculture Organization-Cooperative Programme</td>
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<td>FSRP</td>
<td>Financial Sector Reform Program</td>
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<td>GB</td>
<td>Grameen Bank</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GKF</td>
<td>Grameen Krishi Foundation</td>
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<td>GOB</td>
<td>Government of Bangladesh</td>
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<td>GRS</td>
<td>Grameen Rin Sahajugi</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IFDC</td>
<td>International Fertilizer Development Corporation</td>
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<td>IFI</td>
<td>Informal Intermediary</td>
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<td>IFPRI</td>
<td>International Food Policy Research Institute</td>
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<td>IIMI</td>
<td>International Irrigation Management Institute</td>
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<td>ILO</td>
<td>International Labor Organization</td>
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<td>KREP</td>
<td>Kenya Rural Employment Program</td>
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<td>MBI</td>
<td>Member Based Institution</td>
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<td>MD</td>
<td>Managing Director</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>MSFSCIP</td>
<td>Marginal and Small Farm Systems Crop Intensification Project</td>
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<td>NCB</td>
<td>Nationalized Commercial Bank</td>
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<td>NGO</td>
<td>Non-Government Organization</td>
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<td>PKSF</td>
<td>Palli Karma Sahayak Foundation</td>
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<td>PO</td>
<td>Partner Organization</td>
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<td>PSI</td>
<td>Public Sector Institution</td>
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<td>SEWA</td>
<td>Self Employed Women’s Association</td>
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<td>STW</td>
<td>Shallow Tube Well</td>
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<td>RAKUB</td>
<td>Rajshahi Krishi Unnayan Bank</td>
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<td>RCS</td>
<td>Registrar of Cooperative Societies</td>
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<td>RDRS</td>
<td>Rangpur Dinajpur Rural Service</td>
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<td>RFM</td>
<td>Rural Financial Market</td>
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<tr>
<td>UNDP</td>
<td>United Nations Development Programme</td>
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# BANGLADESH

## RURAL FINANCE

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EXECUTIVE SUMMARY

1. The rural sector is central to Bangladesh’s development strategy and agriculture continues to play a pivotal role in rural growth. The absence of a conducive operating environment threatens to become a serious constraint to further development, especially for agricultural growth and diversification. Efficient and cost-effective financial services are essential elements of an environment that enables entrepreneurship, innovation and production. Households need access to safe savings facilities and farmers and entrepreneurs need timely access to capital to take advantage of market and investment opportunities. Past investment has relied heavily on household and business savings, but there are clearly limits on how far equity financed growth can be pursued.

2. Based on results from a household survey and secondary data, the study finds that informal lenders (IFIs) continue to dominate rural financial markets (RFMs). Member based institutions (MBIs), comprising the Grameen Bank (GB) and non-governmental organizations (NGOs), target the landless poor. They collectively disburse more than public sector financial institutions (PSIs). Overall, the financial markets provide limited services; essentially short term credit. The wealthy have relatively better access to “cheap” finance from the banking sector. The landless poor are being serviced by MBIs to some extent but a vast majority continues to rely in informal arrangements. There is a significant segment of the population with limited access to PSIs who also fall outside the target group of MBIs. These are the small and marginal farmers, a majority of the farming population of Bangladesh, and the small entrepreneurs. They possess few assets to be of interest to banks, but have too much income to qualify as “poorest of the poor.” For broad based development, it is crucial to substantively include this potentially dynamic section of the rural economy in the growth process.

3. Performance of the public sector banks has been very poor. An inefficient delivery mechanism has limited their outreach, and overwhelming arrears have made them unsustainable. The agricultural banks (AGBs) have shown some improvement relative to the other banks (NCBs) as a result of important steps in recent years. However, there remain serious policy, institutional and structural issues affecting their performance. The public sector has failed to appreciably expand savings mobilization, reflecting its orientation towards credit disbursement rather than financial intermediation.

4. Natural disasters and climatic risks are often used to explain the poor recovery by PSIs whose portfolios are heavily concentrated in crop loans. Natural disasters can no doubt be significant factors in loan delinquencies, especially in Bangladesh, and over-exposure to any sector is risky. However, poor recoveries even in years of normal weather, the average or better recovery rates of crop loans relative to the rest of the loan portfolio and the vastly different performance of private and (to a limited extent) NGO lenders in crop lending all make this argument untenable.

5. The real reasons lie elsewhere. The primary problem is inappropriate institutional incentives. Weak governance has subjected formal banks to severe political interference. Loan write-offs and interest remissions have rewarded delinquent behavior and punished the honest. Pressure to meet disbursement targets and external influences in decision making have compounded existing screening and enforcement problems. The second problem is the lack of an effective legal and regulatory framework to enforce contracts and recover loans. This has handicapped lenders and suppressed financial innovation. The third major issue is the interest rate ceiling for agricultural loans which has added to the incentive problems. It has limited the ability of PSIs to cover their costs, created opportunities for rent seeking and distorted the allocation of funds. Other problems include: lack of appropriate employee and borrower incentives, organizational and structural weaknesses, poor management systems, poor human resource management and obsolete financial services and products.
6. The Grameen Bank and NGOs have achieved remarkable success in terms of outreach, and they continue to grow. These institutions almost universally follow the unique Grameen model of credit delivery. The model represents a significant innovation in overcoming the information and enforcement problems that are common to RFMs. At present, the GB alone has greater outreach than the PSIs. Several NGOs are also successfully reaching the poor.

7. As demand for the services of MBIs grows, an important issue is their sustainability. The GB and some “minimalist” NGOs have reached operational self-sufficiency, and appear to be on the way to full self-sufficiency. Most, especially the “holistic” organizations, continue to be heavily dependent on donor funds. While subsidizing “social intermediation” is justifiable for poverty reduction, the reality of declining grants will have to be faced. These organizations would better serve their clients and themselves by introducing transparency in their accounting practices and introducing cost reducing innovations. Training and capacity building in financial management should be high priority areas for most credit NGOs. This will not only help them attract remaining donor funds but, more significantly, allow them access to commercial markets. An important institutional innovation in the direction of sustainability is the PKSF. It effectively screens and monitors borrowing NGOs. It has thus far paid little attention to institutional building aspects, concentrating on NGOs with established records.

8. The potential for using the group lending methodology for small and marginal farmers remains unexploited. Little effort has been expended so far in developing a suitable mechanism to reach them. Almost all MBIs target the landless and finance mostly rural non-seasonal activities. The two notable exceptions are the Grameen Krishi Foundation and the Marginal and Small Farm Systems Crop Intensification Project. Their target group includes small and marginal farmers; the former uses the group lending methodology as do other MBIs, while the latter aims to link self help groups directly with banks with Rangpur Dinajpur Rural Service playing an important supporting role. Both initiatives are still perfecting the delivery system for cultivating households and the preliminary results are very encouraging. This remains an important area for research and experimentation.

9. To some extent, IFIs are able to overcome the information and transaction cost problems. They provide valuable and flexible services to their clients, however, their services and resources are limited. The markets appear to be segmented and non-competitive, with most households relying on reciprocal arrangements. The more competitive segments, e.g., traders and dealers, appear to play a limited and declining role. The main factors limiting the size and scope of informal markets are information (on clients other than kin or neighbors) and resources. There remains significant scope in utilizing interlinkages with the commercial private sector, especially in the relatively backward regions. This could be achieved by actively encouraging competition among the informal lenders by removing the legal, regulatory and institutional obstacles to the efficient operation of these markets.

10. To sum up, rural financial markets in Bangladesh are fragmented and inadequate to meet the demand for financial services. There are very limited savings services available in rural areas and credit is essentially available for short-term. The public sector institutions are unsustainable and have limited outreach. The MBIs target one section of the rural population, and do not in general address the problem of finance in agriculture. They provide a limited range of services; most notably they cannot accept voluntary deposits for prudential reasons, making them unable to intermediate effectively. Further, most currently cannot function without subsidy elements in their financing. The informal sector, while providing much needed services, is unlikely to be able to support a major growth initiative by itself. It remains segmented and constrained for resources.
Reforming the Rural Financial System

11. The primary objective of rural financial sector reforms should be to create a strong and efficient system of financial intermediation. To develop such a system, important policy and institutional reforms are necessary. These reforms should be part of a comprehensive strategy aimed at developing the RFMs as a whole. The goal of the reforms is envisaged as an increase in the general availability of competitively priced financial services by sustainable financial institutions. Improved access to financial services will allow all sections of the population to participate in the growth process, particularly assetless entrepreneurs and small and marginal farmers.

12. By virtue of its ability to mobilize resources with appropriate prudential oversight, economies of scale and ability to pool risks, the formal banking sector is central to the financial system. Therefore, it is crucial to recognize the importance of efficient and sustainable banking institutions. Competition promotes efficiency and the strategy should be to actively encourage private sector participation in RFMs. Effective competition can be provided by a diverse set of intermediaries, including NGOs and traders, merchants and other informal intermediaries. Their participation, however, requires removing a number of policy, legal and regulatory barriers. Over time, the non-formal sectors are expected to be increasingly formalized and integrated into the financial system.

13. The evolution of an efficient and sustainable formal banking sector will take time. In the short- to intermediate-run, as well as part of the integrated system in the long run, the strategy should aim to link the formal, semi-formal and informal sectors. The comparative advantages of each sector can be exploited in promoting the access to financial services for small clients in remote areas. These linkages will significantly improve the efficiency of the system as a whole to intermediate. The banks have a comparative advantage in mobilizing resources and overcoming covariant risks, while the IFIs and MBIs have a comparative advantage in "retailing" services to small clients in remote areas.

14. Within this overall strategy, the report analyzes key issues in three broad areas of strategic importance. These are: the formal institutional issues, using the Agricultural Banks as case studies; the framework for secured transactions; and integration of the formal, semi-formal and informal sectors. The findings and cross-country experiences are used to develop a conceptual and policy framework that would allow the RFMs to operate efficiently. The framework recognizes the functions the government has a comparative advantage in. Its aim is to focus on providing an appropriate incentive structure, an environment that is conducive to efficient financial transactions and innovation, and on using the strengths of the existing system to develop a system of efficient rural financial intermediation.

Main messages

15. The main messages emerging from the report are that the GOB should:

   (a) Extend financial sector reforms to the rural financial sub-sector to make financial and institutional policies consistent across all sub-sectors.
   (b) Stop political interference in the operations of rural financial intermediaries.
   (c) Create a legal and regulatory framework for secured transactions to promote access to credit.
   (d) Promote the integration of the formal, semi-formal and informal sectors to improve the efficiency of rural financial intermediation.

16. The critical financial sector issues are not new and have been part of a long-standing dialogue with GOB. However, they need to be re-iterated in view of their importance for reforming the RFMs.
Next steps

17. Most policy and institutional issues are mutually reinforcing. While proper sequencing of certain reforms is necessary, actions on other, complementary issues should be initiated simultaneously. Prior to these actions, however, key financial sector reforms should be extended to cover rural financial operations, particularly strengthening the management capabilities of the Bangladesh Bank, the lifting of interest rate ceilings on agricultural credit and replacing refinance facility for the agricultural banks by a re-discount window as for other banks. As an integral component of the process of financial intermediation, savings mobilization must be given high priority.

Formal Sector Issues

18. Institutional Design: Deep institutional reforms are necessary for existing public sector banks to improve their performance. Some of these issues are well known but need to be re-emphasized and prioritized to achieve desired results. Subject to the policy reforms mentioned above, critical areas for reform include resource mobilization, incentive structures, human resource management, management information systems, decentralization of decision-making and accounting practices.

19. Product and Process Design: Lessons learned from MBIs, the informal sector and successful rural financial institutions in other countries can be used to design new products and services to improve the outreach and efficiency of the delivery mechanism. These include ambulatory services, especially for savings mobilization, developing new and attractive savings instruments, flexible conditions on purpose and terms of loans to suit client needs and cash flow, borrower incentives for prompt repayment and cautious experimentation with group lending to develop a workable model for small and marginal farmers.

20. Agricultural Banks: Based on un-audited data provided by the two agricultural banks, they are both currently making losses and are technically insolvent. The immediate next step for BKB and RAKUB is to undertake a comprehensive external portfolio audit, including an in-depth analysis of their management systems, accounting practices and corporate policies affecting the quality of their portfolio. Based on the results of the audit, the next steps would have to be worked out. If it is not possible for these institutions to become financially viable, drastic actions including closure would have to be considered. If financial viability after appropriate restructuring is possible, fundamental reforms would have to be undertaken to ensure that the risk of similar problems from re-surfacing in the future are minimized. At the minimum, these reforms would have to address the issue of political interference by establishing an independent and commercially oriented governance structure.

21. Cooperatives: The ILO has proposed a detailed set of recommendations for reforms. In addition, with regard to agricultural cooperatives, it should be noted that unless concrete steps are taken to address the issues of incentives, governance and administrative structures, the performance of the these cooperatives is unlikely to improve, providing little justification for their continued existence.

Framework for Secured Transactions:

22. Problems in Laws: Several legal barriers prevent increased access to credit for the poor. A framework for secured transactions and mortgage lending could be put in place in the short- to medium-run to remove these barriers. The precise nature of legal and regulatory changes needed and an assessment of their economic implications requires detailed discussions between legal experts in the commercial and financial community as well as experts experienced in similar reforms in other countries. Broadly, some
areas of focus would be changes in laws to permit a wider range of collateral security and repossession and sale of collateral under private agreement to relieve the burden on the court system; elimination of usury laws and substitution of truth in lending disclosure; rationalizing homestead and exempt property provisions and linking the age of maturity with the civil status of borrowers.

23. **Problems in institutions:** The institutional framework for creating and monitoring the security of financial transactions is weak and inefficient. Reforming these institutions or creating new ones are essential elements of a long-run strategy. Their success, however, is dependent on the legal changes mentioned above and incentive structures that promote desired behavior. Areas where actions are needed include introduction of regulatory and supervisory provisions for loans secured by accounts receivable and chattel paper; improving public registries; and promoting credit bureaus to improve the information and signaling systems for all types of loans.

Integration

24. **NGOs:** Integration can significantly improve the flow of rural financial services to the mutual advantage of all stakeholders. The institutional and capacity building of smaller NGOs are important medium- to long-run actions. In the short-run, linkages with established NGOs should be strongly encouraged. It is important to recognize, however, that the development of NGO programs proceed in a manner and pace that existing institutional and human capital capacity can sustain. Undue pressure to speed up the pace of expansion of successful programs should be strongly resisted. With these caveats, important steps in integrating NGOs with commercial financial markets would be to develop an appropriate supervision and regulatory framework for the financial operations of NGO sector, encourage large NGOs to establish themselves as banks, encourage “wholesaling” credit to established NGOs and use smaller NGOs as brokers, utilize NGOs to mobilize self-help savings groups, strengthen PKSF financially and institutionally, remove interest rate restrictions for crop-lending, support experimental approaches to reach small and marginal farmers (e.g., GKF and MSFSCIP), and channel grant assistance for training and capacity building through support and network NGOs and PKSF.

25. **Informal sector:** Some actions that could increase in the flow of competitively priced finance in rural areas are expansion of trade and suppliers credit by proper training of bank staff, revision and continuation of the experimental Grameen Rin Sahajugi scheme to encourage greater participation by private rural lenders, and clarifying the position on pawning activity to encourage greater provision by the private sector as well as local governments, subject to optimum regulation.
1. INTRODUCTION

1.1 This study is a joint effort by the Government of Bangladesh (GOB), the World Bank/International Development Association (IDA) and the Asian Development Bank (ADB) to critically review the functioning of rural financial markets (RFMs) in Bangladesh.

1.2 The objective of the study was to identify specific actions that would reduce existing and potential financial sector constraints to agricultural and rural development. The aim would be to develop, over time, an efficient and sustainable system of rural financial intermediation. The 'system' is visualized as an integrated whole comprising of formal, semi-formal and informal sectors, which exploits the comparative advantages of different intermediaries in cost-effectively delivering financial services to rural areas. Particular emphasis is paid to identify practical and cost-effective mechanisms of expanding services to sections of the population who currently have little or no access to such services, especially the small and marginal farmers and entrepreneurs including women.

Background

1.3 With a majority of the Bangladeshi population (80%) residing in rural areas, over half of which lives below the poverty line (Ravallion and Sen, 1994), the rural sector is central to the development policy of the Government of Bangladesh (GOB). Within the rural economy, agriculture occupies a prominent place and is pivotal to future rural development, including the non-farm sector.

1.4 The private sector-led growth strategy and policies liberalizing agricultural markets in the 1980's helped to significantly boost production. The spurt of growth in the late 1980's was mainly in rice, sourced almost entirely in the expansion of dry-season (boro) minor irrigation. The more recent experience is disappointing. It is also frustrating given the existence of considerable unexploited short- to medium-term potential. With a binding land constraint, future growth depends on intensification of current practices, expanding irrigated area to its full potential, diversification into new and higher valued crops and growth of non-crop sectors, especially fisheries and livestock. Agricultural growth and diversification will also stimulate the rural non-farm sector via market linkages.

1.5 Exploiting this potential requires an operating environment that allows the private sector to take advantages of emerging market and investment opportunities. Integral to this enabling environment is access to financial services. Intensification and diversification of agriculture will, inter alia, increase demand for capital. The transformation from a subsistence to a more commercially driven rural sector will require on-farm capital formation and increased demands for working capital, as well as investments in supporting markets (input and output marketing, agro-processing, etc.).

1.6 Scarce resources and seasonality of agriculture make timely and adequate availability of credit particularly important for the rural producers. Accessible and safe saving facilities are an even greater

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1 In 1993/94, it contributed about 33% of total GDP and 32% of exports and employed 65% of the labor force.
2 The expansion in agricultural production from 1985/86 to 1989/90 averaged 3.1% p.a.; growth in the nineties has slowed considerably to 0.4% p.a. (Abdullah, et. al., 1995).
3 Only a third of total irrigable area is currently under irrigation, half of total rice is under HYVs and significant yield gap exists between potential and actual yields. In the long run, however, growth will have to rely on improved technology to raise productivity.
unmet demand by rural households as they try to smooth inter-temporal income fluctuations and build up own resources. Similarly, rural entrepreneurs need deposit and payments systems to reduce transaction costs and smooth cash-flow fluctuations. The lack of deposit facilities force households to rely on inefficient and costly alternatives. The lack of access to medium- and long-term finance inhibits investment by a majority of small and marginal agricultural households in Bangladesh.

1.7 Weak and ineffective financial intermediation constrains private sector investment and efficiency. Traditionally, efforts to increase output and reduce poverty have relied on the provision of capital to producers as the solution. Although well intentioned, this myopic preoccupation with disbursing credit and the neglect of savings mobilization and institutional development has proved to be costly. This approach to rural finance has been followed in Bangladesh as well and has yielded identical results. On the one hand, poorly designed interventions in the formal sector have destroyed the public sector banking institutions and have been a drain on scarce resources; on the other, they have failed to meet the demand for appropriate services, have been distributionally inequitable and have had little visible impact on poverty or development.

1.8 The deteriorating state of the RFMs has raised concerns by the GOB about the ability of the RFMs to support a broad-based process of rural development. The last review of the rural credit sector was done in 1983 (GOB/IDA Agriculture Credit Review), which discussed a number of issues relevant at the time. However, significant changes have taken place since then raising additional issues. Also, considerable knowledge has been gained from the experiences of a number of rural financial institutions (both within Bangladesh and in other countries) providing new insights to deal with persistent problems in RFMs. This study addresses the current issues affecting the performance and efficiency of RFMs in the light of this new knowledge and experience.

