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U N C L A S S I F I E D

AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D.C. 20523

PROJECT PAPER

BANGLADESH

Financial Sector Reform Program
Technical Assistance Project
388-0078

Dated: June 6, 1990

U N C L A S S I F I E D

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROJECT DATA SHEET

1. TRANSACTION CODE: A (A = Add, C = Change, D = Delete) — Amendment Number

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2. COUNTRY/ENTITY: BANGLADESH

3. PROJECT NUMBER: 388-0078

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5. PROJECT TITLE (maximum 40 characters): Financial Sector Reform program - TA

6. PROJECT ASSISTANCE COMPLETION DATE (PACD): MM 08 DD 31 YY 95

7. ESTIMATED DATE OF OBLIGATION (Under 'B.' below, enter 1, 2, 3, or 4)

A. Initial FY 90 B. Quarter 3 C. Final FY 94

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY 90 B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total						
(Grant)	(6000)	(-)	(6000)	(19500)	( )	(19500)
(Loan)	( )	( )	( )	( )	( )	( )
Other U.S. 1.						
Other U.S. 2.						
Host Country					1700	1700
Other Donor(s)				1500		1500
TOTALS	6000		6000	21000	1700	22700

9. SCHEDULE OF AID FUNDING ($000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE 1. Grant	2. Loan	D. OBLIGATIONS TO DATE 1. Grant	2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	2. Loan	F. LIFE OF PROJECT 1. Grant	2. Loan
(1)	FN	200	040			19500		19500	
(2)									
(3)									
(4)									
TOTALS						19500		19500	

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each): 246 253

11. SECONDARY PURPOSE CODE

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code	BR	BS	EQTY	PART			
B. Amount							

13. PROJECT PURPOSE (maximum 480 characters)

1. To implement more flexible Monetary policies by Bangladesh Bank, and to improve BB's supervision of the nationalized commercial banks. 2. To develop financially sound NCBs that are suitable for privatization. 3. To prepare the NCBs for privatization, and expand the share of the banking sector controlled by private banks, including continuing the movement toward divestiture of the NCBs.

14. SCHEDULED EVALUATIONS

Interim MM 01 YY 92 MM 02 YY 93 Final MM 03 YY 95

15. SOURCE/ORIGIN OF GOODS AND SERVICES

[X] 000 [X] 941 [ ] Local [ ] Other (Specify)

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ____ page PP Amendment.)

17. APPROVED BY

Signature: Jack C. Gunther, Jr.

Title: Acting Mission Director USAID/Dhaka

Date Signed: MM 06 DD 06 YY 90

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION

MM DD YY

AID 1330-4 (8-79)

UNITED STATES OF AMERICA
AGENCY FOR INTERNATIONAL DEVELOPMENT
Dhaka, Bangladesh

PROJECT AUTHORIZATION

NAME OF COUNTRY : Bangladesh

NAME OF PROJECT : Financial Sector Reform Program Technical Assistance

NUMBER OF PROJECT : 388-0078

1. Pursuant to Section 103 of the Foreign Assistance Act of 1961, as amended, I hereby authorize the Financial Sector Reform Program Technical Assistance Project (FSRP TA) for the People's Republic of Bangladesh involving planned obligations of an amount not to exceed Nineteen Million Five Hundred Thousand United States Dollars ($19,500,000) in grant funds over a five year period from the date of authorization subject to the availability of funds in accordance with the A.I.D. OYB/allotment process, to assist in financing foreign exchange and local currency costs for the project.

The planned life of the project is five years from the date of initial obligation.

2. The project will assist in restructuring the commercial banking system in Bangladesh to permit more efficient use of scarce capital resources for economic development. This will be accomplished by providing technical assistance, training and commodities to strengthen the Bangladesh Bank and the Nationalized Commercial Banks (NCBs) and to support the Government of Bangladesh program for privatization of the NCBs. The assistance will promote, among other things, use of flexible indirect instruments for implementing monetary policy, improved bank supervision, profitability of commerical banks and an increased share in banking sector activities for private banks. The project provides parallel financing for a much larger financial sector reform program undertaken by the Bangladesh Government which includes major credit inputs from the World Bank/International Development Association (IDA) and additional technical assistance from the International Monetary Fund.

3. The Project Agreement which may be negotiated and executed by the officers to whom such authority is delegated in accordance with A.I.D. regulations and Delegations of Authority shall be subject to the following essential terms and conditions, together with such other terms and conditions as A.I.D. may deem appropriate.

a. Source and Origin of Commodities, Nationality of Services

Except as A.I.D. may otherwise agree in writing:

Commodities financed by A.I.D. under the project shall have their source and origin in Bangladesh or in countries included in A.I.D. Geographic Code 941. Except for ocean shipping, the suppliers of commodities or services shall have Bangladesh or countries included in A.I.D. Geographic Code 941 as their place of nationality.

Ocean shipping financed by A.I.D. under the project shall be financed only on flag vessels of the United States, other countries in A.I.D. Geographic Code 941 and Bangladesh.

b. Conditions Precedent

Prior to any disbursement, or the issuance of any document pursuant to which disbursement would be made, under the bilateral Project Grant Agreement, the Bangladesh Government shall, except as A.I.D. may otherwise agree in writing, furnish in form and substance satisfactory to A.I.D.:

(i) a statement of the names of persons authorized to represent the Grantee for purposes of this project, together with specimen signatures of each person so specified in the statement;

(ii) evidence that the Grantee and IDA have executed a loan agreement for IDA's Financial Sector Credit and that the agreement has become effective; and

(iii) evidence that the Grantee, through the agency of the Bangladesh Bank, has established a Review Committee to oversee progress on all aspects of the Financial Sector Reform Program.

Jack C. Gunther, Jr.
Acting Mission Director

Date: June 6, 1990

Clearance:		Date
OEE/JMudge		6/5/90
PDE/ZHahn		6/6/90
PRO/A:MWarren		6/5/90
CONT/A/JThompson	JJ	6/6/90

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FINANCIAL SECTOR REFORM PROGRAM
TECHNICAL ASSISTANCE PROJECT

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FINANCIAL SECTOR REFORM PROGRAM

TECHNICAL ASSISTANCE PROJECT

SECTION ONE

SUMMARY AND RECOMMENDATION

The Financial Sector Reform Program Technical Assistance Project (FSRP TA) set forth in this Project Paper is a US $19.4 million A.I.D. Grant to the Bangladesh Government (BDG). The Project is comprised of technical assistance, training and commodities. The Project is intended to improve the functioning of the Bangladesh financial sector in a way that will cause more efficient use of capital resources in economic development. The Project will improve investment efficiency by strengthening the Bangladesh Bank's (BB) ability to implement a broad program of monetary and banking reform, improve bank supervision and restructure four Nationalized Commercial Banks (NCBs) with the goal of their eventual privatization. The FSRP TA is to be carried out in coordination with the BDG's Financial Sector Reform Program (FSRP) which is supported by a World Bank International Development Association (IDA) US $175 Million loan, and by an International Monetary Fund (IMF) $1.5 million technical assistance program. The IDA loan is conditioned on BDG implementation of a major program to restructure the commercial banking regulatory and legal framework.

It is recommended that this Project be authorized for fiscal year 1990 funding, with a five year implementation period, subject to the Conditions and Covenants set forth in the Draft Authorization included in this Project Paper.

This PP sets forth the justification for authorization of the Financial Sector Reform Program Technical Assistance (FSRP TA) Project, proposed by the United States Agency for International Development Mission in Bangladesh (USAID/Bangladesh). The PID for this Project was approved by AID/W in State Cable 112633 dated 12 April 1989, a copy of which is included in Executive Annex, E.X.1.

The terms used in the PP are as follows: "Program" and "FSRP" refer to the entire BDG/IDA/AID/IMF program. "Project," FSRP TA or FSRP TA Project refer to the A.I.D.-financed technical assistance component of the Financial Sector Reform Program (FSRP). Financial Sector Credit and FSC refer to the IDA $175 loan to the BDG to support the FSRP.

SECTION TWO

PROJECT BACKGROUND AND RATIONALE

2.1 Background

2.1.1 Broad Context: Major inadequacies in the financial market and institutions inhibit the formal financial sector of Bangladesh from performing an effective and dynamic role in the economic development of the country. The existence of this deep-seated structural problem is manifest in various symptoms: inappropriate or inadequate monetary policy regime; inadequate bank supervision; inadequate mobilization of savings; misallocation of credit; widespread loan defaults and delinquencies; and inefficient credit delivery. The prevalence of these problems closes markets, and reduces the level of savings, investment, capital productivity. The result is a suboptimal use of resources and a lower growth rate of the economy, with consequent diminished employment opportunities. These problems apply to all aspects of the economy and to all regions of the country.

2.1.2 The BDG and International Donor Community Response: In order to address these problems, the Bangladesh Government (BDG) is planning to institute a Financial Sector Reform Program. The Financial Sector Reform Program is partially built upon the experience gained in the A.I.D. Rural Finance Project (388-0037). To support this program and encourage its adoption, the World Bank/International Development Association (IDA) is making available US $175 million, which is scheduled to be disbursed in three tranches: $50 million each in June and December 1990 and $75 million in December 1991. Each tranche is conditioned upon the BDG fulfilling certain policy commitments. Similarly, the International Monetary Fund (IMF) is furnishing four person years of technical assistance to the Bangladesh Bank (BB), subject to fulfillment of the same commitments, to assist the BB to develop a tendering mechanism for the sale of BB bonds to the commercial banks. A.I.D. intends to assist in the implementation of the FSRP with the FSRP TA Project.

2.2 Project Rationale

The rationale underlying the proposed A.I.D. Financial Sector Reform Program Technical Assistance Project is that supporting the FSRP through the provision of technical assistance, training and commodities will make possible an increase in the operating efficiency and loan recovery capability of the formal financial sector, while stopping the use of the banking system to subsidize other sectors of the economy. At the same time, the Project will realize a broad financial liberalization and enable privatization of NCBs in Bangladesh. Assistance to improve the financial and management condition of

the NCBs is expected to permit their divestiture to the private sector by the end of the Project. Restructuring the regulatory framework and divestiture of the NCBs will significantly increase the degree of competition in the banking industry. The reforms and technical improvements will lead to a increased efficiency in the allocation and use of capital with consequent increases in economic growth and greater employment opportunities throughout Bangladesh.

2.3 Relationship of Project to BDG Development Strategy and Historical Background

2.3.1 Introduction: As described more fully in Annex TA3, (Background Analysis: Financial Sector Policies, 1971-1989), the policy of the BDG began to evolve in the later 1970's from its prior emphasis on statism and centralized control of the economy to growing reliance on markets. This shift became more pronounced from 1982 on, as the BDG began to recognize and respond to the failures of statism represented by deteriorating growth performance, accelerated inflation, and increased pressure on the balance of payments. These adverse economic developments convinced the Government that the appropriate development strategy for Bangladesh would be to reduce the bias against exports and create more favorable conditions for private sector expansion through a sustained policy of liberalization and deregulation. The implementation of these macroeconomic policies, particularly fiscal and exchange rate policies, provided the basis for initiatives toward policy reform industry, agriculture, trade and finance.

2.3.2 The NCMBC: A major landmark in the evolution of financial sector policies was the convening, in June 1984, of the National Commission on Money, Banking and Credit (NCMBC). The NCMBC presented its report in June 1986. The NCMBC report set the policy agenda for reform of the financial system for the next several years and constituted the medium-term BDG strategy for financial sector development. Both the Third and Fourth Five-Year Plans (1985-90 and 1990-95 respectively) stress the need for increased domestic resource mobilization and recognized that financial sector reform was necessary if realization of resource mobilization goals were to be achieved.

2.3.3 The Rural Finance Project: Also in 1986, the USAID Rural Finance Project (RFP) was attempting to develop a viable rural banking system. The emphasis on rural banking arose from the great importance placed by both the Government and the Mission on providing financial services in rural areas to increase agricultural output and rural employment growth. Experience with the RFP showed that subsidized credit could be moved readily into the rural sector, but the program was not sustainable because of a high default rate and the presence of major systemic

deficiencies. Because of the deficiencies, rural banking could only be conducted by Government-owned banks, including the NCBs, because low interest rates and high default rates guaranteed losses which in turn were covered by refinancing from the BB. The initial moves under the RFP to improve bank performance resulted in a slowdown in loan disbursements as bank managers increased tightened loan screening and recovery efforts. The result of requiring more sustainability in rural lending was a contraction in net lending.

As a result of the RFP experience, the Government and USAID learned that improvement of rural banking operations would require fundamental changes in the entire formal financial system. It was not feasible for the monetary authorities to address policy issues such as loan recovery, interest rate flexibility, and accounting reforms on a piecemeal basis nor as they applied to a single sector. When the FSRP was first formulated it was to encompass the BB, the commercial banks and the two agricultural banks. Further study indicated that the magnitude of the task was too large. The BDG decided that it would first concentrate on restructuring the regulatory environment and the BB's ability to supervise a less constrained banking system. Once this process was underway the BDG would begin to apply the reforms to the agricultural banks. The RFP is discussed extensively in Technical Analysis Annexes T.A.4., T.A.5., and T.A.6.

2.3.4 <u>Recent Developments:</u> In recent years, there has been appreciable progress in reforming the financial sector. The BB initiated efforts in 1987 to increase the loan recovery rate. The extensive credit studies carried out under the A.I.D. Rural Finance Program and follow on work was instrumental in assisting the BB to initiate work to improve bank supervision and revise capital adequacy, loan reclassification and provisioning rules. The Bangladesh tax code was amended to allow commercial banks to expense the lesser amount between 4.5 percent of gross loans or actual provision charges and interest suspense charges. The Bangladesh Bank Ordinance was amended to permit the BB to issue securities for sale to commercial banks. A new Banking Companies Ordnance has been promulgated that increases banks' capital adequacy requirements to five percent for time and demand deposit liabilities for foreign banks and NCBs and six percent for domestic private banks. Commercial banks are now free to determine their own fee schedules for services. In June 1990, the BDG will publish a new circular that will permit banks to change their loan and deposit rates, within the prescribed bands, more frequently. The interest rate matrix will be adjusted approximately every six months. A Capital Issues Development Committee has been established and a new Loan Recovery Act passed that streamlines recovery of bad debts. It is anticipated that a new set of regulations liberalizing conditions for fixed term

loans, short-term agricultural loans and demand loans will be issued in June or July of 1990.

Work has been initiated to improve the accounting practices of the NCBs, implement a new loan classification system, change the accounting treatment of unpaid accrued interest so as not to show fictitious income, make adequate provisions for loan losses, increase capital adequacy requirements and introduce systems for loan recovery. These changes allow the financial condition of the commercial banks to be evaluated and form the basis for implementing a rehabilitation program.

With respect to the NCBS, the measures will provide crucial information for potential buyers. The Project, by providing TA, training and commodities to implement the above policy changes will support the BDG's efforts in the first phase of reform of the financial sector.

The most significant recent development was publication of Circulars 33 and 34 in November 1989. The Circulars contain a new set of regulations for scheduled banks, and became effective January 1, 1990. The new regulations apply to all commercial banks and, with exceptions, to the two specialized agricultural banks, Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB). The major provisions

-- replace the refinance facility with a rediscount facility;

-- abolish fixed interest rates and established a flexible schedule of lending and deposit rates;

-- permit payments (called subsidies in this PP) out of the national budget to compensate banks for below-market interest rates per the BB interest rate schedule;

-- set out specific measures required for continuing to provide credit to borrowers with poor payment records;

-- increase the rigor for classifying poorly performing loans, increase banks' provisioning requirements against bad loans and require interest suspension on non performing loans;

The exceptions in the two circulars pertaining to BKB and RAKUB are that for agricultural loans BKB and RAKUB retain the refinance facility and do not receive the interest rate subsidy; however, the regulations for commercial banks in Circulars 33 and 34 apply to BKB and to RAKUB non-agricultural loans. BKB and RAKUB are exempted from reclassifying their loan portfolios and taking new provisions against bad loans. The BDG has agreed in principle to gradually apply all Circular 33 and 34 regulations to the agricultural banks.

2.4 Relationship of the FSRP TA Project to the FY 1986-1990 and FY 1990-1996 Country Development Strategy Statements (CDSS)

The origins of FSRP TA occurred under the aegis of the FY 1986-1990 CDSS was written in January 1985. That CDSS stated that USAID would focus ". . . first on agricultural lending, then all rural banking, and finally the national banking system, USAID intends to effect rationalization of rate structures, significantly increased savings levels, and effective bank management." The lessons learned in the Rural Finance Project that was implemented during the period of the FY 1986-90 CDSS caused the emphasis to be redirected from a rural directed credit program to a sector-wide restructuring approach.

The Rural Finance Project (RFP) was introduced under the 1986 CDSS. The RFP sought to develop a viable rural banking system reflecting USAID's strategy noted above. As explained in 3.4.3, the Mission learned that improvement of rural banking operations would require fundamental changes in the entire formal financial system.

Growth and employment are prominent goals in both the 1986 and 1990 CDSSs. The FSRP includes several important changes that will support growth of sustainable, productive employment as discussed in subsection 8.5. A key element in the Mission private sector development strategy in the FY 1991-1995 Country Development Strategy Statement is to facilitate policy reforms that will open markets, i.e., expand competitive markets and increase opportunities for privately owned enterprise. A well functioning financial sector is fundamental in several respects to dynamic market and private enterprise development and growth in all sectors of the economy. The FSRP TA, leveraging $175 million and contingent policy-based conditions for liberalization, will provide a more favorable environment for investment and business. Restructuring the monetary and banking system based on market clearing prices will establish a more competitive and therefore a more efficient financial intermediation system for the allocation of investment capital. Private savers will have greater assurance of receiving positive real interest rates. The restructuring of the central bank-commercial bank system, which is the core of the financial system, will provide the financial basis for all future privatization of public assets.

A second strategy element in the 1990-1996 CDSS is the establishment of conditions for a more open society, one where there is greater opportunity for widespread participation in and reward from economic activity. The FSRP TA strongly supports this strategy element by strengthening the connection between the substantive merit of an investment and its receiving credit while reducing government direction of credit and the allocation of credit to special interests. Under the unreformed system a

relative handful of industries and individuals received credit with little regard to the merit of the use of the funds. Under the reformed system a broad cross section of individuals and firms will gain entitlement to credit based on the expected worth of the individual's investment proposal.

2.5 Relationship of Project To Mission Private Sector Development Strategy

2.5.1 Components Leading Toward an Efficient Private Banking System: One of the objectives of the Project is to achieve an efficient, largely private, banking industry. The establishment a market driven private banking system is linked to achieving higher employment, increased productivity, more efficient use of resources and more rapid economic growth. The FSRP and the FSRP TA as a component thereof, support this objective in four ways;

Flexible interest rates -- The establishment of flexible interest rates will give both the private banks and the NCBs greater scope to improve and expand their operations. The ability to adjust interest to take into account such aspects of the banking industry as cost of funds, credit risks, and local competitive pressures will provide both opportunity and risk to the institutions involved. It is anticipated that private banking will expand as a result of private bankers' sharper competitive instincts and superior experience. This competitive opportunity should make the issuing of additional private bank charters more attractive, thus increasing the financial and political strength of the private banking sector. The likely expansion of private banking should not be mistaken, however, for a guarantee of security and continued existence of all banks, private or nationalized. In a competitive environment where banks are required to meet financial soundness requirements such as capital adequacy, some banks, private or NCB, may fail and go out of business. Just as profits are the reward for efficiency, so is failure the penalty for inefficiency--reward and penalties are inseparable from a well-functioning competitive market environment. This Project does not assure, nor should it be interpreted to imply that all commercial banks, including private banks will always prosper. Another way of stating the fundamental, long-term objective of this Project is to say that it is to create a competitive market operating in an unbiased, rational regulatory environment in which banks are free to manage their own affairs and to reap the rewards or penalties of their own decisions.

Financially sound NCBs -- The Project will increase the ability of the NCBs to make more and better quality loans, thus increasing their real earnings. Without a substantial improvement in the NCBs' operations and financial soundness it would be difficult to sell them to private investors. The

reforms will create a potential asset for private investors: the loan classification, recapitalization and legal reforms will provide the basis for a viable enterprise; the TA, training and commodities furnished under the Project will assist the banks in to restructure their organization and operations.

Increased supervisory capability of the BB -- Improved supervision is necessary to lessen the risk of bank failure or losses to depositors. The improvement in bank supervision and bank MISs will enable Bangladesh Bank to carry out its supervisory functions in a more satisfactory manner. Improved reporting and supervision of commercial banks will essentially be substituted for releasing commercial banks from direct controls.

Ability to meet monetary targets -- With the adoption of a more flexible interest rate regime and of indirect monetary policy instruments, the Central Bank will be better able to meet national monetary targets, leaving commercial banks free to make their own decisions on interest rates and selection of borrowers.

2.5.2 <u>Results Encourage a More Active Private Sector:</u> Achievement of the FSRP TA objectives will contribute directly to AID's policy of encouraging the development of the private sector in two ways:

Increased number and soundness of loans -- Privatization of the banking system and its consequent increase in the number and soundness of loans made to private entrepreneurs will increase the relative size of the private economy per se. In particular, it will increase the size of that portion of the private economy, comprising publically traded companies, that is accessible to prospective individual investors, not simply members of families or closed groups.

Increased independence of economic and political power -- A private banking system is also essential to the development of private enterprise firms as fully independent entities, since government-owned commercial banks are generally able to -- and frequently do -- exert excessive control over enterprises to which they lend.

2.5.3 <u>Role of the FSRP in Overall Mission Strategy:</u> The Mission perceives the continued privatization of the banking system as one of the critical steps in private enterprise development. The Project directly supports the goal of competitive markets and increased reliance on private enterprise development in Bangladesh.

The Mission is confident that the BDG is serious in its desire to expand financial markets and to privatize NCBs. This intent is reflected in the draft BDG statement on the Financial Sector Policy paper, which states: "Within the next three to

five years, we also intend to take steps to privatize one or two of our remaining wholly owned NCBs and significantly reduce government's ownership role in the banking system. The reforms implemented under the FSRP will assist implementation of the BDG objective and directly serve the Mission's aim to support privatization in the Bangladesh economy.

2.6 Relationship of the FSRP TA Project to Other A.I.D.Projects

Two other USAID projects that relate to credit and to the financial sector are the Industrial Promotion Project (IPP) and the Fertilizer Distribution Improvement Project (FDI II). There is no duplication among the projects nor do they conflict. The $13 million IPP provides institution building, training and partial guarantees for credit aimed at assisting small private businesses. Under the IPP lending officers of participating banks will be trained in evaluating prospective borrowers on the basis of the potential profitability of the proposed loan. Coordination with FSRP TA bank training will be the responsibility of the IPP Project Manager and the FSRP TA PSC.

The $65 million Fertilizer Distribution Improvement Project is a policy reform project that seeks to increase agricultural production by providing privately-owned fertilizer distributors access to credit at commercial interest rates. The project is based on the idea that it is possible to increase fertilizer use by increasing the responsiveness and cost effectiveness of fertilizer distribution by increasing the involvement of private firms. Before the project, private distributors did not have regular access to bank credit. By establishing access to a large and reliable credit source, the project directly encourages competition among private dealers and between private dealers and the government parastatal. The major commercial credit component is administered through public and private banks which assist hundreds of fertilizer distributors to purchase domestic and imported product. Numerous Bangladesh Bank officials, private and public sector participating bank officers, dealers and government officials have been trained under the project.

2.7 Relationship of the FSRP TA Project to Future Development Programs

2.7.1 Further Donor Cooperation: The close interrelationships of the financial sector reform program and the coordinated inputs of IDA, USAID and IMF presage further cooperation in the future. Looking ahead, one sees substantial policy-based international credits to Bangladesh, dependent on the successful implementation of the proposed FSRP: ACP-II (discussed below), FSRP-II (the follow-on to FSRP) and ICP-II (a follow-on to IDA's ongoing Industrial Credit Project); ESAF (the Enhanced Structural

Adjustment Facility) of IMF; and projected industrial and agricultural sector credits from ADB. Thus, the combination of the FSRP and the FSRP TA are key to future policy based lending by the multilateral development institutions. An extensive discussion of this subject is contained in Technical Analysis Annex T.A.3.

2.7.2 Agricultural Credit Project-II: USAID has been approached by IDA to provide financing for the TA component of the Agricultural Credit Project II (ACP-II). ACP-II will extend the FSRP reforms to the two largest development finance institutions in Bangladesh: Bangladesh Krishi Bank, and Rajshahi Krishi Unnayan Bank. Together these two institutions provide over 60 percent of total agricultural lending in Bangladesh. Under ACP II, the FSRP policy and regulatory reforms will be extended to the two agricultural banks.

No commitment has been made by USAID to provide TA for ACP II. However, USAID will provide a consultant to act as a team member on a joint IDA-ADB Appraisal Mission with the mandate of further developing the project. USAID will use that opportunity to gather more information to help determine if ACP II policy conditionality is sufficient, if it is feasible and to get a better fix on the cost of technical assistance. Once this information is collected USAID will indicate to IDA and to the ADB if USAID intends to provide the technical assistance component of ACP II. If USAID does agree, it will require that there be a period of approximately one year (to mid 1991) before ACP II is implemented. That period will allow the BDG and USAID time to gain experience under FSRP and permit USAID to monitor the policy performance of the BDG under the FSRP. If during the one-year period USAID determines that policy reform is not progressing satisfactorily, USAID will reconsider its involvement in ACP II.

The TA aspect of the ACP-II project, if approved, will be blended into the FSRP TA Project. On the input side, the incorporation of ACP II will take advantage of some of the TA already in place under the FSRP TA Project; for example, extension of BIBM training to BKB and RAKUB personnel and provision of MIS or personnel management techniques developed under FSRP TA. FSRP TA would nevertheless have to be supplemented to support the larger span of institutions. USAID supports the idea of extending FSRP reforms to the agricultural sector.

SECTION THREE

PROJECT DESCRIPTION

3.1 Project Goal and Purpose

The overall goal of the BDG/IDA/IMF/A.I.D. Program, of which this Project is an integral component, is to improve the functioning of the Bangladesh formal financial system, including the BB and commercial banks (composed of four NCBs and 16 private banks), so as to accelerate the rate of economic growth and employment generation. The purposes of the FSRP TA Project in combination with the BDG/IDA FSRP are: (1) to implement more flexible BB monetary policies, thereby enhancing the BB's ability to maintain monetary stability and improve the efficiency of capital; (2) to expand private banks' share of commercial banking, including continuation of divestiture of the NCBs; and (3) to develop financially and operationally sound NCBs that are suitable for privatization.

The macroeconomic impact of the Project will occur over the long-term. The macroeconomic variables that would be expected to be affected are also influenced by other factors. Therefore isolation of the singular effect of the Project is extremely challenging. Nevertheless, improvement in the following macroeconomic indicators is expected to be evident by the end of this Project and will be addressed in the final Project evaluation:

-- Reduction in the structural inflation rate.

-- Increased profitability of commercial bank lending to the agriculture, export and small industry sectors.

-- Increased investment in the banking sector.

-- Relative stability of real interest rates as compared to nominal interest rates.

3.2 Project Purpose-level Indicators

The set of indicators listed below does not include either those reforms the BDG has already made or will make prior to the start up of the IDA FSC and the FSRP TA. The purposes of the Project are the following:

-- Implement more flexible BB monetary policies and improve central bank supervision of the commercial banks.

-- Develop financially sound NCBs that are suitable for privatization.

-- Expand the share of the banking sector controlled by private banks, including continuation of the movement toward divestiture of the NCBs.

Assessment of the degree to which the Project is accomplishing and has accomplished its purposes will be based on a set of key indicators. The project monitoring mechanisms will be established to generate the information required. Project performance in relation to these indicators will be assessed as part of the four scheduled external evaluations. The final set of purpose-level indicators will be determined by USAID, and the TA Team, in consultation with the IDA and the MOF and BB. The Purpose-level indicators are listed below.

Project Purpose 1.: To implement more flexible BB monetary policies and to improve central bank supervision of the commercial banks. The associated indicators are:

a. Replacement of direct monetary controls by flexible indirect instruments;

b. Increasing share of loan portfolio based on market-determined interest rates;

c. Permanent positions and significant number of staff have received training in the Technical Unit at the BB,

d. More frequent and focussed inspections of bank branches' portfolios and timely follow-up of identified deficiencies;

e. Credit Information Bureau established with 100% referrals for new loan applications.

Project Purpose 2: To develop financially sound NCBs tnat are viable candidates for privatization. The associated indicators are:

a. BDG continues to make transparent subsidy payments on below-market interest rates to commercial banks;

b. All commercial banks are implementing the Bangladesh Bank's instructions per Bangladesh Control Department Circular #34;

c. All NCBs have carried out comprehensive reviews of their credit policies and procedures and have issued appropriate manuals;

d. Special Courts established and judges appointed to administer Financial Loan Court Law;

e. Capital adequacy requirements of the banks are maintained according to the Banking Companies Ordinance;

f. Effective performance planning and budgeting systems established by NCBs;

g. Increased computerization of NCBs' head offices and pilot computerization of 2-3 major and 5-10 smaller branches for each NCB;

h. Management Information Systems (MIS) of NCBs established following project guidelines;

i. Establishment of incentive pay and promotion systems based on branch-level performance.

Project Purpose 3: To prepare NCBs for privatization and expand the role of the private banks in the overall financial sector. The associated indicators are:

a. Private banks (rating partially-privatized NCBs by the portion of their shares privately-held) have increased their share of bank lending to 60 percent;

b. Understanding of problems which emerge from bank privatization has been improved by Studies;

c. Increased real rate of return on NCB non-loan assets;

d. Satisfactory divestiture program and timetable presented by BDG.

3.3 Summary of Main Project Inputs and Organizational Relationships

I. Technical Assistance

A. BB and MOF macro financial consultants will provide assistance in four areas:

(a) analysis of monetary policy issues;
(b) bank supervision, including improved procedures for NCB reporting to the BB;
(c) upgrading the Credit Information Bureau; and
(d) computerization of BB.

B. NCBs--one consultant in each NCB, with assistance from specialists, will direct operations in five areas:

(a) credit
(b) computerization

(c) planning and budgeting
(d) accounting and maintenance of information systems
(e) manpower development in NCBs

II. Equipment Inputs

A. Computers to BB and 4 NCBs

B. Training equipment to BIBM

C. Miscellaneous project equipment, e.g., vehicles, office equipment

III. Overseas Training

A. BB personnel to the Federal Reserve Bank of New York

B. BB, NCB and BIBM personnel to non degree programs in the U.S. for training in monetary economics and bank finance

C. Computer and computer systems training in the South East Asia region.

3.4 Conditionality

In keeping with the instructions contained in the PID Approval Cable (Executive Annex E.X.1.), a set of benchmarks was prepared by USAID/Bangladesh and approved by AID/W (Executive Annexes E.X.2. and E.X.3.) setting forth the steps necessary to insure effective movement toward privatization as one of the Project Purposes. The conditions for negotiations with IDA were largely met in the publication of Bangladesh Bank Circulars 33 and 34. Another circular on increasing the frequency that interest rates may be adjusted by banks will be published in June 1990. In addition to explicit provision of local resources to carry out the Project, two substantive (non-procedural) conditions precedent (CP) to disbursement and seven substantive covenants will be included in the Program Agreement. One condition precedent calls for the BDG, through the BB, to establish a Review Committee to oversee progress on all aspects of the FSRP and prescribes the Committee's membership. Another CP requires evidence that the BDG and IDA have executed a loan agreement for IDA's FSC and that the agreement has become effective.

The seven covenants, listed below, are that the BDG

-- maintain and continue to implement financial policy reforms that are instituted, prior to and during the course of the Project;

-- provide to A.I.D. quarterly quantitative and qualitative information relating to progress in achieving key project benchmarks;

-- provide semi-annual financial reports on the BDG cash and in-kind contributions to the FSRP and to the technical assistance effort financed under the Project;

-- ensure that training services and facilities of BIBM as well as information systems, manuals and other technical assistance outputs developed under the Project be available for the use of private and public sector bankers on an equal basis;

-- maintain capital adequacy ratios according to BB regulations and the Banking Companies Ordinance;

-- beginning in June 1992, the BDG establish and implement, for all NCBs, collection targets, policies and procedures for collecting or writing off any NCB loans not yet collected or written off pursuant to the IDA FSC agreement.

-- the BDG shall conduct a study to be completed by June 1993 that analyzes experience gained in NCB privatization. The study will be used to assist in implementing future privatization and other steps to reduce Government ownership in the banking system. The study and the Government's Action Plan for privatization shall be made available to USAID.

3.5 Main Components of The Financial Sector Reform Program

The Financial Sector Reform Program consist of three main components: balance of payments assistance under the IDA FSC; the FSRP TA Project of A.I.D.; and TA to be provided by the IMF. The BDG will also make significant contributions of staff, including expert staff and facilities to implement the total Program.

3.5.1 IDA FSC: The IDA FSC program loan of $175 million will be disbursed in three tranches. It will be used to recapitalize the NCBs in return for far reaching policy changes in the financial system and in its constituent institutions. There are prior policy conditions that must be fulfilled before IDA will present the project to its Board as well as subsequent policy conditionality linked to the phased drawings under the project. IDA-BDG negotiations were held in March 1990 with a USAID Dhaka representative present. It is anticipated the FSC will be presented to the IDA Board in June 1990. Details of the policy content of the IDA credit, including the policy conditionalities, are given in the Technical Annex T.A.2.

One condition of specific relevance to this PP is that IDA will not proceed with final negotiation of the credit unless BDG notifies the IDA that it has approved a TAPP for the TA and training to be provided under this Project. USAID is working with BB to insure that the TAPP is in conformance with this PP. It has been agreed that the FSRP TA Project will be authorized by the time the FSC goes to the IDA Board, and obligated at the time of signing of the IDA Loan.

3.5.2 **A.I.D. FSRP TA:** The second foreign assistance component, the FSRP TA of A.I.D. is described throughout this PP. Details of the components are addressed below in section 4.1.3.

3.5.3 **IMF TA:** The third foreign assistance component is TA from the IMF. The IMF TA to BB is design and institution of the capacity in the BB to conduct open market operations. The IMF technical assistance will enable the BB to create special financial instruments that can be bought and sold between the BB and the commercial banks as a means to allow individual commercial banks an additional means to vary their reserve balances. The FSRP TA Project includes TA resources that will closely complement the IMF activity.

SECTION FOUR

COST ESTIMATE AND FINANCIAL PLAN

4.1. Cost Estimate

4.1.1. Estimated Cost and Methods of Financing: The FSRP TA will be implemented over a five year period as part of the Financial Sector Reform Program. AID's planned contribution to the overall effort is $19.4 million. The A.I.D. FSRP TA concentrates on technical assistance and training. Approximately 80% of total project cost is for personnel. The remainder consists of training (6 percent) and equipment and supplies (14 percent). The major part of equipment and supplies is accounted for by computers and accessories to improve the information management capabilities of the BB and three of the NCBs.

4.1.2. Bangladesh Government Contribution: The Bangladesh Government's contribution to the Financial Sector Reform Program, of which the FSRP TA is a part, is estimated to be $548.3 million for recapitalization and $1.76 million direct contribution to the TA side. Participants' contributions are explained in Table 4.1.

Table 4.1 Total Cost and Contributions of the Program

	From BDG	(billion Taka)	
1.	Recapitalization of NCBs (including the values of bonds not disbursed as cash), assistance with BJMC and BJC debt service requirements and reimbursement for the cost of interest rate subventions to banks.	18.64	
2.	Direct contribution to FSRP TA	0.06	
	Subtotal	18.70	
		($550 million at Tk 34 : $1)	
	From IDA, USAID and IMF ($)		
1.	IDA FSC	175.0	million
2.	USAID FSRP TA	19.4	million
3.	IMF TA	1.5	million
	Subtotal	$195.9	million
	Grand Total	$745.9	million

The BDG's contributions in direct support of the FSRP TA consist essentially of in-kind contributions by BB and the NCBs of office space, staff assistance, sales taxes and customs duties on imported commodities, utilities, furnishings, printing, other services and support facilities. Commitment of the BDG contribution will be stated in the Project Agreement.

The value of the BDG's contribution in support of the FSRP TA is $1.71 million or 8.7 percent of the total TA component. The BDG's contribution to the FSRP of which the TA is a part, is 73.7 percent, far exceeding the 25 percent requirement. Therefore the BDG contribution, which will be stated in the Project Agreement, will meet the requirements of FAA Section 110 and the guidance in AID Handbook 3, Appendix 2. G.

A.I.D. regulations require Controller certification that methods of implementation and financing are in accordance with Mission standards. A procedure will be established whereby the BB will accumulate and classify direct or indirect, cash or in-kind contributions and report those contributions to the USAID Project Officer. The Project Officer will, in turn, convey the information to the Financial Analysis Section of USAID for inclusion in the quarterly Internal Report of Host Country Contributions.

As recommended by the Mission Project Review Committee, the Project budget includes $120,000 for non-federal audit expenses. The USAID Project Officer, the Project Director and the Team Leader will decide on the appropriate scheduling of audits over the life of the Project.

4.1.3. **Illustrative Budget:** Table 4.2 presents an illustrative budget for the project. Table 4.3 presents the estimated annual expenditure of the Project. 59.4 percent of Project funds will be committed during the first two full years of Project implementation.

Table 4.2 USAID and BDG Contributions
(illustrative)

Project Element	USAID	B D G
Staff	--	1,122,000
Office Rent & Utilities	--	244,000
Technical Assistance		
long-term international	9,705,945	
long-term national	740,077	
short-term international	2,383,682	
short-term national	158,830	
head office support	307,774	
local administration	515,549	
USAID/PSC	809,168	
Subtotal	14,621,025	
Training		
overseas	1,042,491	
in-country	258,679	
Subtotal	1,301,170	
Equipment		
computers & accessories	2,080,000	
other	207,300	
service	218,000	
G & A 10%	250,530	
Subtotal	2,755,830	
Exec. Admin. Officer	415,500	
Contingency	200,000	
Financial Audit	120,000	
Subtotal	735,500	
TOTAL	19,413,525	1,366,000

Notes:
1. Budget estimates based on inflation rates of 3.5% for international consultants' salaries; 10% for national consultants' salaries; and 4.2% for international travel costs.
2. Evaluation resources are included in the short-term TA budget. The budget for evaluation, not separately shown in Table 4.2, is $342,389 to support 12 person months international and 25 person months of national consultants.

Table 4.3 FSRP TA Budget Expenditures by Year
(US$,000)

Project Element	90/91	91/92	92/93	93/94	94/95
Technical Assistance	3,793	4,199	3,316	2,492	1,575
Training	353	361	289	290	8
Commodities	1,476	1,160	48	48	24
Total	5,622	5,702	3,653	2,830	1,607
Share of total Expenditure	30.0	29.4	18.8	14.6	8.3

4.2 Methods of Disbursement

The planned methods of disbursement are summarized in Table 4.4. The following narrative summarizes each component.

4.2.1 Technical Assistance:

Prime Contract -- Following the signing of the Program Agreement, USAID will initiate contracting procedures for a direct A.I.D. contract to hire the prime contractor for the FSRP TA. Because both long- and short-term international and national consultants will be furnished under the prime contract, the prime contractor will be responsible for having required personnel on board as and when required. The negotiated and agreed upon total contract funds will be incrementally committed. Direct reimbursement or payment will be made to the prime contractor for both local and dollar cost expenditures: local administrative, home office support costs, costs associated with long- and short-term international and national advisors, local and international training, commodities (vehicles/equipment) for prime contractor's own use, and service/maintenance and office supplies. For international training, a non-funded PIO/P will be issued by USAID upon receiving a request from the prime contractor.

If the prime contractor is a non-profit firm, advances will be given based on cash flow projections on a maximum of 90 days' need basis and liquidation/reimbursement on a monthly basis.

PSC Project Coordinator -- Outside the prime contract, and also under the technical assistance component, USAID will initiate procedures to hire the services of a personal services contractor (PSC) as project coordinator who will be housed at USAID to

monitor the FSRP TA project. USAID will make direct payment to the PSC project coordinator.

Short-Term International and National Consultants -- To be appointed and hired by USAID in consultation with prime contractor. Reimbursement by USAID will be directly to the consultants.

4.2.2 Project Commodities: All project commodities involving purchase of computers and other accessories for the host country banking network under the project will be procured by the procurement agent of the prime contractor and the costs in connection with the procurements will be reimbursed directly to the suppliers by USAID through individual letters of commitment.

4.2.3 Evaluation: Project evaluations will be performed and conducted by USAID. Reimbursement by USAID will be directly to the consultants/contractors.

4.2.4 Audit: Non-Federal Audit and financial reviews will be performed using local and international IQC accounting/audit firms under supervision of USAID Controller's Office and Regional Inspector General's Audit Office. Disbursement will be direct by the Mission to contractors. The applicable geographic code must be considered and/or waiver obtained for commodity purchases.