Organization

1.9 The report is organized in three parts. Part I gives an overview of the current state of the rural financial sector in Bangladesh. The objective of the section is to take stock of the current situation to provide an appropriate background for discussing the main issues. Part II provides a detailed analysis of the main issues in reforming rural financial markets in Bangladesh. The discussion focuses on three aspects of strategic importance for the future expansion of financial services in rural areas (namely, the formal banking sector, the environment for secured transactions and integration of formal, semi-formal and informal sectors). Part III suggests a general framework for reforms and next steps.

1.10 This report draws on seven background reports prepared as part of this study. The main findings from these reports are synthesized with knowledge and information obtained from previous studies, documents and secondary data on a number of conceptual and empirical issues in rural finance. The background reports contain detailed analyses and supporting evidence on specific issues relating to rural financial markets in Bangladesh. These reports are available on request.

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4 Small and marginal farmers, i.e. those owning between 0.5 and 2.5 acres of land, constitute roughly a third of the total rural households and about 63% of land-owning households. Medium farmers, i.e. those with land between 2.5 and 5.0 acres constitute another 11% of the rural population and 22% of land-owning households (Rahman and Hossain, 1995).

5 The exception to this is the significant growth of micro-credit institutions who have demonstrated the ability to reach the landless poor.
2. THE STATE OF RURAL FINANCIAL MARKETS

2.1 This section briefly reviews the current state of rural financial markets. It discusses the extent and structure of rural financial markets (RFM) in Bangladesh and the existence and nature of unmet demand for financial services by rural households. It complements existing data and knowledge with findings from a survey conducted as part of this study. The primary purpose of the survey was to address a number of empirical issues relating to the performance and efficiency of formal and informal RFMs, to increase our understanding of their behavior.

2.2 Data were collected on 1044 households from 70 villages in six districts in January-February, 1995, on a number of issues, including transaction costs of depositors and borrowers, borrowing behavior, investment pattern and terms of loan contracts, savings and deposit mobilization. Basic information on 885 randomly selected loan accounts from 35 rural branches (of NCBs and AGBs) was also collected. In addition, 892 depositors at these branches were interviewed. In interpreting the results, however, it is important to note that two villages were selected in proximity to each bank branch (i.e., within a four mile radius). Thus, the data may not be representative of the country because of this geographical selection bias.

A. Market Structure

2.3 RFMs in Bangladesh can be technically classified into three sectors: formal, semi-formal and informal. The formal sector includes regulated financial institutions. The semi-formal sector includes micro-credit institutions and programs, mostly organized by non-governmental organizations (NGOs) and some by government organizations (GOs), e.g., Swanirwar. The informal sector includes private transactions falling outside the regulated banking framework. Informal sources include moneylenders, traders and dealers in agricultural markets, shopkeepers, landlords, friends and relatives.

2.4 The formal sector comprises of the public sector banks, specifically two agricultural banks (AGBs) and rural branches of three nationalized commercial banks (NCBs); the largely member owned Grameen Bank (GB)\(^6\); two cooperative networks (COOPs) and, to a very limited extent, private banks.\(^7\) The Grameen Bank began as the Grameen Project, an NGO, in 1976 and was formally established as a bank with a special charter in 1983. It is administratively autonomous and uses the group lending model developed under the Grameen Project and now used by most NGO’s in Bangladesh. Thus, operationally GB resembles the semi-formal sector, but technically and legally it is a formal bank.

2.5 The RFM participants are broadly classified into three categories: public sector institutions (PSI, including AGBs, NCBs, and COOPs); member based institutions (MBIs), including GB and the semi-formal institutions; and informal intermediaries (IFI). This is done to reflect the functional and operational characteristics of the intermediaries for analytical purposes.

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\(^6\) The GOB holds a 25% share of the paid-up capital of Grameen bank, allowing it to appoint 3 of the 13 Directors on the Board. The rest, other than the Chairman and Managing Director, are member nominated.

\(^7\) Two examples of private banks are the National Bank, which has a minor poverty alleviation project in the Barind District, and Islami Bank which has recently launched its Rural Development Scheme.
2.6 **Market share:** Past studies have documented the domination of the informal sector in rural Bangladesh (see, e.g., Maloney and Ahmad, 1988, and Murshid and Rahman, 1990). In the early-mid 80’s, the share of IFIs was estimated at two-thirds of total rural credit and the share the MBIs was estimated at below 4% (Rural Credit Survey, 1987; Rahman, 1992). Aggregate data suggest that the role of MBIs has changed significantly since. In 1993-94, MBIs advanced at least Tk. 1660 crores (with GB alone advancing Tk. 1240 crores). On the other hand, the PSIs advanced Tk. 1100 crores as “agricultural credit” and Tk. 11 crores under their various poverty alleviation programs.

2.7 Results from the survey carried out for this study (hereafter referred to as the survey) generally conform to this picture with the exception of the role of MBIs: 44% of households had borrowed in the past two years (of the sample of 1044); of these, 56% had borrowed from IFIs, 44% from PSIs and 10% from MBIs. There appears to be little overlap among sectors with only 8% borrowing simultaneously from public and informal sectors, and 1.7% from both informal markets and member-based institutions. It should be reiterated that the sample was restricted to close proximity to a bank branch. Hence, the shares of MBIs and IFIs are likely to be underestimates. The data confirm this; even within the sample at hand, the PSI share falls and IFI share rises with the distance of sample households from bank branches.

2.8 **Outreach:** Total rural households are estimated at 16.26 million. Total PSI “agricultural loans” outstanding at the end of FY95 were 7.7 million. A rough estimate of annual loans is obtained using data from the two agricultural banks who made about 578,000 new loans in FY94. Assuming identical loan size for NCBs, total loans by PSIs for FY94 is estimated at 863,000. Thus, assuming one loan per household, this suggests a little over 5% of rural households are currently being serviced annually, despite the large number of rural branches of PSIs.

2.9 The performance of MBIs is much better. At the end of 1994, GB had over 2 million members, with 1.86 million borrowers, 95% of whom were women. There are no comparable statistics for the semi-formal sector; individually, BRAC has over 1 million members and the participating organizations (107 in 1995) of the Palli Karma Sahayak Foundation (PKSF) have another 1.5 million. A vast majority of these too are women. The numbers of MBI borrowers at the end of 1994 is estimated to be at least 4.9 million. Again, assuming one borrower per household, this suggests that MBIs reached over 25% of all households.

2.10 **Distribution:** A majority of the (survey) landless borrowers obtained finance from IFIs (69%), while PSIs and MBIs each extended loans to 19%. At the other extreme, 89% of households with over 0.5 acre obtained loans from PSIs and 26% from IFIs. Among the small and marginal farmers (0.5-2.5 acres), IFIs provided the majority of loans (57%), but PSIs provided loans to 49% of the borrowers. Across occupational groups, PSIs financed a major share only for big businesses and salaried households. The pattern among farmers is the same as with land holding classes but the proportion of small and marginal farmers borrowing from PSIs falls to 42%. Thus, subject to the sample selection caveat, the data show that the PSI bias against the landless continues, but the disparity among other groups appears to have narrowed. IFIs still dominate the RFM.

2.11 **Deposit Mobilization:** The total (rural and urban) deposits by PSIs increased 3 times (Tk. 103.9 billion to Tk. 309 billion) between 1986 and 1994. Of this, 10% originated in the “agriculture and

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8 Data compiled by the Credit Development Forum, a support network of credit NGOs.
9 These numbers include households borrowing from multiple sources. Of the borrowing households, 35% borrowed only from informal sources, 35% only from formal sources and 8% only from semi-formal sources.
10 The share of the cooperative sector was negligible.
fisheries" sector (Bangladesh Bank, 1994). Data from the two AGBs show a four fold increase in deposits (Tk. 4.3 billion to Tk. 17.1 billion) between 1986 and 1994. In contrast, member deposits of Grameen Bank increased 47 times (from Tk. 0.19 billion to Tk. 9 billion) over the same period.

2.12 IFIs do not provide savings services, with the occasional exception of small and unstable informal groups (Murshid and Rahman, 1990; Maloney and Ahmad, 1988). MBIs require involuntary deposits from their members, but do not accept non-member or voluntary deposits. PSIs have also not focused sufficient efforts on this aspect of financial intermediation. Survey results show that of the 82% of the sample living close to a bank, only 37% had deposit accounts. This fell to 11% for households living far from a bank. Over 88% of the depositors surveyed lived within one mile of the bank. Total deposits of bank branches is also strongly influenced by their proximity to urban and business centers. Limited access is confirmed by an analysis of transaction costs, of which time cost and conveyance are the most significant components. The importance of access is also demonstrated by the fact that less than half of the savings deposit holders and less than 30% of term deposit holders were aware of the prevailing interest rate for their accounts.

Public Sector Institutions

2.13 Two specialized agricultural banks, Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB), three nationalized commercial banks (Sonali, Janata and Agrani), and the cooperative networks, the traditional cooperatives under the Registrar of Cooperative Societies (financed by Bangladesh Sambaya Bank Ltd., BSBL) and the two-tier (Comilla model) cooperatives under Bangladesh Rural Development Board (BRDB) (financed by Sonali Bank), comprise the public sector. Of the 5762 total bank branches (as of March 31, 1994), over two-thirds are located in rural areas. This large rural presence of PSIs is a result of the rapid expansion of the banking sector under the Special Agricultural Credit Program started in 1977.

2.14 Deposits originating in the rural sector were Tk. 6863 crores, or 22% of total (private sector) deposits of PSIs, while the outstanding advances were Tk. 5459 crores, or 19% of the national aggregate on March 31, 1994 (Bangladesh Bank, 1994). The deposits originating in the agriculture and fishing sector was Tk. 2388 crores (or 10% of the total). In contrast, for FY94 disbursement of agricultural credit was Tk. 1100 crores and agricultural GDP was Tk. 31,494 crores, about 30% of the national GDP.

2.15 After years of stagnation, disbursements have increased over the past five years reaching Tk. 1480 crores in FY95 (see Appendix Table 1). Of this, over 47% was for crop loans (Appendix Table 2). The AGBs (BKB and RAKUB) dominate, contributing about 65% of the total disbursements to the sector. Lending by BSBL cooperatives continues to be negligible, while BRDB cooperatives’ share went up to 4.4% of total disbursements in FY95 after several years of a virtual standstill.

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11 For example, deposits of branches at Thana headquarters were on average 4.5 times higher than deposits in branches 4 miles away and 8 times the deposits of branches 8 miles away.

12 Rupali Bank, the fourth NCB, is being prepared for privatization and its portfolio is being concentrated on its core business. Rural operations, not considered as core operations, are being transferred to Sonali Bank.

13 Under the program, each bank was forced to open two rural branches for every new urban branch.

14 In 1993-94, total disbursement amounted to 3.5% of agricultural gross domestic product (GDP) at current prices. Current estimates of GDP are not available.

15 BKB’s share was the highest among all banks at 51.7%, followed by Sonali Bank at 14.5% and RAKUB at 13%. BSBL with about 0.1% and Rupali at 0.5% are only marginal contributors.
2.16 The performance of PSIs' "agricultural credit" portfolios mirrors that of institutions in other countries that have pursued the 'supply-led' approach to rural finance. Overdues have mounted steadily, with recovery rates falling below 20% for FY95 (Appendix Table 1). Most overdues are over 5 years past due. Total recovery, thus, might not reflect current performance. Data show that “current recoveries” (Appendix Table 3),\textsuperscript{16} although better, were still less than 56% for FY95. The AGBs have done a relatively better job, recovering two-thirds of their current dues (especially BKB with a recovery rate of 76% of its current dues). The performance of the cooperatives is the worst at 4%. The current upward trend in disbursements without improvement in recoveries is notable, especially for NCBs and COOPs (disbursements grew by 34% FY95).

2.17 Some PSIs appear to have done relatively better under their poverty alleviation credit schemes, which generally use the group-based lending approach to target the landless. The data for most banks are available only on a cumulative basis, hence the size of their poverty alleviation programs relative to total rural lending portfolio is not available.\textsuperscript{17} Even on a cumulative basis, however, with the exception of BKB's own financed schemes, they have failed to achieve sustainable recovery rates. Sonali Bank data indicate an overall recovery rate of 68% (63% on own financed and 74% on donor assisted projects) as of March, 1996. Agrani Bank's recovery rate was 70% as of May, 1996 (70% in own and 88% in donor/other agency financed programs). RAKUB's recovery rate as of May, 1996, was the lowest at 29% (including 80% rates in one collaborative scheme constituting about 50% of its poverty alleviation program). Janata Bank's recovery rate as of May, 1996, was 78% on loans through self-help groups and 88% on individual loans. In contrast, BKB has done remarkably well in its own financed programs with a recovery rate of 97%, although its collaborative programs have performed poorly at a recovery rate of 42%.

2.18 The aggregate statistics on non-poverty alleviation lending compare with household survey data and the survey of loan accounts. Recovery rates for all loans was estimated at 84% from loan ledger records (779 accounts from 35 branches). However, if working capital loans are omitted, the recovery rate declines to 73%. The household survey data yield a similar recovery rate of 76%. About 26% of the households had not repaid their loans at all, while 47% had repaid their loans fully. The data also indicate that households continue to repay their loans past due dates. An analysis of the loan recovery profile (using both the ledger data and household survey data) shows that about 72% of the loans are recovered over a three year period which compares favorably with earlier findings of 75% over five years (Meyer and Srinivasan, 1987).

2.19 Although all recovery rates appear to have increased in recent years, crop loans have performed poorly relative to the rest. For 1994 loans, the household survey yields a 77% recovery rate for all loans, while for crop loans it was only 40%. The performance of crop loans made in 1991 and 1992 was particularly bad, with some improvement in later years. This is not surprising given the politically motivated loan forgiveness program of 1991.

2.20 Interest rates for agriculture are restricted to vary within a 10-14% band. In principle, banks are free to fix the interest rates within the band. In practice, they have little choice; written directives have been replaced by verbal and other forms of political suasion. Interest rates play a key role in the sustainability of lenders, as well as in the allocative efficiency and fairness of financial transactions by creating incentives for rent-seeking and non-price rationing.

\textsuperscript{16} That is, recoveries from loans falling due in the current year.

\textsuperscript{17} The available data were provided by the individual Banks following the Green Cover discussions.
2.21 The perverse effects of subsidized interest rates, i.e., rent seeking behavior and mis-allocation of resources, are evident from sample data. Statistical analysis shows that bribes had a significantly negative impact on the recovery of PSI loans. The majority of rationed borrowers were in the small farmer and landless categories; lack of collateral, refusal to pay bribes and document related problems were the most frequently reported reasons for loan rejection. Also, loans collateralized by land had a significantly poor recovery rate.\textsuperscript{18} With the 2.5 acre ceiling for crop-hypothecated loans, this indicates that larger farmers (i.e., who require collateral) had a poorer repayment record.

2.22 For borrowers, transaction costs make PSI loans less appealing. Past evidence showed that these costs were disproportionately higher for small borrowers and declined with loan size (Ahmad, 1989).\textsuperscript{19} Current data give an average transaction costs amounting to 4.8% of the loan; of this, 29% of the costs were attributable to bank formalities (fees and documentation costs) and the rest to non-bank related costs: 29% to travel and time cost, 21% to bribes and 21% to incidental costs. As expected, costs were higher for small loans: 4.4% for loans under Tk. 1000 and 1.11% for loans over Tk. 40,000. In addition, 33% of applications (25% for crop loans) took over a month to process. It should be noted that the share of travel and time cost is likely to be underestimated because of the proximity of the sample to bank branches.\textsuperscript{20} Overall, there remains significant room for cost-efficiency in the delivery mechanism.

2.23 In the absence of insurance markets, weather risks are an important factor in crop production. Given the proportion of crop loans in PSI portfolios, the poor financial health of PSIs is often attributed to exogenous factors affecting agriculture. The poor recovery of crop loans is usually interpreted to validate this notion.\textsuperscript{21} While natural disasters are undoubtedly important for portfolios concentrated in crop loans, this interpretation of the current situation is untenable. For example, from the household survey data it is difficult to argue that defaults between 1991 to 1994 were due to natural disasters. The data span six agro-ecological zones and there is no evidence of major disasters affecting all districts in any of the years the data reflect. Further, (aggregate) sectoral recovery rates for BKB, the largest supplier of agricultural credit, reveal that recovery of crop loans was the same as the overall average, reflecting more systemic problems.\textsuperscript{22} These problems are also reflected in the recovery rates of PSIs’ poverty alleviation schemes, which are well below those of the MBI’s.

2.24 Also, it is noteworthy that for 1994, Grameen Bank provided Tk. 348 crores for crop and vegetable production under the “general loan” category (including loans for paddy, wheat, other rabi crops, potato, fertilizers and pesticides for cultivation), comprising almost 25% of its portfolio (Grameen Bank, 18 Of total loans, 34% used land as collateral, 47% used hypothecation or third party guarantee, and the rest used other collateral.
19 Ahmad (1989) estimated transactions costs at 29% for small borrowers which declines to 7% for large borrowers.
20 These costs are surely underestimated relative to what might be expected on average.
21 One issue raised at the Green Cover draft discussion meeting was adverse movements in input-output prices. As noted later in para. 2.56, especially footnotes 43 and 44, low profitability as a reason for poor recoveries does not appear to be a strong argument. However, as an empirical issue, and one closely linked to riskiness of crop production (i.e., via market risk), it is proposed that the complementary study being undertaken by ADB (see para. 4.34) revisit the issue.
22 Tea industry loans, working capital loans, and ‘other’ loans were the only ones performing better.
Its loan recovery for the year was 99% (Khandker, et. al., 1995). GB, however, targets the functionally landless, and it is possible that non-farm income acts as insurance for these households. Two programs which include small and marginal producers in their target group are Grameen Krishi Foundation (GKF) and the Marginal and Small Farm Systems Crop Intensification Project (MSFSCIP). Recent GKF data show a recovery rate of 100% and MSFSCIP data indicate recovery rates of 98.5% for small farmers and 91.4% for marginal farmers. These examples clearly demonstrate that it is possible to make good agricultural and crop loans.

2.25 The real problems lie elsewhere. The primary problem is inappropriate institutional incentives. Weak governance has made the PSIs especially vulnerable to political interference. Pressure to meet disbursement targets, non-economic considerations in loan approvals and political forgiveness programs have contributed to the poor quality of loan portfolios. An ineffective legal enforcement framework, expectations of debt forgiveness, adverse incentives and lack of staff motivation have resulted in poor loan recoveries. An inappropriate delivery mechanism has limited reaching a greater number of people and the focus on disbursement has led to little effort being expended in mobilizing rural deposits.

Member-based Institutions

2.26 A rapidly growing segment of RFMs in Bangladesh are the member based institutions. The largest MBI is the Grameen Bank (GB), the only formal institution of its type. All others are NGOs, biggest amongst them being BRAC, ASA and Proshika. Credit Development Forum (CDF) estimates over 1000 NGOs offer credit services. Most MBIs, including the GB, have an explicit social agenda to cater to the poorest sections of the non-agricultural population, with women making up a majority of their clientele.

2.27 There is little dispute about the remarkable success of MBIs both in terms of outreach and the quality of service provided to their clients. Almost all programs use the group lending model pioneered by GB (see Khandker, et. al., 1995). The peer monitoring and joint liability structure of the credit delivery mechanism overcomes the screening, monitoring and enforcement problems that traditional banking suffers from. In addition to the lending technology, GB offers important lessons for institutional design. Strong leadership, functional and operational autonomy, especially from political pressures, rational effective interest rates, diversified portfolio, regular savings deposits, well trained staff, performance based incentives and mandatory loan insurance are all key elements in the success of Grameen Bank.