Table 4.4 Methods of Financing and Implementation
FSRP TA Project (388-0078)

Elements/Components	Methods of Implementation	Method of Financing	Amount
1. Technical Assistance			
a. Prime Contractor	PIO/T, AID Direct Contract, Non-Funded PIO/P for International Training under Prime Contract Budget	Direct Payment	$13,402,000.00
b. PSC Project Coord.	PIO/T, PSC Contract	Direct Payment	$ 809,168.18
c. Other than Prime Contract	PIO/T, AID Direct Contract	Direct Payment	$ 684,000.00
2. Training	Non-funded PIO/P for Training		$ 1,301,000.00
3. Project Commodities	Procurement by Prime Contractor's Agent. PIL, PIO/C, Contract	Direct Payment to Supplier by USAID thru individual L/Comm.	$ 2,756,000.000
4. Evaluations	PIO/T, Contract	Direct Payment	$ 342,388.66
5. Audits	IQC Delivery Order	Direct Reimbursement by USAID to Contractor	$ 120,000.00
Total			$19,414,556.84

SECTION FIVE

IMPLEMENTATION AND ADMINISTRATION

5.1 Gray Amendment Considerations

It is clear to the Project Committee that the only practical way to implement a project of the scope and complexity of this is through a single U.S. consulting firm (prime contractor), competitively chosen, which will assume responsibility for mobilizing, supporting and supervising the numerous individual specialists involved. Because the FSRP TA requires a large amount of highly specialized banking and credit advisory services, along with a requirement for a highly technical home office backstop, it is apparent that the prime contractor should have the depth and capability to deploy, coordinate and support a complex array of the required technical expertise. Examination of the files on small and minority contractors indicated that none of these firms has the required capabilities. Therefore, the prime contractor cannot be selected under a minority business set aside as specified under the Gray Amendment, but rather will be selected through open competition. However, bidders will be encouraged to utilize minority or woman-owned firms for any subcontracting arrangements. The consulting firm will be A.I.D. direct contracted pursuant to standard A.I.D. regulations concerning EEO, and Gray Amendment subcontracting. Bangladesh Bank will represent the BDG on the technical evaluation panel that will rank order bidders' proposals. The prime contractor will be required either to meet the requirements to serve as an A.I.D. Procurement Services Agency (PSA), or to sub-contract a firm that does, for computer procurement (other than for the BB computer, which is to be procured separately by A.I.D.). The Scope of Work for the TA/Training consulting firm is attached in the Administrative Analysis Annex AA4.

5.2 Structure of the FSRP Technical Assistance Project

The proposed FSRP TA Project consists of three main elements: technical assistance, training, and commodities. The elements are outlined in 3.3 and described in more detail below.

5.2.1 The Technical Assistance Element: The Project calls for an estimated total 964 person months of technical assistance plus several auditor months. Technical assistance will be divided into two administrative areas, one administered by the USAID Project Office in coordination with the Project Director and the second area by the TA/training team contracted by USAID/Dhaka. Table 5.1 is an overview of the allocation of technical assistance person months between the two administrative areas and among principal TA functions.

Table 5.1 Summary of FSRP TA Inputs
(person months)

Function	Project Office			TA/Training Team				Total
	LT	ST		LT		ST		
	Int	Int	Nat	Int	Nat	Int	Nat	
Management	52	12	25	104	0	21	0	214
Macro-financial	0	18	10	48	84	24	0	184
Bank Supervision	0	2	0	24	48	12	12	98
NCB operations	0	0	0	216	192	36	24	468
Total	52	32	35	392	324	93	36	964

Note: LT = Long Term; ST = Short Term; Int = International; Nat = National.

5.2.2 The USAID Project Office Group: The Project Office (OEE) will administer and directly contact 119 person months of technical assistance outside of the 837 person month prime contract. The 84 international and 35 national consultant person months will be allocated to the following tasks:

-- 52 months for the Project Coordinator whose duties are described in subsection 5.7.3;

-- Approximately six person months of international and national consultant time to conduct "bridging" tasks. The 12 person months will assist the BB Technical Unit to continue work on loan reclassification, interest rate matrix estimation and capital adequacy analysis that has been under way for the last 18 months. It is critical to the progress of the reforms that technical assistance to the TU continue during the period between the time the last A.I.D.-supported consultant in the TU leaves and the Technical Assistance Team members start to arrive in early 1991.

-- Two person months for an international consultant to assist in computer system configuration and acquisition. The computer consultant will assist USAID by updating technical

12 international and 25 national person months of consultant time to staff four evaluations as described in subsection 6.6.2.

The remaining 12 person months of international and four person months of national consultant time will be contracted by USAID/OEE to address needs for technical expertise as they arise in the course of the Project. It may be necessary, for example, to increase the amount of time for the bridging consultant depending on when the TA Team actually arrives.

5.2.3 **The TA Team:** The Project design calls for a TA/Training team, hereafter called the TA Team, of twelve international and 10 national long-term consultants, plus 142 person months of short term consultant time. Table 5.2 summarizes the TA Team's composition. The TA team will operate under the direction of a long-term international Team Leader/Chief of Party for a period of four years. The Chief of Party, who will be the team's leading expert on bank management and administration, will be based in BB and will be supported by a local administrative staff paid out of Project funds. The TA team's composition, size, and expertise has been approved by the Bangladesh Government and the host country implementing agencies. The team members will be located at designated offices of the BB, MOFP, NCBs, and BIBM.Further details and cost estimates are presented in Annex A.A.2. TA Team members' specific responsibilities and activities are described in subsection 5.3.

Table 5.2 FSRP TA Team Personnel
(Prime Contractor)

Function/Location	Persons Int'l	Persons Nat'l	Person Months Int'l	Person Months Nat'l
Long Term TA:				
Team Leader/BB	1	-	52	-
Executive Admin	1	-	52	-
Macro econs/3B & MOFP	2	4	48	84
Computer-MIS/BB	1	2	24	48
NCB Advisors/ea NCB	4	4	192	192
Credit Expert	1	-	12	-
Accounting MIS	1	-	12	-
Planning Perform Budget	1	-	12	-
Training Advisor	1	-	24	-
Total long term	13	10	428	324
Short-term TA	-	-	57	36
TOTAL	13	10	485	360

Grand Total = 845 Person Months

5.3 Technical Assistance Team Experts and Activities

5.3.1 Credit Analysis: The Project will provide one international consultant for a total of 12 months over the life of the project to perform this function. The objectives of this component are to:

-- Strengthen the loan portfolios and debt recovery rates of the NCBs by improving their credit policies and procedures.

-- Establish a training venue for broadening the number of NCB officer staff trained in credit analysis, loan portfolio supervision, loan classification and other credit topics.

-- Establish a Credit Policy and Procedures Review Group in each NCB to define areas of lending for which current credit policy is inadequate; specify criteria for particular types of lending related to the financial position, credit history and market prospects of the borrower; and write policy and procedures on how to analyze loan proposals, establish appropriate loan structure, repayment terms, collateral levels and documentation requirements.

-- Assist the NCBs to develop procedures for reviewing deposit interest rate schedules and lending rates.

-- Establish computer support and procedures for utilizing the information made available by the BB Credit Bureau.

5.3.2 **Macroeconomic and Monetary Policy Analysis:** Macroeconomic and monetary analysis will be carried out in two BDG offices: in the TU of the BB and the Policy Analysis Unit of the Ministry of Finance and Planning.

Technical Assistance to the BB TU -- The Technical Unit in the BB will constitute the key operational office for implementing and coordinating the FSRP TA. The Technical Unit (TU) was established within BB in 1984 to study interest rate policies and undertake other policy analyses referred to it. Under the IMF SAF, the TU hosted the IMF support group. The TU will host the Project Team Leader and support BB senior management in implementation of the FSRP TA, assisted by TA Team consultants in the PAC. The combination of consultants will provide analytic capability while improving coordination in the formulation of monetary policy within the Ministry of Finance and improving the implementation and functioning of monetary instruments. The two groups will closely coordinate their work under the general supervision of the Project Team Leader in the TU.

Technical Assistance for Macroeconomic and Monetary Policy Analysis to the MOFP PAC -- In 1989, the Policy Analysis Cell (PAC) was established in the Ministry of Finance and Planning (MOF, MOFP) to provide the MOF with macroeconomic analytic support. TA to the PAC under the Project will give the MOF the capacity to communicate and cooperate with the BB on policy analysis issues. (There will be other consultants in the PAC financed by the ADB). The FSRP TA consultants will conduct applied policy analysis on monetary and related issues such as exchange rates, the balance of payments, taxes and government expenditures. Their analyses will be directed toward producing outputs relevant to implementation of monetary and financial reform efforts or to applied monetary/financial policy issues.

Relationship of TU and PAC Consultants' Tasks -- The policy analysis work of FSRP TA consultants in the Technical Unit will concern relatively more specific monetary and financial issues such as interest rate formulation and management, interest rate subsidies, rediscount widow management, monetary programming issues, and collaboration with the IMF expert in development of a BB open market operations capability. The specific tasks of the FSRP-financed consultants in the two groups will be periodically reviewed by the FSRP Project leader in consultation with the Project Director to ensure maximization of complimentarily in the two groups' work programs. The FSRP TA macroeconomic policy analysts in the two groups will have the single objective of improving the ability of decision makers in the BB and in the Ministry of Finance to make well-informed decisions in the formulation and conduct of monetary policy and the implementation of financial sector reforms. A technical link between the BB and the MOF will strengthen the MOF's ability to support BB positions with respect to other BDG institutions.' Together, the TU and the

PAC will provide the monetary and macroeconomic policy analysis required to implement the Project.

FSRP TA Consultant Inputs -- To carry out the functions described above, the FSRP TA Project will provide two long term international consultants, 24 months each, one to the Technical Unit (TU) of Bangladesh Bank and the other to the Policy Analysis of the Ministry of Finance. Four more long term national consultants will be provided within the prime contract, two to work with the PAC for 18 person months each, and the other two to the TU for 24 person months each.

One national consultant will work with the IMF expert and the national economic expert to develop the open market financial instrument mechanism. A second national consultant will work with the expert provided by the IMF to assist the BB in upgrading its bank supervision functions. One long-term international and one national macroeconomic consultant, each for 24 months will undertake statistical and policy analyses of a general or specific nature on macroeconomic issues, as required by BB, and develop expertise in the TU in applied financial, monetary and macroeconomic analysis.

The project will provide two short term international consultants, each 12 person months, one for the TU (BB) and the other for the PAC (MOF). The consultants will be assigned to prepare special studies related to private banking, rural credit and capital markets. The macroeconomic consultants will also follow up on the effects of implementation of interest rate policies under the Program and make appropriate recommendations.

5.3.4 Accounting/Management Information Systems (MIS) at NCBs: The general objective of this TA is to improve the accounting and MIS systems, so as to enable NCB management to monitor operations more effectively and to increase the reliability of accounting and management information. In particular, the TA will implement the reform of accounting practices related to loan classification, treatment of overdue interest and making provisions for classified loans. The TA will also be designed to improve financial statements, strengthen the provision of relevant management information, develop loan pricing capabilities, improve budgeting and planning, obtain more rapid reconciliation of inter-branch accounts, and promote training in accounting. This component will be implemented by one international accounting/MIS consultant based in BB to plan, guide and coordinate the program. The consultant will spend approximately six months in Bangladesh assessing requirements and capabilities. Based on the consultant's assessment s/he will prepare a handbook(s) and other materials as appropriate. The consultant will return in about one year for three months to review and revise the materials based on feedback from bank and

TA Team personnel. The consultant will repeat this procedure for a second three-month period toward the end of the Project.

5.3.5 **Performance Planning and Budgeting:** The objectives of Technical Assistance for Performance Planning and Budgeting are to review the current performance planning and budgeting systems of the NCBs; to strengthen and streamline the systems currently in place and ensure that they are adequate and appropriate as tools for orienting their banking activities toward desired objectives, motivating manager and staff performance, and monitoring results; and to train the staffs of the NCBs in the new, improved systems and assist in their implementation. The Project will provide one international consultant for 12 months on the same six, three and three month schedule outlined in 5.3.4. The consultant will work with the NCB implementation cells.

5.3.6 **Loan Analysis/Administration and Debt Recovery by NCBs:** The objectives of this technical assistance are to strengthen the management of NCB loan portfolios; to develop a strategy to enable the NCBs to increase the debt recovery rate by improving their credit policies and procedures; to develop an analytical framework for training in loan management; to train the staff of the NCBs in using this framework for credit analysis, loan portfolio supervision, and other topics relevant to the lending environment, and to assist the NCBs in the development of analytical tools for reviewing deposit and lending rate schedules within the broad guidelines given by the Bangladesh Bank. This component will be coordinated with the banking training to be provided for certain enterprises under the A.I.D. IPP.

The Project will provide one long-term international consultant and one national consultant to each NCB for 48 months to undertake the implementation of the above activities. The consultants will also provide technical assistance and operational feedback to strengthen the BB Credit Bureau and make it functional, as well as to assist the credit staff of the NCBs in the utilization of the information available. The consultants' work will be vetted by the Credit Expert and they will be assisted by the consultant designated to support the IMF TA for bank supervision. These consultants will work within the implementation cells of the NCBs.

5.3.7 **Acquisition, Installation and Assimilation of Computer Systems at BB and NCBs:** Computerization of key parts of the operations of the BB and of the NCBs is central to implementation of the accounting reforms and loan recovery improvement program. Specific objectives are to: (a) expedite and upgrade the computerization of the BB statistical, bank supervision, accounting and MIS functions; (b) computerize the NCB Head Office accounting and MIS systems, including reconciliation of inter-branch accounts, procedures for comparing actual with

budgeted performance, and loan administration; (c) computerize the accounting systems in a few selected larger urban branches. (d) computerize selected regional bank offices; and (e) integrate the computer systems into the overall operational structures of the NCBs, with an eye to eventual computerization of the complete organization. Accordingly, the Project will provide appropriate capacity computer systems, with the necessary accessories, software and supplies to BB and to three NCBs. An RFQ for a mini computer system for the BB will be issued as soon as possible after the FSRP TA PP is obligated. There are two reasons for the timing of the BB computer acquisition. First, the existing BB computer system has become obsolete and is approaching the end of its manufacturer's support period. Second, the TA Team's efforts will be more productive if the BB computer acquisition is completed, allowing them to concentrate on substantive work.

The remaining aspects of the computerization program for BB and the NCBs, including acquisition of the remaining computers, software, training, and development of plans for integration of computer-based techniques into operational systems, will be the responsibility of the institutional contractor. The Project provides for one long-term international consultant for 24 months, working with two national consultants also for 24 months each. These computer consultants will work with assigned bank officials to undertake the activities at BB and the NCBs.

5.3.8 <u>Special Studies and Activities:</u> Experience in policy reform projects of such large size and broad scope indicates that the work of the long-term resident experts must also be supplemented by specialized short-term consultants on selected issues. The Project provides for 30 person-months of short-term TA. Special activities will be developed in the course of Project implementation as necessary. Topics of proposed studies include: (a) lessons to be learned from operations of the private banks in general and from privatization of Uttara and Pubali Banks; (b) case studies of labor and other personnel issues facing the NCBs; (c) gender issues in employment/advancement and lending; and (d) analysis of impact of privatization on provision of banking services in rural areas.

The BDG has expressed interest in the provision of short-term TA to the Capital Market Development Committee for a study of policies and mechanisms to strengthen the domestic capital markets. Some short-term TA to the Technical Unit, which is responsible for advising senior Bangladesh Bank Management on the implementation of interest rate policies, will be available to examine capital market issues as they related to interest rates.

5.4 Training Components of the TA Team

5.4.1 Long-term Advisor: The Project will provide one long-term international consultant for 24 months. The advisor will be based at the BB and will: coordinate the entire training activity of the Program; maintain liaison with BIBM and the NCB managements; cooperate with the training academies of BB and NCBs on upgrading their courses and improving their course material; collaborate with these training institutes and with the managements of BB and NCBs in pinpointing the need for in-country and overseas training; and participate in the candidate selection process. The advisor will work with BIBM management to train NCB and private bank personnel, develop new courses and upgrade existing course material, and work with the faculty in implementing the new course offerings.

5.4.2 In-country Training: The domestic training element will be focussed on BIBM. Attention will be paid to making training available on a non-discriminatory basis to the private banks as well as BB and the NCBs. The objectives of the technical assistance for in-country training are to strengthen the skills base of BIBM in areas such as accounting and MIS; credit analysis; loan pricing; loan administration and portfolio supervision; performance planning and budgeting; term lending; public sector enterprise lending; agricultural lending and application of computers techniques in these areas. Experience developed by the private banks will be studied for potential broader application. Lending to new ventures, particularly to small and medium sized enterprises, will be the subject of special training carried out in cooperation with the A.I.D. IPP. A further important object of the training will be to address matters of gender discrimination, both through the selection of candidates for training and through teaching all trainees the harmful aspects of such discrimination.

In addition to the activities of the long-term international training consultant, the project has allocated funds for providing 350 person months of in-country training for BB, NCB and private bank personnel over the life of the project at BIBM. The training will be related to the fields of activity of the FSRP TA Project and will be offered through special courses, seminars and workshops.

5.4.3 Overseas Training: Provision has been made in the project for sending 60 staff members of BB and NCBs for a total of 268 person months of overseas training over the life of the project. This program consists of three separate components:

-- Training in monetary economics/commercial bank operations for one semester in the U.S. for 10 persons per year, five persons from the BB and five from the NCBs for a total of 40 persons and 200 person months. These will be the key

operational people whose skills will be used at the management level in the NCBs.

-- Attending Federal Reserve Bank of New York seminars on Central Banking, two persons per year from BB for a total of eight persons and eight person months.

-- Training in the region on bank computerization, four to six months, four persons from the BB and eight persons from the NCBs for a total of 12 persons and 60 person months.

A waiver for regional training outside geographic code 941 is needed on a case by case basis. The case by case waiver will be sought from AID/W, S&T, OIT. Waivers will be submitted by telegram or letter to OIT no later than 30 days prior to the start of the program. (If in the project planning stage the need for a specific amount of training in a non-approved third country is identified, a waiver may be submitted to cover the entire identified portion of the training component. In the case of AID/W Bureau project waivers should be arranged before the training is announced to the field.) OIT is expected to respond to each waiver application by cable or in writing within 10 days of receipt of the waiver. The waiver requesting OIT authorization to train in a country excluded from Code 941 should contain the following:

-- concise description of the training or educational study requested and its relevance to AID project goals.

-- details on the participant(s), including position, technical background, English language proficiency, need for the training and intended use of training on return.

-- information on the availability of similar training in the United States or a Code 941 third country.

-- reason the country where the training is to take place could not sponsor/fund the training.

Additional guidance is found in AID Handbook 10, Chapter 8, Third Country Training. The Training Cost Analysis is included in the Financial Annex, FA3.

5.5 Commodity Procurement Plan

The commodities to be procured under this project include computers, office equipment, and motor vehicles. With the exception of the acquisition of the mini computers for the BB, described in 5.3.7, procurement services will be provided or arranged by the Prime Contractor in consultation with USAID. All commodities will be through Direct Letters of Credit. The

purchase contract for the computer for the BB will be executed by A.I.D. The purchase contract will provide for installation, training and support by the manufacturer. IRM has participated in preparation of this PP and the computerization aspects of the Project.

The computers for the NCBs, micro computers and peripherals will be specified by the computer consultant on the TA Team in consultation with the appropriate BDG officials. All major computer procurements will be approved by AID/W/IRM and the Bangladesh National Computer Board. Computer procurements constitute approximately 75 percent of the overall commodities budget. The remainder involves office equipment, eight motor vehicles, and supplies and service. All of these procurements will be the responsibility of the Prime Contractor in consultation with the USAID Contracts Officer.

5.6 TA Team Logistics and Project Executive Administrator

Arrangements for transportation and other facilities to support the contractor's consultants, including the Chief of Party, will be the responsibility of the prime contractor. The contractor will make arrangements for housing and other support facilities in advance of the initial arrivals of technical specialists. The contractor will be responsible for arranging support facilities for all long and short term consultants on the TA/Training Team who require such facilities.

USAID is concerned that the TA Team Leader's time and attention not be taken up by non technical matters. To that end, the Contractor's TA Team will include a (52 pm) Project Executive Administrator who will be responsible for managing logistics matters such as, international and domestic transportation, housing, maintenance and repair, guard services, phone service, vehicles under the Prime Contractor's control, registration and documentation of contractor's vehicles, international and domestic shipments including customs clearance, international travel arrangements, lodging and transportation arrangements for Prime Contractor consultants and other support activities necessary to the functioning of the Prime Contractor's team in Bangladesh. The exact division of responsibilities between the Project Executive Administrator and the Prime Contractor's headquarters office will be determined by the Prime Contractor.

5.7 Project Administration

5.7.1 Bangladesh Implementation Agencies: The Project will be directed for the BDG by the BB. Much of the TA, training, and commodity procurement will be for the BB. In addition, all three types of inputs will be provided to the four NCBs, and training

in the BIBM will be available to private commercial banks as well. The BB has established a Technical Unit (TU) with general responsibility for implementation of the Financial Sector Reforms, under the guidance of the Deputy Governor of the BB. The TU's organization, staffing and first year work program for 1989 were developed by BB under the RFP. The TU will establish an Administrative Support Unit specifically for the FSRP TA Project, which will be responsible, inter alia, for the administrative aspects of providing the facilities and assistance funded by the BDG contribution to the Project.

The NCBs will have no direct responsibility for project management; however, the Central Bank will be in a position to insure cooperation and necessary support from them. The private banks will not be directly involved in Project administration, except in regard to their utilization of training where they will have the same access as the NCBs.

5.7.2 Coordination Among FSRP Agencies: The FSRP agencies are the Bangladesh Bank, the Bangladesh Institute of Bank Management, the Ministry of Finance and Planning, the four Nationalized Commercial Banks, other commercial banks, World Bank/IDA, and the IMF. The BB is the key BDG agency. There are three coordinating mechanisms in addition to the day-to-day working of the Program participants: the FSRP Review Committee, the USAID Project Coordinator and IDA review missions. The FSRP Review Committee is the key coordinating mechanism. Monitoring and evaluation of Program coordination is discussed in Section 6.

The Bangladesh Bank will be the implementing agency for the BDG. The Project Director will be the Deputy Governor of the Bangladesh Bank who will also serve as Chairman of the FSRP Review Committee. A condition precedent of the Project Agreement is that the BDG establish a Review Committee to oversee progress on all aspects of the Program. The Review Committee will include representatives of IDA, A.I.D. and IMF, the Managing Directors of the four NCB's, the Director of BIBM and the prime contractor Chief of Party. The A.I.D. representative will normally be the Director of the Office of Economics and Enterprise, with attendance by the Mission Director/Deputy Director when desired.

The intention is that the Review Committee will review the progress of work under the Project, identify potential problem areas and take appropriate actions. The objectives to be achieved as conditions for IDA tranches will be regularly reviewed. The Committee will schedule its meetings to coincide with IDA review missions to facilitate tracking of conditionality performance for all members of the Committee and to help integrate the working of the IDA FSC missions into the overall running of the Project.

The Bangladesh Bank's Technical Unit (TU) will provide secretarial services for the FSRP Review Committee. The Technical Unit will maintain a record of Project objectives and report on the progress to achieve such objectives. The TU will prepare for each meeting of the Review Committee a program of tasks to be accomplished during the next quarter by the Bangladesh Bank, the NCBs and the Consultants. This will be reviewed, by the Review Committee to form the basis for the activities for the forthcoming quarter.

There will be a Mid-Term Evaluation near the end of the second anniversary of the arrival of the long-term international consultants (the specific time to be mutually agreed upon USAID and BDG). This evaluation will review the past performance based on measurable outputs and reassess the work plan requirements for the remaining years of the project. The evaluation will allow for mid-course corrections and changes in the project design or project implementation if so required. See Section Six for a detailed evaluation plan.

5.7.3 **USAID Project Coordination:** The FSRP TA will be coordinated by a USDH Project Officer in the USAID Office of Economics and Enterprise. Because the bulk of the technical assistance will be procured by means of a USAID direct contract, and because of the scale and complex nature of the Project, it will provide for a PSC Project Coordinator for coordination and liaison. Under the supervision of the responsible USAID Project Officer, the PSC will serve as liaison between USAID and the Prime Contractor (TA Team), BB, the four NCBs, BIBM, and the World Bank and IMF representatives in Dhaka.

5.7.4 **Team Leader/Chief of Party:** The Team Leader/Chief of Party will have managerial responsibility for implementation of the technical assistance component. For day-to-day operations he will report to the Project Director in the Bangladesh Bank. Since the TA Team is provided under a USAID Direct Contract, the Team Leader will report periodically to the USAID Project Officer, who is responsible for assuring that TA Team personnel resources are applied effectively and as specified in the contract. The Team Leader will also provide technical expertise on bank management and administration. S/he will be based in BB and will supervise the long and short term international and national consultants, working both in the BB and in the NCBs, who will provide the TA and training expertise, and monitor their work to assure that it is accomplished on schedule as specified in the Scope of Work. S/he will be assisted by the officers and support staff of the BB Technical Unit, and will be supported by the various TA Team consultants. Secretarial assistance will be provided by the BB. The Team Leader's term will be for 52 months, and it is intended that s/he will arrive ahead of the other TA Team members accompanied by the Project Executive

Administrator to initiate housing and the necessary arrangements for the long term advisers.

The Project Director in the BB will head the FSRP TA Project. The FSRP TA Team Leader will report to the project director on all technical issues as well as on all important decisions pertaining to the implementation of the project. The project director will review the work plans, work performance, evaluation and all technical reports from the project. The project director will provide overall guidance and direction to the project team leader, managing directors of NCBs and to the Director of BIBM.

5.7.5 Summary of Team Leader/Chief of Party Administrative Tasks:

-- Plan and guide the implementation of the Project and be responsible and accountable for its progress.

-- Coordinate and supervise the long-term and short-term consultants, international and national.

-- Maintain close coordination with the Project Manager/Director, a senior officer appointed by BB as counterpart, with respect to all activities of the FSRP Project in all of its phases.

-- Maintain similar collaboration with the PSC Coordinator and the staff of USAID/Bangladesh.

5.8 Implementation Schedule

FSRP TA Project Paper approved	May 90
FSRP TA Project Authorization and obligation	June 90
WB/IDA Board presentation	June 90
WB/IDA Credit signed: first tranche released	June 90
RFQ for BB computer released	July 90
RFP for Prime Contractor released	July 90
Benchmarks Study Initiated	Oct 90
PSC Project Coordinator Selected	Nov 90
Prime Contract Signed	Nov 90
Benchmarks Study Completed	Dec 90
Team Leader and Project Administrator Arrive	Jan 91
Credit Expert Arrives (3 short term visits)	Feb 91
Computer/MIS Advisor Arrives	Jan 91
First NCB Advisor Arrives	Jan 91
Training Advisor Arrives	Jan 91
Macro-Economic Advisor (BB/TU) Arrives	Feb 91
Macro-Economic Advisor (MOFP/PAC) Arrives	Feb 91
Accounting/MIS Expert Arrives, (3 visits)	Feb 91

Second NCB Advisor Arrives	Feb 91
Third NCB Advisor Arrives	Mar 91
Fourth NCB Advisor Arrives	Mar 91
Planning/Budgeting Advisor Arrives (3 s/t visits)	Apr 91
Study # 1 Begins (Bank Privatization)	Apr 91
Study # 2 Begins (Gender/WID Considerations)	May 91
Study # 3 Begins (Personnel Issues)	Jun 91
Overseas Trainees Begin to Depart	Jun 91
Training Courses at BIBM Commence	Jun 91
RFQs for 3 NCB Computers Issued	Aug 91
Study # 4 Begins (Effect on Rural Areas)	Sep 91
Procurement of Computers for 3 NCBs	Oct 91
First Year Evaluation	Jan 92
Third IDA Tranche	Jan 92
NCB Computers Arrival and Installation	Jan 92
WB/IDA Third Tranche	Feb 92
WB/IDA Appraisal for Follow-on Credit	Jun 92
WB/IDA Negotiations for Follow-on Credit	Nov 92
Second Year Evaluation	Jan 93
Computer/MIS Advisor Departs	Jan 93
Credit Expert Final Departure	Jan 93
Training Advisor Departs	Jan 93
Macroeconomic Advisors Depart	Feb 93
Accounting/MIS Expert Final Departure	Feb 93
Planning/Budgeting Expert Final Departure	Apr 93
BIBM Training Courses Completed	Jun 93
Overseas Trainees Returned	Jun 93
Third Year Evaluation	Jan 94
Fourth Year Evaluation	Jan 95
First NCB Advisor Departs	Jan 95
Second NCB Advisor Departs	Feb 95
Third NCB Advisor Departs	Mar 95
Fourth NCB Advisor Departs	Mar 95
PSC Project Coordinator Departs	Mar 95
Team Leader and Administrator Depart	Apr 95

SECTION SIX

DATA COLLECTION, MONITORING AND EVALUATION PLAN

6.1. Introduction

To support policy changes under the BDG's Financial Sector Reform Program, the WB/IDA is providing $175 million credit; the IMF is providing TA to the BB and USAID proposes to provide $19.4 million in the form of technical assistance, commodities and training. The overall program goal is to restructure and thereby improve the functioning of the Bangladesh formal financial system. The FSRP TA inputs support a strategy intended to:

-- Strengthen the ability of the BB to apply available instruments of monetary policy; formulate and implement monetary and financial policies; and develop or adapt techniques for analyzing monetary, financial and related performance of the economy;

-- Improve bank supervision by the central bank (BB);

-- Increase the operational efficiency of the NCBs; and,

-- Upgrade the skills of the officials engaged in the activities related to reform of the financial sector.

The FSRP TA is an integral component of the overall program. Therefore the monitoring and evaluation effort will address the technical assistance component in the context of the effectiveness and impact of the overall Financial Sector Reform Program.

This section sets out the basic framework of the systems for monitoring and evaluation and identifies relevant key indicators of progress toward achievement of project purposes. Final details with respect to these indicators and the appropriate methods for collecting, analyzing and reporting on the information required will be determined by USAID and the TA Team, in consultation with IDA, MOF and the BB.

6.2. User Identification

The potential users of project information include: IDA, IMF, Ministry of Finance, Bangladesh Bank, Planning Commission, other bilateral donors, USAID project and program officers and senior management and AID/W.

6.3. Indicators of Achievement of Project Goal and Purposes

6.3.1. Goal-Level Indicators: The overall common goal of the GOB's Financial Sector Reform Program and of the FSRP TA Project is to improve the functioning of the Bangladesh formal financial system, including the Bangladesh Bank, and the commercial banks (composed of NCBs and private banks), so as to decrease the structural inflation rate and accelerate the rate of economic growth and employment-generation.

The macroeconomic impact of the Project will occur over the long-term, hence it will be difficult to isolate the net impact on macroeconomic performance indicators. Improvement in the following macroeconomic indicators is, however, expected to be evident by the end of this Project and will be addressed in the final Project evaluation:

-- Reduction in the structural inflation rate.

-- Increased profitability of commercial bank lending to the agriculture, export and small industry sectors.

-- Increased investment in the banking sector.

-- Relative stability of real interest rates as compared to nominal interest rates.

6.3.2. Purpose-level Indicators: The purposes of the Project, achievement of which will result in improved functioning of the Bangladesh formal financial system are the following:

-- Implement more flexible BB monetary policies and to improve central bank supervision of the commercial banks.

-- Develop financially-sound NCBs that are suitable for privatization.

-- Expand the share of the banking sector controlled by private banks, including continuation of the movement toward divestiture of the NCBs.

Assessment of the degree to which the Project is accomplishing and has accomplished its purposes will be based on a set of key indicators. The project monitoring mechanisms will be established to generate the information required. Project performance in relation to these indicators will be assessed as part of the four scheduled external evaluations. The final set of purpose-level indicators will be determined by USAID, and the TA Team, in consultation with the IDA and the MOF and BB. Purpose-level indicators will include, inter alia, the following:

Project Purpose 1.: To implement more flexible BB monetary policies and to improve central bank supervision of the commercial banks. The associated indicators are:

a. Replacement of direct monetary controls by flexible indirect instruments (e.g., open market operations, use of rediscount facility).

b. Increasing share of loan portfolio based on market-determined interest rates.

c. Technical Unit established at Central Bank with permanent positions and significant number of staff having received training.

d. Conduct more frequent and focussed inspection of branches' portfolio, and timely follow-up of identified deficiencies.

e. Credit Information Bureau established, with data in order,with 100% referrals for new loan applications and timely provision of information.

Project Purpose 2: To develop financially-sound NCBs that are suitable for privatization. The associated indicators are:

a. BDG continues to make transparent subsidy payments on below-market interest rates to commercial banks.

b. All commercial banks are implementing the Bangladesh Bank's instructions on loan classification, treatment of unrealized interest, and taking of provisions (per Bangladesh Control Department Circular #34).

c. All NCBs have carried out comprehensive reviews of their credit policies and procedures and have issued appropriate manuals.

d. Number of Special Courts established and judges appointed to administer Financial Loan Court Law.

e. Capital adequacy requirements of the banks are maintained according to the Banking Companies Ordinance (and if stipulated capital adequacy ratios are not achieved, the BB has taken appropriate action).

f. Effective performance planning and budgeting systems established by NCBs.

g. Increased computerization of NCBs' head offices and pilot computerization of 2-3 major and 5-10 smaller branches for each NCB.

h. Management Information Systems (MIS) of NCBs established following project guidelines.

i. Establishment of incentive pay and promotion systems based on branch-level performance.

C. Project Purpose 3: To prepare NCBs for privatization and expand the role of the private banks in the overall financial sector. The associated indicators are:

a. Private banks (rating partially-privatized NCBs by the portion of their shares privately-held) have increased their share of bank lending to 60 percent.

b. Understanding of problems which emerge from bank privatization has been improved by Studies.

c. Increased real rate of return on NCB non-loan assets.

d. Satisfactory divestiture program and timetable presented by BDG.

6.4. Monitoring and Information Systems

6.4.1. Introduction: The FSRP TA is a complex project in terms of the inputs to be provided and the planned changes in financial sector operations. It will be essential that the project be closely monitored. The monitoring methodology will be based on a combination of quantitative and qualitative methods designed to answer the questions of (1) what is happening and what is being accomplished under the Project, and (2) what is happening in the financial sector. Monitoring will accordingly include:

a. monitoring of inputs provided;

b. monitoring of progress in producing outputs;

c. monitoring performance in relation to purpose-level indicators; and

d. monitoring overall performance of the financial sector.

6.4.2. Monitoring of Technical Assistance, Training and Commodity Inputs: The Prime Contractor and the Project Coordinator are responsible for ensuring that the inputs of technical assistance, training and commodities are put into place.

The USAID Project Coordinator and the TA Team Leader will, during the first six months of project implementation, set-up a

system for tracking and reporting to USAID with respect to progress in supplying and "institutionalizing" the complex set of inputs to be provided to the MOF, the BB, the NCBs, the BIBM and the private banks.

The TA Team and the Project Coordinator will, in consultation with the above institutions, establish the appropriate administrative record-keeping and reporting procedures, to monitor progress in institutionalizing inputs. Reporting on inputs should cover:

1. Provision and activities of the macro financial consultants to the BB and MOF in the areas of:

   a. financial market and monetary policy analysis, (b) bank supervision and NCB reporting to BB;

   c. Credit Information Bureau upgrading, and

   d. BB computerization;

2. Provision and activities of consultants to the NCBs in the areas of

   a. credit

   b. computerization

   c. planning and budgeting

   d. accounting and MIS systems

   e. NCB manpower development.

3. Equipment provision and use, including: computers to BB and to NCBs, training equipment to the BIBM, and other project equipment.

4. In-country and overseas training to BB, NCB and BIBM personnel.

The TA Team Leader will submit to the USAID Office of Economics and Enterprise Quarterly Progress Reports on project inputs and any additional administrative data as set out in the above system.

6.4.3. <u>Monitoring of outputs:</u> The TA Team is responsible for ensuring that output benchmarks are met and suitable progress is made towards producing project outputs. The USAID Project Coordinator and the TA Team Leader will, in consultation with the BB and IDA, specify in detail the output targets and annual output schedule.

The USAID Project Coordinator and the TA Team Leader will, during the first six months of project implementation set up the system for tracking and reporting to USAID with respect to implementation progress in achieving planned outputs. This system will include quantitative and qualitative information on progress and results in relation to each of the outputs and will define the associated data collection and reporting requirements of the BB, BIBM and NCBs.

This information will be provided to USAID in the quarterly and annual progress reports of the TA Team and through the provision of administrative records and special reports as set-up by the system. Because of the technical assistance nature of this project it should be noted that many of the planned project outputs are in fact the same as the indicators of project purpose identified above. This system will cover the collection and reporting of monitoring data in relation to outputs in the following areas: (1) macro-financial analysis and policy, (2) BB computerization and MIS system, (3) BB supervision, (4) NCB operations, (5) training.

More specifically, the monitoring information provided will report on progress and results in relation to the following planned outputs:

1. A more detailed analytical framework for macro-financial analysis.

2. A better-trained cadre of officers on macro-sector policy.

3. A fully-operational rediscount window, sale and purchase of BB special securities, and a fully-operational interest rate policy.

4. Expansion of BB's computer operations and MIS system, with a staff trained in computer, statistical and econometric skills.

5. Improved reporting systems of banks to the BB.

6. Bank supervision methods based on analysis of bank financial condition.

7. A fully-operational Credit Information Bureau.

8. MIS systems and improved loan accounting systems established in NCBs.

9. Expanded computerization of NCB head offices and limited number of branches.

10. Planning and performance budgeting systems established in NCBs.

11. Revised loan policy procedures and improved loan recovery of NCBs.

12. Enhanced loan pricing and deposit rate setting and adjustment capabilities of NCBs.

13. Improved BIBM course offerings.

14. Outputs, manuals and techniques available to commercial banks.

15. Studies completed on:
    a. bank privatization,
    b. personnel issues,
    c. gender discrimination
    d. effects on rural areas.

A separate report will be required with respect to outputs in relation to women-in-development that will include: (a) employment levels and number of new women entrants to management and bank officer positions in the BB and NCBs; and (b) the number of women bank officer participants in-country and overseas training programs.

6.4.4. <u>Management Information Systems:</u> Establishment of improved MIS Systems in the BB and NCBs is a key element of the technical assistance. Many of the information requirements to monitor and evaluate the Project and the overall performance of the financial sector will be complementary to the information required by Bank Management.

The following are examples of the information to be included in the MIS system.

1. Quarterly balance sheet, projected four quarters into the future.

2. Quarterly profit and loss statement projected four quarters into the future.

3. Staffing levels by category and explicit listing of all position changes of DGM and above.

4. Number of branches by class of branch and explicit listing of branches open or closed.

5. Loan disbursements and recovery information by lending category.

6.4.5 <u>**Baseline Information:**</u> The TA Team will be responsible for establishing the baseline information with respect to each of the purpose-level indicators and the planned project outputs. This will include both quantitative data and qualitative information to describe and analyze the situation at the beginning of project implementation. This information can be readily obtained for the majority of the purpose-level indicators and outputs. A national consultant will be hired during the first two quarters of project implementation to collect and computerize this information. This baseline information will therefore provide the starting point in relation to which project progress and results can be determined.

6.4.6 <u>**Monitoring Information for Purpose-Level Indicators:**</u> The TA team leader and the Project Coordinator will be responsible, in consultation with the MOF, BB and IDA, for setting realistic targets and benchmarks against which to measure progress in relation each of the indicators of purpose achievement.

The TA team, in consultation with the IDA and the BB, will, during the first two quarters of project implementation, set up a system for data collection and reporting by the BB and the NCBs. This system will identify the data to be collected relative to each progress indicator, and establish the mechanisms for data collection and analysis and the form and timing of reporting to USAID. Since improving overall computer systems is an essential component of the project, this will require both specific additions to data collection and requests for certain sub-sets of information on specific variables.

Monitoring information in relation to each of the purpose-level indicators will be provided on a quarterly and annual basis by the TA Team to USAID. In addition, certain monthly BB and NCB bank reports will be required.

The IDA has established a complex and detailed set of actions sought under the credit and identified a set of conditionalities for release of each of the three tranches. The IDA will be closely monitoring progress in implementing these actions. Many of USAID's monitoring requirements will correspond to those of IDA and accordingly the monitoring systems developed will identify the requirements for shared administrative records and reports.

6.4.7 <u>**Monitoring Overall Financial Sector Performance:**</u> Because the assistance provided under the FSRP TA supports overall efforts to strengthen the financial sector, USAID monitoring activity will also be concerned with monitoring of the macro-economic performance of the financial sector and the effects of the major policy reforms undertaken.

This monitoring will be based on a reporting system developed by USAID, the Prime Contractor and the BB, in consultation with the IDA and MOF, during the first two quarters of project implementation. The information included in this system will provide the detailed basis for tracking the macro-economic indicators identified above (6.3.1), and for determining whether the functioning of the Bangladesh formal financial system has improved. Monitoring information on overall financial sector performance will be shared and reviewed by USAID, IDA, IMF,MOF and BB.

These reports, which will be compiled by the BB and the Prime Contractor and submitted regularly to USAID, will be based on, inter alia, the following data:

Interest Rates -- The interest rates set by each bank for different lending sectors and different deposit types will be compiled monthly. Averages for the banking sectors will be compiled and the overall average for regulated and unregulated categories will be computed. For each borrowing sector the real interest rate will be determined monthly and overall average interest rates for all bank lending will also be defined.

Deposit rates for each bank will be weighted by category to determine average deposit rates by bank; real deposit rates will also be determined monthly. Other interest rate data will include the bank rate, interbank call rate and borrowing rate on BB special securities.

Credit Levels -- The volume of credit will be estimated by quarter for each type of lending category and on a rural/urban/total basis. Data will include balance outstanding, disbursements and collection ratios. Real credit will also be calculated and aggregated for different categories of banks.

Deposit Levels -- The volume of deposits will be estimated on a quarterly basis for each deposit category and on a rural/urban/total basis. Real deposits will also be determined.