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23 In addition, another 10% of GB portfolio is directed towards agriculture for various purposes, including land lease, tube-well purchases for irrigation, fruit production, etc. While the classification of these loans is unclear, it should be noted that the majority of these loans are essentially for activities directly related to crop production and are subject to the same weather and market risks as, for example, paddy cultivation loans. Besides, the fungibility of money makes the precise classifications of loans a moot point.

24 Thus, even if the rest of the 75% of Grameen Banks portfolio was full repaid, the recovery rate for agriculture and forestry loans would have to be at least 96% to maintain a 99% overall recovery rate.

25 As noted in the Green Cover discussions, MSFSCIP extends loans for three purposes, of which crop production is one. However, follow up discussions with GTZ, which provides technical assistance for the project, revealed that recovery rates were not any worse for crop production loans relative to the other two categories.

26 Contrary to widespread perception, Grameen Bank is not an NGO. It started out as an NGO but was converted into a Bank under a special charter in 1983.

27 CDF is a network of credit NGOs assisted by PACT, a USAID funded NGO, which offers training and technical assistance to other NGOs.
2.28 While MBIs have demonstrated the feasibility of reaching the poorest of the poor, the high cost of their operations and declining subsidized funds raise the issue of their sustainability. The GB model relies heavily on social preparation of members, training of staff and the principle of starting small and gradually increasing loan size. These factors add to start up costs, although there are potential economies of scale. In addition to the financial operations of the "minimalist" model (followed by GB and ASA), most MBIs follow a more "holistic" approach, incurring additional "social intermediation" costs of providing varied social services (Bennett, 1994). The potential for self-sustainability of minimalist organizations is demonstrated by the virtual elimination of economic subsidy by GB and full cost recovery of ASA.\textsuperscript{28} For holistic organizations, however, this continues to be a problem.

2.29 Efforts to reduce administrative and transaction costs have been undertaken by most major credit NGOs and should continue to be top priority on their agendas. Some of the larger MBIs already have in place management systems as sophisticated, if not more, as the commercial banks. For smaller NGOs, the lack of professionalism in financial transactions, with poor book-keeping and accounting practices, is a serious concern. While their organizational set up and culture has been molded by their origin as relief and welfare agencies, NGOs have to face the realities of declining subsidized funds. Training and capacity building in accounting and financial management plus greater transparency in their operations is essential not only to make NGOs attractive to the remaining donors but also to enable them to tap commercial markets and banks.

2.30 A major institutional innovation in Bangladesh is the Palli Karma Sahayak Foundation (PKSF). The foundation is an autonomous institution that lends funds to credit MBIs for on-lending. Established and funded by GOB, the foundation's policy has been gradual expansion and capacity building of its Partner Organizations (PO). It seeks to encourage innovation and to learn from and diffuse knowledge through a program of evaluation and research. It has a strict set of criteria that POs need to satisfy to be eligible to borrow funds and it closely monitors their financial and accounting practices.\textsuperscript{29} In the past, however, PKSF has concentrated on lending and monitoring activity and has paid relatively less attention to capacity building or financial development of new or currently ineligible POs.

2.31 Although the lending rate to POs is subsidized, the fact that POs base their credit programs on loans rather than grants is a an important step in the direction towards self sustainability. The graduated (increasing) interest rates with loan size reflects the Foundation's policy to encourage growth of smaller POs. In addition it provides incentives for larger POs to seek commercial finance. The latter objective is served by placing a ceiling on the size of loans available to any PO in a single year, although this is primarily motivated by reducing the Foundation's risk exposure to one entity.\textsuperscript{30}

2.32 The MBIs in Bangladesh have generally chosen to stay away from financing land-owning households (two notable exceptions are discussed below). They also generally focus on non-crop and off-farm activities, although agriculture does constitute a sizable proportion of GB, BRAC, Proshika and

\textsuperscript{28} The "economic sustainability ratio" for ASA has recently been estimated at 102, indicating that even ASA is free of any economic subsidy (World Bank, 1996).
\textsuperscript{29} POs are expected to: have an established credit program with an acceptable recovery rate; be based on a group lending model; practice double entry accounting system; have or develop an MIS system; route all transactions through Banks and maintain staff adequacy.
\textsuperscript{30} Exposure is limited by ensuring that no PO has more than 10% share in PKSF's total portfolio.
With a large proportion of the target population uncovered, the rationale and the scope for expansion of these programs for the landless remains undisputed. At the same time, it is important to recognize another large segment of the population that could greatly benefit from increased access to financial services using the group lending methodology. These are the small and marginal farmers, who constitute roughly two-thirds of farming households and almost a third of all rural households in Bangladesh. This segment remains without adequate access to financial services either from the formal or the semi-formal sectors.

2.33 Group lending for crop production does encounter some potential difficulties. One is covariant risk as group members experience identical climatic and market fluctuations. Most MBI programs charge a risk premium, but these are based on a heterogeneous set of activities. Another difficulty is that production seasonality creates problems in adhering to a weekly repayment schedule. Innovations to overcome this problem include packaging continuous cash yielding activities and seasonal loans to borrowers with ongoing non-crop activities. These loans require part repayment on a weekly basis, with the bulk repayable on maturity. A third variant is a family loan made to women for unspecified activities; this removes a third factor preventing male farmers from joining MBI groups - the time cost and discipline to attend weekly meetings. Seasonal loans, have become particularly popular in GB's portfolio.

2.34 As noted, most MBIs target the landless. One project, the Marginal and Small Farm Systems Crop Intensification Project (MSFSCIP), uses group lending to reach marginal (up to 1.5 acres) and small farmers (up to 2.5 acres) and has a recovery rate of 98%. It aims to link self-help groups with participating banks. Rangpur Dinajpur Rural Service (RDRS), an NGO, plays an important supporting role in group preparation and in the follow-up and supervision process. These groups are “phased-out” of RDRS’s own program and form “federations” after three years. The federations are expected to play a key role in program sustainability. Crucial to their sustainability is a share of the spread which requires a realistic (cost covering) interest rate to be charged for financial services. The current ceiling on agricultural lending, however, prevents charging member farmers a higher rate than other farmers. Given the higher costs of reaching small and marginal farmers, especially with the group lending approach, the policy of controlled interest rates is a major obstacle.

2.35 The group methodology for crop lending is also being developed by the Grameen Krishi Foundation (GKF), a spin-off of Grameen Bank. The project aims to provide credit and non-credit services to agricultural producers. It provides credit in kind and collects repayments in kind. GKF also stands ready to buy the entire crop, providing an important marketing service, and provides extension services to farmers, especially for the new and diversified crops that it actively promotes. The project is bold and innovative, but it is too early to assess its sustainability as it is still evolving and needs to be refined. The recovery rates so far have reportedly been around 100% indicating initial success in using the group methodology for crop lending, but the project continues to incur losses (largely due to the non-profitable deep tubewell operations it inherited).

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31 In 1994, agriculture (other than livestock, poultry and fisheries) constituted 35% of GB portfolio; 11% of Proshika’s lending between 1989 to 1994 was for crop production; BRAC reduced crop lending from 12% to 2% in 1990-91. Almost all NGO’s lend heavily for livestock, poultry and other agricultural activities as well.

32 Risk premium is either implicit in the interest rate or is charged explicitly as a contribution towards an insurance fund.

33 MSFSCIP is a collaborative effort between IFAD, BB, RDRS, GTZ, DAE and local banks.
The Informal sector

2.36 The informal sector continues to be the main source of credit for a majority of the population and a lender of the last resort for many. Households without access to, or those rationed (totally or partially) by other lenders, turn to informal sources to borrow. IFIs are widely perceived to function efficiently, with low defaults and low transaction costs. Personalized transactions alleviate information problems (for screening and monitoring borrowers); geographical proximity makes lenders more accessible; flexibility in terms and conditions allows customizing loans to borrowers' needs; and the threat of monetary and social sanctions creates strong dis-incentives to default.

2.37 The nature of informal markets are revealed by the survey data. On average, households borrowed three times a year from IFIs (ranging from 1 to 20) with loan sizes ranging between Tk. 250 and Tk. 150,000. Most of the loans were small, with over half less than Tk. 2000. The average duration of loans was six months, with over half due in three months and 95% in one year. About 48% of borrowers had a relationship of over 5 years with their lender. Transactions costs were positive, averaging 1.2% of the loan; conveyance and documentation costs were the main components, especially for larger loans.

2.38 The average on-time recovery rate was estimated at 62% and almost 100% of the loans were repaid within 3 years. Small borrowers demonstrated better repayment habits. Interestingly, the average recovery rate for crop loans was the highest at 83%. Flexibility in conditions in response to borrowers' cash-flow problems explains the short- to medium-run delinquency. In the long-run, personalized relationships and repeated interactions ensure continued and reliable access to finance, providing a strong incentive for the borrowers to eventually repay their debt.

2.39 Informal lending is generally presumed to be dominated by loans for non-commercial purposes (i.e., consumption, ceremonial expenses, medical emergencies, etc.). Survey results indicate the opposite: 28% of IFI loans were for consumption purposes, while 59% were for commercial and investment purposes (with 19% for crop production). The IFIs, thus, appear to provide varied and valuable services.

2.40 Also contrary to popular opinion, informal markets are not dominated by unscrupulous moneylenders. Past studies have shown that a majority of transactions are among friends and relatives at zero or nominal interest rates (Rural Credit Survey, 1987; Murshid and Rahman, 1990; Maloney and Ahmad, 1988). Survey data confirm this: 55% of IFI transactions, uniformly distributed by loan sizes, were reported at zero interest rates. Loan sources were diversified with a majority of loans from neighbors (37%), relatives (16%), and friends (26%). Although there were no reported transactions with 'professional moneylenders' per se, with 59% of loans from neighbors, 30% from friends and 27% from relatives carrying positive interest rates, there appears to be substantial moneymarking activity. The average interest rate was 48% per year, increasing to 106% for interest bearing loans. Interest free loans reflect the existence of social safety nets based on reciprocity and hence entail a future cost (i.e., future income opportunities).

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34 Although money is fungible, the superior ability of informal lenders to monitor end-use makes loan purposes instructive to assess the nature of the transactions.
35 About 13% were for 'unspecified' purposes.
36 The incidence of interest free transactions appears to have gone up over time: Rural Credit Survey estimated it at 35% in the early 80's and BIDS study found it to be 46% in the late 80's.
2.41 A potentially important source of credit are traders and dealers, as in non-agricultural rural industries (generally as supplier-cum-buyer arrangements). In agriculture, *dadon* (or forward sale) has traditionally financed paddy and jute marketing, and continues to finance over half of the transactions in upper levels of marketing chains for foodgrains. At the retail level, this interlinkage is now almost nonexistent in advanced areas, although it still prevails in the more backward and remote areas (Hashemi, 1988; Sen, 1988; Crow and Murshid, 1994). In general, given the advantages of trade credit in reducing transaction costs and in diffusing risk, with increasing commercialization of agriculture, trade credit was expected to increase (e.g., as in the case of India and the Phillipines, see Ghathe, 1992). One problem appears to be access to finance by itinerant traders who in turn are unable to finance farmers (Chowdhury, 1994).

2.42 Evidence also indicates limited supplier’s credit. One study estimates 32% of retail fertilizer sales are on credit (Khalily and Slover, 1994); another notes the lack of credit by fertilizer and equipment dealers to farmers (Ahmed, 1994). Survey data corroborate the latter view with few reported credit transactions with input suppliers (3.5%). This is surprising given the advantage of supplier’s credit in increasing sales and expanding market share; it was expected to become increasingly important with the privatization of input markets. Field interviews and case studies (IIMI-BSERT Survey, 1995) reveal a combination of lack of funds and risks in selling on credit under the current circumstances. Dealers are unwilling to approach banks primarily due to transaction costs (with recurring complaints of bribes, generally reported to be 10% of the loan amount). For a large number of potential customers, however, they are unable to establish creditworthiness or to ensure repayment under the current legal and regulatory framework.

2.43 A deeper understanding of the nature of informal markets can be obtained by looking at the factors influencing IFI interest rates. Risk and opportunity cost are often considered as important factors, as are segmentation and non-competitive markets (Adams, 1984, Bottomley, 1990, Bell, 1993, Hoff and Stiglitz, 1996). Statistical analysis, using a Tobit regression with region specific effects, shows that loan frequency (a proxy for risk), purpose and collaterization of loans have no effect on the level of interest rates; a longer repayment period, business relationships (trade credit, share cropping, etc.), loan size (treated as an endogenous variable) and number of lenders tend to raise interest rates; and access to paved roads (i.e., proxy for infrastructure development), proximity of borrowers to a bank branch, and proximity of borrowers to lenders have a negative effect on interest rates.

2.44 These results provide important insights into how informal financial markets operate. Risk does not appear to be as important as is generally believed. This could reflect a highly personalized, and hence secure, nature of the transactions. This is not surprising, considering that recovery rates of IFI loans are generally very high. At the same time, the results are consistent with the hypothesis of market segmentation. Segmentation is confirmed by the seemingly counter intuitive positive effect of the number of lenders and the negative effect of the distance between lender and borrower on interest rates. Overall, the observed effects are consistent with monopolistic competition resulting from high fixed costs of establishing a borrower-lender relationship, non-homogenous loan products as well as market segmentation. The imperfect nature of the markets is also suggested by the negative impact that the proximity of a bank has on informal lending rates. Finally, infrastructure (hence, economic) development has an important effect in reducing interest rates.

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37 See Hoff and Stiglitz, 1996, for the theoretical underpinnings of a monopolistic competition model for rural informal markets.
B. Demand for Financial Services

2.45 For policy purposes it is important to establish if there exists any unmet demand for financial services; for appropriate policy design, it is crucial to identify the nature of the demand. In a low income, low productivity and high risk environment, the basic financial services most demanded are savings facilities, investible resources and insurance against uncertainty (i.e., natural, business and personal risks). Policy makers have traditionally been pre-disposed to believe the only demand that exists is for credit. However, there is sufficient evidence available to show that the demand for other services, particularly deposit facilities, is often greater but is rarely recognized.

2.46 There is significant evidence showing that rural households in all income classes can and do save non-trivial amounts (see, e.g., Maloney and Ahmad, 1988, on Bangladesh, and Adams and Fitchett, 1992, for other countries). Survey results indicate that on average households save over 22% of their incomes. Although not all households are able to save (27% were deficit households), a large proportion of the population does so in various forms. These alternative forms are often inefficient as they incur significant transaction costs and risk capital losses. Over the past decade, the success of MBIs in raising deposits from assetless households demonstrates the thrift that the poor are capable of. This potential for deposit mobilization, however, remains largely unexploited.

2.47 There are currently no risk or insurance markets in rural areas of Bangladesh and their absence continues to be a major market failure. Self insurance via savings can substitute for the absence of contingent markets; however, risk aversion will continue to entail productivity cost unless the income and consumption of households can be perfectly smoothed. Social networks at the local and familial level are able to provide a limited safety net, although they are unable to overcome covariant shocks. For reasons discussed later, this issue has not been addressed in this study.

2.48 The importance of savings services and insurance notwithstanding, a more direct way of influencing productivity growth is timely access to resources for investment. The primary concern, therefore, is whether the lack of access to credit is constraining growth. Rigorous estimation of credit constraints is beyond the scope of this study. Identification problems, self-selection and non-price rationing make it difficult to establish whether the problem is due to the lack of effective demand or whether there is insufficient supply. Direct elicitation is also problematic in a non-competitive environment (with distorted interest rates, non-price rationing and a non-credible threat of enforcement) making it difficult to distinguish between legitimate demand and a demand for grants.

2.49 In principle, potential demand for loans depends simultaneously on the existence of profitable investment opportunities and on the willingness to borrow at a given price. It is informative, therefore, to look at indirect evidence on available opportunities, the pattern of past investment and the revealed willingness to borrow by rural households which might suggest possible constraints.

2.50 Evidence shows that the role of RFMs in financing productive investment in Bangladesh has been limited thus far. Given the strategic importance of minor irrigation, the financing of irrigation equipment is a case in point. The ‘engine’ of growth of the late 1980’s was the rapid spread of shallow tube wells (STWs). There is strong evidence showing that this was largely equity-financed, with the contribution of

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38 It should be noted that all MBI deposits, including GB deposits, are involuntary deposits, as part of the group lending methodology. Nevertheless, the potential is amply evident by the growth of these savings.
both PSIs and IFIs being conspicuously low. The 1991 Census of Lift Irrigation revealed that banks financed 13.8% of then existing equipment, mostly in the early part of the 80's (AST-MOA, 1991). Over 80% were financed from own resources (including relatives and disinvestment of other assets).

2.51 Another study confirms this finding (IIMI-BSERT, Pump Owners Survey, 1995). About 65% of pump owners reported savings as their primary source of funds; credit was used by 28% (banks financed 18% of purchases, mostly in the pre-liberalization period). A large proportion of purchases were associated with sales of other assets (land, livestock and other assets) or by mortgaging land (for 80% of small, 42% of medium and 51% of large farmers). These disinvestments supplemented savings, and in some cases, insufficient credit from various sources. The study also found that ownership of STWs by small farmers was greater in districts that are advanced in irrigation development, with large farmers dominating in the laggard districts.

2.52 Disinvesting one productive asset to obtain another simultaneously demonstrates the perceived profitability of the new investment and reliance on an inefficient mode of financing, suggesting limited access to credit. The latter is confirmed by the finding that of the IIMI/BSERT sample of irrigating farmers, 38% expressed an interest in purchasing their own equipment. Of the interested, 92% cited lack of own funds and 42% cited lack of credit as the primary reason for inability to invest.

2.53 Survey conducted for this study further reveals that not only irrigation, but almost all investments are predominantly self-financed. Overall, 30% of the sample invested during the past one year (mostly in livestock, business, land, and poultry); 28% relied on self-finance, 5% borrowed from banks, and 4% from IFIs. Of all projects, 68% were self-financed, 19% from banks and 12% from informal sources. The contribution of banks was highest for business at 30% of total invested. The average income of households using bank finance was 51% higher relative to self-financing households, while the income of those using informal finance was 44% lower. The average size of bank financed investment was 300% higher for business and 50% for livestock relative to self financed investments. Investment using informal sources was also higher for business (by 200%), but lower for livestock (by 40%). Land investments were similar across sources of finance.

2.54 These results demonstrate the limited role of RFMs in financing past investment. While establishing causality is problematic (for the reasons cited above), the correlation between access to credit and the size of investment, and between access and income status cannot be ignored. Data on credit rationing and self-selection provide further evidence of potential demand. About 10% of the sample applied for bank loans but was rejected. Of these, 84% households owned less than 2.5 acres of land. About half of the rejected projects were abandoned (the rest used other sources). Of the households not applying for loans, 27% reported no need and 26% cited bank related reasons (insufficient collateral, objection to bribes, application complexities, etc.) for not applying. Risk aversion kept 43% out of the market and 3% reported religious reasons. In the informal market, although no household was completely rationed out, over 25% reported quantity rationing (up to 50% of the loan request).

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39 The PSIs, especially agricultural banks, did provide significant financing for irrigation equipment in the early 80's. For the past several years, however, this type of lending has been negligible.
40 The share of Grameen Bank and NGOs combined was less than 0.5%.
41 The reported reasons for rejection were: 44% due to lack of adequate collateral, 28% for lack of bribes, 17% for lack of recommendations by local leaders, 11% for incomplete applications and the rest for other reasons.
2.55 The evidence on unmet demand for credit is not restricted to agricultural producers. The IIMI/BSERT study also conducted a survey of irrigation equipment dealers and traders and concludes that finance is a major constraint to business activities. Studies on the foodgrain marketing sector (IFPRI: Chowdhury, 1994) and fertilizer trade (IFDC: Khalily and Slover, 1995) have reached similar conclusions. They note the inefficiency of the existing financial system and the potential for greater volumes of trade credit which might ultimately flow down the marketing chain to the farmers.