Commercial Banking -- Simplified composite balance sheets and also profit and loss statements will be computed quarterly for each NCB, private banks and foreign banks. Book value and market value of bank capital will be computed on a quarterly basis, by bank type. Capital adequacy estimates will be compiled quarterly. Actual reserves and actual liquidity ratios on a monthly basis, by bank type. Payments of subsidy by BDG to commercial banks. BB special security sales and purchases on a monthly basis, by bank type.

6.5 Progress Review Process

Selective monitoring information will provide the basis for the Quarterly Implementation Reviews by the USAID Mission and AID/W. IDA will conduct two or three Supervision Missions annually to review implementation progress. USAID, as a parallel financier, will be represented on each Mission.

A review process for TA will be established at the time of release of the second tranche. This TA Review Group, comprised of representatives of BDG, IDA, USAID, and IMF will meet at least three times annually to review the findings of the IDA Mission, to assess progress, identify impediments to progress, identify corrective actions and discuss implementation plans.

6.6 Evaluation Plans

6.6.1 IDA Evaluation Plans: IDA will conduct a final evaluation in the first or second quarter after the close of the FSRP in mid-calendar year 1992. USAID will be represented on this Evaluation Mission. The findings and recommendations of this evaluation will be reviewed by the TA Review Group.

6.6.2 USAID Evaluation Schedule: Because of the complex nature and relatively long time horizon of the project, it is essential that comprehensive evaluation be conducted at several critical points in project implementation in order that necessary revisions to strategy and work plans can be made. USAID has scheduled four external evaluations. This evaluation schedule is based on the overall project implementation schedule.If implementation events are revised, the evaluation schedule will be revised accordingly. See Annex F.A.2 for the Evaluation Budget.

First External Evaluation .... January 1992

Mid-Term External Evaluation..... February 1993

TA Progress Evaluation..... January 1994

Final External Impact Evaluation..... March 1995

The following is a brief description of the areas of concentration for each evaluation. The first external evaluation, to be conducted approximately one year after the arrival of the TA Team will focus primarily on the supply and "institutionalization" of inputs. The evaluation will examine whether: (a) first-year inputs of technical assistance, commodities and training are in place as planned in the various institutions; (b) baseline data and project monitoring systems are established and functioning effectively; (c) first-year

output benchmarks have been met; (d) USAID project oversight is effective; and, (e) actions sought under IDA credit have been carried out as scheduled.

The mid-term evaluation, to be conducted two years after the arrival of the TA Team, will be an in-depth and comprehensive assessment of the performance of the project to date. This evaluation will examine (a) the overall progress of the BDG's Policy Reform Project and whether policy objectives and actions sought under the FSRP have been carried out as scheduled; (b) outputs produced under the project in relation to second-year benchmarks, in particular, whether macro-financial and BB computer/MIS outputs have been accomplished, and progress towards end-of-project outputs; (c) progress in relation to each purpose-level indicator; (d) implementation constraints ; (e) effectiveness of donor and BDG co-ordination. This evaluation will provide detailed recommendations with respect to the necessary mid-course adjustments to project strategy and/or implementation in order to achieve project purposes.

The TA progress update, to be carried out approximately one year after the mid-term evaluation, will be a brief external progress review which will examine (a) progress of the TA in relation to planned outputs, and (b) follow-up of recommendations of the mid-term evaluation. The final project evaluation, to be conducted approximately four to five months prior to the end of the project, will be a detailed assessment of project impact. It will examine, inter alia: (a) whether the planned end-of-project outputs have been achieved; (b) the degree to which the project has contributed to the achievement of project purposes; (c) the impact of the project at the macro-economic level in relation to goal-level indicators; and (d) sustainability of the operational improvements in the banking system and the policy reform efforts undertaken.

6.7 Summary of Monitoring and Evaluation Activity

1. Quarters 1-4 of Project Implementation:

   Establish methods for tracking the supply and institutionalization of project inputs.

   Contract, collect and analyze baseline data for outputs and purpose-level indicators.

   Design and setting-up of monitoring and reporting systems to monitor project outputs and purpose-level indicators.

   Design and setting-up of monitoring and reporting systems to monitor overall financial sector performance.

Participation on IDA Supervision Missions.

Participation in TA Review Process.

Review of Prime Contractor's Annual Work Plan, Quarterly Reports and other Prime Contractor reports as set-up by the system.

Quarterly Mission and AID/W Reviews.

2. Quarters 5-8 of Project Implementation:
Continued reporting, record keeping and information-sharing as set-up by the monitoring system -i.e., updating of data and information on inputs, outputs, purpose-level indicators and financial sector performance.

Participation in 2-3 IDA Supervision Missions.

First External A.I.D. Project Evaluation.

IDA Final Evaluation - USAID participation.

Participation in TA Review Process.

Review of Prime Contractor's Annual Work Plan, Quarterly Reports and other Prime Contractor Reports as set-up by the system.

Quarterly Mission and AID/W Reviews.

3. Quarters 9-12 of Project Implementation:
Continued reporting, record-keeping and information-sharing as set-up by the monitoring system - i.e., updating of data and information on inputs, outputs, purpose-level indicators and financial sector performance.

Mid-Term External AID Project Evaluation.

Participation in TA Review Process.

Review of Contractor's Annual Work Plan, Quarterly Reports and other Prime Contractor Reports as established by the system.

Quarterly Mission and AID/W Reviews.

4. Quarters 13-16 of Project Implementation:
Continue reporting, record-keeping and information-sharing as set-up by the monitoring system - i.e., updating of data and information on inputs, outputs,

purpose-level indicators and financial sector performance.

TA Progress Update Evaluation.

Participation in TA Review Process.

Review of Contractor's Annual Work Plan, Quarterly Reports and Other Prime Contractor Reports as set-up by the system.

Quarterly Mission and AID/W Reviews.

5. Quarters 17-20 of Project Implementation:
   Continue reporting, record-keeping and information-sharing as established by the monitoring system, i.e., updating of data and information on inputs, outputs purpose-level indicators and financial sector performance.

   Participation in TA Review Process.

   Quarterly Mission and AID/W Reviews.
   Final External Impact Evaluation.

SECTION SEVEN

SUMMARIES OF ANALYSES AND ECONOMIC BACKGROUND

7.1 Technical Analyses

The following summarizes the contents in the Technical Analysis Annexes, as referenced. Because the FSRP TA is an economic policy project and its substance concentrates on core economic institutions -- the Central Bank, the NCBs and will affect the entire commercial banking system -- much of the material in the PP discusses economic subjects. Therefore, the more analytic economic discussions are included in the project paper itself, rather than in an economic analysis annex. Annex E.A.1 contains a discussion of capital markets.

7.1.1 Summary of Annex T.A.1. -- "Key Constraint: Inadequate Financial System": Annex T.A.1. describes the inadequacies of the financial system which inhibit it from performing an effective and dynamic role in the economic development of Bangladesh. The existence of this problem is manifested in various symptoms: deficient financial intermediation resulting in misallocation of credit and loan delinquencies; a structure of unremunerative incentives, with the result that financial institutions have to be forced to provide credit to priority sectors; and inefficient credit delivery systems, resulting in high transaction costs to the borrower.

The Annex suggests that the financial system is not able to meet the growing financial needs of production, consumption and trade in an efficient manner. Fixed credit ceilings, preferential lending programs, subsidized interest rates, weak bank supervision, low loan recovery rates, inadequate accounting practices, and weak regulatory framework are listed.

7.1.2 Summary of Annex T.A.2. -- "Response of the International Donor Community": A.I.D. spearheaded the effort to convince the BDG that the deteriorating financial system was a brake on economic growth. In 1980, A.I.D. initiated the RFEP, followed by the RFP in 1983. Technical Analysis Annexes TA4, TA5 and TA6 summarize A.I.D.'s experience in the Rural Finance Projects.

These A.I.D. projects, together with the 1982 IDA Financial Sector Review, were instrumental in the BDG decision to convoke the NCMBC, whose report was the final push needed to convince BDG of the dangers of inaction and of the urgency of effective action. This process has culminated in the meeting of minds between the BDG and IDA on the FSRP.

The $175 million IDA FSC is a wide ranging policy-based program designed to achieve comprehensive reform of the policies affecting the financial system and its constituent institutions. The Financial Sector Credit Reform Program will contribute to

recapitalization of the NCBs, conditioned on changes in interest rate subsidies, monetary policy reforms, loan recovery improvement, strengthening the institutional capacity of BB and NCBs, and special studies on selected policy issues and training.

7.2 Background: A.I.D. and Reform of Financial Markets

7.2.1 The Importance of Efficient Financial Intermediation: There is a broad and long-standing consensus among economists on the value of an effective financial intermediation system. Examples of three relatively recent publications on this topic are Money, Interest and Banking in Economic Development, (1988) by Maxwell J. Fry (financed by A.I.D.); Financial Liberalization and Economic Development: A Reassessment of Interest-Rate Policies in Asia and Latin America, (1988) by Ronald J. McKinnion; and the World Development Report 1989, by a writing team led by Millard F. Long. These, and other publications provide ample critical reasoning and evidence that an efficient financial intermediation system is crucial in fostering the economic growth and development process. A sound and resilient financial market is obviously critical in a large-scale privatization effort such as the one confronting Bangladesh. Discussion of the importance of a well functioning financial system and capital market to privatization efforts can be found in Financing Privatization Under Limited Capital Conditions, (1986) AID/PPC/PDPR by Arthur Young Intl. and in Capital Markets and Privatization, (1987) AID/PPC/PDPR by The MAC Group.

7.2.2 A.I.D. Policy Concerning Financial Markets: Financial markets development relates directly to A.I.D.'s overall goal of promoting broad-based and sustainable income growth and employment generation, and, more specifically, to the promotion of the private sector as the most efficient means of attaining growth in income and employment. Firmly linked to those overall goals is the Financial Sector Credit Technical Assistance Project's goal of increasing the availability of long-term investment capital by supporting open financial markets.

In August, 1988, A.I.D. issued a Policy Paper on Financial Markets Development, indicating the Agency's intent to take into account the critical role financial markets have in a well functioning private sector. This paper particularly stresses the role which financial markets play in mobilizing domestic resources, integrating domestic and international financial systems, and promoting widespread private ownership of business enterprises. The Policy Paper goes on to stress policy and institutions in financial markets. The Financial Sector Reform Program and its A.I.D.-funded Technical Assistance component are consistent with and actively implement basic A.I.D. policy on the issue. As such, a successful financial sector project in

Bangladesh will provide valuable input into future A.I.D. programs worldwide.

7.3 The Bangladesh Financial Sector

7.3.1 The Structure of the Financial Sector: The Bangladesh Financial Sector comprises: the Central Bank (Bangladesh Bank); three 100% government-owned Nationalized Commercial Banks (NCBs); one 51% Government owned Commercial Bank (included as a NCB in the Project); eight private domestic commercial banks, two of which have been divested from their prior NCB status; six foreign private commercial banks; four government-owned specialized scheduled banks: two industrial banks (one of which, the Small Industries Bank is just starting and is only partly government owned), and two agricultural banks; three non-scheduled banks (i.e. not directly under the control of Bangladesh Bank through their establishing legislation or through their charter): the Apex Cooperative Bank (BSBL), the Grameen Bank, and a non-scheduled industrial lending bank (BSRS); a number of other non-banking financial institutions (insurance, finance, and leasing companies); and the Dhaka Stock Exchange (DSE). Table 7.1 on the following page provides an overview of the institutions in the Bangladesh Financial Sector.

Table 7.2 summarizes the Bangladesh banking industry in 1988. The four NCBs held two-thirds of bank deposits; made 54 percent of the loans; comprised two-thirds of the overall branch bank network, almost 65 percent of the rural branch network, and over 90% of the rural branch commercial bank network. In contrast, the indigenous private banks had only 22 offices but held 23 percent of deposits and made 19 percent of total advances.

Table 7.1 Structure of the Bangladesh Financial System, June 1987

Bangladesh Bank							
Deposit money banks				Other financial institutions			
Nationalized commercial banks	Private commercial banks	Foreign banks	Specialized banks	Specialized banks	Cooperative institutions	Insurance companies	Others
Sonali Bank	Arab-Bangladesh Bank	Bank of Commerce and Credit International	Bangladesh Shilpa Bank	Bangladesh Shilpa Rin Sangstha Bank	Grameen Bank	Sadharan Bima	House Building Finance Corp.
Janata Bank	City Bank	Grindlays Bank	Bangladesh Krishi Bank			Jiban Bima	Bangladesh Rural Development Board
Agrani Bank	IFIC Bank	American Express International	Bangladesh Jatiya Samabaya Bank			American Life	Investment Corp. of Bangladesh
Rupali Bank	National Bank	Chartered Bank	Rajshahi Krishi Unnayan Bank			Norwich	National Credit Ltd.
	Pubali Bank 1/	Habib Bank				Prudential	Bangladesh Commerce and Investment Co. Ltd.
	Uttara Bank 1/	State Bank of India				Bangladesh General	Saudi-Bangladesh Industrial and Agricultural Investment Co., Ltd.
	Islamic Bank Bangladesh Ltd. 2/	Indosuez Banque				Pragati General	Industrial Promotion and Development Co. of Bangladesh Ltd.
	United Commercial Bank					Peoples General	International Leasing and Development Co. of Bangladesh
	Al-Barakah Bank Ltd. 2/					Green Delta	
						Eastern Union	
						Bangladesh Cooperative General	
						National Life	
						United	

Source: Data provided by the Banking Control Department of Bangladesh Bank.
1/ Previously nationalized commercial banks.
2/ Operates according to Islamic banking principles.

Table 7.2 Structure of the Banking System
(as of Dec. 1988)

Bank Category	Number of Branches Urban	Rural	(billions of Taka) Bank Deposits	Bank Advances
N C Bs	1,175	2,335	112.4	82.6
% share	21.7	43.1	65.7	54.2
Specialized	111	1,004	7.1	32.5
% share	2.0	18.6	4.1	21.6
Indigenous Pvt.	22	--	39.2	28.3
% share	0.4	--	23.0	18.6
Foreign	502	264	12.5	8.9
% share	9.3	4.8	7.3	5.8
Total	1,810	3,606	171.1	152.4
% share	33.4	66.3	100	100

Source: Bangladesh Bank Statistics Department, Scheduled Banks Statistics, 1988, various tables.

7.3.2 Bangladesh Banking and Monetary Policy in the 1980s: The main aspects of the Bangladesh monetary and banking regime have been presented in various parts of this PP. To provide a relatively concentrated discussion of the economics of the FSRP TA the following discussion draws together some of the discussion already noted in preceding sections and supplements it with some technical treatment of economic issues. An expert detailed discussion can be found in World Bank (draft) "Report and Recommendation of the President of the International Development Association to the Executive Directors on a Proposed Credit to the People's Republic of Bangladesh for a Financial Sector Adjustment Credit" (1989).

Until recently, monetary policy in Bangladesh was essentially passive and the central bank's ability to implement policy was extremely limited. Monetary policy tended to be dominated by special interests and political objectives. The main monetary policy tools of Bangladesh Bank were cash and liquid asset requirements, credit ceilings, refinance facilities, margin requirements and administered interest rates. Refinancing of the NCB was used to keep them solvent in a system that otherwise assured their insolvency. The regime had no instruments for making relatively small adjustments in the money supply or for transmitting market signals into money supply changes.

Because deposit interest rates tended to be set relatively high, ample savings deposits meant that banks tended to have ample liquidity. The main function of the NCBs was to provide the desired volume of credit flow to priority sectors at administered, low interest rates. The NCMBC report noted that these practices did not allow monetary policy to function nor the banking system to fulfill its role as financial intermediator.

The refinancing of NCBs by the BB in response to losses caused by non performing loans meant that money supply growth was a partial, but substantial function of the de-facto default rate. Furthermore, whenever the default rate caused refinancing to increase growth in money supply at a rate greater than the growth rate of real output, the default rate was effectively driving inflation at the margin.

Perhaps the most fundamental characteristic of the Bangladesh banking regime was that decisions regarding the size and composition of bank loan portfolios and the pricing of bank services were largely made by the government based on non-financial criteria instead of by bankers using typical commercial and financial criteria. The schedule of administered nominal interest rates changed infrequently with the result that real rates fluctuated with changes in inflation, and in the opposite direction than rates should move to contribute to stability. Lending rates did not adequately reflect relative risk, maturity, or the cost of term deposit funding. Because of the administered rate regime, private banks had little incentive to collect deposits and lend to priority areas while NCBs, which were required to conduct priority lending, had extremely narrow interest rate spreads.

Tax and loan recovery laws were biased against the commercial banking system. Four general aspects are worth noting. First, accounting procedures called for banks to report unpaid but accrued interest as current earnings and to pay income taxes on the fictitious earnings. Second, the system for classifying non performing loans was extremely lax: an extended period of time was required for a loan to be classified as non performing. Third, the legal procedure for collection of non performing loans was prohibitively costly, requiring up to ten years of litigation before payment could be claimed. Fourth, commercial banks operated with minimal reporting and supervision standards, inadequate capital adequacy and loan provisioning requirements, Because of large-scale directed lending, prudent lending criteria were not a part of the system. As noted in 3.4., the BDG is making a series of major changes in the financial regulatory system to address weaknesses and legislation is being changed to make loan recovery more effective as a means to enforce repayment discipline. The FSRP TA will provide the technical and institutional means that will help implement some

technical and operational aspects of the regulatory and statutory changes.

7.3.3 **Preparation of NCBs for Privatization:** One of the key aims of the Financial Sector Reform Program and the TA Project in particular is to make the NCBs viable candidates for sale to private investors by creation of more autonomous, commercially oriented and financially sound NCBs. The BDG's stated intention is that during the life of the Project, the Government "intends to take steps to privatize one or two of our remaining NCBs and significantly reduce Government's ownership role in the banking system." (Draft letter from the Governor of the BB to Barber Conable on Financial Sector Credit: Statement of Financial Sector Policy, dated Sept. 25, 1989.) A covenant in the FSRP TA Project Agreement requires the BDG to conduct a study on NCB privatization and on other steps to reduce BDG ownership in the banking system, and provide the resulting action plan to A.I.D.

The restructuring of the monetary and banking policy/regulatory environment combined with overhaul of the NCBs' financial structures and management systems will greatly increase the likelihood of interesting private investors. At present, potential investors are fully aware of the overvaluation of NCB loan portfolios and hence overstated net worth, and have little interest in purchasing shares. For privatization to occur, the NCBs need to be restructured so as to attain a reasonable ability to function as business-like, operations. They need not, however, be highly profitable to be salable, although the attribute obviously helps. The key variables influencing privatization are the sale price and expected returns. It is the perceived potential for return on investment, not necessarily present profits that determine salability.

The sale of equity shares in the NCBs to the public through the capital market will yield positive benefits both for the government and for the equities market itself. The government will gain revenue from the sales (and the BB will no longer have to use its limited resources to subsidize NCB operating costs). The offering of NCB equity shares will increase the volume and variety of shares available for trading thereby broadening the securities markets.

7.3.4 **Relationship of Project to Capital Markets:** In the formal financial sector, funds are mobilized primarily through the banking system. There is no secondary market for government securities, mo market for corporate debt and the equity market is small. Hence there is a preponderance of debt financing relative to equity finance. The banking system cannot provide large-scale long term funds. Most deposits in banks are short term, banks are limited in their ability to provide long-term lending because of the large risk factor associated with short-term borrowing and long term lending. Furthermore, banks have a tendency to make

loans based on collateral and/or personal relationships, not on projected cash flows. As a result, most companies are highly leveraged and small and medium-scale enterprises are virtually unable to obtain financing. Equity markets are in a rudimentary state and have yet to fulfill their potential to foster efficiency in the mobilization and allocation of long-term finance. Increases in long term interest rates will provide increased incentive for the capital market to play an expanded role in financial investment to augment commercial bank and DFI lending.

While the number of institutions operating in the market is adequate for competitive purposes, there are doubts about the institutional capacity and financial soundness of some of them. The regulatory framework is weak. The equity market lacks breadth and depth. Only a limited range of financial instruments is available. This problem is discussed in the A.I.D. IPP Project Paper. Finally, the Dhaka Stock Exchange (DSE) cannot develop into an effective exchange until it raises both the level and the variety of its capitalization substantially. This will involve establishment of an appropriate regulatory and self-regulatory system for the DSE; increasing the par value limitation; removing the ceiling on underwriting fees; and requiring that most transaction in listed shares take place on the stock exchange. The Economic Analysis Annex EA.1. contains the Recommendations Section of the IDA Working Paper on Capital Markets.

Reform of the financial system and of the NCBs is a crucial aspect in the development of the Bangladesh equity capital market. System reform will increase the supply of loanable funds and, as the securities of the privatized NCBs become available for trading, increase the scope for equity financing as well. Privatization of NCBs will help alleviate the current problem of a lack of securities which, in turn, hampers further financial market development. Deregulation will also help convince the private sector of the government's commitment to developing financial markets and increase investors' confidence in the equity markets. Over time, it is expected that private businesses will be able to finance expansion by publicly selling debt and equity securities. However, development of the equity market is dependent on financial market reform and expansion of private banking.

The development of financial markets will increase the efficiency of the flow of funds between savings and investment. Increased efficiency will take place through a variety of mechanisms: the cost of intermediation will decrease because of increased competition to attract users and providers of funds; the cost of raising funds will decrease as the inflation rate declines; and funds will increasingly be allocated to users based on credit risk, cash flow and profitability, and less on personal

relationships and collateral. As a result, funds will tend to flow to the most efficient firms and individuals. The productivity of capital will increase with related increases in incomes, output and savings.

7.3.5 <u>**The Project and Foreign Investment**</u>**:** Reform of the monetary regime, liberalization of banking regulations and restructuring of the NCBs, coupled with increased financial market activity, will improve the financial environment thereby attracting attract foreign investors to provide both debt and equity capital to Bangladesh, subject to the degree that aspects of the general business climate permits. At least one foreign bank has recently substantially increased its injection of funds into the system. A sustained increase in the inflow of foreign funds would increase the degree of integration of the Bangladesh financial system into the international financial market, further increasing the efficiency of the domestic system. The difference in cost of funds between the markets would narrow and the risks associated with interest and exchange rate fluctuations can be spread among a larger number of market participants.

SECTION EIGHT

ECONOMIC AND SOCIAL ANALYSES

The restructuring of the financial sector under the FSRP TA will realize numerous significant and interrelated economic effects. The following section presents discussions of the role of financial markets in economic development and implications of the FSRP for specific variables: savings, investment, growth, inflation, employment and income distribution, poverty, privatization, and BDG domestic debt. This section also examines the implications for NCB, expansion of private banking, the agricultural sector and risks, social soundness and gender considerations.

8.1 The Financial Market, Financial Intermediation and Economic Efficiency

How a financial system, a system which produces no real goods itself, can significantly influence growth may not be readily apparent. Yet the financial system and the degree of its efficiency is at the heart of the growth process because it is the financial system that enables a large proportion of investment to occur and surplus directs savings to the most productive uses.

Investment can be self financed by the firm or the household or investment can be financed through the financial system, i.e., borrowing, sale of a debt instruments or sale of equity. With self-financed investment there is no need for financial intermediation: the act of saving and investing is internalized such that there are no costs involving information, transaction, monitoring or enforcement. The risk reducing devices of contracts or collateral are not necessary. Self finance, however, depends on there being a balance between the amount to be invested and the savings on hand for each individual firm or household. The financial system comes into play whenever there are firms or households with savings that they neither want to invest nor hold idle or when it is preferred to invest more than is available from their own savings. A financial system, i.e., financial intermediation, relieves the constraint of individual economic entities balancing their savings and investments by collecting surplus savings and transferring them to investors.

As an economy develops and financial needs become more diverse, the financial system evolves from local banks to national banking systems, to include securities markets, foreign banks and an increasing variety of risk-spreading and specialized financial intermediation devices. The move from local banks to a more sophisticated system is called financial deepening. The Bangladesh financial system has many of these features in rudimentary form, but coordinating market and information systems

are extremely underdeveloped or inefficient. A well-functioning financial system means the costs of transferring resources from saver to borrowers is just covering the costs of the services themselves with the maximum possible rate paid to savers and the minimum possible rate charged to borrowers. Theory and experience demonstrate that this ideal condition can only be realized with a competitive market system.

The existence of a financial market influences growth by converting savings into investment that would not otherwise occur. The existence of a financial market also adds flexibility because it can expand and adapt, e.g., by incorporating a capital market, thereby continuing to balance savings with investment. The more efficient the financial market the lower the transactions costs and the larger the relative volume of savings and investment (transaction or intermediation costs approximate the spread between the deposit rate and the lending rate in a competitive system, thus a smaller transaction cost can accommodate higher rates to savers and lower rates to borrowers which increases financial savings and investment). And the more competitive and the greater the depth of the system the greater its efficiency.

8.2 Implications of the FSRP for Economic Growth

The FSRP will contribute to economic growth in several major ways such as changing the relative prices of capital and labor and reducing economic rents. Some of these aspects are discussed under other headings in this subsection which continues the preceding discussion, concentrating on the likely effects of the FSRP on savings, investment and growth.

8.2.1 Savings Effects: The FSRP will probably not increase the rate of total savings (nonfinancial and financial) significantly in the short or medium term. Evidence from general studies suggest that saving rates are not very sensitive to increases in the deposit rate so long as the rate is positive. (References to the deposit rate in this discussion refer to the real rate of interest earned by savers in the commercial banking system.) The deposit rate in Bangladesh has tended to be positive during most of the last several years.

The financial savings rate can be expected to increase, however, because the level of deposit rates affect the form in which savings are held and the deposit rate will tend to move upwards during the period of the FSRP. The deposit rate will rise, reflecting efficiency gains and increasing competition in banking. The average deposit rate over time will tend to increase because the greater flexibility in deposit rates will reduce adjustment lags. Deposit rates will also tend to move upward as the more efficient banks start to compete for savings.

The FSRP will also establish the basis for expansion of the securities market which will tap a new source of savings.

8.2.2 Investment Effects: Net human and capital investment enables output to increase: it causes growth to occur. Economic theory suggests and empirical studies support the idea that the quality of investment is at least as important for growth as the quantity. The 1989 World Development Report points out that the fastest growing countries had higher rates of investment than others. The Report cites studies that find that less than half the growth in output is attributable to increases in labor and capital. Higher productivity explains the rest and higher productivity reflects the allocation of investment to more productive uses. The more efficient the financial system, the higher the incremental output capital ratio (IOCR).

According to the Report, analysis of economies' performance in the 1970s showed that positive real interest rates (denoting economies with non-repressed financial systems) helped growth mainly by improving the quality of investment. The rate of investment was 17 percent higher in countries with positive real rates but the average productivity of investment was almost four times higher. The literature on the subject summarized by Fry concentrates on the deposit rate of interest. The standard departure point in the analyses summarized by Fry is a McKinnon-repressed system and attempt to measure the effects on investment or growth as the deposit rate moves upwards toward its equilibrium level (which causes savings to increase, forcing the lending rate down and causing investment to rise).

As noted earlier, the deposit rate in Bangladesh through most of the 1980s has been positive. The deposit rate, the point of concentration of most of the analytical studies has not been a significant issue in Bangladesh. Furthermore the formulation of the analyses suggests that analysts do not yet have a precise fix on how the causal chain works. For example, the World Development Report 1989, in attempting to assess the impact of interest rates on economic performance, tests a hypothesis composed of a chain of relationships starting with deposit rates to financial deepening to an increase in saving and investment and from financial depth to productivity of investment. The regression analysis results show a small but strong relationship between interest rates and growth that, according to their assessment, appears to operate primarily through the effect of greater financial depth on the productivity of investment. Their R square value of .45 (t values all > 2) is surprisingly high considering that the unexplained portion accommodates all other potential explanatory variables such as fiscal and trade policies and political factors.

The measures in the FSRP have already been listed and discussed in Section Three. One of the main thrusts of the FSRP

is to increase the level of financial discipline, thereby upgrading the quality of lending which is defined by the market as an improvement in the quality of investment. The FSRP will move savings away from financing the operating costs of inefficient industries, away from special interests who are free of the discipline of earning the highest possible return, toward productive uses. (Because no penalty or stigma was attached to non-repayment, borrowers could rationally assume a future stream of funds, thus any given loan could be used for consumption, capital flight or high-risk investment without the discipline of concern of the consequences.) By introducing discipline into the financial system, both bankers and borrowers are forced to concentrate on the same single criterion -- expected return. Although the model is not the one analysts have typically constructed and estimated, the result is the same: the quality of investment -- the marginal product of borrowed capital -- will increase substantially. It is also likely that ability of banks to vary the interest rate spread will enable them to lend in higher risk categories to individually sound borrowers.

8.2.3 <u>Growth Effects</u>: The FSRP will contribute to a higher growth rate through several channels. With successful implementation in the first few years the quality of investment will increase as banks gain lending autonomy and increase the degree of lending discipline; as systemic changes pull up and sustain the real deposit rate; as greater efficiency reduces transactions costs; as financial deepening takes place, driven by systemic reform in the commercial banking system; and by direct efforts under the FSRP to improve and enlarge the functioning of the securities market.

It is not unrealistic to expect the FSRP could add a full percentage point to Bangladesh's real growth rate by the mid to late 1990s. Fry estimates that a one percentage point increase in the real deposit rate of interest towards its competitive market equilibrium level is associated with a rise in the rate of economic growth of about .5 of a percentage point. If we assume a modest increase in the real deposit rate of say .5 percentage points above what it would have been without the FSRP, that could yield a .25 point increase in GDP growth.

It is only possible to speculate in broad terms about the effect of improving the quality of investment. For example, total advances from the NCBs and indigenous private banks for 1988 were approximately 110 billion taka in 1988. Assume reforms cause an instantaneous increase in investment from 25 percent of advances with a 10 percent return to 33 percent of advances with a 14 percent return. Applied to Bangladesh's 1988 GDP (real factor cost), the former rate of investment and return adds a .5 percent increment to GDP; the higher level of investment and increased return on investment adds .9 percent to GDP for a gain of .4 percentage points over the non-reform scenario. The gains

from savings and investment changes yield an increase of .65 of a percentage point.

8.3 Implications for Economic Stability and Resiliency

The ability to restore economic stability and adjust to economic shocks -- economic resilience -- will increase with the FSRP monetary policy regime. An enhanced ability of the system to stabilize itself will decrease the costs of economic dislocation caused by external shocks or internal imbalances. The FSRP improves economic resiliency for several reasons. The discount facility and a (expanding) BB bond market equip the BB with the instruments to help restore internal balance. The new market-based aspect of the financial system means that there can be more efficient adjustment to price changes because the greater responsiveness of price clearing mechanisms in financial markets. The market- oriented financial system will facilitate reallocation of resources among sectors in response to price changes, e.g., if international petroleum prices were to triple, the financial system will more readily direct resources toward alternatives to petroleum and away from petroleum using industries. A reduction in the structural inflation rate adds to stability and makes exchange rate policy more manageable. The attraction of equity capital to the banking industry and an expansion of private commercial banking will diversify the industry and increase resistance to economic disturbances.

8.4 Impact on Inflation

The FSRP will cause a decrease in the structural inflation rate in two major ways. First, the main contributor to the structural inflation rate under the old system was refinancing of NCBs by the BB in response to losses caused by bad loan losses. Whenever the loan default rate was sufficient to cause the BB to refinance NCBs at a rate that increased expansion of the money supply at a rate greater than the growth rate of real output, the default rate was effectively driving inflation at the margin. Second, the high transactions costs of the former system caused interest rates to be higher than necessary. The introduction of competition and greater efficiency in the financial industry will cause average real interest rates to fall, bringing down the structural inflation rate.

8.5 The Impact of Interest Rate Rationalization and Enforcement of Loan Repayment on Employment and Wage Income

The correction of below-market interest rates and diminution of directed lending will influence employment in two ways. First, the bias against labor, that favors capital intensive

investment will be diminished as interest rates come to reflect real capital costs and loan repayment discipline is enforced. Proportionately more labor will be hired per Taka of investment. Second, employment will tend to grow more rapidly in productive industries and individual firms because they will have greater access to capital and become they are more attractive to lending institutions. Restructuring of the financial sector can be expected to exert downward pressure on industries and individual firms that have relied on bank credit tc maintain operations. The real effects of the reform will be to phase out redundant labor over time. Depending on the relative expansion rates of efficient versus inefficient industries, aggregate employment may either increase or decrease in the medium term; however, the marginal productivity of labor will increase, i.e. incomes of wage earners will increase. Increasing returns to labor, and the decrease in quasi rents will improve the distribution of income.

The financial reforms will not completely resolve the issue of channeling financial resources to inefficient industries because some favored industries will still receive capital at below-market rates, although the capital-labor price ratio will increase. The net employment effect on the subsidized industries is not clear and will be a function of their ability and willingness to make adjustments. Nevertheless, financial reform will tend to exert pressure to decrease redundant employment. Productive employment growth in efficient industries will receive the greatest boost by enforcement of borrowing discipline. Under the old regime of de facto grants, selected borrowers were not subject to the conventional investment criterion of comparing the cost of loan amortization to the expected return on the borrowed funds. Thus, borrowers with de facto grants were free to use funds for purposes that would not be sustainable, such as consumption or covering chronic losses. By forcing all borrowers to conform to conventional investment decision behavior, a larger quantity of loan funds will be available for lending to productive undertakings, thereby increasing aggregate sustainable employment.

8.6 Implications of the FSRP for Poverty Alleviation

It is not likely that the FSRP or this Project will affect poverty directly in a significant manner. (Income distribution will improve as a result of FSRP. See para 7.3.4.) The poor will gain, however, for the following reasons. The reforms will decrease the level of quasi rents and free up capital for productive uses. At the margin this will improve income distribution in favor of productive inputs, including labor at all skill levels. The poor will also benefit from paying a lower inflation tax. Without reform the poor, along with other income groups paid the inflation tax generated by central bank credit creation to refinance the NCBs. Furthermore, people in the

higher and middle income groups were much more likely to benefit directly from the subsidies (quasi rents) delivered under the old system. Because of growth and economic efficiency effects of the reforms there is no doubt that the likelihood for diminishing the degree and incidence of poverty over the long run is significantly increased relative to the alternative of no reform.

8.7 The Implications of the Project for Agriculture

What are the implications of the Project for agriculture and specifically, will the Project harm agriculture in any way? The following assessment of the effects of the project suggests that the agriculture sector will be a net beneficiary through increases in the efficiency of investment and improved income distribution. Agriculture will lose without financial sector reform.

During the formulation of the Project design there was concern that, under the old system, funds from a substantial number of the non-performing loans flowed into the informal rural credit market. Reform of the banking system could dry up this source. There was a second concern that if the NCBs were to be placed in a competitive market environment they might curtail their rural operations in favor of presumably more profitable urban operations.

Concern One -- With the Program, the supply of rural informal credit could decrease because NCB loans will be increasingly subject to more strict screening, thereby ruling out loans for informal rural credit, causing the price of informal rural credit to increase. There is little information on the sources of informal credit, but it is unlikely that bad loans from the NCBs are the exclusive source of capital for informal rural credit. Thus, there is no reason to believe that informal rural credit will "dry up," only that the net quantity of rural credit will decrease and its price will increase. A critical question and one that cannot be answered here is the degree of change. This question could be included in the FSRP TA study on rural credit. Note that there is no reason to believe that there would be a proportionately larger increase in the price of informal rural credit, only that credit prices will increase in all sectors and markets, including the rural sector.[1] To the

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[1] It is commonly held that NCBs' bad loans form a disproportionate share of the supply of funds to the informal rural credit market. This implies that defaulters to the NCBs are more willing or able to take the higher risks of rural informal credit, i.e., earn lower effective returns because their capital is ill gotten. This assertion depends on the assumption that private lenders do not attempt to maximize returns for any

extent the Program will cause a redirection of funds away from favored, unproductive industries toward loan-worthy investments, firms in rural areas will have greater access to credit (but probably not average-income individuals because the topic is commercial banking). This development would tend to increase rural income levels, but the effect on rural informal credit prices from the redirection would probably be insignificant.

It is also important to consider the implications for the agricultural sector without financial reform. Under a system with say a 60 percent loan recovery rate in which defaults are covered by money creation, defaulters gain at the expense of all other members of the economy who pay for the bad loans through an inflation tax. The old system redistributes income from all sectors to defaulters. Probably most defaulters (in terms of total value of bad debts) are urban and in the industrial sector (and, probably in higher income brackets). The majority of the inflation tax payers tend to be (low income) rural dwellers in the agricultural sector. The rural to urban income transfer does not change substantially even if some portion of the bad loans flow into the informal rural credit system.

The conclusion is that the net gains to the agricultural sector from the FSRP are positive. Income distribution improves. Inflation taxes are lowered and more potentially sound and productive investments in the agricultural sector will receive credit. The price of informal credit, which was subsidized by inflation tax payers, will tend to increase along with the price of all other credit. If markets and entrepreneurs work as neo-classical economic principles suggest, the informal rural credit market will not be affected disproportionately more than any other financial submarket.

Concern Two -- The FSRP might cause NCBs to decrease their rural lending. There are reports that this is already taking place. The reasoning is that rural operations are more costly or offer a lower return than urban operations. Enforcement of performance criteria will cause NCBs to reduce their lower-return operations. A short answer is yes, if the FSRP works, NCBs will make adjustments to stay in existence and, if it is correct that rural operations are not sufficiently remunerative, then the NCBs will behave as a competitor in an open market. From an economic

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expected risk. A neo-classical viewpoint would hold that a profit-maximizing lender will look for the highest return, adjusted for risk, regardless of how the lender happened to acquire the capital. Thus, enforcing loan repayment discipline, per se, in NCB lending should not have a differential effect on the supply of informal credit to any sector. The influence on informal rural credit prices will reflect the reduction in the subsidy to all borrowers.

perspective there is nothing wrong with that: NCB lending to agriculture may decrease for the right reason.

A reduction in rural lending may not happen. Under the FSRP, agricultural borrowers continue to be subsidized, but the BDG will compensate any commercial bank for lending to agriculture, not just NCBs. Before, NCBs were the principal lenders among commercial banks because the effective interest rate was too low to attract private commercial banks. Now, the effective interest rate to lenders is higher (by 1.1 percentage points right now, it could go up, depending on inflation and future adjustments in the shadow rate of interest) with assurance that the real rate can rise. NCBs might cut back their rural operations for the right reason, but total lending to agriculture may increase -- for the right reason.

A final point is that the FSRP (although not necessarily the FSRP TA) will eventually encompass reform of the two agricultural development banks (BKB and RAKUB), including comprehensive application of the new banking regulations, recapitalization and provision of technical assistance. Improvement in these institutions will improve the delivery of agricultural credit. The delivery of rural credit will not improve without reform in the financial sector and that depends on effective implementation of the FSRP.

8.8 Implications of the FSRP for Privatization

The implications of the FSRP for privatizing the NCBs and increasing the scope for private banking are discussed in subsections 7.2.1 and 7.3.5. The secondary effects of the reforms for enabling privatization throughout the economy are probably more powerful than the direct results of the Project. This is not discussed here, but reference is made to A.I.D. documents that analyze the linkage between financial sectors/capital markets and privatization in subsection 7.2.1.

8.9 The FSRP and Interest Rate Subsidy Reductions

8.9.1 Background: In response to instructions in the PID Approval Cable (Executive Annex E.X.1), an analysis was prepared by USAID/Bangladesh and approved by AID/W (Executive Annexes E.X.2 and E.X.3). The analysis outlines the proposed treatment of the interest rate subsidies to be paid by the BDG for lending to priority sectors of the economy during the interim period prior to full rationalization of the financial sector.

8.9.2 BB Estimates of Savings From Reduction of the Interest Rate Subsidy: For each loan category, the true cost of lending (called the shadow rate by IDA) is established. The shadow rate

reflects the cost of funds, return to capital, administrative costs and bad debt provisions. The BB has estimated the interest rates for different sectors based on the recapitalized balance sheets of the participating NCBs, and on prompt improvement in the loan recovery rate.

Without FSRP and the consequent improvement in loan recovery rates and a lowering of the structural inflation rate, the total subsidy that would be required is calculated to be 5,093 million Taka for the first year; 5,878 Taka for the second; and 6,779 Taka for the third, for a three-year total of 17,747 million Taka. Savings will be realized under the FSRB through two main mechanisms: a reduction in the structural inflation rate that allows a lower interest rate on savings and lower lending costs linked to a higher loan recovery rate.

The first estimate assumes a constant inflation rate of 10 percent, but a higher loan recovery rate that causes subsidies to decrease by 440 million Taka the first year; 1,579 million Taka the second; and 3,114 million Taka the third for a three-year total of 5,133 million Taka.

With implementation of the reforms under the FSRP, the inflation rate is assumed to decline from 10 percent to seven percent over three years. The lower inflation level permits a lower deposit interest rate, enabling a lower NCB subsidy of 347 million taka the first year; 1,138 the second; and 2,140 the third for a three year total of 3,625 million taka. The combined effect is 787 million Taka the first year; 2,717 Taka the second; and 5,254 Taka the third for a three year total of 8,758 million Taka ($274 million).

The above estimates of the total subsidy and the reduction in the subsidy are based on calculations using Bangladesh Bank data on loan recovery and rate targets. The division of the total subsidy between the explicit and implicit categories is based on the Bangladesh Bank's draft interest rate matrix. Should there be differences between the draft matrix and the final matrix, these will affect only the extent to which the subsidies will be explicit, not the total subsidies or the reductions achieved under the FSRP.

8.9.3 **<u>Impact of the FSRP on Subsidy Reduction:</u>** The impact of the FSRP on subsidy reduction will be threefold:

-- The subsidy paid to the banks (and through them to the bank borrowers) will be explicit and appropriated through the budget. This will result in a more equitable distribution of the burden, since the tax system is more progressive than general inflation. The implicit subsidy almost vanishes under the FSRP.

-- The total subsidy paid to the banks will be reduced as a consequence of the FSRP actions, which will improve loan recovery and permit the monetary authorities to lower inflation without the threat of a liquidity crisis in the banking system.

-- The explicit treatment of the interest rate subsidy will give the public more complete information on the cost of subsidized industries and gain support for reforms. The budget amount between 1.5 and 2.0 billion Taka (US$41.1 and 58.8 million at Tk34:$) is a significant amount and seems likely to draw public discussion.

8.10 Short-Term Implications of Recent Reforms for NCBs and for Private Banks

In the initial stage, the implications pertain to bank solvency and to the changes that banks will have to implement to meet new management and institutional requirements. In general the FSRP will place any bank, nationalized or private, which has been employing substandard practices, such as carrying a large number of non performing loans, under stress proportionate to the degree of its substandard performance. The management and institutional aspects of the FSRP will be more profound for the NCBs than for the private banks. To varying degrees the private banks already have performance oriented management, better accounting and loan screening practices than the NCBs have. Foreign private banks will be virtually unaffected because their organizations are on a par with their home country offices.

Whereas some of the private banks are financially weak by industrial country accounting standards; they tend to be in much better condition than the NCBs, which also vary in financial soundness. The immediate financial consequences of the FSRP would be greater for NCBs than for private banks except for one major factor: even though the degree of NCB insolvency, made explicit by the FSRP, will tend to be greater than a private bank, the BB will recapitalize the NCBs in the short run. Private banks will not have recourse to recapitalization from the BB on the same basis. Foreign private banks are not expected to be significantly affected, except the increase in capital adequacy requirements under the FSRP could decrease profits in the year the adjustment is made, but the increase capital adequacy is likely to be offset by tax allowances. Some of the least sound private banks may be obliged to increase their assets and/or decrease their liabilities. On January 1, 1990 some commercial banks found themselves in a state of technical insolvency because of their large holdings of bad debt and inadequate provisioning. Because the current accounting systems are inadequate to provide an accurate assessment of the position of most commercial banks, the insolvency issue is moot until

adequate data can be collected. All banks have a transition period to assess their positions and to take corrective actions.)

8.11 Benefits to Commercial Banks

8.11.1 Nationalized Commercial Banks: The direct benefits of the FSRP TA are itemized in Section 3. The financial benefit to the NCBs is the opportunity to operate as more autonomous, financially viable, commercially oriented entities.

8.11.2 Private Banks: The Project will benefit private banks in several ways. Many of the reforms will help to remove biases against private banking while opening up more opportunities to make profits and increase market share. However, the FSRP TA in no way guarantees that all private banks will always prosper. The FSRP will increase their freedom to compete. Private banks will benefit in the following ways:

-- The new interest rate schedule increases the possible spread between deposit rates and lending rates on the order of two percentage points.

-- Adjustment of the interest rate matrix over time, will allow banks to maintain positive real interest rate levels.

-- Private banks' market share will increase because the FSRP will cause the market of "real borrowers" to expand. Expansion will occur because the NCBs will no longer follow the practice of making de facto grants to many of their clientele. Potential borrowers will encounter a more homogeneous and discriminating banking industry. A subset of borrowers from the NCBs, who before did not have to concern themselves with repayment will be forced to adopt the discipline of repayment. This subset will be added to the market of "real borrowers." Private banks will then become competitors against the NCBs for the their trade for the first time. To the extent that private banks are efficient competitors they will increase their market share.

-- The FSRP will expand private banks' markets further by adding a set of borrowers that, prior to the FSRP, were not attractive because they borrowed at below market interest rates. Private banks, for the first time, will receive the difference between the lending rate and the shadow rate, thereby eliminating one of the factors that discouraged private banks from lending to subsidized borrowers.

-- Indirect monetary policy instruments will give more management latitude to bank managers. Private banks, because they are accustomed to performance-based management

will be best positioned to take advantage of the greater flexibility to manage their own affairs.

-- The reform will lower the structural inflation rate allowing a lower interest rate which will increase the quantity of demand for loans. The private banks, because of their competitive experience will tend to increase their market share.

-- The introduction of new laws and a system of courts offering recourse for delinquent and defaulted loans will reduce costs.

-- Foreign private banks will profit directly from FSRP-generated rule changes which will allow reserves held overseas to count against the one percent bad loan provision, allow the same reserves to be counted against the capital adequacy requirement and to be deducted as a business expense.

8.12 Impact on the BDG Debt Situation

The Project's primary impact on the debt position of the BDG as a result of increasing the private sector's access to finance, should be to speed the transfer of debt from the public sector to the private sector. As the funds flowing to the private sector increase, the public sector will be able to decrease that part of its borrowing, both foreign and domestic, which is used to support the least productive segments of the country's economy.

8.13 Illustrative Financial Rate of Return

The financial rate of return on the total FSRP is approximately 17 percent. The key variable is the loan recovery rate. Change in the loan recovery rate is the most powerful variable relative to other measures of efficiency such as cost per Taka loaned. The recovery rate is therefore used as a proxy for all improvements in banking performance. The measured benefit is the increase in banks' interest earnings. Calculations of net present values of benefits (NPV) are based on the sum of NCB and indigenous banks' advances for 1988 ($2.929 billion at Taka 34:$1) which is assumed to grow at six percent per annum.

The analysis poses a basic scenario without the FSRP in which advances are loaned each year for ten years (with advances expanding at six percent annually) and an unchanging 60 percent recovery rate. The analysis assumes there is virtually no capital loss, only that the "loan" (total NCB and private bank advances in 1988) disbursed at the beginning of each year is

partially repaid at the end of the year, plus interest on the repaid portion. In the second year the bank receives 60 percent of the outstanding balance plus two year's interest. The partial repayment with accumulating interest on the repaid portion continues for ten years in the first year. A second loan in the second year, again generates a series of partial repayments that are summed for nine years, with the repayment series decreasing by one year in each successive year until the tenth year is reached which consists of a one-year repayment. The stream of benefits is truncated and thereby underestimated. Benefits are then calculated by comparing the difference in discounted interest earnings from the base case to the discounted streams of interest income from two different FSRP scenarios: (1) the low case in which recovery rates increase to 70 percent in the first through the third year; 80 percent in the fourth through the sixth year and 85 percent in the seventh through the tenth year; and (2) the high case in which recovery rates for the latter two time periods are 85 and 95 percent.

Costs are the BDG estimate of real resources to recapitalize the system which consists of interest paid on bonds and budget expenditures to offset interest rate subsidies to selected sectors. Recapitalization costs are one hundred million dollars for five years. The cost of TA provided by A.I.D. over five years is added to recapitalization costs. The cost estimate is probably high in that expenditure on subsidized interest rates should decline substantially over the next five years. Three different NPVs of the five-year cost stream are calculated based on 16, 18 and 20 percent discount rates. The three cost NPVs are $341.18 million (16%), $325.96 million (18%), and $311.83 million (20%).

Benefit NPVs Using a 16 Percent Discount Rate
($ million)

Interest rate on loans	Loan Recovery Rate Low	High
16 %	309.09	440.79
18 %	352.16	(502.21)
20 %	366.54	(527.72)

Three different bank rates of interest are used in the calculation of benefit streams, 16, 18. and 20 percent. Gains from improvement in loan recovery rates increase with higher bank loan rates. The benefit NPVs in brackets are estimated. The cost and benefit NPVs indicate that an average 18 percent bank loan rate and the lower schedule of loan recovery yield a benefit NPV of $352 million compared to a cost NPV of $341 million. The financial internal rate of return is 16.7 percent. The IRR

estimate is based on the low-schedule recovery rate and 18 percent loan interest rate and is derived by increasing the discount rate until NPV just equals net present cost.

8.14 Risks To Achieving Project Goals

The discussion is limited to risks to achieving Project objectives, not risks if the Project is not undertaken. Two notes: the following risks are closely related but they are separated to facilitate discussion. A risk discussion is not readily resolved for the expected reason that forecasting what are basically political events is extremely uncertain. Nevertheless some pros and cons can be considered.

Risk one -- The BDG effectively does not continue to pursue financial reform and other donors lose interest. There has been concern throughout the formulation of the Project that USAID could become committed to a four-year technical assistance project but that the will to change might wane after the last IDA FSC tranche is delivered in 1992 and other donors would fail to support the original effort.

Risk two -- Pressure on the Government from parties who want fixed low interest rates will impede and possibly derail reform. This development could take many forms. For example, it could take the form of inter ministerial policy differences wherein an interested Ministry prevails and reimposes fixed, low interest rates. A second example is influential interests, now receiving highly subsidized loans or grants disguised as loans, convince the Government to revert to the old system.

Other Risks:

1. The FSRP is the classic case of removing a quasi rent from an economy: a relative handful of interests benefited under the old system whereas a large number paid the costs which were practically invisible to each individual. Conversely, losers under reform will feel their loses sharply and most beneficiaries will not be aware of their gains.

2. Government entities charged with pursuing a specific objective, e.g., industrialization will perceive their task to be more difficult unless they receive compensating budget resources (to the extent that government is a direct investor).

3. Non-banking businessmen usually detest higher interest rates.

4. NCB management and employees are likely to chafe under demands to perform efficiently.

Risk Offsets:

1. Partial testing of reaction to reforms has not revealed substantial resistance. Elements of the reform program were introduced starting two years ago causing the loan recovery rate to increase. Interest rates and other major changes were introduced four months ago without adverse political repercussion.

2. The Program has been extensively discussed and supported at the highest level of Government as discussed in number six below.

3. The BB is in a powerful institution that is likely to prevail in differences with the NCBs.

4. With respect to NCB employee relations, there are way to manage retrenchment issues as long as the groundwork is completed. The FSRP Project includes an activity to study the problem. Expansion of private banking will create new job opportunities.

5. Borrowers do not like higher interest rates, but in Bangladesh, as elsewhere, they have always paid effective rates higher than the official rates (because credit is unofficially rationed). The FSRP will cause official and effective rates to converge. It has been repeatedly demonstrated that borrowers will pay higher rates on viable investments.

6. At this time it seems highly unlikely that the World Bank is going to go soft on financial reform in Bangladesh. The WB presented a tough message in the Economic Memorandum and at the CG, and the WB is increasingly concerned with below-average economic performance in Bangladesh. With respect to this Project, the Bank proposed a large set of controversial reform measures as conditions precedent that were achieved. IDA's program for reform of the Bangladesh financial sector starts with the FSRP but extends in time and scope well beyond the commercial banking system. Finally, one can speculate that with new international demand for IDA funds, it may not be willing to tolerate backsliding.

Background Note:
An IDA report (December 1989) on the FSC states:

> The main risk in the reform program is that political considerations might interfere in BB's freedom to make substantial upward adjustment in interest rates if inflation were to increase sharply. This risk is reduced in that the interest rate policy has been extensively debated over many months at the highest levels in government before adoption

and the BB will have four opportunities to review interest rates to institutionalize the policy before second trance release. Also NCBs may take longer to reclassify their loan portfolios than anticipated and NCB management performance might not improve as much as desired. Technical assistance has been carefully designed to address both of these risks. Also, Government set up its NCB management task force in order to ensure that fundamental management improvements will be made.

8.15 Social Soundness Analysis

8.4.1 Introduction: In considering the social implications of the Project, it should be kept in mind that the major effects will occur at the macro and sector level with direct impact on individuals limited to some bank managers and employees. It is anticipated that benefits from the development of the Bangladesh financial sector will accrue in varying degrees to all segments of the economy, not all of them will benefit in the same way, within the same time frame, or equally.

8.4.2 Resistance to Reform: A potential source of difficulty involves certain social attitudes. Opposition to reform and restructuring the banking system could arise from several groups. Some civil servants and bank employees may oppose reform either because they hold certain substantive views on the role of Government and banking policies or believe that their jobs are at risk. Other opposition could arise from within the NCBs, where there are widespread views that the banks have "social responsibilities" and should not consider bank viability as a important objective. One can expect opposition from some bank managers and employee organizations to linkage of promotions and bonuses to performance, and requiring successful completion of training as a condition of promotion. The general public and many observers are not likely to appreciate the positive social value of making subsidies explicit (or transparent) instead of hidden. Therefore some may oppose making "subsidy" payments to banks, not understanding that the real subsidy is being made to the borrowers receiving the below-market-rate loan.

Reform of the financial sector can expect resistance from a full range of borrowers: government-owned firms, protected private firms, privileged individuals and small borrowers--all of whom lose a source of de facto grants or highly concessionary funds. The motivation is obvious, but the problem is more widespread and complex than just a faulty banking system. Endemic default by large borrowers can be explained along conventional lines of politics, powerful vested interest and special relationships. But dependents on the banking system for grant funds is common place among small borrowers as well. There is a deeply embedded (and validated) expectation that the

function of the banking system is to provide a kind of safety net much like subsidized crop or disaster insurance schemes in some industrial countries. Thus, one of the first public demands and government responses to social or financial calamity is remission of interest payments and/or loan forgiveness to small borrowers. One of the major thrusts of the FSRP is to covert the financial sector from a special interest and public welfare instrument to a self sustaining financial intermediation system. Legitimate investors, entrepreneurs and the well-informed public will welcome the conversion.

Because of the critical importance of the labor issue, one of the key items in the Scope of Work for the consulting firm and Team Leader will be a demonstrated skill in being able to work successfully with situations of extreme labor sensitivity. Moreover, this issue will continue to be examined and studies undertaken during Project implementation. The concerns of banks' staffs will be taken into consideration. The Project will undertake to develop measures to ameliorate the potential adverse impacts of modernization and privatization.

8.16 Gender Considerations

Two areas of women-in-development will be addressed in this Project. Early in the implementation of the Project, a data profile will be established, analyzing the rates of hiring, promotion, areas of substantive responsibility and decision-making authority, as well as the actual numbers of professional and clerical female employees in BB and the NCBs. This data will be broken out by individual bank in comparison with male employees. This baseline data will be re-examined at the time of the first formal Project Evaluation to determine if improvements are being made in these areas. Necessary remedial steps in areas of hiring, training and promotion will be identified.

It must be recognized that this problem extends far beyond the work place and into society in general. It begins with differential access to scarce food supplies for male and female children, with the latter far more likely to suffer the long term effects of malnutrition. It continues with access to even the most basic education, which is frequently denied to girls. And it is expressed throughout the life cycle in social attitudes limiting the place of women to the home and a few traditionally "female" occupations. Therefore, the task of finding qualified women to hire, train and promote will be one for the long term.

As the financial sector grows, access to jobs, at least in entry level positions, e.g., as accountants, bookkeepers, tellers, and financial analysis, must be the subject of such affirmative action programs as are possible in the real world of

Bangladesh leading, eventually, to an increase in the number of job opportunities for women seeking managerial positions.

The project will probably increase NCB and Bangladesh Bank hiring of women even in the short run, because of the computerization component. The Computer Departments at Bangladesh Bank and Agrani Bank have a higher than average percentage of female employees. (Other banks have as yet only rudimentary computer departments.) Even though this is only a start, it could well serve as a door-opener to broader job access and a diminution of social prejudice.

The second area of gender consideration will be to establish a framework to determine if female loan applicants and eventually borrowers are receiving equal treatment in obtaining credit. At Project inception, data will be developed to ascertain the proportion of women to men as applicants and as successful recipients of loans; differential rigor in evaluating applications; differentials in the purposes for which loans are approved; differentials by gender in repayment rates.

The annual evaluations of the Project will include investigation into changes relative to the baseline data. This will determine if progress is being made to reduce significant gender differentials observed at Project inception. Corrections needed as a result of these evaluations will then be considered.

8.17 Environmental Impact

The Environmental Threshold Decision that the FSRP TA Project will have no direct environmental impact was made at the time of PID approval. Therefore no environmental examination is required.

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I. ACRONYMS

ANNEX I

ACRONYMS

ACD	Agricultural Credit Department of Bangladesh Bank.
ACID	Agricultural Credit Inspection Department of Bangladesh Bank.
ACP	Agricultural Credit Project.
ADB	Asian Development Bank.
A.I.D.	United States Agency for International Development.
AID/W	United States Agency for International Development/Washington.
BADC	Bangladesh Agricultural Development Corporation.
BB	Bangladesh Bank (the Central Bank of Bangladesh).
BBTA	Bangladesh Bank Training Academy.
BB/TU	Bangladesh Bank/Technical Unit.
BCD	Banking Control Department of Bangladesh Bank.
BDG	Bangladesh Government.
BIBM	Bangladesh Institute of Bank Management.
BJC	Bangladesh Jute Corporation.
BJMC	Bangladesh Jute Mills Corporation.
BKB	Bangladesh Krishi Bank.
BSB	Bangladesh Shilpa Bank.
BSBL	Bangladesh Sambaya Bank Ltd.
BSRS	Bangladesh Shilpa Rin Sangstha.
CDSS	Country Development Strategy Study.
CMDC	Capital Market Development Committee.
CP	Conditions Precedent.
CY	Calender Year.
DBI	Department of Banking Inspection (Bangladesh Bank)
DFI	Development Finance Institution.
DIS	Deposit Insurance Scheme.
DSE	Dhaka Stock Exchange.
ESAF	Enhanced Structural Adjustment Facility (IMF).
FSC	Financial Sector Credit (IDA Loan).
FSRP-TA	Financial Sector Reform Program-Technical Assistance (A.I.D. Grant).
FY	Fiscal Year.
ICB	Investment Corporation of Bangladesh.
IDA	International Development Association.
IFIC	International Finance and Investment Corporation.
IMF	International Monetary Fund.
IPC	Import Program Credit.
IPDC	Investment Promotion and Development Corporation of Bangladesh.
IPP	Industrial Promotion Project.
IQC	Indefinite Quantity Contract.
IRM	Internal Resources Management.

LDC	Less Developed Country.
LT	Long Term.
MIS	Management Information System.
MOF	Ministry of Finance.
MOF/PAC	Ministry of Finance/Policy Analysis Cell.
NBFI	Non-Bank Financial Institution.
NCB	Nationalized Commercial Bank.
NCMBC	National Commission on Money, Banking and Credit.
OEE	Office of Economics and Enterprise, (USAID/Bangladesh).
OIT	Office of International Training.
PID	Project Identification Document (A.I.D.)
PIL	Project Implemention Letter.
PIO/P	Project Implementation Order/Participants.
PIO/T	Project Implemention Order Technical Services.
PP	Project Paper (A.I.D.)
PSA	Procurement Services Agency.
PSC	Personal Services Contract.
RAKUB	Rajshahi Krishi Unnayan Bank.
RCGF	Rural Credit Guarantee Fund.
RFEP	Rural Finance Experimental Project (A.I.D.).
RFP	Rural Finance Project (A.I.D.); Request for Proposal.
S&T	Science & Technology.
TA	Technical Assistance.
TAPP	Technical Assistance Project Proforma.
TRP	Technical Resources Project (AID).
TU	Technical Unit.
SAF	Structural Adjustment Facility .
ST	Short Term
U.S.	United States.

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II. EXECUTIVE ANNEXES

Ex1. PID Approval Message
Ex2. Benchmark Cable
Ex3. AID/W Benchmark Approval Cable
Ex4. Log Frame Matrix
Ex5. BDG Request For Assistance
Ex6. Statutory Check list

FSC-TA

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CHRON FILE

ACTION: AID-2 INFO: AMB DCM ECON

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E.O. 12356: N/A
TAGS:
SUBJECT: FINANCIAL SECTOR CREDIT PID (388-0078) - PROJECT COMMITTEE

1. PROJECT COMMITTEE MEETING FOR SUBJECT PID, CHAIRED BY ANE/PD RONALD VENEZIA, WAS HELD ON MARCH 22, 1989. MISSION IS COMMENDED FOR EXTRAORDINARILY WELL PREPARED DOCUMENT. PID WAS APPROVED FOR PP DEVELOPMENT AND AUTHORIZATION BY MISSION DIRECTOR SUBJECT TO THE FOLLOWING GUIDANCE INCLUDING CABLE REPORT PRIOR TO AUTHORIZATION RE BENCHMARKS FOR PRIVATIZATION OF NATIONALIZED COMMERCIAL BANKS AND REDUCTION OF SUBSIDIES.

2. ISSUES:

A. RELATION TO CDSS AND MORTGAGE: THE RELATIONSHIP OF THIS PROJECT TO THE MISSION'S CDSS CURRENTLY UNDER PREPARATION WAS DISCUSSED AS WELL AS MORTGAGE IMPLICATIONS OF AUTHORIZING PROJECT PRIOR TO APPROVAL OF THE NEW CDSS. THERE WAS CONCERN ABOUT HOW THIS PROJECT WOULD FIT INTO THE NEW CDSS AND ITS PRIORITY AMONG THE OTHER NEW PROJECTS PLANNED FOR FY 89 AND FY 90 GIVEN

THAT RESULTS OF NUMEROUS STUDIES AND ASSESSMENTS BEING UNDERTAKEN FOR THE CDSS ARE NOT YET KNOWN. THE MISSION REPRESENTATIVE RESPONDED THAT THIS PROJECT WOULD BE A HIGH PRIORITY UNDER ANY LIKELY CDSS OUTCOME AND URGED THAT THE PROJECT DEVELOPMENT PROCESS NOT BE DELAYED PENDING RESULTS OF CDSS ANALYSES. IT WAS NOTED THAT ILA'S CREDIT MAY NOT BE READY FOR SIGNING AS EARLY AS ORIGINALLY ANTICIPATED THUS GIVING US MORE TIME TO WORK OUT DETAILS OF OUR PROJECT AND POSSIBLY BENEFIT FROM SOME OF THE ANALYSES UNDERWAY FOR THE CDSS. IT WAS RECOMMENDED THAT WE PROCEED AS AGREED DURING THE ACTION PLAN REVIEW, I.E., THAT PRIOR TO AUTHORIZATION, THE MISSION WILL PREPARE A QUOTE CASH MANAGEMENT UNQUOTE PLAN WHICH WOULD OUTLINE HOW THE MORTGAGE WILL BE COVERED. THEREFORE, EVEN THOUGH WE UNDERSTAND THE PRIORITY OF THIS PROJECT AND THE MISSION'S DESIRE TO MOVE AHEAD, FINAL DECISION WILL DEPEND ON OUTCOME OF THE CASH MANAGEMENT PLAN.

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B. SUPPORT TO NATIONALIZED COMMERCIAL BANKS (NCB): THE PID PROPOSES THAT PROJECT RESOURCES SUPPORT THE FOUR NCBS WITH THE OBJECTIVE OF RETURNING THESE ORGANIZATIONS TO A MORE PROFITABLE POSITION PRIOR TO DIVESTITURE. HOWEVER, THE PID DOES NOT INCLUDE BENCHMARKS UPON WHICH SUBSTANTIVE PROGRESS TOWARDS DIVESTITURE CAN BE MEASURED AS CALLED FOR IN POLICY DETERMINATION 14 (IMPLEMENTING A.I.D. PRIVATIZATION OBJECTIVES) AND THE REVISED PRIVATE ENTERPRISE DEVELOPMENT POLICY PAPER. THE PID INDICATED THAT SETTING BENCHMARKS WOULD NOT BE POSSIBLE UNTIL THE FOURTH YEAR WHEN THE BANKS' PROFITABILITY COULD BE ASSESSED MORE ACCURATELY, PROVIDING THE BASIS FOR TARGETING DIVESTITURE. THE PROJECT COMMITTEE FELT, HOWEVER, THAT A.I.D. ASSISTANCE TO THE NCBS SHOULD BE GEARED TOWARD PREPARING THE NCBS FOR EVENTUAL DIVESTITURE BY ASSISTING THE BDG AND THE NCBS TO PREPARE PLANS, STRATEGIES, TIMETABLES, ETC. AND BY HELPING THE BDG OBTAIN THE INFORMATION NEEDED TO MAKE A DECISION REGARDING PRIVITIZATION. COMMITMENT TO AND SUPPORT FOR PRIVATIZATION EFFORTS BY THE BDG, THE WORLD BANK AND THE FINANCIAL SECTOR IS CRITICAL TO THE SUCCESS OF THIS COMPONENT OF THE PROJECT. BENCHMARKS MUST BE ESTABLISHED WHICH FOCUS ON THIS KIND OF ASSISTANCE AND WHICH, IF MET, WOULD DEMONSTRATE CONTINUED COMMITMENT TO PRIVATE BANKING AND PRIVATIZATION IN GENERAL. ONE OPTION DISCUSSED BY THE PROJECT COMMITTEE IS THAT MISSION NEGOTIATE WITH IDA THE INTRODUCTION INTO THEIR CREDIT PACKAGE OF MEASURABLE STEPS (BENCHMARKS) WHICH WILL HELP LEAD TO DIVESTITURE OF THE NCBS. BENCHMARKS

SHOULD BE ESTABLISHED IN TANDEM WITH THE PLANNED TRANCHES UNDER IDA'S FINANCIAL SECTOR CREDIT I (FSC I). DISCUSSIONS WITH IDA ON THIS ISSUE HAVE ALREADY COMMENCED IN WASHINGTON.

C. COORDINATION WITH IDA AND IMF: PROJECT COMMITTEE UNDERSTANDS A.I.D.'S RESOURCES ARE AN INTEGRAL AND ESSENTIAL PART OF THE TOTAL FINANCIAL SECTOR CREDIT PROGRAM. CLOSE AND CAREFUL COORDINATION WITH IDA WILL BE REQUIRED IN THE PROVISION OF A.I.D.'S TECHNICAL ASSISTANCE AND IN JOINT EVALUATIONS OF PROGRESS PRIOR TO DISBURSEMENT OF THE IDA TRANCHES. THIS WILL HELP ENSURE THAT POLICY CHANGES, INCLUDING PROGRESS TOWARD NCB PRIVATIZATION, IS ACHIEVED AGAINST THE PLANNED BENCHMARKS. THE PID STATED THAT THE SPECIFIC MECHANISMS FOR COORDINATION WITH IDA AND IMF WILL BE DETERMINED DURING THE PP DEVELOPMENT.

D. INTEREST RATE SUBSIDIES: AS THE PID NOTES, ANY CONTINUING INTEREST RATE SUBSIDIES TO THE BANKING SECTOR ARE TO BE MADE EXPLICIT. SINCE A.I.D.'S POLICY IS
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GENERALLY TO REDUCE OR ELIMINATE SUBSIDIES, THE PP SHOULD BE EXPLICIT REGARDING THE EXISTING LEVEL OF SUBSIDIES AND HOW, AND OVER WHAT TIME PERIOD, THE SUBSIDIES WILL BE ELIMINATED. WE UNDERSTAND IDA HAS ALREADY FORMULATED A LIST OF STEPS TO BE ACCOMPLISHED OVER THE COURSE OF FSC I INCLUDING AN EXAMINATION OF THE TREND IN THE LEVEL OF EXPLICIT BDG SUBSIDIES OVER TIME AND STEPS TAKEN TO INSTITUTIONALIZE AND SUPPORT THE BDG PROGRAM TO RESTRUCTURE INTEREST RATES. THE MISSION SHOULD REVIEW AND SUPPORT THIS LIST AS APPROPRIATE.

E. ROLE OF THE PRIVATE SECTOR: THE PROJECT COMMITTEE EXPRESSED CONCERN THAT THE PRIVATE SECTOR BE MORE INVOLVED IN THE PROJECT. INDIRECTLY, THE PRIVATE SECTOR BANKS SHOULD BENEFIT SUBSTANTIALLY BY TAKING ADVANTAGE OF THE REFORMS IN THE BANKING SECTOR TO BE INTRODUCED BY THE PROJECT. PRIVATE SECTOR BANKS COULD ALSO BENEFIT DIRECTLY FROM PROJECT ACTIVITIES IF MEANS ARE FOUND TO PROVIDE THEM ACCESS TO SOME OF THE PROJECT-FUNDED TECHNICAL ASSISTANCE AND TRAINING. THE COMMITTEE RECOMMENDED THAT THE REMAINDER OF TA AND TRAINING (I.E., THAT NOT PROVIDED TO THE NCBS TO PREPARE THEM FOR DIVESTITURE) BE QUOTE NEUTRAL QUOTE, THAT IS, AVAILABLE TO ALL FINANCIAL INTERMEDIARIES IN BANGLADESH; PREFERABLY DELIVERED THROUGH AN INSTITUTION THAT COULD SUSTAIN FINANCIAL SEMINARS AND OTHER COURSES IN PORTFOLIO MANAGEMENT, AND THEREBY BENEFIT PRIVATE AS

WELL AS PUBLIC SECTOR ENTITIES. IN ORDER TO INCREASE BOTH THE ROLE AND CAPACITY OF THE PRIVATE SECTOR, ASSISTANCE SHOULD BE PROVIDED IN A MANNER WHICH BROADENS THE OUTREACH OF SUCH ASSISTANCE, PERHAPS THROUGH AN EXISTING PRIVATE SECTOR INSTITUTION SUCH AS A LOCAL UNIVERSITY OR OTHER INSTITUTION OFFERING COURSES IN PORTFOLIO MANAGEMENT. THIS MIGHT ALSO BE ACCOMPLISHED THROUGH COORDINATION WITH PRIVATE BANKING ASSOCIATIONS AND WOULD LEAVE IN PLACE A CAPACITY IN BANGLADESH TO CONDUCT REFRESHER COURSES, ETC.

F. STRENGTHENING FINANCIAL MARKETS: ONE OF THE OBJECTIVES OF THE PROJECT IS TO STRENGTHEN THE CAPITAL MARKETS; HOWEVER, THERE IS LITTLE DISCUSSION AS TO HOW THIS WILL BE DONE. MISSION REPRESENTATIVE NOTED THAT TECHNICAL ASSISTANCE AND STUDIES WERE PLANNED THAT WOULD FOCUS ON WHAT IS NEEDED TO MOBILIZE CAPITAL FOR PRIVATE SECTOR INVESTMENT. PROJECT COMMITTEE FELT THIS WAS A CRITICALLY IMPORTANT AREA IN SUPPORT OF BOTH EXPANDED PRIVATE SECTOR GROWTH AND INCREASED PRIVATIZATION ACTIVITY. THE MISSION SHOULD NOT PRECLUDE ASSISTANCE TO ANY COMPONENT OF CAPITAL MARKET DEVELOPMENT, SUCH AS ASSISTANCE TO THE DHAKA STOCK EXCHANGE, IF THIS PROVES TO BE AN AREA FOR FURTHER DEVELOPMENT.

G. PROVISION OF COMPUTER EQUIPMENT: THE PROVISION OF COMPUTER EQUIPMENT WAS OF SUBSTANTIAL CONCERN TO THE PROJECT COMMITTEE. THE PROVISION OF EQUIPMENT TO SOME NCBS WOULD SUBSIDIZE THEIR OPERATIONS AND INITIALLY MAKE THEM MORE EFFICIENT AND THUS MORE ATTRACTIVE THAN OTHER

BANKS. IT WAS RECOMMENDED THAT THE MISSION EXPLORE THE FEASIBILITY OF (A) THE NCBS PAYING FOR THE EQUIPMENT, (B) THE BDG PAYING FOR IT, (C) IDA INCLUDING IT IN THEIR CREDIT, OR (D) THE MISSION JUSTIFYING IN THE PP THE GRANT TO THE NCBS AND ITS IMPACT ON THE PRIVATE SECTOR. COMPUTERIZATION OF BANGLADESH BANK MIGHT STILL BE GRANT FUNDED IF ALL BANKS IN THE SYSTEM WOULD BENEFIT. THE OBJECTIVE IS TO ENSURE THE ENTIRE FINANCIAL SYSTEM BENEFITS AND THAT WE ARE NOT PROVIDING ASSISTANCE IN A BIASED MANNER.

E. TECHNICAL ASSISTANCE: PROJECT COMMITTEE NOTED THE VERY HIGH LEVELS OF LONG-TERM TECHNICAL ASSISTANCE, RANKING IT AMONG THE LARGEST TA PROJECTS IN THE PORTFOLIO. PREVIOUS EXPERIENCE WITH TEAMS OF THIS SIZE HAS NOT PROVEN TO BE EASY. FURTHER, GIVEN THE RELUCTANCE OF THE BDG TO ACCEPT TECHNICAL ASSISTANCE, MISSION IS ENCOURAGED TO LOOK AT THE LIST OF INDIVIDUAL

LONG-TERM POSITIONS PROPOSED TO DETERMINE IF SOME CAN BE PROVIDED THROUGH SHORT-TERM ASSISTANCE, SUBCONTRACTS WITH LOCAL PRIVATE SECTOR, ETC. WE ALSO ENCOURAGE MISSION TO LOOK AT THE METHODOLOGY OF IMPLEMENTATION OF THE PROJECT AND THE MISSION'S ORGANIZATION AS IT RELATES TO MANAGING A LARGE TECHNICAL ASSISTANCE TEAM; SUCH REVIEW MAY WELL REDUCE THE MANAGEMENT REQUIREMENTS AND THE OVERALL COST OF THIS PROJECT.

3. AS MENTIONED IN PARA 1 ABOVE, REQUEST CABLE REPORT PRIOR TO AUTHORIZATION ON PROJECT COMMITTEE'S RECOMMENDATIONS REGARDING BENCHMARKS FOR PRIVATIZATION OF NCBS AND INTEREST RATE SUBSIDIES. BAKER
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CHRON FILE

CLASS: UNCLASSIFIED
CHRGE: AID 07/09/89
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CLEAR: 1. OPE/RAULAKH
DISTR: AID3 AMB DCM
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E.O. 12356: N/A
SUBJECT: FINANCIAL SECTOR CREDIT (538-0078):
- BENCHMARKS FOR PRIVATIZATION OF NCB'S;
- PROGRAM FOR REDUCTION OF INTEREST RATE SUBSIDIES

REF: A. STATE 112633 B. DHAKA 04490 C. DHAKA 04382

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1. THIS CABLE IS IN REPLY TO REF. A. PARAS 1., 2.B., 2.D. AND 3. REFS B. AND C. ANSWERED THE QUESTIONS RAISED IN REF. A. PARA 2.A. THOSE MATTERS RAISED IN REF. A. FOR INCLUSION IN THE PP HAVE BEEN TREATED THEREIN.

2. IT SHOULD FIRST BE NOTED THAT BOTH THE TIMETABLE FOR IDA BOARD PRESENTATION OF THE FSC PROGRAM AND THE USAID/BANGLADESH TIMETABLE FOR PROPOSED AUTHORIZATION OF OUR FSC-TA PROJECT HAVE BEEN DEFERRED UNTIL NEXT YEAR. IDA IS PRESENTLY PLANNING ITS APPRAISAL MISSION FOR EARLY FALL 1989, ITS NEGOTIATIONS FOR NOVEMBER 1989, AND ITS PRESENTATION TO THE BOARD FOR MARCH 1990. CONSEQUENTLY, USAID/BANGLADESH IS PUTTING ITS PP IN SEMI-FINAL FORM FOR COMPLETION SUBSEQUENT TO IDA NEGOTIATIONS, ASSUMING AID/W APPROVAL OF THIS CABLE, AND AUTHORIZATION UPON IDA BOARD PRESENTATION. OBLIGATION WOULD BE MADE UPON IDA SIGNING. DESPITE THE DELAY, MISSION WOULD APPRECIATE PROMPT AID/W APPROVAL OF THIS CABLE TO PERMIT A POSITIVE RESPONSE TO ANY BREAKTHROUGHS IDA AND BDG MAY MAKE.

3. AS DISCUSSED EXTENSIVELY AT THE PID REVIEW, THE BANGLADESH FINANCIAL SECTOR REFORM PROGRAM IS NOT ONE FOR THE SHORT TERM. BOTH IDA AND THE MISSION FEEL 8-10 YEARS IS A MORE REALISTIC TIME FRAME. THEREFORE, THE REFORMS WE ARE TALKING ABOUT HERE ARE THE FIRST STEPS, TO BE TAKEN UNDER FSC I. ISSUES DEALING WITH THE ACTUAL PRIVATIZATION PROCESS WILL BE ADDRESSED UNDER FSC II. MOREOVER, QUESTIONS OF FINANCIAL SECTOR REFORM IN GENERAL AND PRIVATIZATION IN PARTICULAR INVOLVE A BALANCE BETWEEN THE IDEAL OF AN ECONOMY LARGELY RUN ALONG PRODUCTIVE PRIVATE SECTOR LINES AND THE REALITY OF A SOCIO-ECONOMIC SYSTEM THAT HAS ONLY RECENTLY DECIDED TO MOVE DEFINITIVELY IN THAT DIRECTION. THE FOLLOWING BENCHMARKS REPRESENT ANOTHER MAJOR STEP FORWARD ON THE PART OF THE BDG IN FULFILLING THE REQUIREMENTS FOR FINANCIAL/ECONOMIC PROGRESS SUGGESTED IN THE WORLD BANK REPORT ENTITLED QUOTE BANGLADESH: A PROGRAM FOR FINANCIAL SECTOR REFORM UNQUOTE, WHICH DOCUMENTS

EXTENSIVELY THE CURRENT LIMITATIONS OF THE BANGLADESH ECONOMIC AND FINANCIAL SYSTEM.

4. THE MISSION AND IDA HAVE NEGOTIATED ALL THE BENCHMARKS LISTED BELOW PERTAINING TO PRIVATIZATION WITH THE CONCERNED AUTHORITIES OF BDG, BB AND THE NCBS: THESE ARE REFLECTED IN THE WORLD BANK'S PROJECT PAPER AND IN OUR PP AS RELEVANT. THOSE POINTS REMAINING OPEN CONCERNING THE TIMING AND AMOUNT OF REDUCTION OF INTEREST RATE SUBSIDIES WILL BE ADDED TO THE RELEVANT DOCUMENTS AT THE TIME OF FINAL NEGOTIATIONS.

5. BENCHMARKS FOR PRIVATIZATION

THE OBJECTIVE OF THE OVERALL FSC PROGRAM AND THE A.I.D. FSC-TA PROJECT, AS RELATED TO THE PRIVATIZATION OF THE NCBS, IS TO PREPARE THE GROUND FOR PHASED SALE TO PRIVATE INVESTORS OF THE NCBS, CULMINATING IN MAJORITY PRIVATE OWNERSHIP OF AT LEAST THREE OF THE NCBS WITHIN TEN YEARS. GIVEN THE CURRENT OPERATING INEFFICIENCIES AND FINANCIAL CONDITION OF THESE NCBS, IMMEDIATE DIVESTITURE WILL NOT BE FEASIBLE. LIKEWISE, THE EFFECT OF DIVESTITURE UPON RURAL LENDING IS OPEN TO QUESTION. IN ADDITION, CONSIDERABLE OPPOSITION TO DIVESTITURE ARISES FROM THE LABOR UNIONS' FEAR OF REDUCTION IN STAFF. THESE ISSUES NEED ANALYSIS AND SYSTEMATIC PREPARATION BEFORE FURTHER ATTEMPTS AT PRIVATIZATION, AND ARE SCHEDULED FOR EXTENSIVE STUDY UNDER OUR PROJECT. THE BENCHMARKS SET OUT HERE ARE RELATED TO SEVEN DISTINCT TIME PHASES OF THE PROJECT: (A) APPRAISAL OF THE FSC; (B) NEGOTIATION OF FSC; (C) IDA BOARD APPROVAL OF FSC (TAKEN AS SAME TIME AS TRANCHE 1); (D) TRANCHE 2, SIX MONTHS AFTER BOARD APPROVAL; (E) TRANCHE 3, EIGHTEEN MONTHS AFTER BOARD APPROVAL; (F) AFTER 2 YEARS: (G) AFTER 3 YEARS. THESE BENCHMARKS ARE BASED ON TWO PRIMARY THEMES DEEMED ESSENTIAL FOR SUCCESSFUL PRIVATIZATION AND FOLLOW THE PROGRESS OF REFORM UNDER THOSE THEMES THROUGH THE APPROPRIATE TIME PERIODS: 1) NCBS TO BE MADE PROFITABLE (HENCE SALEABLE) THROUGH IMPROVED OPERATING EFFICIENCY, INTEREST RATE SPREADS, AND LOAN COLLECTION; 2) NCBS TO BE REMIBURSED/ RECAPITALIZED BY BDG INVOLUNTARY FOR ALL LOSSES/DECAPITALIZATION RESULTING FROM BDG CONTROLS.