2.56 The above findings reveal the inadequacy of financial services in rural areas. The past reliance on self-finance has two implications. First, savings are probably the most profitable mode of financing investment, provided the required level of savings exist or can be generated. To accumulate savings, however, there need to exist safe and profitable savings facilities. Thus there appears to be a significant unmet demand for accessible deposit facilities. Second, even though it may be preferable, there are clearly limits on how far and how fast self financed growth can be pursued. The slowdown in agricultural growth in the 90s, raises a genuine concern about the inadequacy of access to resources. Farmers without the required savings or disposable assets, particularly the small and marginal farmers, may be unable to undertake profitable investments.

2.57 Moreover, the tremendous growth of MBI programs in Bangladesh demonstrates significant unmet demand for financial services. Admittedly most MBIs target the landless poor. However, an increasingly wider range of activities are being financed by these programs, with agricultural activities being particularly popular (e.g., at 35%, agriculture commanded the largest share of the sectoral allocation in Grameen Bank’s portfolio for 1993). The high loan recovery of these programs clearly demonstrates both the existence of profitable investments and the willingness of households to borrow at competitive rates (Grameen Bank, 1995). Parallels with the small and marginal farmers, who rely on off farm activities for a significant part of their household income, are obvious. These opportunities are only expected to increase as agriculture gets more commercialized and diversified.

2.58 The above evidence, however, needs to be interpreted carefully. The unmet demand does not appear to be a function of an insufficient supply of funds at the disposal of PSIs (NCBs have had surplus liquidity for several years). A more appropriate interpretation is the general failure to effectively deliver the services demanded. Overall, RFMs provide limited services, essentially short-term credit. They fail to provide adequate deposit facilities for small savers or long-term credit for productive investment. While some sections of the rural population have access to financial services (generally the wealthy, and, more recently, some of the assetless through MBIs), a large section of the rural population, particularly the small and marginal farmers, continue to have little or no access to the RFMs. The PSIs are unable to reach them because of their unsuitable delivery mechanism; they do not qualify for MBI membership; and the IFI fails to provide adequate or suitable services.

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42 The IIMI/BSERT study reports that 81% of the traders expressed need for funds, of which 33% did not apply due to insufficient collateral, about 75% noted complex formalities and almost 66% blamed high unofficial costs.

43 The IIMI/BSERT study found irrigated agriculture to dominate unirrigated agriculture in terms of profitability: irrigated Boro gross margins were 2.4 and 2.1 times greater than local Aus and jute, respectively, and irrigated potato gross margin was 2.8 times non-irrigated potato. The internal rates of return (using 1994 prices) for irrigation equipment was also high: 61% for STW’s used on-farm and 24% for STW’s used for selling water.

44 The profitability per hectare of Boro rice for 1992/93 (Chowdhury, et. al., 1994) compares quite favorably with the estimates using 1989/90 prices (Gisselquist, 1991).
3. ISSUES IN IMPROVING RURAL FINANCIAL MARKETS

3.1 The RFMs in Bangladesh are inefficient and incomplete. The PSIs have limited outreach and their persistent arrears are clearly unsustainable. MBIs have been successful in reaching the poor, but they offer a limited range of financial services making them ineffective for intermediation. Their services are targeted at a specific segment of the rural population and a vast majority of MBIs are critically dependent on grants or subsidized funds. The informal sector, while providing much needed credit in areas untouched by the other two sectors, remains segmented (and hence inefficient and non-competitive) and is also constrained by limited resources. The general failure to provide essential services efficiently, particularly long-term credit for productive investment, threatens to be a significant constraint on the future productivity and efficiency of the rural sector, especially agriculture.

3.2 To improve their functioning, it is essential to address the issues in areas of strategic importance for the future development of RFMs. Accordingly, the purpose of this part of the report is to analyze the issues impeding the efficiency and expansion of financial services in rural areas. With a view to developing a framework and identifying the next steps for reform, the discussion is centered on three key aspects of the rural financial intermediation process where appropriate actions could significantly improve the efficiency of RFMs in Bangladesh.

3.3 The first aspect relates to the central role of the banking sector in a financial system. By virtue of its economies of scale, the potential to mobilize resources with appropriate prudential oversight and to intermediate and pool risks over geographical areas, the banking sector constitutes the backbone of the financial infrastructure. At present, only public sector banks operate in the rural areas. The issues of their sustainability and efficiency raise serious policy concerns.

3.4 The second aspect is the lack of access to credit, especially by the rural poor. Even established NGOs are unable to secure loans against their reputation or accounts receivable. A number of seemingly innocuous legal, regulatory and institutional barriers in framework for secured transactions significantly affects the efficiency of rural financial markets and restricts the flow of funds to rural areas. They limit private sector participation by significantly increasing the costs and risks associated with financial contracts, and prevent the participation of otherwise creditworthy borrowers with little real estate to offer as collateral.

3.5 The third aspect is the effective delivery of credit and savings services to the rural poor, reflecting a systemic failure to intermediate efficiently. The RFMs are currently fragmented with the formal, semi-formal and informal sectors operating in isolation. Given the comparative advantages of each sector in the process of financial intermediation, it seems prudent to integrate the three segments to allow the system as a whole to intermediate. In the short run, this would provide an effective mechanism to reach small borrowers including the small and marginal farmers, and in the long run, it would promote the provision of financial services on a commercial basis.

3.6 The problems and issues associated with each of the three aspects are discussed in the three following sub-sections. The first section analyzes the issues concerning the formal sector institutions. It focuses on agricultural banks -- BKB and RAKUB -- to identify issues related to public sector banks, and briefly discusses issues concerning agricultural cooperatives. The second section discusses the problems with the current framework for secured transactions. Finally, the third section addresses the issues of linking formal sector banks with semi-formal and informal sector intermediaries.
A. Problems with Formal Rural Financial Institutions

3.7 This section focuses on the problems facing PSIs and COOPs. The discussion does not include the Grameen Bank as it has been well studied (see Khandker, et. al., 1995) and does not warrant further examination. Within PSIs, the first part of the analysis is based on a diagnostic review of Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB). Resource constraints and lack of detailed information on the rural-urban breakdown of the operations prevented a similar analysis of the Nationalized Commercial Banks (NCBs). In general, the problems facing the NCBs rural portfolios are similar in nature but probably more severe in magnitude. Nevertheless, the agricultural banks are presumed to be representative of the sector. Their problems are symptomatic and illustrate the issues quite well. The second part of the analysis deals with COOPs.

Agricultural Banks

3.8 In general, (non-specialized) public commercial banks are able to lower their operational costs, and hence raise profitability, because of their urban and industrial operations. In Bangladesh, however, the AGBs are found to be 'technically' more efficient than NCBs in rural credit operations while the NCBs are more efficient in deposit mobilization (Khalily, et. al., 1994). These comparative advantages reflect the better performance of BKB in loan recovery (although RAKUB's performance has been worse) while NCBs have generated more deposits, even in rural areas.

3.9 BKB and RAKUB have not been affected by the financial sector reforms underway since 1990. Both have nevertheless classified their loan portfolios according to the latest Bangladesh Bank (BB) guidelines. Most issues covered by the reforms are equally relevant to the rural financial sector. Important among these are: removal of interest rate restrictions; replacement of refinance facilities (still open to AGBs and COOPs) with a re-discount window as for other banks; strengthening the monitoring and supervisory capabilities of BB to deal with both the banking and non-bank rural financial institutions; and expediting legal reforms for loan recovery, especially strengthening and extension of the court system in rural areas. These issues are well understood and are not elaborated upon further.

3.10 To put the analysis in perspective, financial services provided by BKB and RAKUB are discussed first, followed by an analysis of their performance and a discussion of the main issues.

Financial Services: Trends and Composition

3.11 Credit trends: Annual disbursement by BKB, in nominal terms, stagnated from FY86 through FY93 (fluctuating around Tk. 4 billion), and has since increased sharply to Tk. 7.6 b in FY95. RAKUB's lending similarly fluctuated around Tk. 0.4 b though FY91, increasing sharply to Tk. 1.9 b in FY95. Both experienced declines in FY90 and FY91 due to mounting overdues, tighter lending criteria and funding constraints. Despite recent growth, disbursements in FY94 as a proportion of total assets averaged only

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45 The problems of NCBs are complicated by their limited rural operations (as a proportion of total portfolio), mounting overdues, difficulty in getting staff with the right attitudes and motivation to work in rural areas and the bias towards working in urban areas, largely due to better career prospects.

46 The agricultural credit departments of the NCB's too have benefited only indirectly in that their total portfolios had to be classified for provisioning and through the overall improvement in MIS and training programs.
22% for BKB and 7% for RAKUB. They fell short of loan collections representing a withdrawal of funds from the rural economy in FY87, FY88 & FY90-93.

3.12 BKB's average loan size has increased almost 50% to Tk. 15,120 between FY87 to FY94 and RAKUB's almost doubled to Tk. 8,200, partly due to higher per acre norms. BKB's borrowers went up from 372,000 to 407,000 between FY87 to FY94 and RAKUB's from 100,000 to 170,000 between FY88 to FY94. Both experienced a sharp decline in FY91 caused by GOB's loan waiver program.

3.13 Borrower mix: The majority of recorded loans are for less than Tk. 10,000 targeted at small farmers (for FY94, these constituted 81% by number and 29% by volume of lending for BKB and 79% by number and 53% by volume for RAKUB). Banks' statistics also suggest that the programs are targeted on small farmers with 71% by number and 31% by volume of loans by BKB and 61% by number and 53% by volume of loans by RAKUB going to households owning less than 2.5 acres.  

3.14 Although relatively better recoveries may have contributed to the increased concentration in short-term loans, pressure to meet disbursement targets and expectations of loan forgiveness appear to be the major factors. As for targeting, bank staff could not confirm this to be the true picture. Apparently, recorded land holdings do not constitute total land holdings of borrowers.

3.15 Quality: For FY94, the outstanding loan portfolio was 83% and 80% of the total assets of BKB and RAKUB, respectively; arrears amounted to 48% and 54% of total assets (57% and 57% of total loan portfolios), respectively, reflecting very poor loan recovery. Total loan recoveries were 27% and 16% for BKB and RAKUB at the end of FY94, although current recoveries of 78% and 71%, respectively, indicate significant improvement since FY93. About 78% and 77% of the arrears, and 48% and 51% of total outstanding loans, are over 3 years old for the two banks, respectively, reflecting past practices.

3.16 The recent improvement is a result of concerted efforts, especially by BKB, to improve recovery. Significant among these is an incentive scheme for staff to meet recovery targets. Although interest remissions and waivers have marginally helped recovery in particular years, they have had adverse effects in later years by creating expectations for further remissions. Political loan forgiveness programs have been most damaging, while lack of political will and ineffective legal enforcement have prevented the banks from pursuing defaulters. For FY94, only 1.9% of total overdues (by volume) were filed as certificate cases; of these less than 5% have been disposed off and less than 9% of the amount recovered. About 42% of the cases have been pending from four to ten years.

3.17 Diversification: Portfolio diversification has declined for both BKB and RAKUB over time with concentration in short-term loans (76% and 84%, respectively, of lending in FY94), particularly for crop production (27% and 74% of lending by BKB and RAKUB, respectively). Medium-term loans for draught cattle constituted 7.6% of total FY94 lending for both banks and long-term loans for irrigation equipment went down to 1.1% for BKB and 0.6% for RAKUB. These trends reflect past experience; both

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47 Households with no land holdings are not included in these statistics as the majority of these households took loans for non-agricultural purposes.

48 This is confirmed by the findings of our survey, reported earlier, that about only 42% of small and marginal farmers borrowed from formal institutions over the past two years. Also note that the land holding category is somewhat misleading as small holdings do not necessarily imply "poor" households. Hence the targeting of "small and marginal farmers" per se may be over-estimated.

49 About 27% of lending by BKB in FY94 was for short term loans for tea production.
banks have been particularly vulnerable to defaults in lending for these purposes as is evident from the dominant share of these loans in overdues (39% for BKB and 53% for RAKUB).

3.18 The unsatisfactory past experience with diversification, particularly for agro-industry and medium/long term loans, has made the banks reluctant to diversify. As a result, the current portfolios have become excessively risky, and both banks face significant potential losses due to covariant fluctuations in specific sub-sectors (crop production for RAKUB, and crop and tea production for BKB). Geographically localized, RAKUB is especially susceptible to exogenous fluctuations.

3.19 The problems underlying previous experience, however, continue unaddressed. These include, pressure to meet pre-determined disbursement targets, low quality of appraisal, underfinancing and untimely provision of loans, poor monitoring, inexperience in lending for different activities, unskilled staff and external influences in loan decisions.

3.20 Resource mobilization: Both banks currently face a severe liquidity crisis. Poor recoveries and inadequate deposit mobilization are the major contributory factors. Their main sources of funds are BB refinance (35% for BKB and 28% for RAKUB in FY94), loan recoveries (42% and 41%) and equity (15% and 14%). The dependence of both banks on BB has increased over time, with refinance accounting for 45% of BKB’s and 71% of RAKUB’s disbursements for FY94. Deposits provide only 5% and 6% of funding, respectively. Although total deposits have increased over the past four years at a seemingly good annual average rate of 20% and 24% for BKB and RAKUB, respectively, about 50% of the increase is reported to be due to interest accumulation in savings accounts. Fixed deposits accounted for 64% of total deposits of BKB in FY94 which has raised its average cost of funds.50

3.21 Both banks lack a consistent funding strategy, reflecting their orientation as ‘lending institutions’. Although BKB has taken steps recently to expand deposit mobilization through its staff incentive scheme, these efforts are ad hoc in the absence of a coherent medium or long term financial plan for sustainable growth. The institutional objectives prevent these banks from behaving and operating as financial institutions; consequently there is little incentive to reduce reliance on BB refinance by improving deposit mobilization or to substantially increase lendable equity resources.

Performance Evaluation

3.22 Performance has been assessed by two measures: outreach and sustainability. Three indicators are used to measure outreach: market expansion in terms of number of clients in relation to total rural population; market penetration to find out the proportion of small farmers reached; and market diversification to see the diversity of services provided by the banks. Sustainability is assessed as both the financial and economic viability of these institutions.

3.23 To evaluate the performance of BKB and RAKUB, where possible the analysis is supported by a comparison with two successful rural banks - Bank for Agriculture and Agricultural Cooperatives (BAAC) of Thailand and Bank Rakayat Indonesia (BRI) Unit Desa System (see Box 1 for a brief descriptive background on BRI and BAAC). The aim of this comparative evaluation is to identify critical impediments to the growth and performance of BKB and RAKUB as rural financial institutions, specifically in the areas of policy environment and organizational design.

50 The latest data for RAKUB is for FY91, when 53% of total deposits were fixed deposits.
Box 1. Successful Rural Financial Institutions*

Bank Rakayat Indonesia

BRI started its network of 3600 unit banks in 1970 as part of the national rice intensification program (BIMAS). Until 1983, BIMAS primarily channeled subsidized credit. Low interest rates (12%) made loans desirable and were often allocated to the elite. Poor program design and misguided implementation produced high arrears and declining participation. Deposits carried an interest rate of 1.5% and the low spread offered no incentive to the bank to mobilize savings. The poor deposit record of the bank was generally attributed to "rural undersavings", a presumed lack of trust in banks by villagers, illiteracy and "psychological inability" to use formal banks.

During 1983, BRI’s unit banks suffered a loss of $28 million. The choice was to close the units or to transform them into real banks. As the only providers of banking services in over 75% of the country and to protect the banking infrastructure, the government decided to reform the system. It started financial sector reforms, liberalizing interest rates. BRI initiated a general rural credit program (KUPEDES) at market-based interest rates (33%). Savings mobilization tailored to meet local demand was a major thrust of the program. Interest spread was set to ensure institutional profitability. The goal was to build a sustainable institution that would earn the trust of the people as a place to borrow and to keep savings. Strong emphasis was placed on prompt approval and increasing follow-on loans on prompt repayment. Program design included autonomy, decentralized decision making, profit-sharing for employees, MIS, staff training and interest rebates for prompt repayment from the very beginning.

The performance of BRI unit banks has been very impressive (loans outstanding increased 16 times between 1984 and 1993 with low arrears) and the units are now consistently profitable. Savings have been even more responsive (increasing 99 times). Savings mobilized are currently over twice the total credit outstanding and the number of depositors at 11 million are over 6 times the number borrowers.

Bank for Agriculture and Agricultural Cooperatives (BAAC), Thailand

Founded in 1966, BAAC's primary objective is to provide financial services to the agricultural sector. It replaced the Bank for Cooperatives, which failed for several reasons including poor credit delivery and enforcement problems. A concerted effort was made not to repeat past mistakes. BAAC is state-owned and a proposal to allow it to lend for non-agricultural activities is currently under consideration.

BAAC enjoys certain privileges aimed at stimulating lending to agriculture. For example, it continues to have preferential borrowing rates from the central bank, it is exempt from certain taxes and reserve requirements, and commercial banks are required to invest at least 20% of their deposits in agriculture, either directly or through BAAC. Banks have opted for the latter providing BAAC with access to a large and consistent source of funds.

BAAC has considerable operational and financial autonomy, with the exception of pressure to keep interest rates 1-2% below commercial bank rates reflecting its preferential status with the central bank. It aims at low-medium income farmers and uses progressive interest rates on loans, ceilings on loan amounts and lends to small farmers without traditional collateral though joint liability groups. Initially, BAAC lent through cooperatives, but repayment problems led it to lend directly to farmer groups.

Particular attention was paid in the initial stages of BAAC's development to improve efficiency, staff training, savings mobilization, and the joint liability delivery system. It offers incentives to borrowers for timely repayment and incentives to employees for efficiency and performance. As a result, it has achieved significant success in outreach (77% of farming households) and has been consistently profitable since 1975. Low arrears, cost efficiency and high staff productivity have kept the bank viable despite restricted interest rates.

3.24 Market Expansion: In terms of number of loanees reached, BKB and RAKUB have performed very poorly, covering less than 1% of farming households. They have failed to reach a significant proportion of their target population despite the heavy losses they have incurred over the years due to subsidized interest rates and high arrears. BAAC (77%) and BRI (34%) demonstrate a significant level of outreach. These impressive figures are reinforced by their low arrears (9% and 5.4%, respectively) compared to 57% for BKB and 66% for RAKUB. The continuing growth of BRI's borrowers demonstrates the willingness of its clients to pay high real interest rates (23%) for access to the high quality service.

3.25 In the provision of savings services, the performance of BRI (total deposits of US$ 5243 million covering 34% of the population) and BAAC (US$2,089 million covering 77% of the population) is again in

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*The section on BRI is based on Robinson (1994) and Patten and Rosengard (1991) and the section on BAAC is based on Sacay, et. al. (1996).
sharp contrast to that of BKB (US$ 189 million, serving less than 1% population) and RAKUB (US$ 41 million serving less than 1% population). The relative importance of savings services and the huge demand for such services is evident from the experience of BRI. It covers one-third of all households, around 12 million. In contrast, its loanees number only around 2 million. In terms of volumes, BRI had outstanding loans worth US$938 million while its deposits were US$ 2,071 million, demonstrating the tremendous potential for savings mobilization. These figures are not coincidental; they represent a determined effort by BRI to mobilize resources as a central component of its reforms since 1983.

3.26 Market Penetration: In the absence of other direct measures, market penetration is best demonstrated by considering indirect indicators such as average loan size. The average size of loans by BKB (US$486) and RAKUB (US$538) is less than others (BRI - US$494 and BAAC - US$829), but overall compares reasonably well. The smaller loan size of BKB and RAKUB is partly the result of giving short-term loans without collateral to farmers with land holdings less than 2.5 and partly due to the lower loan ceiling imposed by funding constraints. Field observations, however, indicate that a large proportion of the clients of BKB and RAKUB are well-to-do farmers (with more than 2.5 acres).