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IN SUMMARY: PRE-PROJECT BENCHMARKS/CONDITIONS ARE:

(I) BB/BDG RECLASSIFICATION OF LOAN PORTFOLIOS

(II) BDG DRAFT LOAN RECOVERY LAW

(III) NCB RECOVERY/WRITEOFF STRATEGY FOR MAJOR DEFAULTERS

(IV) BDG INCOME TAX DEDUCTIBILITY FOR UNPAID INTEREST

(V) BB CREDIT RISK BUREAU

(VI) BB PERMIT FREEDOM OF BANKS TO SET INTEREST SPREADS (WITHIN LIMITS)

(VII) BDG INDEMNIFY BANKS FOR BJC BAD DEBTS

(VIII) BDG CREATE CAPITAL MARKETS COMMITTEE

BENCHMARKS/COVENANTS DURING THE FIRST PROJECT SEMESTER ARE:

(I) BDG RECAPITALIZE NCBS THROUGH ISSUING SECURITIES

(II) NCBS ACHIEVE RECOVERY/WRITEOFF TARGETS FOR MAJOR DEFAULTERS

(III) BB/NCBS EXPAND SCOPE OF LOAN CLASSIFICATION
BENCHMARKS/COVENANTS DURING THE REMAINDER OF THE PROJECT ARE:

(I) SPECIAL STUDIES UNDER FSC-TA: EVALUATION OF PRIOR NCB PRIVATIZATIONS; PRIVATE BANKING POLICIES; IMPACT OF PRIVATIZATION ON RURAL CREDIT; AND IMPACT OF PRIVATIZATION ON BANK EMPLOYMENT

(II) NCBS SET AND ACHIEVE IMPROVED LOAN COLLECTION TARGETS

(III) NCBS ATTAIN PROFITS OF 5 PERCENT IN 1991 AND 15 PERCENT IN 1992

(IV) DETAILED BDG PROPOSAL ON DIVESTITURE

THE BENCHMARKS IN DETAIL ARE:

A. PRIOR TO FSC LOAN APPRAISAL:

(I) BANGLADESH BANK INITIATES SATISFACTORY LOAN RECLASSIFICATION PROCEDURES THROUGH ISSUING APPROPRIATE CIRCULAR AND NCBS ACCEPT AND AGREE TO IMPLEMENT THESE PROCEDURES. (THEME 1)

COMMENT: THIS WILL REQUIRE COMMERCIAL BANKS TO CLASSIFY THEIR LOANS ON THE BASIS OF LENGTH OF DEFAULT AND LIKELIHOOD OF REPAYMENT AND TO MAINTAIN AN ADEQUATE LEVEL OF PROVISIONS (I.E. OFFSETS AGAINST INCOME) BASED ON THIS REVISED CLASSIFICATION. IT WILL ALSO LIMIT THE

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TREATING AS INCOME OF ACCRUED BUT UNPAID INTEREST ON LOANS. THIS STEP IS NEEDED TO INSURE THAT THE BANKS REVEAL THE TRUE CONDITION OF THEIR BALANCE SHEETS, SINCE PRIVATIZATION WILL REQUIRE PUBLIC CONFIDENCE IN THE INTEGRITY OF THE BALANCE SHEETS. THIS IS THE FIRST OF SEVERAL BENCHMARKS RELATED TO ACHIEVING SUCH CONFIDENCE.

(II) GOB TO SUBMIT TO IDA AND USAID A DRAFT LOAN RECOVERY LAW CLEARED BY THE MINISTRY OF LAW AND INCORPORATING THEIR COMMENTS. (THEME 1)

COMMENT: SINCE BETTER LOAN RECOVERY IS A PRIMARY KEY TO ACHIEVING NCB VIABILITY, THIS STEP IS NEEDED TO REMOVE MAJOR EXISTING IMPEDIMENTS TO COLLECTION OF OVERDUE LOANS THROUGH THE LEGAL SYSTEM. THE PUBLIC MUST BE CONFIDENT THAT, FOLLOWING DIVESTITURE, THE BANKS WILL BE ABLE TO RECOVER THEIR LOANS AND REALIZE AND DISTRIBUTE THEIR PROFITS.

(III) JOINT BE-NCB PREPARATION OF A DETAILED DEBT RECOVERY/WRITEOFF STRATEGY RELATING TO THE 100 LARGEST BORROWERS IN DEFAULT WITH EACH NCB. (THEME 1)

COMMENT: IT MUST BE NOTED THAT MANY OF THESE LOANS DATE BACK TO THE EARLY 1970S, AROUND THE TIME OF INDEPENDENCE, AND SOME OF THEM ARE TO FIRMS WHOSE OWNERS SUBSEQUENTLY FLED TO PAKISTAN. THEREFORE, WRITEOFF
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RATHER THAN RECOVERY WILL BE A COMMON EVENT.

(IV) BDG CLEARANCE OF AN AMENDMENT TO THE INCOME TAX ACT, OR APPROPRIATE ISSUANCE OF REGULATIONS, WHICH WILL MAKE TAX DEDUCTABLE BANGLADESH BANK-REQUIRED PROVISIONS AND SUSPENSION OF INTEREST. (THEME 2)

COMMENT: THE PRESENT SITUATION IS CLASSIC CATCH 22 - DEBTORS RECEIVE TAX DEDUCTIONS FOR INTEREST THEY OWE BUT DO NOT PAY AND BANKS HAVE TO PAY TAXES ON INTEREST OWED TO THEM BUT NOT COLLECTED. BY EASING THE TAX BURDEN ON THE BANKS, REALISTIC PROVISIONS FOR BAD DEBTS WILL BE FEASIBLE, PARTIALLY AT THE EXPENSE OF FOREGONE GOVERNMENT REVENUE. FOLLOWING IMPLEMENTATION OF THIS AND OTHER FSC REFORMS WE EXPECT NCBS TO EARN REAL PROFITS EVEN AFTER ADEQUATE PROVISIONS ARE MADE FOR BAD DEBTS (SEE PARAGRAPHS F. (I) AND G. (II) BELOW). THIS WILL CONTRIBUTE TO THE ATTRACTIVENESS OF BANK STOCKS GENERALLY AND IMPROVE MARKETABILITY OF NCB SHARES IN PARTICULAR.

F. PRIOR TO FSC NEGOTIATION:

(I) ESTABLISH NEW CREDIT RISK BUREAU IN BB SUPERVISION UNIT AND FORMULATE ITS RULES OF OPERATION. (THEME 1)

COMMENT: THIS WILL DIRECTLY CONTRIBUTE TO BETTER LOAN RECOVERY IN THE LONGER TERM BY IMPROVING INFORMATION ON POTENTIAL BORROWERS.

(II) BB TO ISSUE CIRCULARS SETTING: A) A DEPOSIT INTEREST RATE SCHEDULE, WITHIN A FLOOR AND CEILING; AND B) A LENDING INTEREST RATE SCHEDULE BASED ON QUOTE SHADOW MARKET RATES UNQUOTE, WITH A 3-4 PERCENT BAND. BANKS MAY SET THEIR OWN RATES FOR VARIOUS CATEGORIES OF DEPOSITS AND LOANS WITHIN THE PRESCRIBED LIMITS. (THEME 1)

COMMENT: BY PERMITTING BANKS TO SET THEIR OWN INDIVIDUAL RATES, WITHIN LIMITS, THIS WILL INTRODUCE A MAJOR ELEMENT OF COMPETITION WHICH SHOULD GREATLY SHARPEN THE OPERATIONS OF THE BANKS.

(III) BDG SHALL IMPLEMENT A PROPOSAL TO PROTECT BANKS FROM BAD DEBT LOSSES WITH RESPECT TO ADVANCES TO THE BANGLDESH JUTE CORPORATION (BJC). (THEME 2)

COMMENT: BJC IS ONE OF THE LARGEST AND MOST PERSISTENT DELINQUENTS, BUT SINCE JUTE IS THE PRIMARY BANGLADESH COMMODITY EARNER OF FOREIGN EXCHANGE, AND IS HAVING DIFFICULTIES ON THE WORLD MARKET, RESOLUTION OF THE PROBLEM IS DIFFICULT.

G. PRIOR TO 1ST TRANCHE (TO BE RELEASED SHORTLY AFTER IDA BOARD APPROVAL):

(I) BANGLADESH BANK TO DETERMINE THE INTEREST RATE SUBSIDY TO BE APPROPRIATED FROM THE BUDGET; BDG TO

INCLUDE SUCH IN BUDGET. (THEME 2)

COMMENT: INTEREST RATE SUBSIDIES WILL COVER THE GOVERNMENT REQUIRED LOSSES INCURRED BY BANKS IN LENDING TO PRIORITY SECTORS OF THE ECONOMY (E.G. AGRICULTURE, SMALL INDUSTRY) AT BELOW MARKET RATES, AS LONG AS THAT POLICY IS DEEMED NECESSARY BY THE BDG. HOWEVER, THIS IS SEEN AS AN INTERIM MEASURE RATHER THAN A PERMANENT FIXTURE, IN LIGHT OF THE LONGER TERM SUBSIDY REDUCTION/ELIMINATION PROGRAM DUSCUSSED IN PARAGRAPH 6. BELOW. IN THE INTERIM, THE INVESTING PUBLIC MUST BE ASSURED THAT ANY BANK LOSSES ON PRIORITY SECTOR LENDING WILL BE COVERED BY THE GOVERNMENT BEFORE SELLING OF SHARES WILL BE POSSIBLE; WITHOUT THIS SUBSIDY, PRIVATIZED BANKS WILL EITHER WITHDRAW FROM PRIORITY AREAS OR THE GOVERNMENT'S POSSIBLE FUTURE INTERFERENCE WILL LOWER INVESTOR CONFIDENCE IN THE FINANCIAL VIABILITY OF THE BANKS.

(II) BDG SHALL ESTABLISH A CAPITAL MARKETS DEVELOPMENT COMMITTEE. (THEME 1)

COMMENT: AS PART OF THE FINANCIAL REFORM IT IS THE INTENT OF THE GOVERNMENT TO IMPROVE THE FUNCTIONING OF THE CAPITAL MARKET IN BANGLADESH. THE CAPITAL MARKETS DEVELOPMENT COMMITTEE WILL HAVE THE TASK OF RECOMMENDING CHANGES IN REGULATIONS AND LAWS TO IMPROVE FUNCTIONING OF THE MARKET AND TO DEVISE WAYS AND MEANS TO ENCOURAGE ET

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MORE PRIVATE UNDERWRITING. THE RESULTS OF THESE CHANGES WILL INCREASE THE BREADTH AND DEPTH OF THE BANGLADESH CAPITAL MARKET, THUS IMPROVING THE POTENTIAL MARKET FOR NCB SHARES.

D. PRIOR TO 2ND TRANCHE (6 MONTHS AFTER FIRST TRANCHE):

(I) BDG SHALL RECAPITALIZE NCBS THROUGH ISSUING SPECIAL INTEREST BEARING GOVERNMENT SECURITIES IN SUFFICIENT AMOUNTS TO BRING NET WORTH OF EACH NCB TO 5% OF DEPOSITS. (THEME 2)

COMMENT: THIS STEP WILL INCREASE NET WORTH OF THE NCBS TO A SATISFACTORY LEVEL, AT LEAST PARTIALLY RECOMPENSING THEM FOR PRIOR LOSSES DUE TO BDG POLICIES. THE RESTRUCTURED BALANCE SHEETS WILL PROVIDE THE BASELINE AGAINST WHICH PROGRESS UNDER THE FINANCIAL REFORM PROGRAM CAN BE ASSESSED.

(II) NCBS SHALL ACHIEVE TARGETS SET IN PARAGRAPH A. (III) FOR COLLECTION/WRITEOFF OF 100 LARGEST LOANS IN DEFAULT. (THEME 1)

COMMENT: THIS WILL TEST WHETHER THE PLANNED EFFECTS OF PRIOR BENCHMARKS CAN BE ACHIEVED IN PRACTICE.

(III) NCBS SHALL COMPLETE CLASSIFICATION OF LOAN PORTFOLIO (SEE A. (I) ABOVE) AND SET TARGETS FOR COLLECTION/WRITEOFF OF REMAINING MAJOR LOANS IN DEFAULT. (THEME 1)

E. PRIOR TO 3RD TRANCHE (1 YEAR AFTER SECOND):

(I) A STUDY OF THE IMPACT OF PRIVATIZATION ON PUBALI AND UTTARA BANKS AND PARTIAL PRIVATIZATION OF RUPALI BANK IS TO BE COMPLETED UNDER FSC-TA. (THEME 1)

COMMENT: PUBALI AND UTTARA BANKS WERE DENATIONALIZED IN 1985. RUPALI WAS PARTIALLY DIVESTED. THIS WAS DONE WITH NO ATTEMPT TO CLEAR UP THEIR BALANCE SHEETS. THE SUBSEQUENT HISTORY OF THESE BANKS SINCE THESE ACTIONS IS OF GREAT IMPORTANCE. THE STUDY IS TO IDENTIFY HOW THE BANKS WERE INFLUENCED BY PRIVATIZATION AND, IN THE CASE OF RUPALI, BY PARTIAL DIVESTITURE.

(II) A STUDY OF POLICY ACTIONS TO SUPPORT THE DEVELOPMENT OF PRIVATE BANKING IS TO BE COMPLETED UNDER FSC-TA. THIS STUDY WILL ANALYZE THE ADVANTAGES AND DISADVANTAGES OF SUCH POTENTIAL ACTIONS. (THEME 1)

F. AFTER 2 YEARS:

(I) THE 1991 PERFORMANCE OF THE NCBS SHOULD SHOW A 5% PROFIT AFTER THE REQUIRED PROVISIONS AND TREATMENT OF UNCOLLECTED INTEREST. (THEME 1)

(II) ESTABLISH LOAN COLLECTION TARGETS FOR 50% OF REMAINING LOANS: ESTABLISH IMPROVED TARGETS FOR 1992 FOR

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ALL MAJOR NCB BRANCHES. (THEME 1)

(III) A STUDY ON THE IMPACT ON RURAL CREDIT WHEN THE NCBS ARE PRIVATIZED TO BE COMPLETED UNDER FSC-TA. (THEME 1)

COMMENT: WITH THE DIVESTITURE OF PUBALI AND UTTARA, BOTH BANKS REDUCED THEIR OPERATIONS IN RURAL AREAS, ESSENTIALLY WITHDRAWING FROM LENDING THERE. IT IS ANTICIPATED THAT PRIVATIZATION OF THE REMAINING NCBS COULD LEAD TO SIMILAR RESULTS UNLESS APPROPRIATE PREPARATORY ACTIONS ARE UNDERTAKEN. THIS STUDY WOULD CONSIDER THE LIKELY EVOLUTION OF RURAL BANKING FOLLOWING DIVESTITURE, AND CHANGES IN POLICIES NEEDED TO ENCOURAGE CONTINUED PARTICIPATION IN RURAL BANKING.

G. AFTER 3 YEARS:

(I) ACHIEVE TARGETS FOR LOAN COLLECTION (F. (II)). (THEME 1)

(II) THE 1992 PERFORMANCE FOR THE NCBS SHOULD SHOW A MAJOR INCREASE OF PROFITS. THE PRETAX RETURN ON OWNERS' EQUITY SHOULD REACH 15%.(THEME 1)

(III) STUDIES ON THE IMPACT OF PRIVATIZATION ON BANK EMPLOYMENT UNDER FSC-TA ARE TO BE COMPLETED. RECOMMENDATIONS ARE TO BE INCLUDED ON MEASURES TO EASE
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THE LABOR PROBLEMS THAT MIGHT EMERGE DURING PRIVATIZATION. (THEME 1)

COMMENT: MAJOR OPPOSITION TO FURTHER PRIVATIZATION OF THE BANKS ARISES FROM THE LABOR UNIONS. STRATEGIES TO MODERATE THIS OPPOSITION NEED TO BE IDENTIFIED AND COSTED.

(IV) A DETAILED PROPOSAL ON DIVESTITURE OF THE NCBS IS TO BE PREPARED BY THE BDG, INCLUDING PHASING, PROCEDURES AND ESTIMATED STOCK SALE PRICE. (THEMES 1 AND 2)

COMMENT: THE DETAILED PROPOSAL FOR DIVESTITURE WILL PROVIDE THE BASIS FOR SPECIFIC BDG ACTIONS. BY THE END OF THE THIRD YEAR, WE ANTICIPATE THAT A SIGNIFICANT IMPROVEMENT OF THE NCB'S FINANCIAL PERFORMANCE, BASED ON THEIR MORE SOLID CAPITALIZATION, IMPROVED LOAN RECOVERY RESULTS AND A MORE FLEXIBLE INTEREST RATE POLICY, WILL RESULT IN GREATER COMPETITIVE CAPABILITIES AND FAR MORE MARKETABLE SECURITIES. DURING THE LAST PART OF THE FSC-TA, AND DURING NEGOTIATIONS OF FSC II AND A POSSIBLE FSC-TA II, THE PROCESS OF ACTUAL DIVESTITURE WILL HAVE BECOME THE MAJOR OBJECTIVE TO BE ACHIEVED.

6. REDUCTION OF INTEREST RATE SUBSIDIES:

A. THE SUBJECT OF REDUCING INTEREST RATE SUBSIDIES IS BOTH LINKED TO AND DISTINCTIVE FROM THE REFORM OF THE FINANCIAL SECTOR. IT IS LINKED BECAUSE THE FINANCIAL SECTOR HAS HERETOFORE BEEN USED AS THE CONDUIT FOR SUCH SUBSIDIES, FORWARDING THEM IN A WAY THAT WAS LARGELY INVISIBLE TO BOTH THE PUBLIC AND THE MAJORITY OF THE GOVERNMENT, AND WAS ALSO VIRTUALLY PAINLESS IN THAT IT APPEARED TO BE FREE MONEY, REFLECTING NOTHING MORE SERIOUS THAN A DIMINUITION OF NCB PROFITS. AND IT IS DISTINCT, BECAUSE IT REPRESENTS THE NEED FOR A SUBSTANTIVE POLICY DECISION - THAT CERTAIN SECTORS OF THE ECONOMY MUST LEARN TO STAND ON THEIR OWN FEET - RATHER THAN A PROCEDURAL DECISION AS TO HOW A PARTICULAR SUBSTANTIVE POLICY IS TO BE IMPLEMENTED.

B. THE PERNICIOUS EFFECTS OF EXISTING BDG FINANCIAL POLICIES CAN BE SEEN UPON ANALYSIS OF THE LENDING PICTURE IN BANGLADESH. CURRENT COSTS OF LENDING FOR BOTH BANKS AND NON-PRIORITY BORROWERS ARE HIGH DUE TO: (A) HIGH COST OF FUNDS ARISING FROM THE INFLATION RATE AND BDG INSISTENCE ON POSITIVE REAL INTEREST RATES TO STIMULATE SAVINGS; (B) INADEQUATE INTEREST INCOME FROM LENDING TO PRIORITY SECTORS, ARISING FROM BDG RESTRICTIONS ON LENDING INTEREST RATES; (C) POOR LOAN RECOVERY DUE TO INADEQUATE COLLECTION AND FORECLOSURE LAWS, LEADING TO A HIGH REQUIRED PROVISION LEVEL.

C. AS A RESULT OF THESE FACTORS, THE NCBS REQUIRE A FORM OF SUBSIDIZATION IN ORDER TO FULFIL THEIR ROLE AS CONDUIT FOR SUBSIDIES TO PRIORITY SECTORS OF THE ECONOMY: THEIR EARNINGS FROM INTEREST ON LOANS AND OTHER ASSETS ARE INSUFFICIENT TO COVER THE COST OF FUNDS AND

ADMINISTRATIVE COSTS, DUE TO THE BDG INTERFERENCE IN LENDING SPREADS AND DEBT RECOVERY.

D. THE FORM OF THIS SUBSIDY TO THE NCBS IS COVERT, HOWEVER, RATHER THAN OPEN, BEING PROVIDED EFFECTIVELY THROUGH EXPANDING THE MONEY SUPPLY, THUS INSURING AN EVER INCREASING FLOW OF DEPOSITS TO MAINTAIN THE FLOAT. THIS POLICY OF MONETARY EXPANSION HAS RESULTED IN AVERAGE ANNUAL INFLATION RATES OF 10-12 PERCENT. A SUSTAINED REDUCTION IN MONEY SUPPLY GROWTH CANNOT BE ACHIEVED UNDER PRESENT CONDITIONS, THEREFORE, WITHOUT THE RISK OF A CREDIT CRISES EMERGING AS THE DIMINISHED FLOW OF NEW SAVINGS ENDANGERS THE NCBS' LIQUIDITY SITUATION AND, CONSEQUENTLY, THEIR ABILITY TO MAINTAIN LENDING LEVELS. THIS RISK EFFECTIVELY PREVENTS THE TIGHTENING OF MONETARY POLICY TO THE POINT WHERE INFLATION CAN BE SIGNIFICANTLY REDUCED.

E. THE SUBSIDIES THROUGH INFLATION ARE HIDDEN FROM BOTH PUBLIC AND BDG SCRUTINY AND THE BANKS ARE WIDELY PERCEIVED AS HAVING SUFFICIENT RESOURCES. THE PRESENT LEVEL OF INFLATION-GENERATED SUBSIDIZATION IS ESTIMATED AT 5.42 BILLION TAKA PER ANNUM. THIS IS FOUND FROM THE ESTIMATED DIFFERENCE BETWEEN NOMINAL INTEREST RATES AND THE TRUE COST OF LENDING AT EXISTING RECOVERY RATES. THE BURDEN OF THIS SUBSIDIZATION IS CARRIED BY WHOEVER LOSES FROM THE INFLATION. THE BURDEN PROBABLY FALLS IN A REGRESSIVE WAY, AS BOTH RURAL AND URBAN LANDLESS
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HOUSEHOLDS ARE DEPENDENT ON EARNINGS OF UNSKILLED WORKERS, AND THERE IS A LARGE SUPPLY OF SUCH LABOR AVAILABLE. THE BENEFICIARIES OF INFLATION ARE, TRADITIONALLY, THOSE WHO HAVE ASSETS WHICH APPRECIATE MORE RAPIDLY THAN THE GENERAL PRICE LEVEL. THESE TEND TO BE PRIMARILY THE OWNERS OF URBAN LAND.

F. PARAGRAPH 2. D. OF REF A. ENJOINED THE MISSION: QUOTE WE UNDERSTAND IDA HAS ALREADY FORMULATED A LIST OF STEPS TO BE ACCOMPLISHED OVER THE COURSE OF FSC 1 INCLUDING AN EXAMINATION OF THE TREND IN THE LEVEL OF EXPLICIT BDG SUBSIDIES OVER TIME AND STEPS TAKEN TO INSTITUTIONALIZE AND SUPPORT THE BDG PROGRAM TO RESTRUCTURE INTEREST RATES. THE MISSION SHOULD REVIEW AND SUPPORT THIS LIST AS APPROPRIATE. UNQUOTE

G. THE FSC WILL INTRODUCE A SYSTEM FOR MAKING SUBSIDIES EXPLICIT: FOR EACH LOAN CATEGORY THE TRUE COST OF LENDING (CALLED SHADOW RATE BY IDA) IS ESTABLISHED. THIS IS BASED ON COST OF FUNDS, RETURN TO CAPITAL (OWNERS' EQUITY), ADMINISTRATIVE COSTS, AND BAD DEBT PROVISIONS. BE HAS ESTIMATED SUCH INTEREST RATES FOR DIFFERENT SECTORS BASED ON THE RECAPITALIZED BALANCE SHEETS OF THE PARTICIPATING NCBS, AND ON AN EARLY PROMPT IMPROVEMENT IN THE LOAN RECOVERY RATE.

- (I) WITHOUT FSC/FSC-TA AND THE CONSEQUENT IMPROVEMENT IN LOAN RECOVERY RATES, THE TOTAL SUBSIDY THAT WOULD BE REQUIRED IS CALCULATED AT 5,093 MILLION TAKA FOR THE FIRST YEAR; 5,878 FOR THE SECOND; AND 6,779 FOR THE THIRD, FOR A 3 YEAR TOTAL OF 17,747 MILLION TAKA (DOLLARS 555 MILLION).

- (II) THE FIRST SET OF IMPROVEMENT CALCULATIONS (#3) PRESENTED IN THE TABLE BELOW ARE BASED ON A CONSTANT INFLATION RATE. EVEN WITH CONSTANT INFLATION, PROGRESS ON LOAN RECOVERY WOULD REDUCE SUBSIDIES BY 440 MILLION TAKA THE FIRST YEAR; 1,579 THE SECOND; AND 3,114 THE THIRD FOR A THREE YEAR TOTAL OF 5,133 MILLION TAKA (DOLLARS 160 MILLION).

- (III) WITH IMPLEMENTATION OF THE REFORMS SET FORTH IN THE POLICY FRAMEWORK PAPER (PFP) AND THE IMPACT OF THE FSC/FSC-TA, THIS INFLATION RATE CAN BE REDUCED SYSTEMATICALLY FROM THE STRUCTURAL RATE OF 10 PERCENT (THE PRESENT INFLATION RATE IS 8 PERCENT, BUT THAT APPEARS TO BE THE RESULT OF A TEMPORARY ECONOMIC SLOWDOWN AND THUS AN ABERRATION FROM THE STRUCTURAL LEVEL). 7 PERCENT IS THE PROJECTED INFLATION RATE AFTER 3 YEARS. THE PROJECTED REDUCTION OF THE STRUCTURAL INFLATION LEVEL (#4) WILL PERMIT A LOWER DEPOSITOR INTEREST RATE, AND WILL THUS LOWER THE NCB SUBSIDY BY 347 MILLION TAKA THE FIRST YEAR; 1,138 THE SECOND; AND 2,140 THE THIRD FOR A THREE YEAR TOTAL OF 3,625 MILLION TAKA (DOLLARS 114 MILLION).

- (IV) THE COMBINED EFFECT IS 787 MILLION TAKA THE FIRST YEAR; 2,717 THE SECOND; AND 5,254 THE THIRD FOR A

THREE YEAR TOTAL OF 8,758 MILLION TAKA (DOLLARS 274 MILLION). THUS, THE FSC/FSC-TA SHOULD-RESULT IN CUTTING THE SUBSIDY IN HALF WITHIN THREE YEARS.

H. THE FOLLOWING TABLE SUMMARIZES REDUCTION OF SUBSIDIES ONCE FSC IS IN PLACE:

	YEAR1	YEAR2	YEAR3	NOTE
	(MILLIONS OF TAKAS)			
1. INFLATION (%)	10	8	7	
2. TOTAL SUBSIDY	5093	5875	6779	NO CHANGES IN INFLATION RATE OR LOAN RECOVERY
3. REDUCTION THROUGH IMPROVED LOAN COLLECTION	440	1579	3114	NO REDUCTION IN INFLATION
4. REDUCTION THROUGH SLOWER INFLATION	347	1138	2140	NO IMPROVEMENT IN

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					LOAN RECOVERY
5. - - -	REDUCTION THROUGH COMBINED EFFECT	787	2717	5254	COMBINED EFFECT
6.	REMAINING SUBSIDY	4306	3158	1525	LINE 2 - 5
-	EXPLICIT	(1764)	(2049)	(1335)	
-	IMPLICIT	(2542)	(1131)	(190)	

THE EXPLICT SUBSIDY IS THE SUBSIDY TO BE PAID BY THE GOVERNMENT. IT IS BASED ON THE TRUE COST OF LENDING AT THE END OF THE THIRD YEAR PERIOD FOR LOAN RECOVERY.

I. THE ABOVE ESTIMATES OF THE TOTAL SUBSIDY AND THE REDUCTION IN THE SUBSIDY ARE BASED ON CALCULATIONS USING BANGLADESH BANK DATA ON LOAN RECOVERY AND PFP INFLATION RATE TARGETS. THE DIVISION OF THE TOTAL SUBSIDY BETWEEN THE EXPLICIT AND IMPLICIT CATEGORIES IS BASED ON THE BANGLADESH BANK'S DRAFT INTEREST RATE MATRIX. THIS MATRIX IS CURRENTLY UNDER NEGOTIATION BETWEEN IDA AND BDG. HOWEVER, EVEN SECULD THERE BE DIFFERENCES BETWEEN THE DRAFT MATRIX AND THE FINAL MATRIX, THESE WILL AFFECT ONLY THE EXTENT TO WHICH THE SUBSIDIES WILL BE EXPLICIT, NOT THE TOTAL SUBSIDIES OR THE REDUCTIONS ACHIEVED UNDER THE FSC/FSC-TA PROGRAM.

J. THE IMPACT OF FSC/FSC-TA ON SUBSIDY REDUCTION WILL BE THREEFOLD:

(I) THE SUBSIDY PAID TO THE BANKS (AND THROUGH THEM TO THE BANK BORROWERS) WILL BE EXPLICIT AND APPROPRIATED THROUGH THE BUDGET. THIS WILL RESULT IN A MORE EQUITABLE DISTRIBUTION OF THE BURDEN, SINCE THE TAX SYSTEM IS MORE PROGRESSIVE THAN GENERAL INFLATION. THE IMPLICIT SUBSIDY ALMOST VANISHES UNDER THE FSC/FSC-TA PROGRAM.

(II) THE TOTAL SUBSIDY PAID TO THE BANKS WILL BE REDUCED AS A CONSEQUENCE OF THE FSC ACTIONS, WHICH WILL IMPROVE LOAN RECOVERY AND PERMIT THE MONETARY AUTHORITIES TO LOWER INFLATION WITHOUT THE THREAT OF A LIQUIDITY CRISIS IN THE BANKING SYSTEM.

(III) THE EXPLICIT TREATMENT OF THE BANK SUBSIDY WILL POSSIBLY GENERATE PUBLIC SUPPORT FOR REDUCTION OF THE SUBSIDY THROUGH BETTER LOAN RECOVERY OR HIGHER NOMINAL INTEREST RATES. THE BUDGET AMOUNT OF 1.5-2.0 BILLION TAKA IS A SIGNIFICANT AMOUNT AND IS CERTAIN TO DRAW MUCH PUBLIC DISCUSSION. MAST

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ANNEX EX4.

Financial Sector Reform Program Technical Assistance Project: [illegible]

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
OUTPUTS 1) A more detailed analytical framework for macro-financial analysis 2) A better trained cadre of officers on macro-economic policy 3) A fully operational rediscount window, sale and purchase of BB special securities, and a fully operational interest rate policy 4) Expansion of BB's computer operations and MIS system, with a staff trained in computer, statistical and econometric skills 5) Improved reporting systems of banks to the BB 6) Bank supervision methods based on analysis of bank financial condition 7) A fully operational Credit Information Bureau 8) MIS systems and improved loan accounting systems established at the NCBs 9) Expanded computerization of NCB head offices and limited number of branches 10) Planning and performance budgeting systems established in NCBs 11) Revised loan policy procedures and improved loan recovery of NCBs 12) Enhanced loan pricing procedures and improved loan recovery of NCBs 13) Improved BIBM course offerings 14) Outputs, manuals and techniques available to commercial banks 15) Studies completed on bank privitization, personnel issues, gender discrimination, effects on rural areas. 16) A report on outputs with respect to women in development issues, including: employment levels and number of new women entrants to management and bank loan officer positions in the BB and the NCBs, number of women bank officier participants in in-country and overseas training programs		OUTPUT: Output monitoring is the responsibility of the TA Team. The USAID Project Co-ordinator and the TA Team Leader will, in consultation with the BB and IDA, specify in detail the output targets and annual output schedule	PROGRAM AND PROJECT CONDITIONALITY AID Conditions Precedent to Disbursement: * Specimen signatures received * IDA's Financial Sector Credit executed with BDG * BDG, through Bangladesh Bank, has established a Review Committee to oversee Program progress AID Covenants: * BDG continually honors IDA FSC loan agreement * BDG ensures office space is provided in BB, NCBs, BIBM, and MOF, for technical consultants * BDG provides to AID every 3 months reports on progress made toward key project benchmarks * BDG provides to AID every 6 months financial reports on BDG cash and in-kind contributions to the FSRP TA and the larger FSC program * BDG ensures training services and facilities of BIBM, as well as information systems, manuals and technical outputs are available for equal use by private and public banks * Bangladesh Bank regulations and the Banking Companies Ordinance regarding capital adequacy are maintained * Beginning June 1992, BDG shall establish and implement for all NCBs, collection targets, policies and procedures for collecting or writing off any NCBs loans not yet collected written off pursuant to IDA FSC loan agreement * Not later than June 1993, BDG shall submit to AID a detailed proposal for divestiture for at two of the NCBs, and for Rupali Bank to become at least 51% privately owned. The proposals will include phasing, procedures and estimated stock sales prices.

INPUTS

FSRP TA Illustrative Summary Budget

1) USAID Total: $ 19,413,525.46	1)* Long term expatriate consultants,	$ 9,705,945.21	1) Reports from the FSRP TA Prime Contractor and Project Co-ordinator
	* Long term national consultants	$ 740,076.99	
	* Short term expatriate consultants	$ 2,388,652.16	
	* Head office suport (Prime contractor)	307,774.06	
	* Local administrative	$ 515,548.59	
	* Project coordinator	$ 809,168.18	
	* Equipment	$ 2,755,830.00	
	* Training	$ 1,301,170.05	
	* Short term national consultant	$ 158,830.56	
	* Senior Administrative Officer	$ 415,499.66	
	* Other, including audits	$ 320,000.00	
2) IDA Total: $ 175,000,000.00	2)* A loan in three tranches:	$ 50,000,000.00 $ 50,000,000.00 $ 75,000,000.00	2) IDA Reports
3) BDG contribution to FSRP BDG contribution to FSRP TA Total: 10.48 billion Taka ($308.24 million, using 34 Taka : $1)	3)* Recapitulations of NCBs * Contribution to TA	10.42 billion Taka .06 billion Taka	3) Documents and Reports from NCBs, BB, MOF, FSRP TA Prime Contractor

Financial Sector Reform Program Technical Assistance Project: 388-0070

NARRATIVE SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	IMPORTANT ASSUMPTIONS
OUTPUTS 1) A more detailed analytical framework for macro-financial analysis 2) A better trained cadre of officers on macro-economic policy 3) A fully operational rediscount window, sale and purchase of BB special securities, and a fully operational interest rate policy 4) Expansion of BB's computer operations and MIS system, with a staff trained in computer, statistical and econometric skills 5) Improved reporting systems of banks to the BB 6) Bank supervision methods based on analysis of bank financial condition 7) A fully operational Credit Information Bureau 8) MIS systems and improved loan accounting systems established at the NCBs 9) Expanded computerization of NCB head offices and limited number of branches 10) Planning and performance budgeting systems established in NCBs 11) Revised loan policy procedures and improved loan recovery of NCBs 12) Enhanced loan pricing procedures and improved loan recovery of NCBs 13) Improved BIBM course offerings 14) Outputs, manuals and techniques available to commercial banks 15) Studies completed on bank privitization, personnel issues, gender discrimination, effects on rural areas. 16) A report on outputs with respect to women in development issues, including: employment levels and number of new women entrants to management and bank loan officer positions in the BB and the NCBs, number of women bank officier participants in in-country and overseas training programs		OUTPUT: Output monitoring is the responsibility of the TA Team. The USAID Project Co-ordinator and the TA Team Leader will, in consultation with the BB and IDA, specify in detail the output targets and annual output schedule	PROGRAM AND PROJECT CONDITIONALITY AID Conditions Precedent to Disbursement: * Specimen signatures received * IDA's Financial Sector Credit executed with BDG * BDG, through Bangladesh Bank, has established a Review Committee to oversee Program progress AID Covenants: * BDG continually honors IDA FSC loan agreement * BDG ensures office space is provided in BB, NCBs, BIBM, and MOF, for technical consultants * BDG provides to AID every 3 months reports on progress made toward key project benchmarks * BDG provides to AID every 6 months financial reports on BDG cash and in-kind contributions to the FSRP TA and the larger FSC program * BDG ensures training services and facilities of BIBM, as well as information systems, manuals and technical outputs are available for equal use by private and public banks * Bangladesh Bank regulations and the Banking Companies Ordinance regarding capital adequacy are maintained * Beginning June 1992, BDG shall establish and implement for all NCBs, collection targets, policies and procedures for collecting or writing off any NCBs loans not yet collected written off pursuant to IDA FSC loan agreement * Not later than June 1993, BDG shall submit to AID a detailed proposal for divesture for at two of the NCBs, and for Rupali Bank to become at least 51% privately owned. The proposals will include phasing, procedures and estimated stock sales prices.

INPUTS

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1) USAID Total: $ 19,413,525.46	1)* Long term expatriate consultants.	$ 9,705,945.21	1) Reports from the FSRP TA Prime Contractor and Project Co-ordinator
	* Long term national consultants	$ 740,076.99	
	* Short term expatriate consultants	$ 2,383,662.16	
	* Head office suport (Prime contractor)	307,774.06	
	* Local administrative	$ 515,548.59	
	* Project coordinator	$ 809,168.18	
	* Equipment	$ 2,755,830.00	
	* Training	$ 1,301,170.05	
	* Short term national consultant	$ 158,830.56	
	* Senior Administrative Officer	$ 415,499.66	
	* Other, including audits	$ 320,000.00	
2) IDA Total: $ 175,000,000.00	2)* A loan in three tranches:	$ 50,000,000.00 $ 50,000,000.00 $ 75,000,000.00	2) IDA Reports
3) BDG contribution to FSRP BDG contribution to FSRP TA Total: 10.48 billion Taka ($308.24 million, using 34 Taka : $1)	3)* Recapitulations of NCBs * Contribution to TA	10.42 billion Taka .06 billion Taka	3) Documents and Reports from NCBs, BB, MOF, FSRP TA Prime Contractor

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ANNEX EX5.

MOST IMMEDIATE/BY SPL. MESSENGER

From : Mohammad Shahid Ullah,
Asstt. Chief.

Ministry of Planning
External Resources Division
Sere-e-Bangla Nagar
Dhaka-7

D.O No. ERD/America-1(TA)-4/88/101 #442

Dated April 23, 1990

Subject : Technical Assistance for the Financial Sector Credit.

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ACTION TO:	
REPLY DUE:	5/9
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Dear Mr. Young,

With reference to the above subject, this is to inform you that the Technical Assistance Project Proforma (TAPP) for the Financial Sector Credit Programme prepared by the Bangladesh Bank was discussed in a meeting of the Special Project Evaluation Committee (SPEC) on March 20, 1990. Later, the project was discussed with ILA & USAID officials by the concerned officials of Bangladesh Government. As a result of these discussions, the TAPP was required to be revised and approved by the SPEC. Necessary actions are now being taken for revision of the TAPP and it's approval by the competent authority.

We shall inform you of the further development in this matter in due course.

RECEIVED
APR 25 1990
USAID
DHAKA

Sincerely

23/4/90

(Mohammad Shahid Ullah)

Mr. Frank J. Young
Programme Officer
USAID Mission to Bangladesh
American Embassy Building
Baridhara, Dhaka.

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ANNEX EXE

STATUTORY CHECKLIST

AID PROJECT NO. 388-0078 FINANCIAL SECTOR REFORM PROGRAM TECHNIAL ASSISTANCE

5C(1) - COUNTRY CHECKLIST

Listed below are statutory criteria applicable generally to FAA Funds, and criteria applicable to individual fund sources: Development Assistance and Economic Support Fund.

A. GENERAL CRITERIA FOR COUNTRY ELIGIBILITY

1. FY 1990 Appropriations Act Sec. 569(b) Has the President certified to the Congress that the government of the recipient country is failing to take adequate measures to prevent narcotic drugs or other controlled substances which are cultivated, produced or processed illicitly, in whole or in part, in such country or transported through such country, from being sold illegally within the jurisdiction of such country to United States Government personnel or their dependents or from entering the United States unlawfully? — No.

2. FAA Sec. 481(h); FY 1990 Appropriations Act Sec. 569(b). (These provisions apply to assistance of any kind provided by grant, sale, loan, lease, credit, guaranty, or insurance, except assistance from the Child Survival Fund or relating to international narcotics control, disaster and refugee relief, narcotics education and awareness, or the provision of food or medicine.) If the recipient is a "major illicit drug producing country" (defined as a country producing during a fiscal year at least five metric tons of opium or 500 metric tons of coca or marijuana) or a "major drug-transit country" (defined as a country that is a significant direct source of illicit drugs significantly affecting the United States, through which such drugs are transported, or through which significant sums of drug-related profits are laundered with the knowledge or complicity of the government): (a) Does the country have in place a bilateral narcotics agreement with the United States, or a multilateral narcotics agreement? and (b) Has the President in the March 1 International Narcotics Control Strategy Report (INSCR) — N/A

determined and certified to the Congress (without Congressional enactment, within 45 days of continuous session, of a resolution disapproving such a certification), or has the President determined and certified to the Congress on any other date (with enactment by Congress of a resolution approving such certification), that (1) during the previous year the country has cooperated fully with the United States or taken adequate steps on its own to satisfy the goals agreed to in a bilateral narcotics agreement with the United States or in a multilateral agreement, to prevent illicit drugs produced or processed in or transported through such country from being transported into the United States, to prevent and punish drug profit laundering in the country, and to prevent and punish bribery and other forms of public corruption which facilitate production or shipment of illicit drugs or discourage prosecution of such acts, or that (2) the vital national interests of the United States require the provision of such assistance?

3. 1986 Drug Act Section 2013 (This section applies to the same categories of assistance subject to the restrictions in FAA Sec. 481(h), above.) If recipient country is a "major illicit drug producing country" or "major drug-transit country" (as defined for the purpose of FAA Sec. 481(h)), has the President submitted a report to Congress listing such country as one: (a) which, as a matter of government policy, encourages or facilitates the production or distribution of illicit drugs; (b) in which any senior official of the government engages in, encourages, or facilitates the production or distribution of illegal drugs; (c) in which any member of a U.S. Government agency has suffered or been threatened with violence inflicted by or with the complicity of any government officer; or (d) which fails to provide reasonable cooperation to lawful activities of U.S. drug enforcement agents, unless the President has provided the required certification to Congress pertaining to U.S. national interests and the drug control and criminal prosecution efforts of that country? N/A

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4. FAA Section. 620(c). If assistance is to a government, is the government indebted to any U.S citizen for goods or services furnished or ordered where: (a) such citizen has exhausted available legal remedies, (b) the debt is not denied or contested by such government, or (c) the indebtedness arises under an unconditional guaranty of payment given by such government or controlled entity? No.