3.27 Since the country circumstances differ widely, a comparison is made between the average loan size with GNP per capita in that country. The ratio for BKB (221%) and RAKUB (245%) is much larger than BAAC (39%) and BRI (67%) suggesting that BKB and RAKUB tend to serve a narrower segment of the population, not reaching households at the lower end of the income distribution.

3.28 Market Diversification: BRI has the most diversified loan portfolio and savings services. BAAC is diversified in terms of funding sources but its loan portfolio is concentrated in agriculture. RAKUB is restricted to Rajshahi division and geographic concentration is unavoidable. Like BKB, it has chosen to concentrate current lending for crop production, while BKB also has a high concentration in tea loans. BKB and RAKUB have most of their deposits in fixed term and a minor proportion in demand balances and are heavily dependent on the central bank for funds.

3.29 A bank's behavior is largely determined by the objectives enshrined in its charter. BKB and RAKUB are mandated to provide credit for agriculture and for the development of cottage and other allied industries. BAAC is authorized to provide financial assistance to agricultural producers while BRI is to provide credit and savings facilities for rural small income activities.

3.30 Financial Performance: An adequate level of profit is needed to provide an appropriate return to shareholders; to reassure depositors that business is sound and competently managed; and to maintain and expand its capital base to satisfy prudential criteria and facilitate growth. The adequacy of earnings is measured by two indicators: operating ratio, i.e., operating income as a ratio of operating costs including provision for loan losses; and return on assets, i.e., the ratio of net profit after tax to average total assets.\footnote{Because of wide variations in equity structures of the different banks, return on assets is used a more appropriate indicator for comparison.}

3.31 Both BKB and RAKUB have incurred losses each year since FY92, the year they started to classify and provision for their portfolios under the new system. Current losses are estimated at 4.0% and 4.9% of their average total assets, respectively. BRI (1.8%) and BAAC (0.96%), on the other hand, are generating a positive return on their assets.
3.32 The key factors contributing to low operating ratios and negative profits are high provisions for loan losses, an inadequate interest margin and high administrative costs. All banks have positive average on-lending rates (10.3% for BKB, 5.7% for RAKUB, 25.1% for BRI and 12.0 for BAAC). The cost of funds vary, with BRI paying the highest rate at 8.3% (BKB paid 6.0%, RAKUB 6.7% and BAAC 6.8%). The interest margin was negative for RAKUB and 4.3% for BKB in contrast to 16.8% for BRI and 5.2% for BAAC. The variations reflect the policy environment in each country - interest rate restrictions, types of customers served, and access to funds at varying costs. BRI's favorable interest margin reflects a market-based interest regime while BKB's positive spread was a result of heavy reliance on low cost funds from the Bangladesh Bank. BKB, RAKUB and BAAC face interest rate ceilings on loans to the agricultural sector, although BAAC still has a slightly higher interest margin than BKB.

3.33 For viability, the interest margin must be able to cover loan losses and administrative costs. RAKUB is clearly unable to even cover its (subsidized) cost of funds. BKB has a positive, but evidently insufficient spread. The ceiling on interest rates is clearly a major problem in raising the interest spread. The major contributor to the problems of BKB and RAKUB, however, is the provision for loan losses. The recovery performance of BKB (with 57% portfolio in arrears) and RAKUB (66%) is extremely poor, resulting in very high provisions. BKB’s provisions for FY94 amounted to 6.8% and RAKUB’s to 4.4% of the FY94 average loan portfolio. The interest margin is insufficient to absorb these losses. On the other hand, BAAC (9% portfolio in arrears) and BRI (5.4%), have low bad debts and provisions (2.9% of portfolio for BRI and 5% for BAAC).

3.34 The administrative costs are 5.4% of the loan portfolio for BKB and 5.0% for RAKUB. The ratio is the lowest for BAAC (2.2%) and the highest for BRI (9.0%). To overcome the high cost of serving a large number of small loans, BAAC has adopted a group lending methodology (co-operatives and farmers’ associations). BRI’s high costs reflects its use of individual lending, although it has modified its delivery mechanism to use local agents with superior information and control on clients to overcome the identification and enforcement problems. BRI’s costs are also affected by aggressive deposit mobilization. BKB and RAKUB continue with the traditional individual-based banking methodology that does not use local agents, not do they spend much resources in savings mobilization. Both of these factors help keep their costs lower than BRI.

3.35 Group lending has significantly increased staff productivity (measured by the number of loans per employee) and contributed to lower costs in BAAC (277 versus 118 for BRI, 118 for BKB and 143 for RAKUB). Personnel cost is clearly the single largest expense, although it is significantly lower for BAAC (52% of administrative costs) and BRI (56%) than for BKB (84%) and RAKUB (83%). It is largely influenced by the level and mix of employees and their salary as well as density of borrower population.

3.36 Administrative expenses as a proportion of interest bearing liabilities were 3.9% for BKB and 3.4% for RAKUB in FY94, and as a proportion of assets they were 2.8% and 2.1%, respectively. Moreover, these costs have been increasing over time, primarily because of excessive staff costs. BKB and RAKUB are overstaffed with a much higher proportion of employees at head and regional offices than is necessary. Personnel costs have also been boosted by an increasing proportion of officers at the top end of their salary scale due to freezing of new recruitment and inability to retrench staff.

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53 With the exception of poverty lending programmes of BKB and RAKUB, which are implemented using groups with the assistance of NGOs.
3.37 Economic Viability: The information on financial profits is of limited use as it does not account for subsidies. Financial viability does not ensure economic viability; financial profits are thus a poor indicator of sustainability. The subsidy dependence index (SDI) is used to estimate the subsidy dependence.

3.38 Funds used by BKB and RAKUB are below market rates (as equity and concessional borrowing); as such they have enjoyed an economic subsidy due to the difference between the financial costs and the opportunity cost of these funds (i.e., market rate of interest). The extent of subsidy received by these banks for FY94 was 130% (BKB) to 154% (RAKUB) indicating heavy subsidy dependence. BRI has attained complete subsidy independence; BAAC is moderately subsidy dependent with an SDI of 23%. The results suggest that the average lending rate would have to be raised from 10.3% to 23.7% for BKB and from 5.7% to 14.5% for RAKUB to make them sustainable (i.e., to eliminate subsidies).

3.39 Current financial condition: Both BKB and RAKUB have incurred losses in each of the past three years.54 Although provisions are a major share of these losses, even without provisions (which represent past mistakes), BKB and RAKUB still made losses in FY94, indicating persistent problems. At the branch level, 70% of BKB and 64% of RAKUB branches made losses in FY94.55

3.40 Both banks are technically insolvent. As of June 30, 1995, net worth of both banks was negative. Based on available data, it is estimated that BKB would require over Tk. 6556 million and RAKUB would require Tk. 2367 million to even meet the international capital adequacy standards (8% of risk adjusted assets). The requirements are likely to be higher if the portfolio risk is appropriately accounted for. These estimates, however, need to be confirmed and the true financial position of the banks can only be determined after a full external portfolio audit.

Critical Issues

3.41 Both BKB and RAKUB are unsustainable and have failed to deliver adequate financial services, both qualitatively and quantitatively. The analysis above identifies a number of problems, resolving which requires squarely addressing critical issues affecting performance of these banks.

3.42 Sustainability: Adequate interest margins, control of arrears and reducing administrative costs are key to sustainability. The banks have little control on interest margins as they face interest ceilings. High and effective interest rates are the most important variable for the success of rural finance institutions. Loan recoveries are hampered by frequent and blanket loan forgiveness programs, pressure to meet disbursement targets, ineffective legal framework to enforce repayments and inadequate incentives for prompt repayment. Administrative costs can be traced to inappropriate technologies for lending and deposit mobilization and organizational and structural inefficiency.

3.43 Governance: Owned by GOB, the AGBs fall under the administrative control of the Ministry of Finance. As financial institutions, they come under the supervision of BB. The autonomy and discretion of the banks is severely curtailed by formal and informal government interference. Thus, despite the poor

54 The losses for FY93, FY94 and FY95 were, in million Tk.: 1444, 731 and 1931 for BKB, and 535, 306 and 663 for RAKUB.
55 It should be noted that at the branch level profitability measurement is still flawed as branches do not take account of loan provisions or income reversals. These are collectively consolidated at the head office and the data are relayed to the branches routinely.
financial condition of the banks, GOB continues to use them as conduits for political and social transfers. The predominance of official representatives on the Board of Directors discourages commercial orientation, with development objectives over-riding efficiency and viability. The present condition of the banks reveals the weakness and inability of BB to supervise and control the rural banking operations.

3.44 Institutional culture: Although established as banks, the mission of BKB and RAKUB is perceived to be disbursement of subsidized agricultural loans rather than to function as autonomous financial institutions. Managing Directors (MD) have historically been selected from among senior civil servants, with the only (recent) exception of the current MD of BKB, who is a professional banker. Financial viability has often been compromised in favor of socio-political objectives. In line with civil service norms, the MDs are also frequently transferred severely affecting policy and management stability. The bureaucratic set up of the institutions has created the perception that financial services, primarily credit, are an entitlement and that the borrowers are “beneficiaries”. This identity crisis propagates the treatment of loans as grants amongst borrowers. The inability, or more accurately, the unwillingness to pursue repayment has reinforced this perception.

3.45 Management systems: Strategic planning is non-existent, with business and financial plans projected on an annual basis. Budgeting is also on an annual basis making it difficult to monitor performance on a quarterly or semi-annual basis to identify emerging problems. Information flows of basic financial ratios lack consistency, accuracy and timeliness making control functions difficult and limiting management’s ability to identify critical areas and take timely action.

3.46 Incentive structures: The bureaucratization of the institutions has created adverse incentives, both for the institution and staff. There is little incentive for managers or staff to pay attention to branch viability or portfolio quality without accountability for performance and effect on their compensation or tenure. BKB and RAKUB have recently introduced an incentive scheme based on established targets for disbursement, recovery and deposit mobilization. The scheme is a good start and has already yielded positive results. Its design needs to be re-evaluated, however, to focus on full recovery and savings mobilization.56

3.47 Range of services and products: The banks offer a very limited range of products and services using technology that has failed to work in the past. They are also mandated by their charter to restrict lending to agricultural activities and cottage and allied industries. Both are currently over-exposed to risks in particular sectors, especially crop production. The banks also offer very limited savings services, while it is well demonstrated that more people demand savings services than loans.

3.48 Human resource management: The rapid expansion of the late 70s and early 80s has left an overstuffed and poorly trained bureaucracy. The recruitment freeze has for several years prevented fresh ideas and blood to come into the banks. Banking is a highly competitive service industry and depends on highly qualified and motivated personnel. The civil service pay scales, promotion policies and qualification requirements are inappropriate for bank service.

56 Including disbursements in the incentive scheme is unnecessary as recovery related incentives will implicitly encourage an increase in good loans. The scheme should also stop setting recovery targets below full amounts due. In general, without proper accounting practices and adequate MIS and controls, transaction based incentives are likely to encourage book-keeping malpractices. A profit-sharing arrangement together with the threat of termination for poor performance would be a more appropriate incentive scheme.
Agricultural Cooperatives

3.49 The basic activity of two agricultural cooperative systems currently in place in Bangladesh, the RCS (traditional) and the BRDB (two-tier, Comilla model) cooperatives, has essentially been banking, and unfortunately, only on the credit delivery side. The performance of both has historically been extremely poor, with the BRDB cooperatives performing relatively better in the early 80s. The situation took a turn for the worse in 1991 when lending by both COOPs virtually stopped because of GOB refusal to write off loans of cooperative members as it did for agricultural loans from banks.\(^5\) The refusal of cooperative members to repay their loans made the societies ineligible for fresh loans. While the impasse continues for the RCS societies, some BRDB cooperatives have been made eligible after recent interest remissions and rescheduling of loan repayments and lending activity has recommenced. The underlying problems - institutional, political and organizational - that have been responsible for the past performance remain unresolved.

3.50 The Bangladesh experience follows that of cooperatives in other countries. In general, most COOP movements have failed because of implementation problems (Huppi and Feder, 1990). In principle, COOPs provide an important institutional solution to the problems inherent in rural credit markets. The challenge, however, is to design such a constitution which provides endogenous incentives for the cooperative management team to adopt optimal policies (Chaves, 1994).

3.51 Similar problems have affected the two Bangladeshi COOP systems. Their failures can be attributed to the violation of the basic tenets of cooperatives: they have been imposed from the top down, endowed a bureaucratic structure and lack of accountability; the basic aspects of cooperation, e.g., savings mobilization for capital accumulation, are ignored with heavy reliance on external resources; and they have a large and heterogeneous group membership.

3.52 The numerous structural and institutional problems have been well documented (Planning Commission, GOB, 1989). These include misconduct by officer bearers, fake loans, politicization, inadequate internal and external control, complex administrative structures, etc., (see, e.g., BRDB-Sonali Bank study, 1992). Numerous recommendations have been made on how to improve the COOP systems, but virtually none have been acted upon so far.

3.53 A recent ILO/UNDP (1995) study provides a review of the earlier studies, identifying the key issues and problems. The study proposes a fundamental shift away from the current organizational and procedural structure with an aim to promote genuine cooperative principles. The review and the proposed legal, regulatory, institutional and organizational changes are comprehensive. In general, the views and analysis presented in the review and action plans for reform are endorsed and are not repeated here for the sake of brevity.

3.54 The critical issue is the future role of the two agricultural COOP systems in Bangladesh. With regard to the banking aspects, unless the key issues of autonomy, institutional rationalization, governance and incentives are appropriately addressed, the COOPs will continue to be ineffective and unsustainable. Without substantive and significant changes, there seems to be little rationale for their continued existence.

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\(^5\) The GOB waived all loans up to Tk. 5000 by agricultural producers. COOP loans are technically made to the COOP society and hence being greater than the eligible amount, failed to qualify for waiver.
B: **Constraints on Access to Credit: The Framework for Secured Transactions**

3.55 Access to credit is one of the key constraints in rural finance. Farmers and rural entrepreneurs appear to have projects with high rates of return, yet they are either unable to obtain finance, or when they do, the loan sizes they are offered or interest rates they face make otherwise attractive investments unprofitable. The GOB has unsuccessfully tried to stimulate these investment opportunities by lowering the price of credit. The PSIs have failed to reach the small borrower.

3.56 The fundamental problems in RFMs are information and the inability to enforce contracts. A lender often has little or no knowledge about the borrower. Faced with uncertainty about the borrower’s intent to repay, and without an effective mechanism to recover the loan, commercial transactions are forced to be conducted strictly on non-credit basis. Buyers thus have to rely on own savings or loans from friends and relatives. Sole reliance on internal financing severely limits economic activity, especially lumpy investments. One response to these problems has been group lending that has succeeded in effectively reaching those with few assets. A majority, however, have to rely on reciprocal arrangements or on limited sources of a segmented informal market to meet their financing needs.

3.57 The role of trade and supplier’s credit has remained minor in Bangladesh, and may in fact be declining. Private rural lending remains largely in the hands of those who are able to enforce repayments through social pressure. These agents have not succeeded in linking with banks, with non-bank lenders (e.g., finance and leasing companies), or with non-financial creditors (e.g., equipment and input suppliers). Nor have such financial intermediaries established themselves in rural areas. Bangladesh's NGO solidarity group lenders have achieved world renown. Yet, on the one hand, even their operations in rural areas are limited and they are reluctant to fund larger investments needed by many farms and rural businesses. On the other, they have difficulty in obtaining refinance from formal banks. On net, the situation in rural Bangladesh is that many high return projects remain unfunded.

3.58 This section discusses the legal, regulatory, and institutional problems that contribute to the high cost and limited loan sizes confronting the small borrower in Bangladesh. It discusses options that would permit expanded access to credit by the poor and help NGOs to lower their costs and expand their financing base. The suggested changes would provide a framework in which private lenders and sellers-on-credit could profitably expand their rural operations, and provide conditions under which even state operated lenders would be able to collect their loans were they inclined to do so.

**Problems In Laws And Regulations**

3.59 Several features of the Bangladeshi legal and regulatory system limit access to credit in rural areas. The principal difficulty is the inability to use collateral for loans. Rural borrowers have limited ability to provide a mortgage on their land that would satisfy a private lender. The borrower’s have no effective ability to use movable property -- equipment, supplies, livestock -- as collateral.

3.60 Consequently, private lending in rural areas depends entirely on non-collateral enforcement systems -- how well the lender knows the borrower and how likely the lender perceives the borrower as being willing and able to repay. These information and monitoring costs are high; the result, compared with collateral based systems, is smaller loans and higher interest rates.
3.61 For movable property, the primary problem arises from a defective framework for secured transactions. This makes it difficult for private lenders to make loans secured by movable property—equipment, supplies, and livestock. These same defects limit non-financial creditors who might provide supplemental financing through natural conduits of rural credit, especially dealers and suppliers of farm inputs. It further makes it difficult for non-financial creditors themselves to get access to credit from the formal financial sector. These same defects limit the ability of NGO lenders to refinance their portfolios of loans with private formal sector lenders.

### Box 2: Importance of Movable Property Financing

The inability to finance movable property has significant implications for production and growth. Producers face high interest rates on loans for movable property—essentially because these loans are considered unsecured—and therefore invest less in such equipment. While estimates for Bangladesh are not available, a recent study estimates the cost, in terms of reduced production, due to the inability to use movable property as collateral for loans in Argentina and Brazil to be between 5% to 10% of the national GNP (Fleitig, 1995).

3.62 These defects arise from: gaps and problems in the laws, which often fail to cover important financial transactions; from problems in enforcing laws, that arise from long delays in the courts and difficulties in obtaining official assistance in enforcing court judgments; and finally from problems in institutions, such as registries, which work slowly and expensively and, therefore, discourage many types of lending that require registration. These problems arise in three areas:

**Creation of security interests:** many economically important types of security interests—types of loans against movable property—cannot easily be created in Bangladesh.

**Perfection:** the key action of publicizing the existence of loan contracts to make them safer for lenders could be simplified, made less expensive, and more secure.

**Enforcement:** the process of seizing and selling the collateral that backs the security interest is slow, expensive, and unpredictable; it relies on court procedures and government actions that cannot be depended on to produce timely results.

3.63 For real estate, the problems arise from difficulties in registration systems that make mortgages riskier than they should be; slow court procedures make it expensive to repossess and sell mortgaged property; and the impact of the law's homestead provisions (discussed below). For example, although taking "charges" on real estate or movable property are heavily regulated by statutes, the associated risks are high. This is due to the technical inadequacy of land registries. Multiple agencies can issue certificates making it difficult to establish if the title is good or whether there exist prior charges against the property (Bhuiya, 1994).

3.64 Many other legal and regulatory issues also raise the cost of supplying rural credit, limit loan sizes and access to credit. Of these, the most important are: homestead and exempt property provisions prevent small holders, preeminently the poor, from using their holdings as collateral or purchasing equipment on credit. Usury laws drive informal lenders underground, so that rural borrowers fail to get the benefit of competition or proper regulation of lending practices. The age of majority of 18 makes it impossible for a large number of married poor and heads of households under that age to sign lawful contracts to borrow.58

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58 In 1988-89, among rural females aged 15-19, 49.3% were married and 3.5% were widowed, divorced or separated. Statistics for rural males were 3.1% and 0.4% (BBS, 1991). Presumably, a large proportion of these, especially women, are under the age of 18 and hence ineligible to borrow legally.
There are no supervisory norms for personal (unsecured) lending and banks lack guidance about prudent practices. Supervisory and regulatory authorities have no system for distinguishing sound from unsound unsecured lending making it difficult for banks to predict the regulatory treatment of such loans; but regulatory treatment is key in determining profit.