5. FAA Sec.620(e)(1). If assistance is to a government, has it (including any government agencies or subdivisions) taken any action which has the effect of nationalizing, expropriating, or otherwise seizing ownership or control of property of U.S. citizens or entities beneficially owned by them without taking steps to discharge its obligations toward such citizens or entities? No.

6. FAA Sec. 620(a), 620(f), 620D; FY 1990 Appropriations Act Secs. 512, 548. Is recipient country a Communist country? If so, has the President: (a) determined that assistance to the country is vital to the security of the United States, that the recipient country is not controlled by the international Communist conspiracy, and that such assistance will further promote the independence of the recipient country from international communism, or (b) removed a country from applicable restrictions on assistance to communist countries upon a determination and report to Congress that such action is important to the national interest of the United States? Will assistance be provided either directly or indirectly to Angola, Cambodia, Cuba, Iraq, Libya, Vietnam, South Yemen, Iran or Syria? Will assistance be provided to Afghanistan without a certification, or will assistance be provided inside Afghanistan through the Soviet-controlled government of Afghanistan? No.

7. FAA Sec. 620(j). Has the country permitted, or failed to take adequate measures to prevent, damage or destruction by mob action of U.S. property? No.

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8.	FAA Sec. 620(l). Has the country failed to enter into an investment guarantv agreement with OPIC?	No.
9.	FAA Sec. 620(o); Fishermen's Protective Act of 1967 (as amended) Sec. 5. (a) Has the country seized, or imposed any penalty or sanction against, any U.S. fishing vessel because of fishing activities in international waters? (b) If so, has any deduction required by the Fishermen's Protective Act been made?	No.
10.	FAA Sec. 620(q); FY 1990 Appropriations Act Sec. 518 (Brooke Amendment). (a) Has the government of the recipient country been in default for more than six months on interest or principal of any loan to the country under the FAA? (b) Has the country been in default for more than one year on interest or principal on any U.S. loan under a program for which the FY 1990 Appropriations Act appropriates funds?	No.
11.	FAA Sec. 620(s). If contemplated assistance is development loan or to come from Economic Support Fund, has the Administrator taken into account the percentage of the country's budget and amount of country's foreign exchange or other resources spent on military equipment? (Reference may be made to the annual "Taking Into Consideration" memo: "Yes, taken into account by the Administrator at time of approval of Agency OYB." This approval by the Administrator of the Operational Year Budget can be the basis for an affirmative answer during the fiscal year unless significant changes in circumstances occur.)	N/A
12.	FAA Sec. 620(t). Has the country severed diplomatic relations with the United States? If so, have relations been resumed and have new bilateral assistance agreements been negotiated and entered into since such resumption?	No.

13.	FAA Sec. 620(u). What is the payment status of the country's U.N. obligations? If the country is in arrears, were such arrearages taken into account by the A.I.D. Administrator in determining the current A.I.D. Operational Year Budget? (Reference may be made to the "Taking into Consideration" memo.)	Current.
14.	FAA Sec. 620A. Has the President determined that the recipient country grants sanctuary from prosecution to any individual or group which has committed an act of international terrorism or otherwise supports international terrorism?	No.
15.	FY 1990 Appropriations Act Sec. 564. Has the country been determined by the President to: (a) grant sanctuary from prosecution to any individual or group which has committed an act of international terrorism, or (b) otherwise support international terrorism, unless the President has waived this restriction on grounds of national security or for humanitarian reasons?	No.
16.	ISDCA of 1985 Sec. 552(b). Has the Secretary of State determined that the country is a high terrorist threat country after the Secretary of Transportation has determined, pursuant to section 1115(e)(2) of the Federal Aviation Act of 1958, that an airport in the country does not maintain and administer effective security measures?	No.
17.	FAA Sec. 666(b). Does the country object, on the basis of race, religion, national origin or sex, to the presence of any officer or employee of the U.S. who is present in such country to carry out economic development programs under the FAA?	No.

18. FAA Secs. 669, 670. Has the country, after August 3, 1977, delivered to any other country or received nuclear enrichment or reprocessing equipment, materials, or technology, without specified arrangements or safeguards, and without special certification by the President? Has it transferred a nuclear explosive device to a non-nuclear weapon state, or if such a state, either received or detonated a nuclear explosive device? (FAA Sec. 620E permits a special waiver of Sec. 669 for Pakistan.)	No.
19. FAA Sec. 670. If the country is a non-nuclear weapon state, has it, on or after August 8, 1985, exported (or attempted to export) illegally from the United States any material, equipment, or technology which would contribute significantly to the ability of a country to manufacture a nuclear explosive device?	No.
20. ISDCA of 1981 Sec. 720. Was the country represented at the Meeting of Ministers of Foreign Affairs and Heads of Delegations of the Non-Aligned Countries to the 36th General Assembly of the U.N. of Sept. 25 and 28, 1981, and did it fail to disassociate itself from the communique issued? If so, has the President taken it into account? (Reference may be made to the "Taking into Consideration" memo.)	Bangladesh was represented at the Non-aligned countries meeting which took place during the 36th session of the UNGA, Sept., 1981. According to the President's "Report to Congress on Non-Aligned Countries Regarding the Communique of Sept. 28, 1981, Submitted in Accordance with Sec. 720(b) of PL 97-113," Bangladesh was among the countries which entered written reservations on the communique subsequent to its issuance.
21. FY 1990 Appropriations Act Sec. 513. Has the duly elected Head of the Government of the country been deposed by military coup or decree? If assistance has been terminated, has the President notified Congress that a democratically elected government has taken office prior to the resumption of assistance?	N/A

22. FY 1990 Appropriations Act Sec. 539 Does the recipient country fully cooperate with the international refugee assistance organizations, the United States, and other governments in facilitating lasting solutions to refugee situations, including resettlement without respect to race, sex, religion, or national origin?	Bangladesh does not have a refugee situation which involves any international refugee assistance organization, the United States or other governments in facilitating lasting solutions.
B. FUNDING SOURCE CRITERIA FOR COUNTRY ELIGIBILITY	
Development Assistance Country Criteria.	
a. FAA Sec. 116. Has the Department of State determined that this government has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, can it be demonstrated that contemplated assistance will directly benefit the needy?	No.
b. FY 1990 Appropriations Act Sec. 535. Has the President certified that use of DA funds by this country would violate any of the prohibitions against use of funds to pay for the performance of abortions as a method of family planning, to motivate or coerce any person to practice abortions, to pay for the performance of involuntary sterilization as a method of family planning, to coerce or provide any financial incentive to any person to undergo sterilizations, to pay for any biomedical research which relates, in whole or in part, to methods of, or the performance of, abortions or involuntary sterilization as a means of family planning?	No. On March 1, 1988 AID Administrator Woods suspended reimbursement to the BDG for compensation payments related to voluntary sterilization (client, referral agent and physician providers) to review whether any payments were incentives. Although no finding was made that such payments were incentives, the Administrator decided it was in the U.S.'s best interests not to resume payment of these costs but rather to concentrate U.S. assistance on other high priority aspects of the program.

2. Economic Support Fund Country Criteria:

a. FAA Sec. 502B. Has it been determined that the country has engaged in a consistent pattern of gross violations of internationally recognized human rights? If so, has the President found that the country made such significant improvements in its human rights record that furnishing such assistance is in the U.S. national interest? N/A

b. FY 1990 Appropriations Act Sec. 569(d). Has this country met its drug eradication targets or otherwise taken significant steps to halt illicit drug production or trafficking? N/A

Project No. 388-0078

5C(2) - PROJECT CHECKLIST

Listed below are statutory criteria applicable to projects. This section is divided into two parts. Part A includes criteria applicable to all projects. Part B applies to projects funded from specific sources only: B(1) applies to all projects funded with Development Assistance; B(2) applies to projects funded with Development Assistance loans; and B(3) applies to projects funded from ESF.

CROSS REFERENCES:	IS COUNTRY CHECKLIST UP TO DATE?	Yes.
	HAS STANDARD ITEM CHECKLIST BEEN REVIEWED FOR THIS PROJECT?	Yes, see attached.

A. GENERAL CRITERIA FOR PROJECT

1.	FY 1990 Appropriations Act Sec. 523; FAA Sec. 634A. If money is to be obligated for an activity not previously justified to Congress, or for an amount in excess of amount previously justified to Congress, has Congress been properly notified?	Amount has been justified to Congress in accordance with standard Agency procedures.
2.	FAA Sec. 611(a). Prior to an obligation in excess of $500,000, will there be: (a) engineering, financial or other plans necessary to carry out the assistance; and (b) a reasonably firm estimate of the cost to the U.S. of the assistance?	Yes. Adequate Technical and Financial Analyses and Plans have been prepared and are included in this PP. Cost estimates are reasonably firm.
3.	FAA Sec. 611(a)(2). If legislative action is required within recipient country with respect to an obligation in excess of $500,000, what is the basis for a reasonable expectation that such action will be completed in time to permit orderly accomplishment of the purpose of the assistance?	No such action is required.
4.	FAA Sec. 611(b); FY 1990 Appropriations Act Sec. 501. If project is for water or water-related land resource construction, have benefits and costs been computed to the extent practicable in accordance with the principles, standards, and procedures established pursuant to the Water Resources Planning Act (42 U.S.C. 1962, et seq.)? (See A.I.D. Handbook 3 for guidelines.)	N/A.

5. FAA Sec. 611(e). If project is capital assistance (e.g., construction), and total U.S. assistance for it will exceed $1 million, has Mission Director certified and Regional Assistance Administrator taken into consideration the country's capability to maintain and utilize the project effectively?	Project involves no capital assistance.
6. FAA Sec. 209. Is project susceptible to execution as part of regional or multilateral project? If so, why is project not so executed? Information and conclusion whether assistance will encourage regional development programs.	No effect on regional programs. Project is part of a larger multilateral program, including World Bank and IMF.
7. FAA Sec. 601(a). Information and conclusions on whether projects will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competitions; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions.	The project strives toward establishing international standards in financial intermediation. This will increase the flow of trade. Foster private initiative and competition, develop private banking systems, discourage monopolistic lending practices and improve technical efficiency.
8. FAA Sec. 601(b). Information and conclusions on how project will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. participation in foreign as stance programs (including use of private trade channels and the services of U.S. private enterprise).	Yes. Project strives toward establishing international standards in financial intermediation. This in turn will result in greater public confidence and a more stable economy, both of which are crucial elements to increase US private trade and investment in Bangladesh.
9. FAA Secs. 612(b), 636(h). Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.	Since FSRP-TA project is part of a large multilateral program, the total BDG contribution should also be considered in the larger program context. The BDG is contributing a total of Tk. 18,700 million ($ 550 million) program, of which 58 million Taka is the direct contribution to the FSRP-TA component. Overall, the BDG contribution to the total program is over 25%.

10. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release?	No, N/A.
11. FY 1990 Appropriations Act Sec. 521. If assistance is for the production of any commodity for export, is the commodity likely to be in surplus on world markets at the time the resulting productive capacity becomes operative, and is such assistance likely to cause substantial injury to U.S. producers of the same, similar or competing commodity?	N/A.
12 FY 1990 Appropriations Act Sec. 547. Will the assistance (except for programs in Caribbean Basin Initiative countries under U.S. Tariff Schedule "Section 807," which allows reduced tariffs on articles assembled abroad from U.S.-made components) be used directly to procure feasibility studies, prefeasibility studies, or project profiles of potential investment in, or to assist the establishment of facilities specifically designed for, the manufacture for export to the United States or to third country markets in direct competition with U.S. exports, of textiles, apparel, footwear, handbags, flat goods (such as wallets or coin purses worn on the person), work gloves or leather wearing apparel?	Technical assistance is provided for improving the financial system. Financial market efficiency will dictate in what areas investment occurs. If U.S. exports are impacted, it would be as a longer term indirect consequence. Assistance will not be used directly to procure prohibited investments.
13. FAA Sec. 119(g)(4)-(6) & (10). Will the assistance: (a) support training and education efforts which improve the capacity of recipient countries to prevent loss of biological diversity;	No.
(b) be provided under a long-term agreement in which the recipient country agrees to protect ecosystems or other wildlife habitats;	No.
(c) support efforts to identify and survey ecosystems in recipient countries worthy of protection;	No.
or (d) by any direct or indirect means significantly degrade national parks or similar protected areas or introduce exotic plants or animals into such areas?	No.

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14. FAA Sec. 121(d). If a Sahel project, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of project funds (either dollars or local currency generated therefrom)?	N/A.
15. FY 1990 Appropriations Act, Title II, under heading "Agency for International Development." If assistance is to be made to a United States PVO (other than a cooperative development organization), does it obtain at least 20 percent of its total annual funding for international activities from sources other than the United States Government?	In the unplanned event that assistance is to be made to a U.S. PVO, PVO will be required to comply with this section.
16. FY 1990 Appropriations Act Sec. 537. If assistance is being made available to a PVO, has that organization provided upon timely request any document, file, or record necessary to the auditing requirements of A.I.D., and is the PVO registered with A.I.D.?	See above.
17. FY 1990 Appropriations Act Sec. 514. If funds are being obligated under an appropriation account to which they were not appropriated, has the President consulted with and provided a written justification to the House and Senate Appropriations Committees and has such obligation been subject to regular notification procedures?	N/A.
18. State Authorization Sec. 139 (as interpreted by conference report). Has confirmation of the date of signing of the project agreement, including the amount involved, been cabled to State L/T and A.I.D. LEG within 60 days of the agreement's entry into force with respect to the United States, and has the full text of the agreement been pouched to those same offices? (See Handbook 3, Appendix 6G for agreements covered by this provision).	Because agreement involves planned LOP oblications of less tha $ 25 million and will not include significant policy issues, the Case-Zablocki Act does not apply.

19. Trade Act Sec. 5164 (as interpreted by conference report), amending Metric Conversion Act of 1975 Sec. 2. Does the project use the metric system of measurement in its procurements, grants, and other business-related activities, except to the extent that such use is impractical or is likely to cause significant inefficiencies or loss of markets to United States firms?	Yes.
Are bulk purchases usually to be made in metric, and are components, subassemblies, and semi-fabricated materials to be specified in metric units when economically available and technically adequate?	Yes.
20. FY 1990 Appropriations Act, Title II, under heading "Women in Development." Will assistance be designed so that the percentage of women participants will be demonstrably increased?	Yes.
21. FY 1990 Appropriations Act Sec. 592(a). If assistance is furnished to a foreign government under arrangements which result in the generation of local currencies, has A.I.D. (a) required that local currencies be deposited in a separate account established by the recipient government, (b) entered into an agreement with that government providing the amount of local currencies to be generated and the terms and conditions under which the currencies so deposited may be utilized, and (c) established by agreement the responsibilities of A.I.D. and that government to monitor and account for deposits into and disbursements from the separate account?	N/A.
Will such local currencies, or an equivalent amount of local currencies, be used only to carry out the purposes of the DA or ESF chapters of the FAA (depending on which chapter is the source of the assistance) or for the administrative requirements of the United States Government?	N/A.
Has A.I.D. taken all appropriate steps to ensure that the equivalent of local currencies disbursed from the separate account are used for the agreed purposes?	N/A.

If assistance is terminated to a country, will any unencumbered balances of funds remaining in a separate account be disposed of for purposes agreed to by the recipient government and the United States Government?	N/A.
B. FUNDING CRITERIA FOR PROJECT	
1. Development Assistance Project Criteria:	
a. FY 1990 Appropriations Act Sec. 546 (as interpreted by conference report for original enactment). If assistance is for agricultural development activities (specifically, any testing or breeding feasibility study, variety improvement or introduction, consultancy, publication, conference, or training), are such activities: (1) specifically and principally designed to increase agricultural exports by the host country to a country other than the United States, where the export would lead to direct competition in that third country with exports of a similar commodity grown or produced in the United States, and can the activities reasonably be expected to cause substantial injury to U.S. exporters of a similar agricultural commodity; or (2) in support of research that is intended primarily to benefit U.S. producers?	N/A. Technical Assistance is to improve the financial system, therefore, assistance to agricultural development would only be an indirect possibility, if the more efficient bank structure signals agriculture as a worthwhile investment.
b. FAA Sec. 107. Is special emphasis placed on use of appropriate technology (defined as relatively smaller, cost-saving, labor-using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)?	A positive return to savings will increase the cost capital, and may thus encourage labor intensive technologies.
c. FAA Sec. 281(b). Describe extent to which the activity recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government.	Project is responding to BDG's acknowledged need to initiate financial reform. BDG and local consultants are activic participants in the reform process. Training is component of the Project.

d.	FAA Sec. 101(a). Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth?	Strengthening the Financial intermediation process will support self-sustaining economic growth.
e.	FAA Secs. 102(b), 111, 113, 281(a). Describe extent to which activity will: (1) effectively involve the poor in development by extending access to economy at local level, increasing labor-intensive production and the use of appropriate technology, dispersing investment from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using appropriate U.S. institutions; (2) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward a better life, and otherwise encourage democratic private and local governmental institutions; (3) support the self-help efforts of developing countries; (4) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (5) utilize and encourage regional cooperation by developing countries.	Project will effectively involve the poor by ensuring a positive rate of return on their savings. The increased cost of capital will encourage labor intensive technologies, the project reinforces sustainable development through mobilizing the local capital to service both the rural and urban areas, increasing the self-determination of the majority, including women.
f.	FAA Secs. 103, 103A, 104, 105, 106, 120-21; FY 1990 Appropriations Act, Title II, under heading "Sub-Saharan Africa, DA." Does the project fit the criteria for the source of funds (functional account) being used?	Yes, Sec. 106.
g.	FY 1990 Appropriations Act, Title II, under heading "Sub-Saharan Africa, DA." Have local currencies generated by the sale of imports or foreign exchange by the government of a country in Sub-Saharan Africa from funds appropriated under Sub-Saharan Africa, DA been deposited in a special account established by that government, and are these local currencies available only for use, in accordance with an agreement with the United States, for development activities which are consistent with the policy directions of Section 102 of the FAA and for necessary administrative requirements of the U.S. Government?	N/A.

h. FAA Sec. 107. Is emphasis placed on use of appropriate technology (relatively smaller, cost-saving, labor-using technologies that are generally most appropriate for the small farms, small business, and small incomes of the poor)?	Same as B.1.b.
i. FAA Secs. 110, 124(d). Will the recipient country provide at least 25 percent of the costs of the program, project, or activity with respect to which the assistance is to be furnished (or is the latter cost-sharing requirement being waived for a "relatively least developed" country)?	Although the BDG contribution to the FSRP-TA component is less than 25%, the overall BDG contribution to the total FSRP program is over 50%. Since the FSRP-TA is a component of a large multilateral effort, the total BDG contribution should be considered as more than sufficient.
j. FAA Sec. 128(b). If the activity attempts to increase the institutional capabilities of private organizations or the government of the country, or if it attempts to stimulate scientific and technological research, has it been designed and will it be monitored to ensure that the ultimate beneficiaries are the poor majority?	Project increases institutional cpacities of the Financial institution. Impact on women will be monitored.
k. FAA Sec. 281 (b). Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civil education and training in skills required for effective participation in government processes essential to self-government.	Same as B.1.c.
l. FY 1990 Appropriations Act, under heading "Population, DA," and Sec. 535. Are any of the funds to be used for the performance of abortions as a method of family planning or to motivate or coerce any person to practice abortions?	No.
Are any of the funds to be used to pay for the performance of involuntary sterilization as a method of family planning or to coerce or provide any financial incentive to any person to undergo sterilizations?	No.

Are any of the funds to be made available to any organization or program which, as determined by the President, supports or participates in the management of a program of coercive abortion or involuntary sterilization?	No.
Will funds be made available only to voluntary family planning projects which offer, either directly or through referral to, or information about access to, a broad range of family planning methods and services?	No.
In awarding grants for natural family planning, will any applicant be discriminated against because of such applicant's religious or conscientious commitment to offer only natural family planning?	No.
Are any of the funds to be used to pay for any biomedical research which relates, in whole or in part, to methods of, or the performance of, abortions or involuntary sterilization as a means of family planning?	No.
m. FAA Sec. 601(e). Will the project utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?	Yes.
n. FY 1990 Appropriations Act Sec. 579. What portion of the funds will be available only for activities of economically and socially disadvantaged enterprises, historically black colleges and universities, colleges and universities having a student body in which more than 40 percent of the students are Hispanic Americans, and private and voluntary organization which are controlled by individuals who are black Americans, Hispanic Americans, or Native Americans, or who are economically or socially disadvantaged (including women)?	Efforts will be made to ensure that at least 10 percent of subcontracting opportunities are made available to socially and economically disadvantaged U.S. firms and individuals.

o. FAA Sec. 118(c). Does the assistance comply with the environmental procedures set forth in A.I.D. Regulation 16?

Yes. This program qualifies for a categorical exclusion under Regualtion 16.

Does the assistance place a high priority on conservation and sustainable management of tropical forests? Specifically, does the assistance, to the fullest extent feasible: (1) stress the importance of conserving and sustainably managing forest resources; (2) support activities which offer employment and income alternatives to those who otherwise would cause destruction and loss of forests, and help countries identify and implement alternatives to colonizing forested areas; (3) support training programs, educational efforts, and the establishment or strengthening of institutions to improve forest management; (4) help end destructive slash-and-burn agriculture by supporting stable and productive farming practices; (5) help conserve forests which have not yet been degraded by helping to increase production on lands already cleared or degraded; (6) conserve forested watersheds and rehabilitate those which have been deforested; (7) support training, research, and other actions which lead to sustainable and more environmentally sound practices for timber harvesting, removal, and processing; (8) support research to expand knowledge of tropical forests and identify alternatives which will prevent forest destruction, loss, or degradation; (9) conserve biological diversity in forest areas by supporting efforts to identify, establish, and maintain a representative network of protected tropical forest ecosystems on a worldwide basis, by making the establishment of protected areas a condition of support for activities involving forest clearance or degradation, and by helping to identify tropical forest ecosystems and species in need of protection and establish and maintain appropriate protected areas; (10) seek to increase the awareness of U.S. Government agencies and other donors of the immediate and long-term value of tropical forests; and (11)/utilize the resources and abilities of all relevant U.S. government agencies?

No.

N/A.

N/A.

p. FAA Sec. 118(c)(13). If the assistance will support a program or project significantly affecting tropical forests (including projects involving the planting of exotic plant species), will the program or project: (1) be based upon careful analysis of the alternatives available to achieve the best sustainable use of the land, and (2)/take full account of the environmental impacts of the proposed activities on biological diversity? N/A.

q. FAA Sec. 118(c)(14). Will assistance be used for: (1) the procurement or use of logging equipment, unless an environmental assessment indicates that all timber harvesting operations involved will be conducted in an environmentally sound manner and that the proposed activity will produce positive economic benefits and sustainable forest management systems; or (2) actions which will significantly degrade national parks or similar protected areas which contain tropical forests, or introduce exotic plants or animals into such areas? N/A.

r. FAA Sec. 118(c)(15). Will assistance be used for: (1) activities which would result in the conversion of forest lands to the rearing of livestock; (2) the construction, upgrading, or maintenance of roads (including temporary haul roads for logging or other extractive industries) which pass through relatively undergraded forest lands; (3) the colonization of forest lands; or (4) the construction of dams or other water control structures which flood relatively undergraded forest lands, unless with respect to each such activity an environmental assessment indicates that the activity will contribute significantly and directly to improving the livinghood of the rural poor and will be conducted in an environmentally sound manner which supports sustainable development? N/A.

s. FY 1990 Appropriations Act Sec. 534(a). If assistance relates to tropical forests, will project assist countries in developing a systematic analysis of the appropriate use of their total tropical forest resources, with the goal of developing a national program for sustainable forestry? N/A.

t. FY 1990 Appropriation Act Sec. 534(b). If assistance relates to energy, will such assistance focus on improved energy efficiency, increased use of renewable energy resources, and national energy plans (such as least-cost energy plans) which include investment in end-use efficiency and renewable energy resources? N/A.

Describe and give conclusions as to how such assistance will: (1) increase the energy expertise of A.I.D. staff, (2) help to develop analyses of energy-sector actions to minimize emissions of greenhouse gases at least cost, (3) develop energy-sector plans that employ end-use analysis and other techniques to identify cost-effective actions to minimize reliance on fossil fuels, (4) help to analyze fully environmental impacts (including impact on global warming), (5) improving efficiency in production, transmission, distribution, and use of energy, (6) assist in exploiting nonconventional renewable energy resources, including wind, solar, small-hydro, geo-thermal, and advanced biomass systems, (7) expand efforts to meet the energy needs of the rural poor, (8) encourage host countries to sponsor meetings with United States energy efficiency experts to discuss the use of least-cost planning techniques, (9) help to develop a cadre of United States experts capable of providing technical assistance to developing countries on energy issues, and (10) strengthen cooperation on energy issues with the Department of Energy, EPA, World Bank, and Development Assistance Committee of the OECD. N/A.

u. FY 1990 Appropriations Act, Title II, under heading "Sub-Saharan Africa, DA" (as interpreted by conference report upon original enactment). If assistance will come from the Sub-Saharan Africa DA account, is it: (1) to be used to help the poor majority in Sub-Saharan Africa through a process of long-term development and economic growth that is equitable, participatory, environmentally N/A.

sustainable, and self-reliant; (2) being provided in accordance with the policies contained in section 102 of the FAA; (3) being provided, when consistent with the objectives of such assistance, through African, United States and other PVOs that have demonstrated effectiveness in the promotion of local grassroots activities on behalf of long-term development in Sub-Saharan Africa; (4) being used to help overcome shorter-term constraints to long-term development, to promote reform of sectoral economic policies, to support the critical sector priorities of agricultural production and natural resources, health, voluntary family planning services, education, and income generating opportunities, to bring about appropriate sectoral restructuring of the Sub-Saharan African economies, to support reform in public administration and finances and to establish a favorable environment for individual enterprise and self-sustaining development, and to take into account, in assisted policy reforms, the need to protect vulnerable groups; (5) being used to increase agricultural production in ways that protect and restore the natural resource base, especially food production, to maintain and improve basic transportation and communication networks, to maintain and restore the renewable natural resource base in ways that increase agricultural production, to improve health conditions with special emphasis on meeting the health needs of mothers and children, including the establishment of self-sustaining primary health care systems that give priority to preventive care, to provide increased access to voluntary family planning services, to improve basic literacy and mathematics especially to those outside the formal educational system and to improve primary education, and to develop income-generating opportunities for the unemployed and underemployed in urban and rural areas?

N/A.

v. International Development Act Sec. 711, FAA Sec. 463. If project will finance a debt-for-nature exchange, describe how the exchange will support protection of: (1) the world's oceans and atmosphere, (2) animal and plant species, and (3) parks and reserves; or describe how the exchange will promote: (4) natural resource management, (5) local conservation programs, (6) conservation training programs, (7) public commitment to conservation, (8) land and ecosystem management, and (9) regenerative approaches in farming, forestry, fishing, and watershed management. N/A.

w. FY 1990 Appropriations Act Sec. 515. If deob/reob authority is sought to be exercised in the provision of DA assistance, are the funds being obligated for the same general purpose, and for countries within the same region as originally obligated, and have the House and Senate Appropriations Committees been properly notified? N/A.

2. Development Assistance Project Criteria (Loans Only) N/A.

a. FAA Sec. 122(b). Information and conclusion on capacity of the country to repay the loan at a reasonable rate of interest.

b. FAA Sec. 620(d). If assistance is for any productive enterprise which will compete with U.S. enterprises, is there an agreement by the recipient country to prevent export to the U.S. of more than 20 percent of the enterprises's annual production during the life of the loan, or has the requirement to enter into such an agreement been waived by the President because of a national security interest? N/A.

c. FAA Sec. 122(b). Does the activity give reasonable promise of assisting long-range plans and programs designed to develop economic resources and increase productive capacities? N/A.

3. Economic Support Fund Project Criteria N/A.

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA?

b. FAA Sec. 531(e). Will this assistance be used for military or paramilitary purposes? N/A.

c. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made? N/A.

5C(3) - STANDARD ITEM CHECKLIST

Listed below are the statutory items which normally will be covered routinely in those provisions of an assistance agreement dealing with its implementation, or covered in the agreement by imposing limits on certain uses of funds.

These items are arranged under the general headings of (A) Procurement, (B) Construction, and (C) Other Restrictions.

A. PROCUREMENT

1. FAA Sec. 602(a). Are there arrangements to permit U.S. small business to participate equitably in the furnishing of commodities and services financed?	Yes. Although the prime contract will be competitively bid, there will be opportunities for small business participation through subcontracting.
2. FAA Sec. 604(a). Will all procurement be from the U.S. except as otherwise determined by the President or determined under delegation from him?	Yes. Standard Agency exceptions will be followed where appropriate.
3. FAA Sec. 604(d). If the cooperating country discriminates against marine insurance companies authorized to do business in the U.S., will commodities be insured in the United States against marine risk with such a company?	N/A.
4. FAA Sec. 604(e). If non-U.S. procurement of agricultural commodity or product thereof is to be financed, is there provision against such procurement when the domestic price of such commodity is less than parity? (Exception where commodity financed could not reasonably be procured in U.S.)	N/A.
5. FAA Sec. 604(g). Will construction or engineering services be procured from firms of advanced developing countries which are otherwise eligible under Code 941 and which have attained a competitive capability in international markets in one of these areas? (Exception for those countries which receive direct economic assistance under the FAA and permit United States firms to compete for construction or engineering services financed from assistance programs of these countries).	N/A.

6. FAA Sec. 603. Is the shipping excluded from compliance with the requirement in section 901(b) of the Merchant Marine Act of 1936, as amended, that at least 50 percent of the gross tonnage of commodities (computed separately for dry bulk carriers, dry cargo liners, and tankers) financed shall be transported on privately owned U.S. flag commercial vessels to the extent such vessels are available at fair and reasonable rates?	No. 50/50 Shipping will be followed.
7. FAA Sec. 621(a). If technical assistance is financed, will such assistance be furnished by private enterprise on a contract basis to the fullest extent practicable? Will the facilities and resources of other Federal agencies be utilized, when they are particularly suitable, not competitive with private enterprise, and made available without undue interference with domestic programs?	Yes, private enterprise will service much of the technical assistance, although other U.S. government agencies will be utilized if required.
8. International Air Transportation Fair Competitive Practices Act, 1974. If air transportation of persons or property is financed on grant basis, will U.S. carriers be used to the extent such service is available?	Yes.
9. FY 1990 Appropriate Act Sec. 504. If the U.S. Government is a party to a contract for procurement, does the contract contain a provision authorizing termination of such contract for the convenience of the United Status?	Yes.
10. FY 1990 Appropriations Act. Sec. 524. If assistance is for consulting service through procurement contract pursuant to 5 U.S.C. 3109, are contract expenditures a matter of public record and available for public inspection (unless otherwise provided by law or Executive order)?	Yes.

11. Trade Act. Sec. 5164 (as interpreted by conference report), amending Metric Conversion Act of 1975 Sec. 2. Does the project use the metric system of measurement in its procurements, grants and other business-related activities, except to the extent that such use is impractical or is likely to cause significant inefficiencies or loss of markets to United States firms?	Yes.
Are bulk purchase usually to be made in metric, and are components, subassemblies, and semi-fabricated materials to be specified in metric units when economically available and technically adequate?	Yes.
12. FAA Secs. 612(b), 636(h); FY 1990 Appropriations Act Secs. 507, 509. Describe steps taken to assure that, to the maximum extent possible, foreign currencies owned by the U.S. are utilized in lieu of dollars to meet the cost of contractual and other services.	N/A. See item #9 of 5C (2) above.
13. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release.	No. The U.S. does not own excess Bangladesh Taka.
14. FAA Sec. 601(e). Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?	Yes.
B. CONSTRUCTION	
1. FAA Sec. 601(d). If capital (e.g, construction) project, will U.S. engineering and professional services be used?	No construction will be financed.
2. FAA Sec. 611(c). If contracts for construction are to be financed, will they be let on a competitive basis to maximum extent practicable?	N/A.

3. FAA Sec. 620(k). If for construction of productive enterprise, will aggregate value of assistance to be furnished by the U.S. not exceed $100 million (except for productive enterprises in Egypt that were described in the CP), or does assistance have the express approval of Congress?	N/A.
C. OTHER RESTRICTIONS	
1. FAA Sec. 122(b. If development loan repayable in dollars, is interest rate at least 2 percent per annum during a grace period which is not to exceed ten years, and at least 3 present per annum thereafter?	N/A.
2. FAA Sec. 301(d). If fund is established solely by U.S. contributions and administered by an international organization, does Comptroller General have audit rights?	Yes.
3. FAA Sec. 620(h). Do arrangements exist to insure that United Stateds foreign aid is not used in a manner which, contrary to the best interests of the United States, promotes or assists the foreign aid projects or activities of the Communist-bloc countries?	Yes.
4. Will arrangements preclude use of financing:	
a. FAA Sec. 104(f); FY 1990 Appropriations Act under heading "Population, DA," and Secs. 525, 535. (1) To pay for performance of abortions as a method of family planning or to motivate or coerce persons to practice abortions; (2) to pay for performance of involuntary sterilization as method of family planning, or to coerce or provide financial incentive to any person to undergo sterilization; (3) to pay for any biomedical research which relates, in whole or part, to methods or the performance of abortions or involuntary sterilizations as a means of family planning; or (4) to lobby for abortion?	1) Yes. 2) Yes. 3) Yes. 4) Yes.

b.	FAA Sec. 483. To make reimbursements, in the form of cash payments, to persons whose illicit drug crops are eradicated?	Yes.
c.	FAA Sec. 620(g). To compensate owners for expropriated or nationalized property, except to compensate foreign nationals in accordance with a land reform program certified by the President?	Yes.
d.	FAA Sec. 660. To provide training, advice, or any financial support for police, prisons, or other law enforcement forces, except for narcotics programs?	Yes.
e.	FAA Sec. 662. For CIA activities?	Yes.
f.	FAA Sec. 636(i). For purchase, sale, long-term lease, exchange or guaranty of the sale of motor vehicles manufactured outside U.S., unless a waiver is obtained?	Mission utilizes blanket waiver for purchase of non-U.S. free world right hand drive vehicles.
g.	FY 1990 Appropriations Act Sec. 503. To pay pensions, annuities, retirement pay, or adjusted service compensation for prior or current military personnel?	Yes.
h.	FY 1990 Appropriations Act Sec. 505. To pay U.N. assessments, arrearages or dues?	Yes.
i.	FY 1990 Appropriations Act Sec. 506. To carry out provisions of FAA section 209(d) (transfer of FAA funds to multilateral organizations for lending)?	Yes.
j.	FY 1990 Appropriations Act Sec. 510. To finance the export of nuclear equipment, fuel, or technology?	Yes.
k.	FY 1990 Appropriations Act Sec. 511. For the purpose of aiding the efforts of the government of such country to repress the legitimate rights of the population of such country contrary to the Universal Declaration of Human Rights?	Yes.

1. FY 1990 Appropriations Act Sec. 516; State Authorization Sec. 109. To be used for publicity or propaganda purposes designed to support or defeat legislation pending before Congress, to influence in any way the outcome of a political election in the United States, or for any publicity or propaganda purposes not authorized by Congress? Yes.

5. FY 1990 Appropriations Act Sec. 574. Will any A.I.D. contract and solicitation, and subcontract entered into under such contract, include a clause requiring that U.S. marine insurance companies have a fair opportunity to bid for marine insurance when such insurance is necessary or appropriate? Yes.

6. FY 1990 Appropriations Act Sec. 582. Will any assistance be provided to any foreign government (including any instrumentality or agency thereof), foreign person, or United States person in exchange for that foreign government or person undertaking any action which is, if carried out by the United States Government, a United States official or employee, expressly prohibited by a provision of United States law? Yes.

MAS:MQ:06/05/90:Doc. 0176N

III. PROJECT ANALYSIS

A. TECHNICAL ANALYSIS

TA1. Key Constraint Financial Sector
TA2. Policy Content of IDA FSC
TA3. Background Analysis; FSC, 1971-1989
TA4. Excerpts from AID 1983 RFP
TA5. Excerpts from 1986 RFP Report
TA6. Excerpts from 1987 RFP Report

KEY CONSTRAINTS: FINANCIAL SECTOR

The problem addressed by the FSC-TA project can be stated very simply as the persistence of glaring inadequacies in the financial system which inhibit it from performing an effective and dynamic role in the economic development of Bangladesh. The existence of this deep-seated structural problem is manifested in various symptoms: inadequate mobilization of savings; deficient financial intermediation resulting in misallocation of credit and loan delinquencies; unremunerative structure of incentives, with the result that financial institutions have to be forced to provide credit to priority sectors; and inefficient credit delivery systems, resulting in very high transaction costs to the borrower. The prevalence of these symptoms evidently detracts from the ability of the system to finance the growing needs of production, consumption and trade in an efficient and economical manner and thus to make the vital contribution expected of the financial system to economic development. The existence of this unsatisfactory state of affairs is due to a large number of factors, of which the most important are discussed below:

1. Until recently, monetary policy in Bangladesh relied primarily on: the imposition of fixed ceilings on the Nationalized Commercial Banks (NCBs) to control overall monetary expansion; liberal refinance programs and preferential interest rates to ensure the desired volume of credit flow to priority sectors; and control of interest rates to limit the cost of bank credit, particularly to priority sectors, while maintaining high deposit rates (since 1980) to mobilize savings. As pointed out forcefully in the 1986 National Commission on Money, Banking and Credit (NCMBC) report, the use of these three instruments has caused rigidity in monetary policy and has been responsible for many of the difficulties of the financial system.

Fixed credit ceilings, which are rigid and discriminatory, have created a situation where unpaid accrued interest on overdue loans extended by NCBs to public enterprises and other priority sectors (as a result of the use of preferential credit programs) absorbs a large part of the new credit available under the ceiling, at the expense of new (possibly more efficient and productive) borrowers. Credit ceilings may even encourage default, if borrowers have doubts about credit renewal and decide simply to hold on to the credit thay already have by failing to repay..

The use of preferential lending programs and subsidized interest rates, represents a high-powered selective credit intervention. Most preferential lending and associated refinancing is done by NCBs and Development Finance Institutions (DFIs). Under preferential lending programs (most of which entail significant interest rate subsidies to borrowers), banks carry most of the subsidy cost and incur losses on much of this lending when bad debt expense is taken into account. For the main preferential programs, an average

negative net spread of about 4% was calculated for 1985, after provisions for bad debt. In 1985 alone, the NCBs may have incurred losses of Tk. 1 billion, or over 5% of loans outstanding, as a result of the preferential lending programs.

Interest rates are determined by BB for all classes of deposits and all types of maturities, through a comprehensive system of controls on the level and structure of interest rates, which has been maintained since independence. The NCMBC report clearly brings out the harmful effects this policy has had on the exercise of monetary policy, the operation of the financial system and the functioning of the economy at large. Government policy has been geared primarily toward limiting the cost of bank credit in general and to priority sectors in particular, while high deposit rates have been maintained since 1980 to mobilize increased financial savings. The inadequate spread between deposit and lending rates has undermined the viability of financial institutions, as they are generally unable to earn enough to provide for a reasonable return on equity after adequate provision for bad debts. The quality of investments being financed deteriorates: interest rates are not used to allocate credit to activities with the highest rate of return, since credit is rationed by other criteria, as discussed in the preceding paragraphs. Since long-term lending rates are generally lower than the short-term rates, the volume of long-term lending is reduced in view of the banks' obvious preference to lend short-term at higher interest rates.

As in the case of other monetary policy instruments, the maintenance of lower interest rates for priority sectors has had the obvious but unintended effect of reducing the banks' propensity to lend to these very sectors. The control over interest rates has added to the rigidity of monetary policy. The situation remains unsatisfactory even though there has been some rationalization of the interest rate structure under the influence of the policy analyses provided by the A.I.D. Rural Finance Project (RFP).

A fundamental defect of these three instruments is that they substitute the judgment of the government for the judgment of the banker in vital decisions regarding the size and composition of the loan portfolio. Their use penalizes the more efficient and dynamic financial intermediaries; it also has the perverse effect of impinging on the financial institutions' ability to increase credit to productive sectors by removing their incentive for lending in the priority areas, since they have to operate the preferential programs at a significant loss; similarly, it inhibits financial institutions from developing their capabilities to allocate credit based on evaluation of financial risk and return; and has, in a real sense, been responsible for the loan delinquencies by, in effect, taking away the responsibility of managing the loan portfolio from the financial system. In summary, reliance on these rigid policy instruments has led to efficiencies and distortions in credit allocation and has reduced the efficiency of monetary policy.

2. In a fundamental sense, bank supervision by BB has been weak because many of the problems of banks have been created by the monetary policy itself, as shown earlier. In part, however, the bank supervision function of BB has been exercised ineffectively because of financial stringency and administrative and staff constraints. The number of supervision staff is inadequate and there is urgent need for training to upgrade their technical competence. The supervision responsibilities within BB are not clearly defined, divided as they are between the Department of Banking Inspection (DBI) and the Agricultural Credit Inspection Department (ACID). Comprehensive inspections, which are infrequent, have become formal exercises in loan classification and audit-type reviews of various irregularities. For example, implementation of the basic Banking Control Department (BCD) Circular No. 41 of December 26, 1985 (on classification of overdue loans, treatment of overdue accrued interest as current income, and provisions for nonperforming loans) has been seriously delayed because ACID can inspect rural branches on a schedule of only once in three years, given current resource constraints. Since the public sector banks have not followed the practice of making their own classification of overdue agricultural loans, there is no factual basis for timely implementation of the provisions of BCD Circular No. 41 regarding the establishing of provisions for nonperforming loans or the stopping of the practice of accrual of overdue interest as current income. As a result, loan delinquency problems and accounting anomalies have gone undetected to the point where the viability of most of the public sector banks is threatened.