Problems In Institutions

3.65 Besides the legal system, certain institutional features limit access to credit in rural Bangladesh.

3.66 Legal registries are expensive to search, they are not sufficiently open to public access, and are technically weak. This makes it expensive to register security interests in small real estate holdings, movable property, accounts receivable and chattel paper. Such registration is essential to open channels of credit to rural borrowers. Where land holdings are small and of low value, these costs make registration of mortgages prohibitively expensive and drive the poor out of the credit market. It often takes over a year for a Land Registry Office to register a transfer or conveyance of property. It becomes difficult, therefore, to prove title even though the purchaser has registered the sale. These delays lead to problems where the purchaser wants to mortgage his property by depositing title deeds.

Box 3: Registries

In most countries, the law designates the registries where security interests (debts, liens, conditional sales and leasing contracts) must be filed in order to be recognized. Bangladesh shares with Latin America, North America and some European countries a system of security interests that integrally involves registries.

Registries come in many forms: operated by state, operated by semi-public groups like chambers of commerce, or operated privately. When the incentives are correct, registries operate well. In Colombia, where the registries are run through business associations, and in Argentina, where they are run privately, the registries operate efficiently. However, in Washington, D.C. in the U.S. and in La Paz in Bolivia, the state-run registries leave much to be desired.

Many transitional economies do not use registries. Rather, agreements are filed with notaries and are not typically publicly available. Where lending against movable property has developed in economies without registries, it has tended to be limited to leasing, sales with retention of title and hire-purchase. Where more general financing of movable property occurs, a single lender, typically a bank, has general control of lending to the borrower.

3.67 Credit reporting systems are just starting for large industrial bank loans. In general, lenders have no system for basing credit decisions on past repayment performance of borrowers. Hence, borrowers who are unknown outside their area, especially the poor, have no way to gain access to credit by publicizing a strong repayment record. For agricultural credit, the banks have a pass-book system, but with inefficient information sharing among banks it fails to be an effective signaling system. Non-bank lenders and credit-sellers have no access to even this rudimentary system.

Box 4: Credit Information

One reason informal lenders lend only to those they know and formal lenders avoid informal markets is that it is difficult to get information about the repayment histories of different borrowers. This information is usually available only to local lenders and to sellers on credit who have been in the area for years. Lenders with such information hold with them some monopoly power.

Credit bureaus are one way for borrowers to establish their reputations for repayment. In Brazil and Argentina, merchants associations collect and provide information about buyers on credit. In Chile, private companies supply such information. In Bolivia and Peru, the Chambers of Commerce have such efforts underway.

Credit Bureaus are a big business in the industrial countries, where unsecured lending flourishes. Not only does a credit bureau give information about payment histories, but it provides a credible threat of denial of future access to loans to borrowers who might be tempted to default. Private companies supply the information; the state regulates access to the information and the rights of borrowers to correct the record.
Expected Market Response To Reforms

3.68 Fixing the above legal, regulatory and institutional problems could open up a number of channels of credit to the poor. Some specific measures in particular are expected to help the expansion of formal sector lending in rural areas.

3.69 To some degree, this will take place because the adjustment of homestead and exempt property restrictions will permit an expansion of traditional bank mortgage lending. To a greater degree, it will occur because banks will be in a better position to lend to merchants, stores and non-bank lenders using loans secured by accounts receivable, chattel paper and inventories.

3.70 Private formal sector lending is expected to expand in three ways: (a) traditional bank lending secured by mortgages would expand; (b) bank lending to non-traditional customers, including NGOs, using non-conventional collateral -- accounts receivable, chattel paper, inventories -- will permit new channels through which banks can reach rural poor; (c) non-traditional bank and non-bank financial institutions -- like finance companies, pawnshops, leasing companies, factors, and trade creditors -- will expand their own-financed operations.

3.71 Accounts Receivable and Chattel Paper Financing: As now practiced in Bangladesh, account receivable financing does not work. For example, Sonali Bank lends to Thana Central Cooperative Associations for onlending to Village Societies, who in turn onlend to members. The Association provides book debts and assets to Sonali Bank as guarantee. However, to date Sonali has yet to recover such debts from defaulting associations. Obviously, political motives intermingle with legal and regulatory issues to produce this result. Nonetheless, difficulties in assigning and transferring accounts, together with the difficulties in registering security interests against those accounts, make the collection process difficult and expensive. This is one key reason private lenders will not make these loans.

3.72 Lenders in Bangladesh do not accept accounts receivable or chattel paper as primary collateral. Only a few accept them as secondary collateral, after obtaining a mortgage or the personal guarantee of the borrower. These forms of financing could be important means of channeling funds from banks and private investors to dealers and to non-bank private and NGO lenders. Accounts receivable financing would permit the dealer to use the paper generated in credit sales as collateral for a bank loan. Chattel paper financing would permit the non-bank private and NGO lenders to use the loans they make -- their account debt or book debt -- as collateral for a bank loan.

3.73 On default by the NGO, the bank would be entitled to the payments from NGO’s accounts. There are two ways to monitor this. In one, the debtors (customers of the NGO) could make their payments through the bank; e.g., payments would be deposited to the bank account of the NGO. This would permit the bank to monitor the cash flow and intervene to block withdrawals in the event of an NGO default. In the second case, the bank can transfer (sell) the portfolio to another NGO that specializes in similar activities. For example, another NGO specializing in group lending might buy the portfolio of the defaulting NGO. This would ensure the bank that a position directly against the account debtor would not be necessary. In such a system where portfolios are transferred among NGOs, it is helpful to have the NGOs organize into a group that arranges the transfer of such portfolios. It would be in their group interest to do so and would raise the total value of their portfolios when considered as collateral.
3.74 Dealer financing is a potentially important mode of financing Bangladesh agriculture. However, there are problems linking this chain of dealers with the private formal sector. At the first level of operation, a wholesaler could use his stock of fertilizer as collateral for a bank loan. The pledge system works well and placing the collateral under the control of the lender provides adequate security in the Bangladesh context. But as the wholesaler removes the fertilizer from the warehouse and sells it, the bank requires repayment of the loan. Since the fertilizer is in the warehouse for only the first one or two months of a three to six month loan and crop period, banks in effect supply no more than 17 percent to 50 percent of the credit required by the wholesaler. The balance of the credit extended to the farmer is supplied out of the capital of the dealer and the wholesaler.

3.75 Accounts receivable financing would permit the bank to continue extending credit to the wholesaler. In that system, the wholesaler would use accounts receivable from farmers as collateral for a bank loan. The bank financing would remain in place until the farmer repaid the wholesaler. Permitting this to work requires simplification of the procedure of transferring accounts and a credit bureau that permits rating the accounts receivable.

3.76 Loans by NGO lenders would similarly be facilitated by changes in the regime governing accounts receivable and chattel paper financing. When banks lend to NGOs, they require as collateral the real estate of the NGO and personal guarantee of the directors. However, this is not a sufficient source of finance for the onlending program of the NGO. The size of the outstanding loans of the NGO is largely independent of the value of NGO’s real estate. If the credit line depends mainly on the real estate, the credit line will not expand as the NGOs lending program expands.

3.77 If the credit line could be secured on the chattel paper of the NGO, the many small loans that the NGO makes, bank refinancing would increase along with the lending program. In such a system, the bank would not become a lender to the ultimate account debtor, i.e., the solidarity group. Rather, it would take the portfolio of group accounts as security. The amount of loan relative to the collateral would depend on the NGO’s track record and other evidence about the quality of account debts, including the collection and monitoring system. If the NGO defaulted, the bank would be entitled to the payments from the account debtors. However, the bank need not become the creditor of the groups; it could resell the group debt to another NGO experienced in monitoring such loans.

3.78 To facilitate the expansion of accounts receivable and chattel paper financing requires actions on several fronts: simplify and reduce the cost of transferring accounts receivable and chattel paper to improve their quality as collateral; introduce a regulatory and supervision system for bank loans thus secured; designate a place for registration of security interests in accounts receivable and chattel paper that permits cheap and reliable public access; and promote credit bureaus to permit simple and accurate scoring of quality of accounts receivable and chattel paper.

3.79 Leasing and Hire-Purchase: Several leasing and hire-purchase operations are underway in Bangladesh. In leasing and hire-purchase, title to the good in question remains with the leasing or the hire-purchase company. The simplest operation in Bangladesh is the car lease. Because of centralized registration, cars are regarded as the simplest piece of equipment to recover, although repossession still requires a court order and a police action. Leasing machinery is much more difficult. It is easier for the debtor to appeal and opportunities of the debtor to resist are easier. Two separate court interventions are required: first to seize the equipment and second to sell it.
In principle, these operations fare better in court recovery cases because the lessor or hire-purchase company need prove only that payments are not being made as contracted and can proceed directly to an execution proceeding to get a court order for the police to assist in the recovery of the goods. In practice, this is not a large advantage in Bangladesh, since the completion of an execution process can also take years. This is too long a period for the recovery of movable property, which loses value rapidly with time. Indeed, leasing companies typically require supplementary guarantees in addition to the leased item — a mortgage against the property or the personal guarantee of the director of a company. For the hire purchase companies, there is a strong preference for dealing with salaried employees and using their employer and a co-worker as cosignatory.

The greatest strength of leasing operations in the context of Bangladesh is that they lend and collect with much more vigor than banks. The high arrears of public banks show symptoms of a weak incentive structure of state-owned banks. But even private banks may lend and collect without vigor if they are decapitalized and risk only public's money or are engaged in insider and related party lending. The finance and hire-purchase companies, by contrast, have only their own and shareholder's money at risk -- they do not take deposits. Another advantage of leasing and hire purchase contracts in the Bangladesh context is that the interest payment is typically treated as a leasing fee, making the transaction readily compatible with Islamic banking precepts.

There is significant scope of extending the operations of leasing and hire purchase more deeply into the rural areas. The main problems are the high costs of monitoring and collection. The repossession and sale of leased property is severely limited by the backlog in legal courts. A better legal framework could remove much of the repossession and sale process from court administration. Leasing companies also lack access to services for credit rating and reporting on customers and the lack of an appropriate and centralized registry for leased assets to prevent them from being used as collateral.

Personal Lending: Formal sector lenders in Bangladesh typically do not lend without proof of ownership of real estate. They do not lend only on the basis of past payment performance. One interesting exception to this is the private extension of unsecured credit to government employees on the cosignature of their supervisor. The latter model will typically not be applicable in rural areas, particularly to the poor. For those emerging from poverty, with good future earnings prospects and good loan repayment records, loans without collateral or proof of ownership of real estate can be an important source of funds. These loans are not made by Bangladeshi banks, although they are common in many industrial countries.

The problems lie in the absence of an effective signaling system to publicize good behavior and identify delinquent borrowers. An empirically-based credit rating system could effectively supervise and regulate personal loans. This is another area where credit bureaus can provide useful services.
3.85 Rural financial markets in Bangladesh currently operate in three largely segmented sectors. The characteristics of the sectors reflect their advantages in overcoming the fundamental problems of screening, monitoring, enforcement and transaction costs. The formal sector as presently constituted suffers from all four. Its inability to develop a suitable delivery mechanism or products to deal with rural realities combined with an inappropriate operating environment make it difficult for it to operate efficiently. In principle, the formal sector has advantages in mobilizing deposits, pooling risks by intermediating over large areas and individuals, and financing larger and longer term investments.

3.86 The advantages of the semi-formal and informal sectors lie in the areas that the formal sector is particularly weak in, i.e., "retailing" credit: screening creditworthy small borrowers who may not have adequate collateral to offer; lower transaction costs; and ability to recover loans. Their disadvantages are also in areas that will remain the strengths of the formal sector in the foreseeable future. The non-formal sectors are exposed to covariant fluctuations because of their localized operations. Their other major problem is the lack of voluntary deposit facilities, which limits the resources available to them. The informal sector does not by and large accept deposits (with the minor exceptions of mutual savings groups documented by Maloney and Ahmed, 1988). The semi-formal sector has mobilized involuntary savings, which now amount to considerable sums raising prudential concerns. At present they are not allowed to accept non-member deposits and hence cannot access large savers, nor is it advisable under the current regulatory framework and capabilities of the central bank.

3.87 It seems desirable, therefore, to exploit the comparative advantages of each sector by linking the three sectors of the RFMs. This will allow the system as a whole to intermediate in providing more cost-effective and efficient services to the rural areas. Over time, the operations of each sector are expected to become increasingly formalized with the maturing of the legal and regulatory framework, with successful intermediaries evolving to a fully integrated self sustainable system.

Linking Banks With NGOs

3.88 Most formal sector institutions, i.e., public sector banks and some private banks, are currently experimenting with group lending along the lines of the GB model. Most of these schemes fall under their poverty alleviation programs and hence target the landless and almost all are driven by a sense of "social obligation". Detailed cost data or evaluations of these programs are not as yet available, but should receive very high priority and be subjected to rigorous economic and financial analysis to establish the true benefits and costs before these programs are expanded further.

3.89 The NGO experience suggests that this highly supervised lending model is a costly operation. Substantial costs for training field workers and the "social preparation" of borrowers are essential. To be successful the programs need highly motivated staff, appropriate incentive structures and high effective interest rates (or a combination of service charges, insurance fees and nominal interest rates) to cover operational expenses. In the short run, it would be highly optimistic to assume that the formal institutions will be able to provide these services efficiently or cost-effectively. The lack of data and transparency in their poverty lending programs adds to the skepticism.

3.90 A more effective solution would be to link formal banks and established NGOs to exploit their respective comparative advantages. There are three useful models of such linkages.
3.91 (a) The NGO establishes itself as a bank. This is the extreme form of linkage in which a successful NGO converts itself into a bank. The best example of this linkage is found within Bangladesh: the Grameen Bank started as an NGO, the Grameen Bank Project, and became a formal bank in 1983. Other examples are Bancosol in Bolivia, SEWA in India and KREP in Kenya.

3.92 There are several advantages for an NGO to convert to a bank. First, it gains access to funds on the same terms as the other commercial banks. This would eliminate one layer of intermediation and the costs/fees associated with it. Second, the legal basis for using the savings of the NGO's members for relending to other members becomes firmer. Third, it can raise deposits from non-members like any other commercial bank as it will be subject to the appropriate supervision and prudential regulations of the Bangladesh Bank as a formal financial institution.

3.93 Besides these advantages, this is a crucial step in the institutional development of an NGO representing its graduation to full self-sustainability. From the rural finance policy perspective, this is the direction that larger and established NGOs should be strongly encouraged to take. To that extent, the rejection of BRAC's application for a license to become a scheduled bank is very disappointing.

3.94 (b) The NGO acts as an intermediary. In this model, the bank lends to an NGO for on-lending to its members. The NGO is responsible for the loan, bearing all credit risk, in exchange for the difference between the loan terms and the on-lending rate. Relative to grants or concessional funds, this would increase NGOs' cost of funds, but it would also represent a major step towards self sustainability.

3.95 There are several projects where banks have lent under this model, typically at the donor's behest, either using donor funds directly or by establishing guarantee funds. A significant recent development is a commercial loan from Agrani Bank to ASA. The agreement represents an important landmark for both the institution building aspect of NGOs and for the maturity of the financial system towards more effective intermediation and outreach. Several other similar proposals are under consideration by various banks which should be strongly encouraged, subject to appropriate appraisal.

3.96 The long time it took to process the loan is indicative of problems in linking PSIs and NGOs, despite the reputation and performance of a successful NGO like ASA. The lack of precedent and the comfort level of bank management are understandable. However, the lack of enthusiasm among bank staff and procedural complications despite collateral security (Dhaka office building of ASA) are issues that need to be addressed for smoother processing of similar agreements in the future.

3.97 Important as it is, this model is best suited for linking banks with big NGOs which have transparent accounting procedures and are operationally self-sufficient. Banks would probably not be interested in entering such agreements with smaller NGOs for various reasons, particularly because of their nascent institutional structure and lack of transparency in accounting practices. For these organizations, PKSF is the most appropriate channel till they attain the level of institutional capacity and professional development that makes them attractive to the formal sector institutions.

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59 This is perceived by many to be a grey area legally, although whether it in fact is an issue or not is not clear at this point and needs to be clarified by the proper authorities.

60 It is not clear why BRAC's application was rejected, despite the fact that the reputation of the sponsors is an important criteria under the guidelines for granting licenses.
3.98 (c) The NGO acts as facilitator or "broker". In this case, the bank bears the credit risk by lending directly to the borrowers and shares a part of its spread with the NGO as commission for identifying borrowers and ensuring repayments (i.e., for acting as a broker). The commission should be linked to the rate of recovery. A weaker form of this model is the facilitator version where bank lends to borrowers at the behest of the NGO, but the NGO services are paid for by a third party (usually a donor). This model has a more extensive history in Bangladesh than model (b), going back to the GOB promoted Swanirvar program, under which field staff were allowed a commission on recoveries from borrowers.

3.99 There are examples where this model has done well (e.g., MSFSCIP and RD-5 Productive Employment Program). However, while this model may be commercially viable to the bank, it requires subsidies for the NGO’s non-credit operations on which the recovery rates depend (usually involving significant donor funds and technical assistance). In general the commission to the NGOs is not enough and smaller NGOs are opting out of this arrangement. Other problems include tensions with the government agency involved and the non-conciliatory attitudes of both bank and NGO staff.

3.100 A recent study (FSRP, 1994) assessed three cases of banks’ involvement with group lending. Where banks lend directly to groups without NGO support, the recovery rate was too low to be viable at current interest rates. In the case corresponding to model (c), the subsidy to sustain NGO expenses was estimated at 45%. The break-even analysis revealed that the effective interest rate would have to be 55% for the program to be sustainable. It was only in model (b), with a "wholesale" loan from a bank to a well-run NGO, that was found to be commercially viable to both the bank and the NGO.

A Possible Division of Responsibilities in NGO Credit

3.101 Although detailed cost evaluations of the models are lacking, a possible division of responsibility between NGOs, banks, PKSF and donors that begins to suggest itself is as follows.

3.102 Model (c) is constrained by interest ceilings for agricultural lending. Currently, the banks’ margin is insufficient to allow a high enough "commission" to NGOs to cover their costs for identifying borrowers, recoveries and organizing the groups. These costs, and the social intermediation costs of “holistic” NGOs, therefore, will continue to require subsidies from donors as technical assistance.

3.103 Ceilings do not apply to non-crop lending by NGOs, and probably not to crop-lending. NGOs could, therefore, internalize non-credit costs in model (b). The poverty-focused lending of NGOs can be expanded by large NGOs borrowing from banks, and smaller NGOs from PKSF. PKSF could also borrow from the central bank and scheduled banks, pooling the funds to arrive at an interest rate small NGOs could afford. PKSF would thus provide an indirect link between banks and NGOs.

3.104 NGOs are likely to be more reliable than most of banks’ traditional customers. Nevertheless, under the current regulatory framework, it is unreasonable to expect banks to make unsecured loans to small and less established NGOs. These NGOs either have inadequate collateral, or are unwilling to offer it,

61 The numbers are derived from real cases; however, it is not known which program they refer to.
62 Probably, because this may be another grey area, which has not been put to the test on a large scale. Grameen’s seasonal loans clearly finance crop-lending, among other activities. On the other hand, other programs, e.g., BRAC’s two IFAD-financed projects for poultry and fisheries, did observe the ceiling, for reasons not clear, although the activities here were not even crop-related.
expecting collateral-free bank loans just as they lend to their borrowers. Besides risk considerations, banks lack the necessary appraisal and monitoring expertise that PKSF has developed.