3. The preferential lending programs with subsidized interest rates (mentioned in item III.A.I above) have imposed high costs on the NCBs because of their poor loan recovery rates. These programs as well as the inefficiency of NCBs, as reflected in poor credit approval and collection procedures, have resulted in massive nonpayment of debt (and interest). To be fair, the NCB inefficiency is partly attributable to government pressure to make large and repid disbursements under the preferential lending programs, which has naturally undermined efforts to maintain good credit approval practices.

At the end of 1986, overdue (by more than one year) loans added up to about 20% of the loan portfolio of NCBs. The percentage of overall loan recovery steadily dropped from 57% of disbursements to about 30% in 1985 and to an estimated 25% in 1986. There are some indications of an improvement in the recovery rate in 1987, but reliable data was not available as of the drafting date of this PP. Total recoveries on NCB agricultural loans over the 1982-86 period amounted to 35% of disbursements (with the unpaid amounts totalling Tk.8.1 billion), although the bulk of these loans was short-term, due within a year or less. If close to 30% of agricultural loan disbursements are never repaid, 1/ the NCBs would lose Tk.3.8

1/ Robert Nathan Associates, Final Report on Rural Finance Project, Vol. 1: Main Report, 1986, p.30.

billion plus uncollected accrued interest out of their 1982-86 disbursements. Assuming that the recovery rate of loans to other priority sectors is no better than that of agricultural loans for which some information is available (and there are indications that it may be worse for public enterprises and small industry), one can gauge the magnitude of the problem of the NCB's if one bears in mind that, as of the end of 1985, some two-thirds of the NCB loan portfolio was in preferential programs, including 20% to eight large public sector corporations. Looked at in another way, the NCBs have lent 1,400% of their capital and reserves to just two public jute corporations which are in poor financial condition and probably unable to repay their debt. There is another source of NCB losses which is related to problems of loan recovery. The NCBs incur losses due to amnesties, forced rescheduling, and interest remissions allowed, without reimbursement to NCBs, by BDG from time to time, mostly in the case of the recurring natural disasters.

4. Existing accounting practices show large (fictitious) profits of NCBs and do not reveal their disastrous financial predicament. The difference between the illusion of large profits and reality of actual-or-near-bankruptcy of NCBs is due to dangerously flawed accounting practices and can be explained in simple terms as the result of the slow pace of loan classification, of the treatment of overdue accrued interest as current income, and of the maintenance of inadequate provisions for nonperforming loans. Despite the serious debt recovery problem and the large size of overdue loans in relation to the loan portfolio (as described in item III.A.3 above), NCB's go on treating their loan portfolio as if it consisted of performing loans and continue to accrue interest income on much of their overdue debt, even on debt overdue many years. This situation persists in spite of the issuance of the comprehensions BCD Circular No. 41 (described in III.A.2 above) on December 26, 1985, which lays down sound rules for loan classification, treatment of overdue accrued interest as income and provisions for unsatisfactory loans.

The basic problem, which accounts for most of the unsound accounting practices and the consequent unreal financial results, is the near-absence of a sound and workable loan classification system. If a loan classification system quantifying nonperforming loans does not exist, overdue accrued interest will continue to be treated as current income and no provisions for unsatisfactory loans will be made. While the criteria laid down in BCD Circular No. 41 for classification of nonperforming loans into "loss", "doubtful" and "substandard" seem reasonable enough, its application has been partial and very slow because of its requirement that the classification be undertaken by BB inspectors. Both the DBI and ACID suffer from severe staff constraints; ACID can inspect rural branches on a schedule of only once in three years. Even the data on the aging of overdue loans is not readily available; BB has recently started efforts to collect such data from banks. Since the NCB's have only recently started their own loan classification process, this means that the basic information for the implementation of BCD Circular No. 41 with respect to provisions or the treatment of overdue interest, is lacking. In the meantime, the fiction of large profits of NCBs goes on.

According to BCD Circular No. 41, interest on loans classified as "loss" or "doubtful" are not to be treated as income nor even to be accrued in a suspense account from the moment of classification. Such interest may be kept in a memorandum account, in case the loan is eventually collected. On loans classified as "substandard", the banks may continue to show accrued interest as income for two years after classification and then stop. None of this would be possible if the loan classification did not exist. To give an indication of the extent to which earnings are overstated due to the practice of accruing interest on past due loans, the transfer of only 10% of the reported interest income to a memorandum account would have reduced the 1985 combined pre-tax profit of NCB's by Tk.785 million, essentially reducing them to little more than a break-even position after tax.

As for provisions for unsatisfactory loans, Circular No. 41 prescribes provisions of 50% against "doubtful" and 100% against "loss" classifications of loans. While this requirement has not been met owing to absence of adequate loan classification, Circular 41 also prescribed a minimum level of provision against total loans outstanding, starting at 2% at the end of 1985 and steadily rising to 4% by the end of 1989. At the end of 1986, the NCB's had provisions amounting to 2.7% of this gross loan portfolio, roughly in line with the requirements of the circular. If an additional provision of Tk.2.4 billion is made to raise total provisions to 6.0% of portfolio, it would have more than wiped out the reported profits of NCBs during 1982-86.

As stated by IDA 2/: "Poor debt recovery performance has clearly undermined the NCBs' financial viability. Changes in accounting policies relating to provisions and suspension of interest would correct the presently distorted signals which seriously underestimate the costs of poor debt recovery and hence fail to identify the need for adequately performing assets and for recapitalization. The distorted signals also do little to encourage improved collection performance. Among the distorted incentives it fosters are:

(a) They produce artificial profits that mask the seriousness of the problem and encourage government and management to postpone corrective action to address it and to continue to decapitalize the banks through transfer of dividends and taxes based on these "profits".

2/ IDA, Bangladesh-A Program for Financial Sector Reform, Vol. II: Main Report, December 1987, pp.75-76.

(b) In the intermediate term, they have made bad loans seem as profitable as good loans. In fact, where penalty interest is charged, loans that are not collected may appear more profitable than those that are! For this reason, as well as the lack of personal responsibility for loan portfolios in the NCBs, there are few penalties to banks and branch managers for making bad loans.

(c) Poor loan accounting and classification policies (as well as inadequate management information systems) make it difficult for the managements of NCBs to monitor the quality of branch loan portfolios and performance. It also makes it difficult to establish a financial incentive system for managers based on collections and/or "true" profitability.

(d) Administrative expenditures incurred to intensify collection efforts can actually hurt profits as presently reported.

Collections normally do not increase "profits" while the incurred administrative expenses reduce them."

One interesting aspect of the present accounting system, which has probably served to delay the necessary reforms, is that NCB bonuses and other staff incentives are based on the present fictitious and bloated profits. However, a circular letter from the BB, dated 26-12-85, conveys a decision of the top level of the BDG that bonuses will be paid on the basis of actual recovery and not on the accrual basis. The circular adds the instruction that the bonus will be calculated only after making provision for bad and doubtful debt, according to a formula derived from a BB audit of ten representative branches of each of the NCBs.

Fiscal considerations have also contributed to the present accounting mess. The NCB's have been making large transfers to the Government as its legally prescribed share of the "profits" (see next paragraph and item III.A.5. below), thus giving the fiscal sector a vested interest in the perpetuation of the present untenable situation. Furthermore, the uncertain tax treatment of loan write-offs (Section III.A.5) has resulted in the banks carrying loans on the books which have practically no possibility of recovery: for example, loans made to persons who left Bangladesh at the time of Independence.

On the surface, the NCBs are a highly successful profit-making venture. They reported a combined profit of about Tk. 1.5 billion over the 1982-86 on an equity investment that totals only Tk. 0.7 billion, after paying the Government a total of Tk.4.7 billion in taxes and dividends. The full implementation of the accounting reforms mandated by Circular 41 would eliminate the fictitious profits and would bring into the open what has been obscured by current accounting practices - that the rural branches of the NCBs, and possibly the banks themselves, are in a dangerously weak financial position. The banks would, in fact, show a substantial negative net worth.

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5. A complicating factor which has delayed the necessary accounting reforms is that the fiscal system has become dependent on the revenues contributed by the illusory profits of the NCBs. The full implementation of the accounting reforms would have a serious impact on fiscal revenues. The payment by NCBs of taxes and dividends to the Government during 1982-86 (see item III.A.4) are equivalent to about three-fourths of their net profits before tax or 4% of tax revenues.

The major relevant income tax provisions governing commercial banks and DFIs are summarized below:

- Gross profits (which include accrued interest), before allocation to reserves, are taxed at the rate of 60 percent. However, a 10 percent tax rebate is allowed to the DFIs (but not to commercial banks) for transfers to special reserves.

- Thus, the provision for bad and doubtful debts may not be deducted from profits before tax. However, a new law (Income Tax Ordinance of 1984) permits such annual provision to be deducted from pre-tax profits in the case of overdue rural loans up to 1.5 percent of the outstanding overdue loans.

- Income tax treatment of bad debt write-offs (loan losses) appears to be discretionary. Such write-offs, as deductions from pre-tax profits, are disallowed in the first instance but may eventually be allowed if tax payers file appeals or otherwise persist in seeking reconsideration.

- In addition to the 60 percent tax on gross profits under the income tax law, the BB's Nationalization Order of 1972 provides for mandatory transfer of net profits to the government, in the case of NCBs and DFIs.

6. The development of capital markets in Bangladesh has lagged behind that of the banking sector. These markets still are in a rudimentary, underdeveloped state and have not adequately fulfilled their role of fostering efficiency in the mobilization and allocation of long-term finance. While the number of institutions operating in the market is seemingly adequate, there are doubts about the institutional capacity and financial soundness of some of them. The regulatory framework is weak. The market lacks breadth and depth, only a limited range of financial instruments is available, and the turnover is rather small. Erratic and large price fluctuations do occur from time to time due to speculation but their frequency is not excessive.

There is no secondary market for Government Securities; the corporate bond market is non-existent because of the availability of term loans from DFIs at well below market rates. The lack of an active capital market constrains competition and determination of the level and structure of short term interest rates, which causes segmentation of the market and results in less efficient resource allocation.

The major participants in the capital market are the Dhaka Stock Exchange (DSE), the Investment Corporation of Bangladesh (ICB) with a predominantly public sector ownership, and three relatively young financial institutions with majority foreign or private participation - the Industrial Promotion and Development Company, the National Credit Ltd and the Bangladesh Commerce and Investment Ltd. Insurance Companies also participate in capital market transactions; however, the insurance industry is dominated by two nationalized insurance companies, the Jiban Bima Corporation for life insurance and the Sadharan Bima Corporation for general insurance.

The DSE does not appear to be well organized in the sense of having developed a complete body of rules and regulations to prescribe either its own activities or those of its members in their relations with customers. There has been a surge of activity in the DSE since 1982 but total stock market capitalization, despite its recent growth, totalled only $100 million equivalent at the end of 1985 compared with, for example, $1,400 million in Pakistan. The ICB has been active largely in providing underwriting/bridge finance, has launched a small investors' scheme as well as investment trusts, and has undertaken secondary market merchandising. While it has shown "profits", its reported profitability is substantially overstated and may hide problems. It has made few provisions for bad debt and would probably show losses if proper provisions were made. As regards the three foreign/private institutions listed above, they have not been in operation long enough for any meaningful evaluation to be made. As for insurance companies, the Jiban Bima Corporation has not been able to contribute to capital market development because, after independence, a substantial part of its assets remained in Pakistan while it had to assume all its liabilities in Bangladesh. The Sadharan Bima Corporation has been somewhat more active in capital market development, with a moderate amount of investment in the private sector through an IBC consortium.

POLICY CONTENT OF IDA FINANCIAL SECTOR CREDIT (FSC)

The IDA FSC Program, amounting to $175 Million, is a complex and wide-ranging policy-based program designed to achieve a comprehensive reform, far-reaching in its implications, of the policies affecting the financial system and its constitutent institutions. The prior conditions for the FSC and the subsequent policy conditionality governing the phased drawing under the project would go far to remedy the problems enunciated in The World Bank document entitled: BANGLADESH: A PROGRAM FOR FINANCIAL SECTOR REFORM.. The major prior conditions are:

- Approval by the Bangladesh Cabinet of a policy paper incoporating the policy conditions required by IDA for the FSC.

- Issuance by the Bangladesh Bank of a new circular on loan classification that will make possible prompt implementation of existing BB circulars governing the treatment of overdue accrued interest as current income, and the making of provisions for nonperforming loans.

- Obtaining Law Ministry clearance for the draft Loan Recovery Act.

The major prior conditions, and several of the more specific, must be satisfied before IDA will finalize the negotiations by sending an appraisal mission to Dhaka, currently scheduled for late July, 1989. The subsequent policy conditionality means that drawings (after the first one) under the FSC will not be permitted by IDA unless the relevant policy conditions are satisfied. Another major IDA condition is that it will not proceed with the signing of the FSC agreement with BDG (scheduled for March, 1990) unless it has been notified of formal approval of FSC-TA by A.I.D.

The substance of the overall FSC Program may be summarized as: recapitalization of NCBs; interest rate subsidies to commercial banks; monetary policy reforms (including reforms of the interest rate structure); accounting reforms; loan recovery improvement; strengthening the institutional capability of BB and NCBs; and special studies on selected policy issues and training. While the broad-based TA program seeks to improve the institutional performance of BB and NCBs, and the proposed reforms of monetary policy and accounting practices are designed to create the proper environment for the NCBs and

private commercial banks alike to operate efficiently and profitably, the FSC project envisages two important financial infusions into the sector from BDG: recapitalization of NCBs through issuance of interest-bearing BDG financial instruments; and interest rate subsidies to commercial banks to offset the effect of BDG interest rate policies for lending to priority sectors on their profitability:

i) Recapitalization of NCBs: This measure, an important part of the rehabilitation of NCBs, is a recognition that much of their present financial plight is due to their being forced to carry out unprofitable Government directives, and is designed to compensate them for their portfolio of largely non-recoverable loans (and overdue interest). The recapitalization would take the form of transfer to NCBs of 15-year Government bonds at 8% interest for an estimated amount of Tk 7.5 billion - an amount calculated to raise their capital and reserves (including an adequate provision for bad debt) to a minimum of 5% of deposits. The cost to the Government would be the annual interest expense, amounting to Tk. 600 million. The precise scenario as to what would happen after 15 years, when the bonds mature, has not been worked out but it is expected that, with the rehabilitation of NCBs and possible future privatization (partial or total), feasible options can be found. The possible recapitalization of private banks, as distinct from the NCBs, to the extent that they have non-recoverable loans on the books as a result of their participation in preferential lending programs, is under consideration. The recapitalization of private banks, if any, will be determined on the basis of the Government participation in their share capital.

ii) Interest rate subsidy: One of the prior conditins of the IDA credit is BDG approval of more flexible interest rate policies, which would mean an immediate rise of 3-6% in the present administered rates for most categories of loans except preferential programs, and of 2-3% for preferential programs - except agriculture where there would be no change for the present. The preferential programs are for agriculture, jute industry (working capital and exports), other exports, small-scale industry, and special programs. An interesting feature of the proposed interest rate structure is the replacement of the present fixed interest rates by a 3% band for most credit programs, excluding

preferential programs (4% band for "other" programs), which would make it possible for banks, nationalized or private, to compete among themselves. Even with these increases, the interest rates for the preferential credit programs would still be substantially below the "shadow" rates, calculated as a proxy for market interest rates. The FSC programs of IDA would require that the hidden subsidy be made explicit and that the differene between the new administered rates for the preferential programs and the "shadow" rate be paid to all banks (nationalized or private). Most of the subsidy payments would go to the nationalized banks, because private banks' participation in the preferential programs is rather low. It is expected that bringing the cost of the subsidy out into the open would generate pressures for the dismantling of the system of administered interest rates in the foreseeable future. The cost of the subsidy is estimated at Tk.1.7 billion annually.

FSC-TA

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APPENDIX

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
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April 17, 1989

Mr. M.K. Anwar
Secretary, Finance Division
Ministry of Finance
Bhaban 7, Room 283
Dhaka, Bangladesh

Dear Mr. Anwar:

It was, as always, a pleasure to see you during my last trip to Dhaka. I am writing to you, today, about our recent Financial Sector Credit mission. We can appreciate that decisions on interest rates are not necessarily easy in such a sensitive area. Moreover, we share your Government's concern that the NCBs be given sufficient incentives to improve collections and are not allowed to solve their problems by simply passing on unacceptably high bad debt expense in the form of provisions. In fact, as you know, one of the major objectives of the financial sector reforms is to elicit substantial improvements in debt collection. NCBs would have to reduce their average bad debt expense by about 50% from present levels almost immediately in order to make satisfactory profits if they charge the shadow market rate on loans. Moreover, the new accounting policies will show fairly dramatically the cost of bad debt in the financial statements. GOB can take action to warn or remove managers whose performance is not satisfactory. Moreover, future interest rate schedules can be further tightened to reduce the scope for bad debt once banks have had some opportunity to adjust to the new environment, take advantage of improvements in the legal framework, reap the benefits of focusing on their 100 largest defaulters, and utilize the technical assistance to introduce better performance budgeting and loan monitoring systems. In our view, it would be dangerous to further reduce bank margins because of the high costs through loss of confidence that can be incurred if banks show losses in their accounts. I particularly appreciate the time and attention which you personally have devoted to resolving the interest rate issue and look forward to learning of the results of your further discussions within Government regarding the interest rate matrix at an early date.

Although the mission did not have the opportunity to discuss the proposed matrix of policy actions for the Financial Sector Credit (Annex 1- slightly modified from the version provided to you by the February mission, largely to incorporate Bangladesh Bank suggestions) with you in detail, it had been given to the Ministry of Finance in July 1988 and subsequently discussed on several occasions with BB and with Mr. Kibria. They indicated support for

the program as outlined in the matrix, which has been modified to reflect their concerns. Following a series of discussions over time, we also understand that other Ministries (with the possible exception of the Ministry of Law, with which we have not met) largely agree with the policy actions relevant to their areas of responsibility. Moreover, I was encouraged to learn that you agree in substance with the draft financial sector policy letter which we had provided to you and that you do not anticipate any serious issues with other conditions once the interest rate issue is resolved. We understand that you will be drafting a new draft financial sector policy letter for discussion with the next mission.

In response to your request for a detailed time table of conditionality for further processing of this credit, we sent a letter to the Secretary, ERD on March 16, 1989 with a copy to you. These steps, together with conditions of negotiations and Board Presentation, are indicated in Annex 1. Most of these actions have been discussed extensively with GOB and BB during previous missions, have been largely agreed in substance and, in a number of cases, have been nearly completed. Indeed, in view of the delays, we would urge you to proceed toward implementing some of the items on this list, e.g., many of those relating to BB, now without waiting for the appraisal and negotiation of this Credit. Bangladesh would only gain from quicker implementation of many of these reforms.

We are awaiting a letter from you informing us that the conditions for appraisal have been met, and including copies of the initial BB interest rate schedules for lending and deposits, an English version of the draft loan recovery law cleared by the Ministry of Law, the GOB proposal on BJC advances, GOB clearance of the amendment to the Income Tax Act and a draft financial sector policy letter.

Subject to the receipt of that letter and agreement that the timing is convenient, we would propose to appraise the Credit in late July/early August, 1989. We would urge that appraisal not be delayed beyond these dates to maintain the momentum for reform. For the appraisal to be completed satisfactorily, it would be necessary to hold sufficient discussions with Government to reach agreement on the wording for most elements in the policy action matrix and with respect to the financial sector policy letter.

Assuming a July/August mission, we would propose the following schedule for project processing:

Appraisal Mission	:	July 22-August 6
Negotiations	:	November 1989
Board Presentation	:	March 1990

FROM WORLDBANK WASHINGTON

If that schedule is met, we would anticipate that the proposed US$175 million credit would be disbursed as follows:

Tranche 1 (at effectiveness)	US$50 million	April 1990
Tranche 2	US$50 million	October 1990
Tranche 3	US$75 million	October 1991

Sincerely yours,

Shinji Asakuma, Director
Country Department 1, Asia Region
International Development Association

cc: Mr. Enam Ahmed Chaudhury
Secretary, ERD.

Mr. M. R. Khan
Deputy Governor, Bangladesh Bank

cc: Clift, Koch (AS1CO), Temple (AS1IE)

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ANNEX 1

Steps to be Taken Prior to Appraisal

1. GOB agreement on initial Bangladesh Bank interest schedules for lending and deposits, which will be implemented prior to negotiations.

2. GOB to submit a draft loan recovery law to IDA cleared by the Ministry of Law and incorporating its comments.

3. Preparation of a detailed GOB proposal agreed among Ministry of Jute, Ministry of Finance and Bangladesh Bank for better protecting the commercial banks vis. BJC advances.

4. Issuance of a BB circular defining the new loan reclassification definitions and the accounting policies for possible bad debt and suspension of interest, and requiring the commercial banks to proceed now with reclassifying their December 31, 1988 loan portfolio using the new definitions and requirements.

5. GOB clearance of an amendment to the Income Tax Act to be included in the Finance Bill which will make BB required provisions and suspension of interest tax deductible.

6. Preparation of a detailed debt recovery strategy for each NCB relating to their 100 largest borrowers in default and to the 10 largest borrowers in default in at least three branches in each zone. Strategies should include targets for collections by loan by quarter for the period January 1989-March 1991 (Mr. Abid Hasan of our Resident Mission will be available to assist the NCBs in finalizing these strategies).

7. Preparation of a draft financial sector policy letter covering the topics discussed in the initial draft submitted by IDA (Annex 2).

Steps to be Taken Prior to Negotiations (To be reviewed during appraisal

1. Issue a BB circular establishing a floor and ceiling within which scheduled banks may set term deposit and savings rates.

2. Issue a new BB lending interest rate schedule based on "shadow market rates" with a 3-4% band within which banks may set their lending rates for various categories of loans.

3. Amend the Bangladesh Bank Act to give it power to define and adjust liquid asset requirements.

FROM WORLDBANK WASHINGTON (UED)04.19.'89 17:39 NO.47 PAGE 2

6. Receive USAID commitment to provide technical assistance to strengthen management, accounting and training programs.

7. Change NCB personnel policy to call for rotation of most personnel after five years rather than three years.

8. Agree to appoint NCB managing directors for at least five years.

9. Submit a satisfactory loan recovery law to Parliament.

10. Enact amendment to income tax legislation to make BB required provisions and suspension of interest tax deductible.

11. Revise national industrial policy to remove references to financial institution lending requirements for repayment schedules, etc., and allow institutions to determine these

12. Establish a Capital Market Development Committee.

FROM WORLDBANK WASHINGTON (WED)04.19.'89 17:48 NO.47 PAGE 7

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BACKGROUND ANALYSIS: FINANCIAL SECTOR POLICIES, 1971-1989

The donor agencies - particularly the United States Agency for International Development (A.I.D), the World Bank (IDA), IMF, and ADB - have been active in Bangladesh since its independence in 1971. In the first few years after independence, the donor agencies were primarily concerned with relief and rehabilitation - an emphasis which was gradually transformed into a massive development effort by the end of the decade to build up the physical infrastructure (where practically none existed) and productive capacity. The donor programs were increasingly hampered by wholesale nationalization and highly centralized control of the economy 1/, instituted in pursuance of a statist ideology that was, at least in part, derived from the circumstances of the creation of Bangladesh. These policies badly distorted the price relationships; the World Development Report of the WB for 1983 states that Bangladesh had a very high "distortion index", which was partly responsible for the low growth rate.

The BDG policies have come a long way since then - and in the right direction. The statist policies slowly gave way, starting in the mid-1970's with a change of regime, to policies designed to promote a mixed economy in which allocation decisions are increasingly influenced by market forces rather than by government edict. Concurrently, the donor agencies began to emphasize policy reform through policy dialogue, technical assistance and loan/grant conditionality. For example, during the second half of the 1970's, A.I.D., IDA 2/ and ADB devoted attention to improving the efficiency of the jute and cotton textiles industries, promoting export development, alleviating structural constraints affecting the industrial sector, increasing agricultural production, and improving food grain distribution. During the same period, the IMF concentrated on bringing about improvements in macroeconomic policies. Largely as a result of these donor activities, including transfer of resources as well as contribution to policy reform through technical assistance and policy dialogue, real gross domestic product (GDP) has been increasing, albeit unevenly, at a rather modest average annual rate of about 3.2% since 1977-78 3/.

1/ Aggravated by other factors such as inept policies, inefficient public administration, and widespread corruption.

2/ Bangladesh is currently the largest IDA-only recipient of IDA funds. The main vehicle for the IDA policy-based lending has been a series of 13 Import Program Credits (IPC's) since 1972.

3/ Unfortunately, owing to continued large increases in population, the improvement in real per capita income has been insignificant - an average annual rate of around 0.7% - during this period.

The implementation of these drastic policy changes was not a smooth process and was characterized by setbacks. A three-year Extended Fund Facility arrangement of the IMF, incorporating an ambitious program of macrocosmic and structural policy reform, was initiated at the end of 1980, but became inoperative within six months, owing to the inability of BDG to carry out the policy commitments, and was eventually cancelled. Similarly in 1982, IDA was unable to convince BDG to undertake the kind of policy reforms required by IDA in order to approve a financial sector credit. However, lack of obvious and immediate accomplishments is not the real test of success of a continuing policy dialogue. The IDA Financial Sector Review of 1982 had a significant, though somewhat delayed, impact on the course of BDG thinking regarding policies towards the financial system to be followed over the next few years. In the same vein, it must be noted that the modest Rural Finance Experimental Project (RFEP), undertake by A.I.D. as a pilot project during 1978-82, generated the ferment in BDG policy thinking that produced significant changes in policies towards the financial system in subsequent years.

The process of evolution of macroeconomic financial policies gathered momentum after 1982, in response to the country's severe macroeconomic difficulties, which adversely affected growth performance and price developments, and increased the pressure on the balance of payments. The Government implemented adjustment policies supported by a standby arrangement (policy-based loan) in 1983 with the IMF. There was a setback in 1984, due to expansionary monetary policies which intensified the inflationary and balance of payments pressures, aggravated by a deterioration in credit recoveries in both agricultural and industrial sectors. The adjustment process was resumed in 1985 and has since been sustained, yielding significant gains in fiscal, monetary and exchange rate policies, supported by an IMF standby arrangement in 1985-86, followed by a Structural Adjustment Facility (SAF) arrangement which is still in force. The implementation of a broad-based program of structural reforms was supported by a series of policy-based IDA 4/ credits, particularly IPCs XI, XII and XIII, as well as an industrial credit project (ICP I), and an agricultural credit project (ACP I). These IDA credits promoted policy initiatives in agriculture, industry and trade, and addressed issues of appropriate levels of government expenditures, effective resource utilization, fiscal planning, budgetary management, development project implementation and administration, and agricultural policies and institutions. The ADB 5/ supported parallel policy reforms in agricultural and industrial policies.

4/ Largest provider of aid, bilateral or multilateral, to Bangladesh.

5/ Fourth largest provider of aid, bilateral or multilateral, to Bangladesh, and second largest among international agencies after IDA.

In the creation of an environment conducive to policy reform (particularly after 1982), A.I.D. 6/ has played a crucial role, occasionally using policy conditionality, but relying primarily on continuous and intensive policy dialogue (supported by technical assistance) with BDG, and on close coordination with other donors on the kind of policy reforms to be sought at a given time. In particular, as indicated by the inception of the RFEP in 1978, A.I.D. saw financial sector reform as a high priority area of policy emphasis. By the completion of the RFEP in 1982, the policy thinking of BDG with respect to the functioning of the financial system had been influenced to the extent that it agreed to the initiation of the Rural Finance Project (RFP) in 1983 to continue the policy analysis suggested by the pilot project, the RFEP. The $75 million RFP was authorized in August 1983 and is scheduled (including two extensions) to be completed in June 1989. The purpose of the project was to create, through policy changes and institutional reform, an efficient and economically viable nationwide rural financial system that would mobilize rural savings and provide credit facilities to a broader segment of private farmers and entrepreneurs. The project amount of $75 million was disbursed in three approximately equal annual installments in 1983, 1984 and 1985. Prior to each disbursement, AID and BDG agreed on several policy changes, most of which have been implemented.

While the RFP has been concerned first and foremost with the rural financial system, as its name indicates, two special characteristics of the modality of its operation explain its influence on the evolution of BDG thinking regarding the reform of the financial sector (not just the rural financial system) and on the design of the FSC project. These two characteristics are described below:

1. For the realization of its objectives, the RFP sought to bring about certain changes in BDG policies, BB policies and operational modalities, NCB procedures and practices, and the legal framework. These desired changes are summarized as follows:

   - Changes in interest rate policies - basically, increases in deposit and lending interest rates to reflect the actual cost of funds - designed to mobilize rural (and urban) savings by maintaining positive real interest rates and to provide incentive to the financial system to meet the credit demand of the rural sector by increasing the spread between deposit and lending rates.

6/ Largest provider of grant assistance to Bangladesh, second largest source of aid after IDA, and largest bilateral donor.

- Changes in accounting practices of financial institutions active in agricultural lending - mainly, criteria for loan classification, treatment of accrued interest on overdue loans as income, provision for non-performing loans - so as to reveal clearly the dangerously weak financial situation of these institutions and bring out the urgency of remedial action.

- Changes in tax laws governing the treatment of overdue accrued interest, provision for bad or doubtful or substandard loans, and write-off of bad debts.

- Changes in interbranch accounting and in staff incentives, in order to improve branch accountability and profitability.

- Building up the loan recovery capacity of NCBs and BKB with respect to agricultural loans by improving the data base and loan accounting and follow-up, and formulating a comprehensive loan recovery program.

2. The RFP approach was to assemble and present to BDG the factual basis 7/ for policy analysis and to describe and evaluate the policy options as well as the consequences of inaction, so as to set in motion a process of development in BDG policy thinking through an ongoing policy dialogue, supported by technical assistance. This has made possible a national discussion of these issues. The deliberations of the high-level National Commission on Money, Banking and Credit (NCMBC) have contributed to better understanding of the problems of the rural banking system in Bangladesh and the adoption of effective policies by the BDG to deal with these problems.

The two above mentioned characteristics of RFP: the kind of policy changes it has sought to bring about, and the approach it has followed in influencing BDG thinking, have made a meaningful contribution to the changes that have already occurred or are being contemplated, which would significantly improve the functioning of the financial system in general. The ferment in policy thinking generated by the RFP is evident in many parts of the NCMBC report. For example, the report accepts the idea that the lending interest rate calculation should begin with the deposit interest rate deemed necessary to provide a positive real return to savers, and then add enough percentage points to cover the financial institutions' cost

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7/ Some of the facts were obtained for the first time in Bangladesh through RFP surveys.

of credit delivery and loan losses, and provide a small profit. Given this agreement on the basic method of calculating a rational structure of interest rates, the problem becomes a manageable one - that of determining the basic facts on administrative costs, on the magnitude of loan losses, and on provisions necessary to cover loan losses. These basic facts have been ascertained by RFP, and "shadow" interest rates based on these basic facts have been incorporated in the interest rate policy recommendations of FSC. In fact, IDA has set their implementation as prior conditions for the credit. Thus, RFP has had a major impact on financial system as a whole and has laid much of the ground-work for the FSC.

This project is the culmination of the sustained efforts, over a prolonged period, of bilateral and multilateral donors to influence BDG thinking as to the appropriate evolution of the financial system: namely, toward deregulation and reduction of government ownership. Understanding the historical sequence makes it possible to establish the following propositions that provide the framework for both the FSC Program of IDA and the FSC-TA Project of A.I.D.:

- The experience in Bangladesh has shown that the best way to influence BDG policies is through patient, low-key but continuous policy dialogue, supported by the presentation of relevant facts and policy analyses as part of technical assistance. 8/

- Given the intractable problems facing Bangladesh - extreme poverty, pressure of population on resources, backwardness of physical and institutional infrastructure, and frequent and severe natural disasters, to name just a few - donors have to act in concert if their aid programs are to be effective.

- The donors have, in fact, acted in concert in Bangladesh, not just in terms of participation in each other's projects and/or financing, but also through concerted efforts to influence and guide BDG policy thinking in a market-oriented direction. This has been particularly true with respect to the collaboration among A.I.D., IMF, IDA and ADB regarding financial sector reform.

- In the efforts to convince BDG with respect to the agenda for financial sector reform and the urgency of corrective policy actions to prevent the situation from deteriorating further, A.I.D. has played a continuous and effective, and possibly even a leading, role. As far back as the late 1970's, A.I.D. was able to perceive that the detoriarating state of the financial system would soon become a major impediment to economic growth. This led to the initiation of the RFEP in 1980 followed by the RFP in 1983. These projects, together with the 1982 IDA Financial Sector Review, were instrumental in the BDG decision to convoke the NCMBC,

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8/ As brought out in A.I.D., Evaluation of the Rural Finance Project in Bangladesh, February 1987.

whose report was the final push needed to convince BDG of the dangers of inaction and of the urgency of effective action. This process has culminated in the meeting of minds between BDG and IDA on the FSC.

On the basis of these propositions, it is easy to see the importance of this interdependent multilateral venture, the FSC Program, and of A.I.D.'s strategic role in it through the FSC-TA Project. The linkage of the FSC-TA Project with credits planned for the near future by international agencies is described below:

1. The IDA Appraisal Mission for the FSC is currently scheduled to visit Bangladesh in mid-July 1989, provided that BDG has met the prior conditions by that time; USAID-Bangladesh proposes to have a representative participating in the IDA Appraisal Mission. Similarly, an IDA representative may participate in the A.I.D. teams for the mid-term and final evaluations of FSC-TA project. In March, 1990, IDA expects to conclude the formal FSC agreement with BDG. It is also possible that the OECF (Japan) may commit a substantial amount of funds to FSC in some form of cofinancing with IDA. It is important to note, however, that IDA will not finalize the FSC agreement if A.I.D.'s technical assistance component is not committed by that time.

2. One of ingredients of the current three-year SAF of the IMF, which expires in June 1989, is to facilitate a phased transition from direct, rather rigid monetary controls to the use of indirect, more flexible instruments for the management of liquidity and credit. This activity, as well as IMF assistance to BB in strengthening bank supervision, pertain to the TA component of the proposed FSC. In addition, the IMF is contemplating the possibility of an enhanced SAF, which would continue the TA for the monetary policy and central banking components of financial sector reform beyond the expiry of the current SAF. However, it is unlikely that the IMF will proceed with the enhanced SAF if there is no FSC.

3. The preparatory work has almost been completed for the policy based ACP II of IDA, which is intended to extend to the two state-owned agricultural development finance institutions (DFIs) the same process of rehabilitation and liberalization as the FSC is designed to do for the NCBs. The ACP II is scheduled to start soon after the FSC begins operations and to utilize the infrastructure to be created by the FSC. USAID/Bangladesh has been requested by IDA to play a role in ACP II similar to that in the case of FSC, namely, that of providing TA. It is certain that IDA would not proceed with ACP II if there is no FSC.

4. After the completion of the three-year FSC, IDA plans to initiate FSC-II, under which progress towards privatization of NCBs and market orientation of the financial system as a whole is expected to be more rapid, because the groundwork would already have been laid during the three-year duration of FSC. Obviously, there would be no FSC II if the first FSC does not get off the ground.

5. Sometime in the next two or three years, IDA plans to launch a policy-based ICP II which would extend policy reforms (similar to FSC) to industrial finance and undertake institutional rehabilitation of industrial DFIs. This project also would not get started if there is no FSC.

6. In addition, the ADB plans to follow up the FSC with substantial policy-based loans to the industrial and agricultural sectors. Again, the linkage with the FSC is clear.

To sum up, a large volume of lending to Bangladesh by international agencies, designed to promote transition to a market-oriented financial system with a sizable and growing role for private sector institutions, is dependent on the conclusion of the FSC agreement which, in turn, is contingent on A.I.D. agreeing to undertake the TA for this project. If, for any reason A.I.D. decides not to proceed with the FSC-TA project, the carefully constructed multilateral effort to put the financial system of Bangladesh on a sound footing would collapse, with highly adverse consequences not only for the policy reform process in the country but for international cooperations as well. Conversely, approval of this project involving the commitment of a relatively small amount of A.I.D. funds would lead to the inflow into Bangladesh of a large volume of policy-based lending from international sources and would contribut effectively to the economic development of the country.

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EXCERPT FROM A.I.D. 1983 RURAL FINANCE PROJECT

Project Objective

1. Goal and Purpose

1.30 The project goal, drawn from the BDG's Second Five Year Plan, is to accelerate food production and expand opportunities for employment in rural areas. The project purpose is to create an economically viable rural financial system which mobilizes savings and provides credit facilities to private farmers and entrepreneurs. Principal outputs include: a rationalized interest rate system, improved savings mobilization techniques, more efficient lending procedures, improved management systems, and practical banking research. BDG inputs are: needed policy changes and assignment of an adequate number of experienced officers and staff of both the Central Bank and financial institutions, who are dedicated to the success of these policies. A.I.D. will provide local currency contributions to support the rural credit system, and technical assistance, including foreign and domestic advisors, training programs and equipment to support implementation of policy changes.

2. A.I.D. Policy

1.31 This project conforms to the A.I.D. Policy Paper "Pricing, Subsidies, and Related Policies in Food and Agriculture" and State 252939 dated September 9, 1982, which outlined key points of the forthcoming A.I.D. Policy Paper "Financial and Capital Market Development." The Policy Paper on Pricing states that: "A.I.D.'s primary purpose...(is) to support a system of financial institutions that effectively mobilizes and allocates private indigenous financial resources" (page 10). This project supports interest rate rationalization, savings mobilization and loan recovery. The Policy Paper establishes as a target decontrol of interest rates and: "where it is not possible to pursuade a government to eliminate interest rate controls," then "significant measures to reduce controls where they adversely affect the mobilization or allocation of credit: (page 11). The BDG is considering major increases in interest rates for rural lending and refinance to achieve economic viability and also establishment of an Advisory Committee on Interest Rates to review and recommend changes periodically. These changes will provide flexibility of the interest rate structure for savings, refinance, and lending rates. Further, this project follows principles of the A.I.D. Spring Review of Small Farmer Credit and subsequent work at Ohio State University and elsewhere. The Mission has relied on findings of the RFEP and also of the A.I.D.-BANCOOP Project in Peru, which emphasized the importance of savings mobilization through competitive interest rates, promotion campaigns, and incentives to bankers.

1.32 This project covers A.I.D.'s four key precepts: policy dialogue, institution building, technology transfer and private sector support. Policy issues are the heart of this project. The BDG is prepared to undertake policy changes to create an economically viable rural financial system including fuller cost recovery on lending operations, increased savings mobilization, and improved loan recovery. Institution building is also an important component at different levels. As a consequence of policy changes regarding accounting and incentives, banks will become more performance oriented. Procedural changes in savings and lending practices will increase efficiency of rural financial institutions. Certain elements of central bank operations will also become more efficient as a result of Federal Reserve assistance furnished under this project. The project will also finance technology transfer from the Federal Reserve System and from experts in such technical fields as interest rate methodology and bank branch rationalization. In regard to supporting the private sector, the project will have two major impacts. First, it will expand availability of credit facilities to private farmers and rural entrepreneurs, thereby facilitating private sector trade and investment. Second, it will substantially improve the climate and profitability of the rural banking system and make it a potentially attractive area for private institutional investors. A few private banks already operate in Bangladesh; however, they seek only profitable business accounts in commercial centers and are uninterested in rural financial markets. The creation of a favorable banking climate and an economically viable rural financial system will support the BDG efforts to disinvest itself of a segment of government owned banks.

(Paragraphs 1.33 and 1.34 omitted).

D. Project Elements

1.35 This project will support BDG policy changes necessary to create an economically viable rural financial system. The $75 million will be obligated in three tranches during FY 83, FY 84, and FY 85. The first year obligation of $25 million will support the BDG's planned initial policy changes. Obligations during the second and third years will follow review of performance and implementation of changes to achieve the project purpose. The project has two principal elements: local currency support for use in the rural credit system to support policy changes and technical assistance to help implement policy changes.

1. Local Currency Support for Rural Finance System

Each year, a disbursement will be made for purchase of local currency to be used for the rural credit program. The first year, this disbursement is expected to be $24 million. This is particularly suitable because of Bangladesh's need for quick disbursing aid and local cost financing.

2. Technical Assistance Element

1.37 Technical assistance will be provided to the Bangladesh Bank to help implement policy changes and related procedural changes. Certain portions of the plan will require short-term advisory services, training, an incentive fund, and aquipment, to be financed by the project. The plan is described below. Costs of technical assistance are estimated at $3.3 million, of which $1.0 million will be allocated from the first year obligation. Allocations in subsequent years may be increased or decreased depending upon reviews.

FSC-TA

EXCERPTS FROM RFP 1986 REPORT

THE EXECUTIVE SUMMARY OF THIS ANNEX IS APPENDED HERETO - THE ENTIRE ANNEX IS IN THE BULK FILE OF THE USAID/BANGLADESH OFFICE OR PRIVATE ENTERPRISE.