3.105 The Bangladesh Bank removed the prohibition against "clean" loans about two years ago, till which time model (b) would not have been possible. BB now actively supports model (b) linkages. The banks' response has been lukewarm, with the exception of the Agrani-ASA venture noted earlier. Important constraints in this area are legal and regulatory barriers to secured transactions, as discussed in the previous section, which limit the access of NGOs to commercial finance.

3.106 With regard to crop-lending, smaller NGOs are unlikely to be interested given their self-imposed rationale focusing on non-crop anti-poverty-lending. They operate on a localized scale, especially where large NGOs are not present. Larger NGOs could undertake crop-lending for the cultivating poor more successfully than banks if interest controls are lifted. Till then, arrangements such as in GKF and MSFSCIP will be needed, with donors funding organizational inputs of NGOs. However, NGOs should be allowed a "service charge" to cover the higher cost of delivery of financial services to the cultivating poor relative to lending to other farmers. The equity or "social acceptability" argument against differential charges do not apply if the poor have no access to other sources.

3.107 In the interim, there is a need to document experience under model (c) and a continuing need for technical assistance from bilateral donors. It is crucial that all projects generate detailed cost data and be subjected to rigorous financial and economic evaluations. There is also possibly a case for bilateral donors to set up risk funds as in the MSFSCIP to encourage banks to participate. However, here again lack of documentation of actual experience with risk funds prevents a judgment on their desirability. Although once model (c) is shown to be viable, risk funds would not be required.

3.108 At present, the most important role for grant assistance is training and capacity building of credit NGOs generally. This can be channeled through a combination of support NGOs such as PACT, a network NGO, umbrella organizations of NGOs such as ADAB and CDF, and through PKSF.

3.109 PKSF has acquired valuable expertise over the years and is in a better position to absorb loan funds than when it was initially set up. It provides a focal point for donor assistance for poverty alleviation efforts, and a means of mixing soft funds with commercial funds from banks. It is also a suitable channel for grant assistance from donors to NGOs for training and institutional development.

3.110 Ideally, PKSF's lending rate should be at least as high as either (i) the cost of raising deposits by NGOs, so as not to discourage savings mobilization efforts or (ii) the sum of PKSF's costs, a realistic loan loss rate and an inflation premium. Thus in the interest of transparency, only the lending rate to PKSF would be subsidized. Subsidies to NGOs for training and institutional development, and possibly to meet operational expenses for a limited initial period, should be handled through a separate window.

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63 This would encourage PKSF to curb the first two, and preserve the real value of the loan fund.

64 In the Philippines for instance the government sponsored Grameen Bank Replication Program offers grant assistance up to 50 percent of the operational costs of a replicant NGO for up to 3 years. The original World Bank proposal to assist PKSF had included a Social Development Fund for capacity building grants. More recently, the UNDP has proposed that PKSF take over the responsibility to identify and implement capacity development grants to NGOs under the PDP program (for which UNDP is understood to have available funds of US $ 70,000 recently).
3.111 There is a pressing need for an appropriate regulatory and supervision framework to exercise some degree of prudential oversight over deposit taking NGOs, whether they are borrowers of commercial credit or not. However, the degree of oversight should be carefully considered so as not to saddle NGOs unduly with extra transaction costs, or affect their essential nature (i.e., semi-informality). The framework should be designed to ensure, _inter alia_, transparency in NGO accounts and a standardization of accounting conventions (including definitions of the recovery rate).

**Linking Banks With The Informal Sector**

3.112 Of the various segments of the informal rural credit market, three which are of potential interest from for linkage purposes are (i) trade credit, (ii) private lending agents, and (iii) pawnshops.

3.113 Trade and credit market interlinkage is an important source of finance. There are significant possibilities of using trade channels to deliver credit to the farmer's doorstep at lower cost and risk than direct delivery by formal banks. The scope is relatively greater in backward regions, suggesting a more pro-active policy stance in these areas. It is a reasonable hypothesis that greater access to formal credit by the _beparis_ (lower level traders), as well as increased flows to other marketing agents will ultimately lead to higher flows of _dadon_ and better terms to the farmers. A problem facing the _beparis_ is that lacking godown facilities, they are unable to pledge stocks (as against hypothecating them, see previous chapter). Similarly, improved access to formal credit for input dealers and security of hire-purchase contracts will lead to an increase in credit sales and competition to the benefit of farmers.

3.114 The Gramin Rin Sahajugi (GRS) scheme of BKB and RAKUB is an innovative initiative using loan agents to deliver credit to rural areas. The conditions of the scheme and current political circumstances have hampered its performance. One problem is that the present margin allowed to the GRSs is insufficient. To fully exploit the advantages of informal lenders, restrictions on on-lending rates and purposes should be removed (especially given the impracticality of monitoring them). The objective should be to promote competition among informal lenders to ensure that the market rate settles at a level that reflects costs and a normal level of profits, leading to a lowering of informal rates. Another reason for the unsatisfactory performance of the scheme is that borrowers prefer bank loans in anticipation of loan forgiveness (during the upcoming elections), which the GRSs will not entertain.

3.115 Pawnshops are another potentially important source of credit. Given the many advantages of pawnshops, they are highly successful in a number of countries (for example, their success in Thailand, Malaysia and Indonesia has spurred expansion of government-run pawnshops to compete with the private sector). In Bangladesh, their legal position is unclear and should be clarified at the earliest. This would allow them to operate openly, reducing their transaction costs, in response to the demand for their services, subject of course to an optimum degree of regulation. It is unclear if there are any explicit legal or regulatory barriers to the operation of pawnshops. Nevertheless, the issues discussed in the previous section on legal and regulatory framework for secured transactions would apply here as well and should permit increased pawning activity.

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65 With a system of such prudential oversight in place it might be possible to allow NGOs to raise deposits from non-members.
4. A FRAMEWORK FOR REFORM AND NEXT STEPS

4.1 The rationale for improving the functioning of the rural financial system is threefold. First, the enormous and unsustainable drain on budgetary resources due to PSI losses has very high opportunity costs. Second, inadequate access to financial services prevents a large proportion of small borrowers from participating in the growth process. Third, ineffective intermediation significantly constrains investment and efficiency and threatens to jeopardize future growth.

4.2 To improve the RFMs, significant policy and institutional reforms are inevitable. The problems with the formal financial system, as well as the solutions, are well known and have been conveyed to the GOB on several occasions. Most issues, however, persist and need to be addressed in a comprehensive and decisive manner. While some actions have been taken at the macro-sectoral level, the policies and institutions dealing with rural finance have been left out of the reform program. This clearly reflects a failure to appreciate the significance and the magnitude of the problem in RFMs.

4.3 To achieve tangible progress, actions must be designed to target the causes of the malaise in the RFMs rather than simply dealing with the symptoms. Evidence from other countries clearly points to the failure of policies designed to relieve the symptoms; for example, attempts to reduce default rates by superficial measures (e.g., interest remissions) without addressing the key issues of governance, incentives and enforcement have universally failed. Similarly, previous attempts at reforms in Bangladesh have been largely ineffective in producing lasting effects.

4.4 It is critical, therefore, that future reforms be undertaken as part of a coherent strategy that aims to develop the RFMs. The goal should be to increase the general availability of competitively priced and untargeted financial services by sustainable financial intermediaries. To avoid past mistakes, the strategy should be based on a consistent conceptual and policy framework. This section develops such a framework and identifies key strategic areas where actions are needed to improve the performance of the rural financial system.

4.5 The primary emphasis of the rural finance strategy should be to create a strong and efficient system of financial intermediation with sustainable institutions. For efficiency, the best strategy is to actively promote competition by encouraging private sector participation in RFMs. Over time, semi-formal institutions should be increasingly formalized (in terms of financial and accounting sophistication and transparency) and integrated into the commercial financial system. Improving the legal and regulatory framework for secured transactions and contract enforcement are also essential elements in promoting private sector participation and the flow of capital, including NGO credit, into the rural areas and must be an integral part of the reforms. With the maturing of legal and regulatory institutions, the informal transactions should also be integrated into the system, adding to the competitive market forces.

4.6 The involvement of private banks in rural areas or the transformation of the PSIs is likely to take time and should be part of a medium- to long-term strategy. For the short-run, as well as part of the integrated system in the long-run, the strategy should aim to link the formal, semi-formal and informal sectors. This will significantly improve the "retailing" of financial services to small clients in remote areas and improve the efficiency of the system as a whole to intermediate. The changes in the framework for secured transactions will significantly help speed up the process of integration and should be undertaken on a priority basis.
A. A Framework for Reform

4.7 The Government of Bangladesh has long recognized the importance of finance for development. Finance embodies two crucial aspects: "capital" (or investible resources) and the "financial system" (or the process and institutions to deliver the capital to end users) (Krahnen and Schmidt, 1994). Both are necessary components of financial markets. Unfortunately, too often developing country governments have considered subsidized capital as both a necessary and a sufficient condition for development, with little or no attention paid to institutional development for delivering the capital on a sustainable basis.

4.8 The traditional, or "supply-led", approach has repeatedly been shown to result in inefficient and unsustainable financial institutions that fail to reach a majority of the small borrowers, including the poor (Adams, et. al., 1984, Gonzalez-vega, 1984). The success of rural financial institutions that have followed the alternative, or "institution building", approach testifies the importance of institutional and mechanism design for delivering services in rural areas. In considering reforms of the RFMs in Bangladesh, therefore, it is critical to shift the policy focus from subsidized agricultural credit disbursement towards building an efficient and sustainable system of rural financial intermediation.

4.9 In fostering such a system, it is crucial to recognize the role that financial markets are expected to perform. Policy and institutional reforms should then be accordingly designed to address the problems affecting the performance of RFMs.

4.10 Role of Financial Markets: Among the many roles of financial markets, the key are: intermediation, i.e., transfer of resources (capital) from surplus individuals and areas (savers) to deficit individuals and areas (investors); agglomeration of capital, i.e., to put capital in the hands of investors who typically require more capital than individual savers can offer; and allocation, i.e., optimal distribution of scarce resources (Stiglitz, 1993).

4.11 The primary issue, therefore, is the role of RFMs in assisting the development objectives of Bangladesh. The financial system is not designed to carry out explicit social or political objectives and should not be used to do so. Alternative channels are more appropriate to deliver social transfers. For example, social imperatives such as disaster relief are best delivered by relief agencies directly to intended beneficiaries. This would ensure the most effective use of relief resources and not compromise the integrity of the financial system. There is no justification for using the public sector institutions for furthering myopic political objectives. Political interference, in various forms, has destroyed the credibility of the public sector institutions in the past and is creating externalities which threaten to undermine non-public sector operations as well.

4.12 Role of Government: The government has significant responsibilities in promoting financial markets: creation of a stable macro-economic environment, principally control on inflation; establishing an appropriate legal and regulatory framework for the efficient operation of financial markets; and effective and appropriate supervision of financial institutions (Robinson, 1994; Besley, 1994; Stiglitz, 1993).

4.13 The GOB has had considerable success in creating a favorable macro-economic environment. It has also created a vast physical infrastructure, i.e., a wide bank branch network (albeit at an enormous cost). The other roles that only the government can play, namely to regulate financial markets and to provide a legal and regulatory environment for the creation and enforcement of financial contracts, have remained largely unfulfilled so far. Unfortunately, the function that the government has no comparative
advantage in, direct intervention in markets by influencing price determination and allocation of resources, has been pervasive and has severely affected the functioning and efficiency of RFMs.

4.14 Direct interventions by GOB have not only been ineffective but they have also been very costly. A more appropriate policy for GOB, besides creating a conducive policy and regulatory framework for financial transactions, would be to invest its resources in rural infrastructure and agricultural research to more directly contribute in raising the productivity of rural investments instead of subsidizing PSIs.

4.15 Competition: To attain efficiency requires an appropriate incentive structure. At the market level, the most effective way to promote efficiency is to foster competition, de facto establishing the optimal performance based incentive structure. This principle applies to RFMs as well. Competition will force existing intermediaries to either improve their performance or be forced out of the market. It will also move the price of capital to its socially optimal level.

4.16 Effective competition can be brought about in a number of ways. One is the active encouragement of private sector institutional development at the local and regional levels, including commercial banks, innovative non-bank financial intermediaries, leasing companies, etc. The issues concerning formal sector banks moving into rural areas are discussed in the next sub-section. There are, however, other alternatives that can significantly improve the flow of funds in rural areas and help move the price in the informal capital markets to competitive levels. An important factor in promoting these intermediaries is the removal of legal and regulatory barriers to efficient conduct of financial transactions involving small borrowers. These changes would increase the provision of credit by competitive non-bank private lenders and by MBIs on a commercial basis. The graduation of successful NGOs to become bank or non-bank financial intermediaries and direct competition among PSIs in local markets are other alternatives which can improve efficiency.

4.17 The Formal Banking Sector: Given their history, and the associated economic and financial costs, a major policy issue is the future structure of the banking sector and role of PSIs.

4.18 Conceptually, market liberalization without due regard to the realities of RFMs by itself may not be a desirable goal (Stiglitz, 1993). If the net social returns to efficient financial operations are greater than the returns perceived by private lenders, public sector role can be rationalized on grounds of market failure (due to the information and enforcement problems and high transaction costs in rural areas). However, there is no rationalization for inefficiency or imprudent practices which essentially represent policy and institutional failures. With an appropriate incentive and regulatory framework, there is no a priori reason to believe that either the private or the public sector has a comparative advantage in efficiency. The success of BAAC and BRI, both in the public sector, clearly demonstrates that it possible for PSIs to become successful, given appropriate institutional and policy design (recall Box 1 on page 19.

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66 The estimated recapitalization requirement of the AGBs is about Tk. 9 billion (at the end of FY95) and their average loss over the last three years has been Tk. 1.9 billion (Tk. 2.6 billion for FY95). The budgetary impact of these figures can be gauged by the fact that the FY94 Annual Development Program was Tk. 90 billion, with agriculture’s share being Tk. 16 billion. For the same cost as the recapitalization requirements, GOB could have donated 600,000 STWs to poor farmers (using total investment cost for an STW of Tk. 15,000 estimated by IIMI-BSERT survey, 1995). Or, instead of the average annual losses, it could have donated over 126,000 STWs in each of the past three years.

67 Some examples of successful examples of non-bank financial institutions are the Savings and Loans Associations as in Benin; the Credit Unions in Guatemala; Village Credit Funds in Albania; the Credit Management Groups organized by MYRADA in India (see Yaron, et. al., forthcoming, for details).
on the transformation of BRI and BAAC, and see Chaves and Gonzalez-vega (1996) on the key role of institutional design in determining the success of nine financial institutions in Indonesia, including BRI.  

4.19 An assessment of the public and private sector roles in the current Bangladeshi context is complicated by several factors. Given the problems associated with rural transactions, whether the private sector will be interested in entering the rural areas in the near future is an open question. The withdrawal of Uttara and Pubali Banks from rural areas after privatization, and the transfer of Rupali Bank’s rural portfolio to Sonali Bank as it gets ready for privatization, suggests it is unlikely. A major deterrent for private banks is the operating environment for financial transactions. The presence of PSIs and interest rate ceilings may be crowding out private banks. The failure of the legal and regulatory framework to provide protection to the lenders obstructs even existing private (informal) sector activity. The perception by the borrowers that “bank” loans are entitlements or grants further dissuades formal sector lenders. Finally, from a prudential point of view, the supervisory capabilities of the central bank are at the moment inadequate. This raises the issue of the desirability of unfettered private sector activity without an adequate strengthening of sector regulation.

4.20 Given the key role of the formal sector in financial intermediation, the first order of priority is to ensure an environment that is conducive for the creation of efficient and sustainable institutions. This entails significant and substantive reforms to remove policy distortions and to provide appropriate incentives for the institutions to behave accordingly. As noted, competition provides the best incentive structure for optimal performance. Accordingly, the policy should be to promote competition by actively encouraging participation of private sector banks in rural areas.

4.21 Whether or how fast private banks will in fact be forthcoming is uncertain at this time. The issue then is the future of PSIs. Given their current state, it is unlikely that there will be any private sector bidders for these banks. Closure is going to be a politically difficult option; it would also create a void in already incomplete RFMs and would also entail the loss of assets built up over many years. Another option, a second best alternative till such time as there is sufficient private sector interest, might be to reform the existing institutions to put them on a sound footing. The choice among the options would depend on their relative costs and feasibility based on a thorough review of the PSIs’ portfolios. In principle, a properly designed and executed restructuring can be successfully conducted, but it would require strong political will and unwavering commitment to reforms. This would not only stop recurrent budgetary losses, but also significantly expand delivery of financial services to rural areas. Eventually, once the profitability of rural operations is demonstrated, either private banks will follow or the PSIs could be privatized, as in the case of Indonesia. In Indonesia, the private sector had a distinctive bias against the rural sector. It is only after the public sector banks proved that rural micro-finance operations can be profitable that the large private sector banks got interested and are now actively operating in rural areas (Robinson, 1995).

Research on a number of successful rural financial institutions also reveals that there is no systematic tendency for state-sponsored institutions to perform better or worse than private or NGO sector institutions (Hulme and Moseley, 1996; Yaron, 1992; CAER-HIID, 1994). The key to success is autonomy, institutional design and suitable financial policies.

There are examples where significant reforms of previously poor agricultural banks are underway, such as PBDAC in Egypt and the Vietnam Bank for Agriculture.
4.22 **Autonomy:** The most significant issue for any reforms of PSIs to be successful is whether they will continue to be run like government departments and used as conduits for transfers and granting favors for local power brokers, or whether they will be made independent to operate as banks.

4.23 A necessary condition for independence from political interference is to ensure that the PSIs are autonomous. Autonomy implies freedom to make loans based on risk and efficiency, hire and compensate staff commensurate with their skills based on market conditions, and undertake expenditures on the basis of financial performance (McNaughton, 1994). In principle, autonomy is determined by independence in decision making. In practice, state ownership as well as unregulated private ownership compromise autonomy and undermine sound management of financial institutions. While prudential regulation can control private banks, state banks are easily subjected to political goals.

4.24 A good indicator of insulation from external pressures is composition and strength of the governance structure, i.e., the board and the management. The PSIs need to be reoriented in their mission, role and strategy to operate as banks. Accordingly, the control and management functions of the institutions need to be conducted in an independent and professionally competent manner. The composition and outlook of their boards needs to be more commercial, with adequate representation of business and banking experience. The management of the PSIs should be in the hands of skilled and professional bankers, with clear and transparent functions, responsibilities and incentive structures.

4.25 The critical importance of autonomy is well demonstrated by the recent experiences of the Vietnam Bank for Agriculture, Banades Bank in Nicaragua and Banco Agricola in the Dominican Republic. Despite well designed and thorough institutional reforms, the performance of Banades Bank and Banco Agricola has failed to improve because of weak governance and continued political interference. At the same time, the ability of banking officials to restrict political interference in the affairs of the Vietnam Bank for Agriculture has helped significantly improve its performance.

4.26 **Deposit Mobilization:** Of the two basic aspects of financial intermediation, namely deposit mobilization and lending, the former is less problematic both in principle and in practice. Deposit mobilization is central to the sustainability of a financial institution: it promotes autonomy by warding off pressures and conditionalities imposed by external funds, it generates resources for lending and promotes efficiency by forcing the institution to operate on commercial principles. On the demand side, deposits serve two key roles in a risky environment: they provide security against income fluctuations obviating the need for contingency borrowing, and help build financial discipline, equity, and hence creditworthiness, of individuals (repeat transactions establish lender-borrower history).

4.27 Given the multidimensional benefits of deposit services, and an apparently huge unmet demand in rural areas, the provision of safe, accessible and liquid savings facilities has been the most neglected aspect of rural finance in Bangladesh. The formal sector institutions, who are the only appropriate institution to provide this service (for prudential reasons) have performed poorly because of adverse incentives to mobilize deposits. For effective financial intermediation, it is essential to re-orient the mission and incentives of banking institutions to properly emphasize savings services.

4.28 **Interest rates:** The primary financial policy reform needed is to lift the ceiling placed on interest rates. Research on successful financial institutions around the world has shown that the most significant variable in explaining their financial sustainability is the interest rate (CAER-HIID, 1995). Subsidies impose huge budgetary costs, create adverse incentives for staff and divert resources to less productive
uses. Although well intentioned, this policy has not only failed to deliver the subsidy to intended beneficiaries, it has also discouraged deposit mobilization.

4.29 The current situation in Bangladesh is paradoxical. Interest rates for high cost operations like agriculture (and small scale industries) are restricted to fluctuate within a band (10%-14%), while interest rates for other activities have, at least in principle, been completely liberalized. The imperfect and incomplete nature of RFMs make it difficult to establish a "market" rate of interest. As a practical matter, financial institutions should be allowed to set interest rates that cover their costs (cost of funds, administrative costs and default costs) and earn a nominal profit to ensure growth. Clearly, for sustainability, a lower interest rate requires curbing defaults or reducing other components of cost.

4.30 The feasibility of charging high effective interest rates, and the willingness to pay by rural borrowers, is amply demonstrated by the success of MBIs in Bangladesh. Also, interest rates charged by informal lenders continue to be substantially higher than the real interest rates charged by the PSIs. There is significant evidence showing that access to high quality financial services is more important to borrowers than the interest rate. This finding is not specific to Bangladesh, but is found universally. (Hulme and Moseley, 1995, CAER-HIID, 1994; and Otero and Rhyne, 1994).

4.31 Insurance: An important issue is how to deal with frequent natural disasters and their impacts on borrowers and lenders. For borrowers, almost every traditional crop insurance scheme around the world has proven to be a costly disaster (Gudger, 1991). The problems, besides design and management issues, arise due to covariant nature of disasters, moral hazard and political intervention.

4.32 There is clearly a need for innovative insurance alternatives that can overcome these problems. One example of such scheme is a simple drought or flood ticket (Hazell, 1992). Based on exogenous and objectively verifiable criteria, the scheme overcomes several objections to traditional insurance, particularly moral hazard and adverse selection problems and transaction costs (insurance lotteries can be sold by local shopkeepers/lottery vendors). To avoid political manipulation, it would be advisable to encourage private sector provision of such insurance, subject to appropriate regulations. Whether such a scheme would be feasible in the context of Bangladesh and the final modalities would need a detailed and thorough investigation.

4.33 For PSIs, one proposal is the Agricultural and Rural Credit Guarantee Fund (ARGF) designed to insure default losses to banks due to unforeseen risks. The scheme raises several issues, the primary being the potential for political misuse and prospects for an unbiased implementation. It is also not clear if there are advantages to such a scheme over, say, an up-front insurance premium/fees charged to borrowers.

70 To get a crude idea of the level of distortion, consider the interest rates that BKB would have to charge to become financially viable. On a cost plus basis, using current BKB estimates for default costs of 8.5%, administrative costs of 3.9%, average cost of funds of 6.0% and a 1% profit (for growth), the break even interest rate would be about 21.2%. Thus with current ceiling of 14% the provision of PSI credit in rural areas is simply not viable. However, it should be noted that this is at the current levels of operational efficiency and institutional structure.

71 A crop insurance scheme piloted in Bangladesh by the Sadharan Bima Corporation since 1977 has had a similar experience.

72 For example, in a purely hypothetical case, if the probability of a flood/drought is 10% in a given area and the average cost of administration of the scheme is 2% of total indemnity value, a ticket could be sold to individuals for Tk. 12 redeemable for Tk. 100 in the event of a flood/drought.
Almost all MBIs use the latter to cover default risks, even for agricultural loans. Further, it remains unclear if there are net gains to be had from yet another public sector endeavor.

4.34 Given the frequency of natural disasters, the political imperative of disaster relief and the need to restore the integrity of the rural credit system, the issue of dealing with natural disasters appropriately and cost-effectively needs to be addressed urgently in a comprehensive and consistent framework. A complementary study by the Asian Development Bank is intended address the key issues and is currently underway.

B. Main Messages

4.35 Within the broad framework outlined above, four key messages emerge from this report:

(a) **Extend financial sector reforms to the rural financial sub-sector:** The issues concerning sectoral management and policy are not new and have been part of a long-standing dialogue with the Government on financial sector reforms. However, these reforms have so far been restricted to the non-rural banking sector, specifically excluding the agricultural banks and the rural operations of NCBs. It is essential to extend the reforms to cover the RFMs and to make financial policy issues consistent across sub-sectors. The former includes strengthening Bangladesh Bank to deal with the management of the rural financial sector and expediting legal reforms for loan recovery with adequate attention paid to the issues surrounding rural credit. The latter includes a consistent interest rate policy, specifically removal interest rate ceilings on rural credit, and a consistent re-discount policy for the agricultural banks as for commercial banks.

(b) **Stop political interference in the operations of rural financial intermediaries:** The biggest obstacle to the development of healthy rural financial institutions is the pervasive political interference in their management and operations. A pre-requisite for any reforms for the formal sector is to allow the banks complete functional and operational autonomy to perform as banks. Without the ability to adopt policies that are consistent with their financial viability and operational efficiency, there is little hope for the current institutions to become either sustainable or effective in delivering essential services to prospective rural clients. Critical areas for banks’ viability are: freedom to set interest rates and other policies; freedom from politically motivated loan and interest forgiveness programs; freedom from pressures to meet disbursement targets; and political interference in borrower selection.

(c) **Create a legal and regulatory framework for secured transactions to promote increased access to credit by the poor:** A framework that helps in the creation, perfection and enforcement of collateral can significantly increase access to credit for the rural poor from banks as well as non-bank private lenders. It will also significantly expand access of NGOs to capital markets. The current legal and institutional framework in Bangladesh suffers from a number of defects which hinder the functioning of all three aspects of a secured transaction. Most forms of collateral that the poor and businesses have to offer, such as movable property, accounts receivable, credit history or good previous repayment performance, cannot be used to access credit in Bangladesh. At the same time, lenders are handicapped in extending credit due to absent or deficient institutions and laws that fail to protect them against potential default, and in some cases prevent them from even making
loans. Removal of these obstacles should be among the top priorities in reforming the RFMs.

(d) Promote integration of the formal, semi-formal and informal sectors to improve the efficiency of rural financial intermediation: The delivery of financial services could be significantly improved if the current fragmentation of the RFMs could be overcome. Integration can improve the efficiency of RFMs by exploiting the comparative advantages of each sector. In the short-run, it provides a cost-effective mechanism to significantly increase the outreach of formal institutions and also provide access to resources for NGOs and competitive informal sector intermediaries. For the long-run, it would improve the efficiency of RFMs by allowing the system as a whole to intermediate, improving both the allocation of resources and reducing costs of rural financial intermediation. Some linkages already exist and other potentially important ones are emerging. The removal of institutional inertia and political obstacles to emerging linkages should be given a very high priority.

C. Next Steps

4.36 In working towards the goal of an efficient system of financial intermediation, actions need to be taken on several fronts. Some of these actions can be implemented in the short-run while others will require a medium- to long-run time horizon. Most policy and institutional issues are mutually reinforcing. While proper sequencing of certain reforms is necessary, to achieve the desired results actions on complementary issues can and should be initiated simultaneously.

4.37 These actions, in consonance with the broad strategy for rural finance and the analysis presented in this report, can be broadly classified into three categories: formal sector issues, the framework for secured transactions and integrating the financial system. Prior to these actions, however, the significance of the extension of sectoral reforms to the rural financial sector cannot be emphasized enough. Key among these are the strengthening the management capabilities of the Bangladesh Bank to cover the rural financial sector and a consistent macro-financial policy framework, particularly the lifting of interest rate ceilings on agricultural credit and replacing refinance facility for the agricultural banks by a re-discount window as for other banks. As an integral component of the process of financial intermediation, savings mobilization must be given high priority.

Formal Sector Issues

4.38 Institutional Design: For the performance of existing public sector banks to improve in a significant and sustainable manner, significant reforms are necessary. Most of these are well known and will yield results only in the long-run. However, they need to be re-emphasized and prioritized as integral part of the rural finance reform strategy. Subject to the policy reforms mentioned above, critical areas for action include:

(a) deposit mobilization;
(b) institutional and staff incentive structures, e.g., profit sharing;
(c) human resource management policies;
(d) management information systems;
(e) decentralized decision making;
(f) expedite upgrading of accounting practices to acceptable standards.
4.39 **Product and Process Design:** Several lessons learned from MBIs, the informal sector and successful financial institutions in other countries can be used to design new products and services to improve the outreach and efficiency of the delivery mechanism. Some of these are:

(a) ambulatory services to reduce transactions costs, especially for savings services;
(b) develop new and varied savings instruments to increase access and flexibility;
(c) use flexible conditions on purpose and terms of loans to suit client needs and cash flow;
(d) borrower incentives such as larger repeat loans and penal charges for delinquent loans;
(e) experiment with group lending to reach small and marginal farmers using the approaches developed by GKF and MSFSCP. However, a strong word of caution is to place significant importance to transparency of accounts and recording of costs information to allow proper evaluation of all experimental schemes.

4.40 **Agricultural Banks:** Based on un-audited data provided by the two agricultural banks, they are both currently making losses and are technically insolvent. The immediate next step for BKB and RAKUB is to undertake a comprehensive external portfolio and operational audit, including an in-depth analysis of the management systems, accounting procedures and practices, and corporate policies affecting the quality of their portfolio. Based on the results of the audit, the next steps would have to be determined. If it is not possible for the institutions to become financially viable in the future, drastic actions including closure would have to be considered. If financial viability is possible after appropriate restructuring, reforms would be needed to ensure that the risk of similar problems re-surfacing in the future are minimized. At the minimum, these reforms would have to address the issue of political interference by establishing an independent, competent and commercially oriented governance structure.

4.41 **Cooperatives:** The ILO has proposed a detailed set of recommendations for reforms. In addition, with regard to the agricultural cooperatives, it should be noted that unless concrete steps are taken to address the issues of incentives, governance and administrative structures, the performance of these cooperatives is unlikely to improve, providing little justification for their continued existence.

**Framework for Secured Transactions:**

4.42 **Problems in Laws:** Several legal barriers prevent increased access to credit for a large number of rural poor. A framework for secured transactions and mortgage lending could be put in place in the short-to medium-run to remove these barriers. The precise nature of legal and regulatory changes that would be necessary and the economic implications of specific options would require detailed discussions between legal experts drawn from the commercial and financial community as well as experts experienced in the reform of secured transactions from other countries. Broadly, areas where changes should be focused are:

(a) laws to permit a wider range of security interests, e.g., movable property, accounts receivable and chattel paper;
(b) laws to expedite repossession and sale of collateral under private agreement to relieve the burden on the court system and help expansion of leasing and hire-purchase financing;
(c) elimination of usury laws and substitute truth in lending disclosure to encourage competition and increased provision of financial services by private lenders;
(d) rationalization of the homestead and exempt property provisions to allow for a general reserve, not specific property, to improve the collateral quality of poors' assets; and
(e) link the age of maturity to verifiable civil status (e.g., marriage or having a child) to permit more of the young married poor or heads of households to sign lawful contracts.
4.43 **Problems in institutions**: The institutional framework for creating and monitoring the security of financial transactions is at present weak and inefficient. Reforming these institutions or creating of new institutions are essential elements of a long-run strategy. Their success, however, is dependent on the legal changes mentioned above and the provision of incentives to promote desired behavior. Some areas where essential reforms are needed are:

(a) regulation and supervision of loans secured by accounts receivable and chattel paper;
(b) expansion, modification and unification of public registries to reduce costs, improve efficiency in accessing information on existing liens; and improve the quality of collateral;
(c) promotion of credit bureaus to improve information and signaling systems for all types of loans including personal loans; invite modern credit reporting agencies to explain to local businesses and chambers of commerce on how to establish and make the system work; eliminate legal barriers to the operation of credit bureaus; introduce a system of Bank supervision and regulation of personal loans that uses information from credit bureaus.

**Integration**

4.44 **NGOs**: Pro-active steps by both the Government and the NGO community can significantly improve the flow of rural financial services, to the mutual advantage of all stakeholders. The institutional and capacity building of smaller NGOs are important medium- to long-run actions. In the short-run, linkages between established NGOs with existing banks can be encouraged. However, it is important to recognize that the development of NGO programs must proceed in a manner and at a pace that the existing institutional and human capital capacity can sustain. Therefore, whether to build on past success or to expand its scope to include small and marginal farmers, the pressure to speed up the pace of expansion of successful programs should be strongly resisted. With these caveats, some important steps towards integrating the NGOs and the commercial financial markets are:

(a) developing an appropriate oversight and regulatory framework for the NGO sector, especially in the light of the significant volumes of deposits being mobilized by them;
(b) encouraging successful NGO's to establish themselves as banking institutions (to subject them to prudential norms and also expand flow of resources to the poor);
(c) PKSF should be strengthened both financially and institutionally, and encouraged to put additional focus on the capacity and institutional building aspects for small NGOs;
(d) explore possibilities of using NGOs to mobilize self-help savings groups to provide lower cost and more accessible savings facilities in rural areas.
(e) larger NGOs, or NGOs certified by PKSF, should try to establish linkages with banks;
(f) banks should actively explore ways of using smaller NGOs as brokers or facilitators, in exchange for a fee, to increase outreach and reduce costs;
(g) allow NGOs to charge a “service fee” in recognition of the additional costs associated in dealing with small producers and crop-lending;
(h) strongly encourage and support experimental approaches and research on perfecting the group lending methodology for small farmers such as those of GKF and MSFSCIP, and encourage other NGOs to reach out to small and marginal farmers; and
(i) channel grant assistance increasingly to training and capacity building of credit NGOs through support and network NGOs and the PKSF.
4.45 Informal sector: Greater integration of the formal and informal sectors would increase the flow of competitively priced finance in rural areas. Actions on different fronts can have a mutually reinforcing effect in increasing the outreach of the formal sector institutions. Some examples are:

(a) banks could increase trade credit and suppliers credit by proper training and orientation of concerned staff; this would allow greater flows of banks’ funds to rural areas;
(b) the terms and conditions of the experimental GRS scheme of BKB should be revised to make them incentive-compatible for the GRS and to encourage greater participation; and
(c) clarify the position on pawning to encourage the private sector and local governments to provide this useful service, subject to optimum prudential regulation.
REFERENCES


### Appendix

**Table 1: AGRICULTURAL CREDIT STATISTICS***

*(Taka crores at current prices)*

<table>
<thead>
<tr>
<th>Year</th>
<th>Program/Target</th>
<th>Disbursement</th>
<th>Due for Recovery</th>
<th>Recovery</th>
<th>Percentage of Recovery</th>
<th>Overdue</th>
<th>Outstanding</th>
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<td>1983-84</td>
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<td>595.78</td>
<td>23.57</td>
<td>1932.38</td>
<td>3863.49</td>
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<td>1992-93</td>
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<td>4719.93</td>
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<td>18.42</td>
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<td>1993-94</td>
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<td>1100.78</td>
<td>5141.18</td>
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<td>19.04</td>
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<td>1994-95</td>
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<td>1096.77</td>
<td>19.68</td>
<td>4479.17</td>
<td>7068.29</td>
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*Source:* Bangladesh Bank

*Note:* Provisional data for 1994-95.
Table 2: Agricultural GDP and Credit*

<table>
<thead>
<tr>
<th>Year</th>
<th>AGRIC. GDP</th>
<th>NCB</th>
<th>By Organization</th>
<th>By Type</th>
<th>Other(2)</th>
<th>Total</th>
<th>Total Credit as % of Ag. GDP</th>
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<td></td>
<td>BKB/ RAKUB</td>
<td>Crop</td>
<td>Term Credit(1)</td>
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<td></td>
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<td>1005.3</td>
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<td>614.7</td>
<td>123.6</td>
<td>564.8</td>
<td>1152.8</td>
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<td>667.3</td>
<td>(3) 3.04</td>
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<td>379.2</td>
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<td>656.3</td>
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<td>30059.6</td>
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<td>1991/92</td>
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<td>n.a.</td>
<td>389.7</td>
<td>958.1</td>
<td>65.1</td>
<td>n.a.</td>
<td>1479.9</td>
<td>n.a.</td>
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</table>

Source: Bangladesh Bank.

*Provisional data for FY95.

(1) Includes agricultural term credit as well as financing for marketing, transportation and agro industries.

(2) Includes loans for fisheries, tea production & cold storage facilities for agricultural products.

(3) Includes some loans for which breakdown is not available.
Table 3: Status of Agricultural Loan Recovery*
From July 1, 1994 to June 30, 1995
(Taka crores at Current Prices)

<table>
<thead>
<tr>
<th>Name of Bank/Organization</th>
<th>Amount of loans overdue from previous years</th>
<th>Recovery from loans overdue from previous years</th>
<th>Percentage of recovery</th>
<th>Amount of loans due in the current year</th>
<th>Recovery from loans due in the current year</th>
<th>Percentage of recovery</th>
<th>Total recoverable loans</th>
<th>Total loans recovered</th>
<th>Percentage of recovery</th>
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<tr>
<td>Sonali</td>
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<td>59.01</td>
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<td>149.35</td>
<td>60.89</td>
<td>40.77</td>
<td>744.58</td>
<td>119.90</td>
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<td>Janata</td>
<td>239.73</td>
<td>42.48</td>
<td>17.72</td>
<td>102.80</td>
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<td>39.34</td>
<td>342.53</td>
<td>82.92</td>
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<tr>
<td>Agrani</td>
<td>141.93</td>
<td>43.36</td>
<td>30.55</td>
<td>94.42</td>
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<td>31.77</td>
<td>236.35</td>
<td>73.36</td>
<td>31.04</td>
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<td>Rupali</td>
<td>63.19</td>
<td>7.86</td>
<td>12.06</td>
<td>13.72</td>
<td>2.91</td>
<td>21.21</td>
<td>78.91</td>
<td>10.77</td>
<td>13.65</td>
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<tr>
<td><strong>Sub-Total</strong></td>
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<td><strong>152.71</strong></td>
<td><strong>19.65</strong></td>
<td><strong>360.29</strong></td>
<td><strong>134.24</strong></td>
<td><strong>37.26</strong></td>
<td><strong>1402.37</strong></td>
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<td>2204.69</td>
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<td>RAKUB</td>
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<td>300.44</td>
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<td>40.05</td>
<td>1053.12</td>
<td>178.83</td>
<td>16.98</td>
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<tr>
<td><strong>Sub-Total</strong></td>
<td><strong>2315.21</strong></td>
<td><strong>164.66</strong></td>
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<td><strong>Sub-Total</strong></td>
<td><strong>831.16</strong></td>
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<td><strong>1.14</strong></td>
<td><strong>82.84</strong></td>
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<td><strong>Grand Total</strong></td>
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<td><strong>7.80</strong></td>
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<td><strong>55.56</strong></td>
<td><strong>5574.18</strong></td>
<td><strong>1096.77</strong></td>
<td><strong>19.68</strong></td>
</tr>
</tbody>
</table>

**Summary**

| FY: 94-95 | 4188.45 | 326.86 | 7.80 | 1385.73 | 769.91 | 55.56 | 5574.18 | 1096.77 | 19.68 |
| FY: 93-94 | 3921.03 | 370.80 | 9.46 | 1220.83 | 608.32 | 49.83 | 5141.96 | 979.12 | 19.04 |

*Source: Bangladesh Bank
*Provisional data for FY95
IMAGING

Report No: 15484 BD
Type: SR