FSC-TA

EXCERPTS FROM RFP 1986 REPORT

EXECUTIVE SUMMARY

The recommendations contained in this Report are systemic in that they are not meant to supersede the specific recommendations made in each of the twenty specialized reports, but rather represent an attempt to present a series of inter-related actions that are required to improve the financial viability of the rural banking system. They also are made in line with the hierarchical structure that exists in the system from branch bank to Government. The overall thrust of these recommendations is to provide for a system of incentives and changes in rules and regulations that would affect the motivation of rural branch bank managers and staff, thereby to increase their efforts to mobilize savings, increase loan recovery rates, sanction productive, high return loans and operate efficient branch banks.

Although grouped by major categories, the thrust of the recommendation's are closely related to one another and their impact is mutually supporting. The general position which motivates these recommendations is that the rural banking system must have greater autonomy: its actions should be motivated by the interests of the participants, rather than directed from outside, and the participants must carry the responsibility for what they achieve or fail to achieve. In addition to those recommendations grouped according to the main categories of the RFP's work, there are a number of general recommendations which affect more than one of the specific categories.

The continued rapid development of the rural economy requires the mobilization of greater resources, the application of these resources to the most productive opportunities, and the recovery of these resources so that they will be available to other agriculturists. These recommendation's will serve to direct the rural finance system toward achievement of these results.

Key Recommendations cover:

<u>Savings Mobilization;</u>

<u>Loan Recovery;</u>

<u>Training and Institutional Development;</u>

<u>Accounting and Management Information Systems; and</u>

<u>Data Collection and Project Evaluation.</u>

EXCERPTS FROM RFP 1987 REPORT

Overview and Assessment of a Rural Loan Supervision Program

Minimum loan supervision is expensive, requiring 2-3% of the earnings from loans. The loan supervision described in this paper is concentrated on the critical issues of rural lending; (a) Improving irrigation projects, (b) Raising the rate of loan recovery; (c) Reducing the abuse of loan sanctioning (c) Reducing the misuse of loan proceeds. It does not take the place of extension service or others change agents. Equally it defines certain minimum responsibilities of the bank branch: the branch is not to be a convenient post office for a plethora of rural development programs, rather loan supervision requires a more active role by the banks than has been the case in recent years.

To initiate a loan supervision program for rural areas requires the following steps by the financial sector.

a) Bangladesh Bank would need to determine if a loan supervision program is warranted. It is not obvious that this should be undertaken. There are three areas of importance for the authorities to consider in making a decision.

   1) The costs to the bank and the possibility of recovering such costs through better loan recovery. Staff must be increased to permit the work to be done. Although the cost of supervision can probably be met and viability of the system will improve, it is unlikely to increase to the point where perceived profits are being earned; administrative costs will rise, cash receipts will increase, but accounting revenues will not, since current accounting systems already create fictitious profits..

   2) The capacity of the financial and legal systems to take corrective action when there is abuse of lending purpose. Without suitable corrective action, it is unlikely loan supervision will make a great deal of difference in the quality or recovery of loans.

   3) The difficulties caused in the first years as abuse in the financial system is curbed; this will be resisted by those presently benefitting and the authorities must be prepared for a protracted battle to establish a loan inspection system.

b) Each bank would develop its doctrine for inspection and appropriate reporting forms. In this paper some suggestions have been made as to what this doctrine might be. It must include procedures for "supervision of the supervision".

c) The banks and Bangladesh Bank should jointly work out the steps needed for corrective action. A program to insure that such corrective action can be taken promptly is necessary for the success of the program.

d) The banks must develop and carry out training programs for loan supervision. The size of the training effort should be linked to the program for implementation of loan supervision.

Implementation: The implementation of a loan supervision program will take time to be effective. A steady process of developing and testing doctrine should take two years. During this initial period, each bank may wish to take four districts to implement a loan supervision program. Many of the problems, particularly concerning term loans, cannot be grasped without experience with supervision. The implications of serious loan supervision are far reaching and it is probably best, if this is the policy of the authorities, to approach implementation in stages.

Costs and benefits: It has been estimated that the costs of loan supervision would be 2-3% of the value of the loans. What cost savings can be expected?

a) At present, an RFP survey estimates, fradulent loans amount to 5-6% of the total loans disbursed in agriculture. Loan supervision will result in a significant reduction of this amount. Perhaps half of the fradulent loans would be prevented.

b) Loan recovery will improve. For term loans, where recovery is particularly poor, an improvement from 40% of the amount due to 60% is possible. This corresponds in the long run to 4-5% improvement in costs of bad debt. For crop loans improvement would be perhaps 10% over existing levels or a reduction in bad debt costs of 3-4%.
A reasonable loan supervision program would reduce true system costs by 8-10% suggesting, very roughly a benefit cost ratio of 3. The breakdown of costs and revenues would be as follows:

	Without Supervision	With Supervision
Cost of funds	9%	9%
Bad debt allowances		
Crop loans 1/	11.1%	7.5%
Term 2/	14.0%	9.3%
Total	12.3%	8.2%
Fradulent loans (savings)	0	-3%
Administrative costs		
Branch	3%	5%
H.O.	1%	2%
Total Cost	25.3%	21.2%
Earnings	21%	20%
Profits (loss)	(4.3%)	(1.2%)

1/ Assumes 70% recovery without supervision, 80% with supervision; growth rate in disbursements 10% per annum, write off after 5 years; 60% share.

2/ Assumes 40% recovery without supervision 60% with supervision; growth rate in disbursements 7% per annum, write off after 8 years; 40% share.

The above table gives costs as a percent of assets. The cost of funds is taken at 9% and is the same with or without supervision. The costs include allowances for bad debts. These are defined as a percentage of assets disbursed some years in the past which are not yet recovered. Only the principal not recovered is taken as a cost. Fradulent loan reduction is taken per a) above. Administrative costs are increased by 3% in the "with supervision" case. The total cost of lending without supervision is 25.3%; this high figure arises from the heavy costs associated with the very poor loan recovery; the cost is reduced to 21.2% with supervision. Earnings are reduced slightly with supervision, as better loan recovery reduces the collections of penalty charges. Altogether the losses drop from 4% to 1%.

A sound loan supervision program would significantly reduce the high level of bad debt, estimated here at 12.3% of the system in a normal growth configuration, declining to 8.2%, while incurring additional costs of 3%. These are rather speculative estimates based on the long term loan recovery position.

Relationship with the informal markets: Informal markets are expected to shrink (relatively) with the development of improved loan supervision. Can one be confident that the controlled, formal market loans are better for the economy than uncontrolled, informal sector loans? The argument here is involved and we restrict ourselves to the broad outlines: (1) If the market approach - improve loan recovery and do not be concerned with loan supervision - could be made to work, then there is indeed no need to block the arbitrage between formal and informal by controlling loan use; (2) Improving loan recovery without supervision may be impossible; leakages are not just to the informal markets, but to urban areas, consumption etc; (3) The position of farmers in rural areas is more complex than facing markets with different prices and arbitraging between them. The rural elites have considerable power to extract maximum payments from farmers. These same elites cannot themselves carry the burden of rural development. There is no evidence that land holdings are becoming more concentrated; instead the linkages between the urban and rural economies are more blurred and rural elites are increasingly engaged in non-agricultural activities. (4) So long as there exist widespread price distortions and restrictions on the flow of investments among sectors one cannot be confident that the market directed investment opportunities are optimal. The present situation in Bangladesh strongly points to the existence of such widespread distortions that the rural elite groups are unwilling to invest in agriculture. Consequently the informal market arbitrage is not financing purchases of inputs and irrigation equipment but instead is being directed towards land acqusition or being directed off towards urban investments.

The financial sector viewpoint: What is outlined in the next three sections is the type of credit supervision by banks that would be effective. The financial institution viewpoint may be characterized by the following:

a) The branch bank must take responsibility for its loans. While others can help farmers and small businesses to organize projects, the branch manager must take the responsibility for the loan as he will have the responsibility for collection. Furthermore, the branch bank needs to develop systematic, continuing relationships with its loanees. To achieve such a relationship the branch must work regularly with the farmer. Supervision of one loan leads naturally into additional loans.

b) The branch, in taking such responsibility, will incur major costs through increased staff requirements and these must be accepted for successful credit supervision. Loan supervision cannot be carried out without enough staff.

c) A training program is needed to prepare staff for supervision and this should be undertake by the banks operating in rural areas if satisfactory loan supervision is to be achieved.

A financial sector view of credit supervision: In this section some practical suggestions for credit supervision in agriculture, appropriate for rural Bangladesh, are briefly set out. The general viewpoint is to keep this supervision to a minimum, but it cannot be completely omitted, and the degree of supervision should vary with the type of loan. Supervision is linked with loan recovery, as is detailed below, but the main objective of loan supervision is to insure that the loan proceeds are used as the borrower requested. The proposed level of supervision is not cheap and requires a considerable effort at manpower development.

This type of loan supervision does not substitute for the work of rural change agents; but equally such change agents cannot substitute for bank loan supervision.

Crop loans: Little supervision of crop loans by the bank is needed nor is desirable. Current doctrine of the Bangladesh Bank is that crop loans are to be made for the length of the crop's growing season. Therefore for a farmer with multiple crops there are multiple disbursements. The growing season is the natural period for extension of a crop loan; although all crop lending has not been adjusted to this doctrine (set out in the 1986/87 Agricultural Credit Program) this change will be made in the near future. Such a rhythm to crop lending makes it easy to define the required loan supervision. The bank staff should visit the farmer twice during the crop season. The first visit is to check that the crop has been planted and to determine as far as possible the inputs that have been applied; a second visit is needed near, but before, harvest to determine if there is any crop failure and to remind the farmer that the loan is to be repaid upon harvesting and crop disposal. It is not necessary, nor the bank's duty, to provide any more detailed

supervision. Incidently it is important and useful for the bank representative to show continuing interest in the farmer's financial position; the bank should seek to develop a protracted relationship with the farmer and should be aware of his plans and intentions. The bank representative should estimate the loan recovery position on the basis of the second visit taking account of probable yields, losses, crop prices, marketed surplus etc. A simple but different supervision report form sufficies for each of the two visits. Of course if the bank is financing two different planting seasons for this farmer four visits are necessary etc. The question of informing the farmer of appropriate fertilizer dosage, planting times, irrigation requirements etc should be left to the extension service. Bank staff should, however, know the recommended practices and be able to tell the farmer if asked. The supervision report should determine if the extension agent has visited the farmer, frequency of such visits, etc.

Corrective action: Inspection of crop loans is not enough. There are consequences of the inspection for each of the two visits. (1) If the farmer has failed to plant the crop for which the loan has been made what action should be taken? The answer is obvious and unpalatable; immediate legal action should be initiated to have the loan repaid. If present loan contracts do not provide the basis for this then the language of future contacts should be changed so that the bank has a basis for immediate recourse to the courts. It is precisely at this point that we come to the critical aspect of the crop loan supervision program. If the crop loans are used for the intended purpose, then no difficulty emerges; but if there is widespread abuse then the question is: "will the banking system take any action?" The answer is clear - if we are to have an agricultural credit program, then prompt action is needed to show the farmers that while credit is available for production loans, credit is not available for purposes not agreed to with the bank. The value of loan inspection is very limited if there is no sanction for gross misuse of the loan proceeds. However, the inspection should not be very much concerned with the use of the loan proceeds to purchase inputs such as fertilizer. It is impossible to verify that the recommended fertilizer dosage has been applied. One can only hope that so long as the agreed crop is planted and loan recovery is forced, farmers will use the inputs as recommended. It is the extension service which is to persuade the farmer to use the proper inputs not the bank staff. (2) If loan recovery from the value of the crop produced is judged insufficient for repayment, then the Branch Manager should be prepared to take remedial action e.g. working out a rescheduling of the loan. The second visit is also used to raise with the farmer his plans for crop sale and when the loan will be repaid. The very attention of the bank to the farmer's crop results will raise recovery rates. An inspection cum corrective action program promises to be effective so long as the Branch has sufficient flexibility to lend to farmers for the purposes which they desire. Otherwise there will be deception - borrowing for "allowed" crops etc. At present there is considerable flexibility although Branch Managers may not be aware of it or all programs may not be authorized at particular branches.

Livestock loans: Livestock loans generally involve purchase of animals. These term loans are particularly difficult to supervise as ownership of livestock is difficult to verify. Nevertheless, the bank staff should require a receipt for purchased of the animal and should visit the farmer quarterly to insure that the livestock has not been sold. Again the bank must take an interest in the economic situation facing the farmer and, in particular, the earnings that are related to the livestock loan. Simple supervision reports should be completed after each visit. The bank may consider branding animals purchased under their loan with an appropriate mark (easily subcontracted to the private sector). Branding combined with a payment voucher system requiring the seller of the animal to report to the bank for the money would reduce the risk of inappropriate use of the funds.

Corrective action: Livestock loans are believed by many to be one of the major categories of loans where misuse of credit is most common. Action when it is found that the animals are not present at the farm should again be swift; legal steps should be initiated to recover immediately the full value of the loan. The pursuit of such term loans with vigorous enforcement is necessary to establish the credibility of livestock credit programs. If the livestock dies of disease (equivalent to a crop failure) then the Branch Manager may consider a rescheduling of the loan. There is obviously room for abuse here and if the farmer is to be protected against the risk of animal disease the identification of the animal must be satisfactory.

Irrigation loans: Irrigation term loans are a particularly difficult area for the banks as these loans are large and the recovery record is poor. For these loans more extensive supervision is required than for other term loans: A monthly visit is needed; (a) To determine whether the equipment is on site and if not where it is; (b) to determine the operational problems encountered with the equipment; (c) to determine the use to which the equipment has been put during the month. This is a heavy supervision requirement. Nevertheless, without this effort one cannot expect satisfactory operation and maintenance of the equipment. Before the loan is repaid the only effective collateral available to the bank is the equipment. Therefore, the bank should insist upon proper maintenance to protect its asset. Indeed, proceeds of the loan might be withheld from initial disbursement to pay for maintenance during the loan period. That is, the owner has the maintenance performed and the bank would pay directly to the maintenance company. Preventive maintenance is particularly important and is rarely carried out. The bank would also press and if necessary make marginal supplementary loans to keep the equipment operating.

For Deep Tube Well loans the extent of bank supervision should be even greater. In addition to the monthly inspection, the supervising bank should follow carefully the economic position of the deep tube well providing the manager with support, checking his accounts, assisting with loan for operating funds, providing for direct payment into his account of payments by farmers who borrow for crops

involving water charges, etc. The involvement of the bank in the supervision of irrigation credits has two objectives: a) To protect the bank's interest in the equipment until the loan is repaid; and b) to assist the owners and managers to improve the business management of the project. The importance of improved performance of irrigation equipment can hardly be overestimated. This equipment is the real basis for raising food supplies in Bangladesh.

Corrective action: Corrective actions vary. If the equipment is missing at the time of a monthly inspection then the loan should be called immediately if the equipment cannot be adequately accounted for. If water charges are not being paid by the users there is little the bank can do unless it is making crop loans to the water users. In the latter case the bank can help by direct payment as noted above. If the equipment is working badly then the bank must intervene to insist upon maintenance (see suggestion above) In other words, so long as the asset is there, the bank helps the owner to use it more effectively. Supplemental loans and rescheduling must be possible if circumstances warrant. Loan supervision provides the basis for judgment as to the need for such actions. The supervision of irrigation projects must be linked to loan recovery. Regular contact permits the bank to press for payment. Regular supervision visits also permit the Branch Manager to understand the real reasons for poor loan recovery.

Other term loans: Term loans require quarterly visits by the bank staff to check on the condition of the assets and to discuss with the borrower the financial condition of the project. The bank staff must have sufficient knowledge of the project to assess its progress and problems. Particular attention should be paid to the maintenance requirements of equipment; as mentioned above consideration should be given to including in the loans the cost of maintenance during the repayment period and paying for such maintenance services directly to the vendor upon certification by the owner of completion of the work.

Corrective action: As for other loans the bank must be prepared to take prompt legal recourse if the assets are removed. Collateral must be seized promptly. Recovery of the loan is part of the supervision process for term loans; the bank staff using the supervision visits to press for repayment as necessary.

Supervision of loan supervision: The above description of a feasible level of loan supervision will work only if there is systematic supervision of the branch loan supervision activity by the bank H.O. and by Bangladesh Bank. The branch level supervision reporting could easily deteriorate into report fabrication and provide a channel for further corruption (see of below). This can be overcome only through "supervision of the loan supervision". The bank H.O. should have a number of inspectors whose task is to check branch loan supervision reports. This inspector would arrive unannounced at a Branch; take recent supervision reports, select a few loanees at random and carry out field visits to verify the validity of the report. Branches

which showed unsatisfactory supervision performance would be subject to a complete portfolio audit. The Bangladesh Bank would carry out a similar supervisory role with its own inspectors.

Suitable annual targets for checking in the first few years are:

Head Office	:	5000 loans per year or 2% of the total number of agricultural loans whichever is less.
Bangladesh BAnk	:	1% of all agricultural loans in rural branches.

This requires a major effort by the banks to develop staff to inspect supervision reports in the field. However, after some years, this program can be reduced, once its effectiveness is demonstrated and satisfactory inspection standards are built into the banking system. However, without supervision of the supervision it would be an error to initiate a major program of loan supervision.

Conflicts with change agents: The proposed level of loan supervision carries with it a number of problems apart from the costs and training. These are fairly sensitive issues and although well known to everyone working in the rural finance sector are rarely openly discussed. Nevertheless, these issues have a direct relationship on the success of the agricultural credit program, and loan supervision in turn has a strong impact on these issues. Three issues, closely related, are relevant:

1) Fradulent loans: These are loans made to people who do not exist, or who do not know they have been made a loan recipient. Loan supervision exposes these loans immediately. Of course the branch manager who makes such loans can obtain the cooperation of the staff responsible for supervision, but it adds to his difficulties. Loan supervision is one of the essential steps in reducing fradulent loans.

To increase the effectiveness of loan supervision, the supervision of loan supervision should include as a principle: When a single fradulent loan is uncovered, the branch's entire portfolio will be field checked by a H.O. inspection team to insure every loanee of record can be located and that the he agrees that he is the loanee.

2) Bribes to branch staff to obtain loans. This practice is widespread. So long as interest rates in informal credit markets are significantly higher than the cost of bank loans one should expect the branch bank staff to arbitrage between the markets. They do so in all countries with wide spreads in interest rates; they do so in Bangladesh. This process of arbitrage is probably not complete and some loan recipients [illegible]

The supervision program will limit this secondary arbitrage, but will have limited impact on the branch staff bribes.

3) Bribes to persons outside the banking system engaged in preparing lists of potential loanees and in supervising the implementation of projects financed by the bank. The collection of such bribes exploits the administrative power of non-banking organizations which are engaged in the cycle of approving agricultural credit. This phenomenon is pervasive in Bangladesh, as elsewhere where credit is rationed by low interest rates. Credit supervision will result in conflicts between the change agents and the Branch Bank. The change agents will see increased supervisory attention by the branch as threatening to their power (one can predict this confidently not only for the official organizations but also the NGOs). The term loans involving irrigation equipment are particularly relevant here, as the proposal calls for rather frequent supervision. This will result in loanee complaints - justified or not - being lodged with the bank. The more careful the checking by the bank of the actual physical assets held by the loanee the more threatening supervision becomes to the change agent. To the extent supervision unmasks the difference between the value of the loan and the value of the real assets purchased, the more it will upset the easy sanctioning and disbursement practices now followed.

While the potential conflicts can be readily forecast, the solutions can only be worked out in the field on a case by case basis. The bank is not an organization which should engage itself in dealing with corruption elsewhere. But the banks should strive for openness and objectively and should work to prevent pay offs, difficult as this may be, in areas of its direct financial interest.

Consequences of loan supervision: Above, we discussed the relationship of corruption and loan supervision. A loan supervision program which involves corrective action will tend to expose, and hence reduce corruption. It will make fradulent loans more difficult to conceal; it will make it difficult for loanees to borrow for one purpose and use it for another; it will make it more difficult to dispose of a real asset without the bank learning of this and taking appropriate legal action. If a supervision program such as this one is carried out then there will be certain consequences:

1) Disbursements will initially tend to decline. The extent of this decline will depend upon the degree to which loans are currently misused. We would expect that farmers would no longer be willing to take loans other than for the agreed purpose. There are no reliable estimates as to the extent of the current misdirection of funds so it is impossible to guess at the impact on aggregate disbursements. Corrupt persons in the system will be more difficult. It will take time to rid the financial system of such branch staff and to change the attitudes of many who have been little concerned with making good loans and concentrated on personal earnings. Most rural bank officers, however, will respond eagerly to the opportunity to really improve their branch's impact on rural development

2) There will be greater conflict between rural elites who have abused the rural banks in the past and have grown used to their privilege of large loans for fictious purposes, the real use of which is beyond the control of and is generally unknown to the bank. The branch managers must be made aware that poor loan supervision will be caught by the H.O. and Bangladesh Bank, and this will be held against them. These pressures from H.O. must be strict as the pressure on the branch manager from local elites can be immense.

3) It is likely that funds put through the informal sector in rural areas will decline. At present there is some linkage of funds from loans made by financial institutions to lending in the informal market. The money lender deposits funds in the bank; borrows from the bank for some ostensible purpose; relends in the informal market at an effective higher rate of interest than the cost of borrowing. If there is supervision to insure the loan is used for the purpose for which it is borrowed, then the diversion of funds for relending to informal markets will be somewhat reduced. The money lender may reduce deposits so as to increase his informal market lending.

The magnitude of these effects is impossible to estimate. Nevertheless, a more rigorous loan supervision process will reduce flexibility of the interconnection between formal and informal. Ultimately loan supervision is justified only if the loan purposes are better investments than the alternative uses that the funds would find in the informal markets.

B. FINANCIAL ANALYSIS

FA1. Financial Analysis
FA2. Financial Tables

ANNEX FA1.

Financial Analysis

The financial analysis for the Financial Sector Reform Program Technical Assistance Project is detailed in the following tables. Table 1 illustrates the project budget by major categories. Table 2 is the budget phased by expenditure per project year. Table 3 provides the phased budget by foreign exchanging and local currency sub-components.

The Budget for the Prime Contractor is illustrated in Table 4. The other budget which excludes the prime contractor, categories expenditures for audit, project coordinator, short term national and international consultants, and equipment is shown in Table 5. Equipment and supplies are detailed in Table 6. Training is phased by year in Table 7. The Evaluation Budget is in Table 8.

ANNEX FA2
FINANCIAL TABLE

TABLE 1

Summary Budget: Financial Sector Reform Program
Technical Assistance Project: FSRP-TA

Long term international consultants	$9,705,945.21
Long term national consultants	$ 740,076.99
Short term international consultants	$2,383,682.16
Head office support (prime contractor)	$ 307,774.06
Local administrative	$ 515,548.59
Project coordinator (PSC)	$ 809,168.18
Equipment	$2,755,830.00
Training	$1,301,170.05
Short Term National Consultant	$ 158,830.56
Senior Administrative Officer	$ 415,499.66
Contingency	$ 200,000.00
Financial Audit	$ 120,000.00

GRAND TOTAL = $19,413,525.46

TABLE 2

Summary Phased Budget by Project Year: FSRP-TA

Cost Items	1 1990/91	2 1991/92	3 1992/93	4 1993/94	5 1994/95
Long term technical assistance	$2,674,631.69	$3,125,247.65	$2,468,340.75	$1,974,083.08	$1,012,887.22
Short term technical assistance, head office local administrate support, equipment and supplies and training	$2,835,332.06	$2,394,552.91	$1,042,374.22	$ 709,239.66	$ 441,336.57
Total	$5,509,963.74	$5,519,800.56	$3,510,714.96	$2,683,322.74	$1,454,223.79

TABLE 3

Phased Summary Budget By Foreign Exchange and Local Currency: FSRP-TA

	1 TOTAL	2 1990/91	3 1991/92	4 1992/93	5 1993/94	1994/95
Foreign Exchange						
Prime Contractor	13,339,496.37	3,638,030.57	3,640,670.19	2,835,686.87	2,149,015.01	1,076,093.73
Other Budget	3,860,128.48	1,498,782.35	1,439,851.88	309,934.51	288,050.43	323,509.30
Evaluation	282,965.76	43,698.23	45,300.15	93,922.23	24,341.65	75,703.49
Sub-total	17,482,590.60	5,180,511.15	5,125,822.23	3,239,543.61	2,461,407.09	1,475,306.52
Local Currency						
Prime Contractor	1,831,648.36	410,740.75	562,596.30	390,303.69	350,690.46	117,317.16
Other Budget	39,863.67	14,982.50	4,392.30	10,831.53	9,657.34	0.00
Evaluation	59,422.83	15,972.00	8,784.60	12,078.83	7,972.02	14,615.38
Sub-total	1,930,934.86	441,695,25	575,773.20	413,214.04	368,319.83	131,932.54
Total (F.E.+L.C.)						
Prime Contractor	15,171,144.73	4,048,771.32	4,203,266.49	3,225,990.55	2,499,705.48	1,193,410.89
Other Budget	3,899,992.15	1,513,764.85	1,444,244.18	320,766.04	297,707.77	323,509.30
Evaluation	342,388.58	59,670.23	54,084.75	106,001.06	32,313.68	90,318.87
GRAND TOTAL	19,413,525.46	5,622,206.40	5,701,595.43	3,652,757.65	2,829,726.92	1,607,239.06

Table - 4

Budget For Prime Contractor: FSRP -TA

	Total	1 1990/91	2 1991/92	3 1992/93	4 1993/94	5 1994/95
1. Long Term International	10,121,444.87	2,462,319.30	2,794,252.95	2,236,177.96	1,770,909.40	857,785.27
2. Short Term International	1,639,756.11	611,775.23	498,301.69	305,247.25	73,024.96	151,406.98
3. Head Office Support	307,774.06	56,456.04	58,884.81	61,430.90	64,100.83	66,901.48
4. Equipment	228,030.00	228,030.00	0.00	0.00	0.00	0.00
5. Training	1,042,491.33	279,450.00	289,230.75	232,830.75	240,979.83	0.00
Sub-total (Foreign Exchange)	13,339,496.37	3,638,030.57	3,640,670.19	2,835,686.87	2,149,015.01	1,076,093.73
6. Long Term National	740,076.99	161,716.50	263,538.00	152,193.20	127,552.39	35,076.91
7. Short Term National	77,544.06	23,958.00	43,923.00	9,663.06	0.00	0.00
8. Local Administrative	515,548.59	91,253.25	123,086.70	124,643.97	126,356.97	50,207.70
9. Operating Cost of Equipment	239,800.00	59,950.00	59,950.00	47,960.00	47,960.00	23,980.00
10. Training	258,678.71	73,863.00	72.098.60	55,843.46	48,821.10	8,052.55
Sub-total (Local Currency)	1,831,648.36	410,740.75	562.596.30	390,303.69	350,690.46	117,317.16
GRAND TOTAL	15,171,144.73	4,048,771.32	4,203,266.49	3,225,990.55	2,499,705.48	1,193,410.89

Table 5

Financial Sector Reform Program - TA
Other Budget (excluding Prime Contract)

	Total	1990/91	1991/92	1992/93	1993/94	1994/95
1. Audit and Contingencies	302,000.00	40,000.00	89,000.00	40,000.00	40,000.00	93,000.00
2. Project Coordinator	809,168.18	117,838.55	160,251.57	176,251.57	175,025.47	180,040.31
3. Short Term International Consultant	743,926.05	196,642.04	135,900.46	187,844.46	97,366.61	126,172.48
4. Equipment	2,288,000.00	1,188,000.00	1,100,000.00	0.00	0.00	0.00
Sub-total (Foreign Exchange)	4,143,094.23	1,542,480.58	1,485,152.03	403,856.74	312,392.08	399,212.79
1. Short Term National Consultant	81,286.50	25,954.50	13,176.90	16,910.36	10,629.37	14,615.38
2. Audit	18,000.00	5,000.00	0.00	6,000.00	7,000.00	0.00
Sub-total (Local Currency)	99,286.50	30,954.50	13,176.90	22,910.36	17,629.37	14,615.38
Grand Total	4,242,380.73	1,573,435.08	1,498,328.93	426,767.10	330,021.45	413,828.17

Table 6

Equipment and Supplies: FSRP - TA

Item	Number	Total cost	Remarks
1. Computers and accessories			
Main frame or mini	4	$ 900,000.00	BB plus 3 NCBs; Agrani already has adequate facilities
Voltage regulator-for main frame		$ 65,000.00	
Mini/Micro computers	100	$ 600,000.00	
Accessories		$ 250,000.00	Diesel generating sets, UPS, spares
Supplies		$ 50,000.00	For start up
Software		$ 75,000.00	
A/C for computer		$ 90,000.00	
Upgrading of computers		$ 50,000.00	
Sub-total		$2,080,000.00	
2. Other equipment			
Word processors	8	$ 40,000.00	For use by typists and consultants
FAX machine	1	$ 3,000.00	
Typewriters	12	$ 11,000.00	2 electric + 10 manual
Desk and pocket-calculators		$ 500.00	
Photocopier	5	$ 2,500.00	
Air conditioner	10	$ 12,000.00	
Refrigerator	1	$ 300.00	
Vehicles	8	$ 88,000.00	4 vans + 4 cars
Training equipment		$ 50,000.00	
Sub-total		$ 207,300.00	

3. Service

Word processors	$ 20,000.00
Photocopier service & supplies	$ 50,000.00
Vehicles, tyres,- maintenance, servicing	$ 25,000.00
Vehicle operation	$ 58,000.00
Office supplies	$ 65,000.00
Sub-total	$ 218,000.00
Total	$2,505,300.00
G & A 10%	$ 250,530.00
Grand total	$2,755,830.00

Phasing

	1990/91	1991/92	1992/93	1993/94	1994/95
1. Computers	$1,080,000.00	$1,000,000.00	$ 0.00	$ 0.00	$ 0.00
2. Other equipment	$ 207,300.00	$ 0.00	$ 0.00	$ 0.00	$ 0.00
3. Services	$ 54,500.00	$ 54,500.00	$ 43,600.00	$43,600.00	$21,800.00
	$1,341,800.00	$1,054,500.00	$ 43,600.00	$43,600.00	$21,800.00
G & A 10%	$ 134,180.00	$ 105,450.00	$ 4,360.00	$ 4,360.00	$ 2,180.00
Grand total	$1,475,980.00	$1,159,950.00	$ 47,960.00	$47,960.00	$23,980.00

Table 7

Training: FSRP - TA

	1990/91	1991/92	1992/93	1993/94	1994/95
In country Training:	$ 5,863.00	$ 12,898.60	$ 14,188.46	$ 6,500.60	$ 0.00
Books and journals	$ 33,000.00	$ 24,200.00	$ 6,655.00	$ 7,320.50	$8,052.55
Research Fund	$ 35,000.00	$ 35,000.00	$ 35,000.00	$ 35,000.00	$ 0.00
Overseas training:					
Computer	$ 62,100.00	$ 64,273.50	$ 0.00	$ 0.00	$ 0.00
FRBNY	$ 10,350.00	$ 10,712.25	$ 11,087.18	$ 11,475.23	$ 0.00
Monetary/macro econ	$207,000.00	$214,245.00	$221,743.58	$229,504.60	$ 0.00
Total	$353,313.00	$361,329.35	$288,674.21	$289,800.93	$8,052.55

Project total $1,301,170.05

Table 8

Monitoring and Evaluation Budget: FSRP - TA

A. First External Evaluation:

2 person month's international consultants starting in January, 92: $22,650.08 (Table G-7,91/92)X2=		$ 45,300.16
4 P/M national consultarts starting in January 92: $2,196.15 (Table G-8,91/92)X4		$ 8,784.6
Sub-total (A)	=	$ 54,084.76

B. Monitoring System Design Support:

2 P/M international consultants starting in January 91: $21,849.12 (Table G-7, 90/91)X2	=	$ 43,698.24
2 P/M national consultants starting in January 91: $ 1, 996.50 (Table G-8, 90/91)X2	=	$ 3,993.00
Sub-total (B)	=	$ 47,691.24

C. Base Line Data Collection & Analysis:

6 P/M national consultants starting in January 91: $ 1,996.50 (Table G-8, 90/91)X6	=	$ 11,979.00
Sub-total (C)	=	$ 11,979.00

D. Mid-term External Evaluation:

4 P/M international consultants starting in Feb. 93: $23,480.56 (Table G-7,92/93)X4	=	$ 93,922.24
5 P/M national consultants starting in Feb., 93 $ 2,415.77 (Table G-8, 92/93)X5	=	$ 12,078.85
Sub-total (D)	=	$106,001.09

E. TA Progress Update Evaluation:

1 P/M international consultant starting in January 94:
$24,341.65 (Table G-7, 93/94)X1 = $ 24,341.65

3 P/M national consultants starting in January 94:
$2,657.34 (Table G-8, 93/94)X3 = $ 7,972.02

Sub-total (E) = $ 32,313.67

F. Final External Impact Evaluation:

3 P/M international consultant starting in March, 95:
$ 25,234.50 (Table G-7, 94/95)X3 = $ 75,703.5

5 P/M national consultants starting in March, 95
$ 2, 923.08 (Table G-8,94/95)X5 = $ 14,615.4

Sub-total (F) = $ 90,318.90

Grand-total=$342,388.66 (A+B+C+D+E+F)

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C. ECONOMIC ANALYSIS

EA1. Capital Markets

IDA Recommendation Capital Market d Recommendations

Capital Markets - Potential and Recommendations Potential for Development of the Capital Market

The development of the capital market in Bangladesh has lagged development in the commercial banking and development financing systems and it has not adequately fulfilled its potential role of fostering greater efficiency in the mobilization and allocation of long-term finance. As discussed above: (a) there is no secondary market for government securities; (b) the corporate debt market is non-existent; and (c) the equity market has grown but there is substantial scope for improvement.

The supply of new corporate debt and equity securities in Bangladesh will depend primarily on the level of new industrial investment by the private sector, the proportion of such investment to be undertaken by large companies which would issue such securities, and how such large companies choose to finance these investments. If the previous investment financing patterns continue, the burden of financing will continue to be with the commercial banks and DFIs. Given the limitations of these institutions, especially their inability to provide adequate equity and long-term local currency loans, the planned level of investment is not likely to be achieved without the equity and long term loan finance that could be raised through a better developed securities market. However, it should be borne in mind that the actual level of investment, especially by the private sector, will depend heavily on an improvement in the investment climate and overall economic conditions. If the incentives to invest are improved and the obstacles to raising capital through securities issues are dealt with, it will be reasonable to expect an increase in the supply of securities.

61. While the securities market could, and should contribute more to the financing of private investment in Bangladesh, its limitations must be recognized. In this connection, a comparison of Bangladesh's equity market with other markets (Table 18) is useful.

Talbe 18: STOCK MARKETS - CROSS COUNTRY COMPARISON YEAR END 1985

	No of Listings	Market Capitalization (US$ billion equiv.)
USA	6.360	2,200
UK	2,116	328
Japan (Tokyo only)	1,829	910
India	4,344	15
Brazil	616	42.9
Pakistan	361	1.4
Korea	342	7.4
Malaysia	283	20.0
Argentina	227	1.4
Chile	227	2.0
Mexico	188	4.2
Philippine	130	.9
Thailand	100	1.8
Nigeria	94	2.6
Bangladesh /a	78	.1

/a Data for Bangladesh as of June 1986.

The countries listed in Table 18 have larger corporate sectors and higher per capita income than Bangladesh.

62. The increase in new equity issues in the medium term would be based primarily on the supply of shares which ICB needs to turn over from its portfolio. ICB estimates that from June 1986 to June 1987, twenty-four companies in its portfolio would float public share issues in the market amounting to Tk 90 million. The Stock Exchange estimate for the coming year is more conservative: it expects a total of 17 share issues by December 1987. Continuation of the government policy of divestment from public sector companies would lead to about 20 public share issues over the next five years. Assuming these estimates are correct, it would be reasonable to expect about 75 share issues in the coming five years; if the average size of these share issues stays at about the average attained in the last three years, i.e., around Tk 14.6 million, then about Tk 1.1 billion would be raised in the primary equity market.

63. Because of their novelty, it is more difficult to estimate the future level of bond issues by the private sector. Discussions with the financial and business communities suggest that without a government guarantee it is unlikely that more than one or two public debenture issues could be made annually over the next three to five years. Recommendations are made below for developing this market over the medium term.

64. The potential supply of long-term government securities will depend on Government's financing needs. IBRD staff projections 1/ indicate that over the period 1987-1992, the overall budget deficit would total Tk 260.5 billion. This deficit is expected to be financed by external grants and borrowings of Tk 256.4 billion and net domestic financing of Tk 4.1 billion. The domestic financing component provides an approximate indication of the amount of new government loan stocks that might be issued over the next five years.

65. The foregoing suggests that the capital market should witness a modest supply of shares and bonds over the next few years. On the demand side, foreign capital could absorb some of the planned issues, but recourse to Bangladeshi private savings is also inevitable if this supply of shares and bonds is to be placed successfully. The level of additional resources that could flow into corporate and government issues from institutional investors is difficult to estimate. This will largely depend on the growth of the contractual savings institutions analyzed earlier, which in turn will depend on the degree of success in implementing the recommendations to be made below. For instance, development of life insurance will require life insurance companies to match their long-term liabilities (life insurance policies) with long-term investments, thus creating demand for long term securities. Moreover, growth in the contributions to the pension funds will make more funds available for new investments.

66. The potential demand from individual investors is even more difficult to gauge. Without information on the characteristics of existing individual investors in securities in Bangladesh it is not possible to project the extent of involvement of this class of investor in the future. However, the substantial oversubscription to share issues witnessed over the last three years indicates that supply rather than demand for securities has been the major constraint to increased growth of the capital market.

1/ Table 11 Bangladesh: Consolidated Central Government Operations. December 10, 1986.

Recommendations for the Development of the Capital Market

67. Successful development of the capital market will require a comprehensive, co-ordinated and sustained program of measures - economic policy, institutional, fiscal and legal. Such a program will require positive government leadership, aimed at creating an environment conducive to the mobilization of long-term savings through securities. The recommendations set forth below combine three approaches to market development: (a) removal of barriers and impediments; (b) provision of incentives to stimulate desired action to increase the supply of securities; and (c) introduction of new ways of doing things. The measures suggested below to develop the capital market can be grouped in three categories: (a) those that increase the supply of shares and bonds; (b) those that provide better protection for investors, and (c) strengthening of the institutional framework.

68. Supply of New Debt Securities on the Market. At present the market is suffering from a shortage of new debt securities for public subscription. As previously discussed, there is growth potential in the supply of short- and medium-term debt instruments. To realize this potential, steps should be taken to ensure that the terms and yields of securities issued are competitive and attractive enough to tap household savings directly.

69. The development of the bond market will need to rely on the issuance of bonds by Government and government-owned financial institutions. To make them attractive to institutional or private investors, these bonds should be redeemable after a period of two years and, in the case of the government bonds, eligible as reserves of the commercial banks.

70. The DFIs and the NCBs could undertake bond issues with State guarantee in order to raise long-term local currency funds. Initially, five-year rather than ten-year bonds would be issued, making them less risky in the eyes of investors.

71. To forestall the risk of capital losses to savers due to future increases in interest rates, it would also be worthwhile to consider the issuance of bonds at variable interest rates. In order to avoid disrupting the operation of the financial system, adjustable interest rates, if adopted, should be tied to other market rates such as the rate on time deposits or market-determined T-bill rates. For instance, the interest rate on a bond issue could be adjusted annually to equalize it with the interest paid on two-year deposits at the time of the adjustment, plus a spread of, say, 1%. With this type of bond, (a) fluctuations in the overall level of interest rates would be reflected in the rates paid on bonds and the price at which they are quoted on the market would always remain very close to their nominal value; (b) consequently, savers would face no risk of capital loss; (c) the cost of funds to borrowers would closely follow the cost of bank credit; (d) with the decrease in risk to savers and borrowers, the term of borrowings could be lengthened (for example, initially to at least five years). The

variable rate feature is all the more desirable because it is unlikely that, in the short- or medium- term, there will be a secondary market in bonds to provide for an adjustment of yields.

72. In the longer-term, the development of the bond market would also enable non-financial public enterprises and private companies to tap local savings directly by issuing bonds. This would have the effect of lowering their borrowing costs since they could partially circumvent bank intermediation and of creating an alternative to commercial bank financing. Given the present stage of development of the capital market, it would difficult for an issue of bonds without government or other guarantee to be floated successfully. Generally, to generate enough demand, the issue of bonds in Bangladesh will call for attractive and flexible terms and other characteristics where they will be offered for public subscription: i.e., interest rates that are sufficiently competitive with the return on other financial instruments; a wide variety of redemption features; obligations with variable interest rates; and obligations convertible into capital or participating in the profits of the issuing entities.

73. The recommendations made later for BSB and BSRS to grant some of their larger term loans in the form of debentures which can later be sold to the public through ICB should further contribute to the growth of the bond market in the medium-term.

74. Better Investor Protection. Providing for better investor protection could require strengthening the institutional component of the regulatory framework, improving accounting standards and the quality of financial statements and ensuring that the Companies Act contains provisions conducive to the growth of the capital markets. These measures would help improve the financial discipline of companies in Bangladesh.

75. Regulatory Institutions. The existing regulatory mechanism is weak, largely because of inadequate staff and because the Controller of Capital Issues (CCI) has to carry an excessively heavy burden on account of his numerous other duties in the Ministry of Finance. To enhance the quality of control and prevent its diffusion, it is recommended that a separate independent Securities Authority be formed. This Securities Authority should combine the functions of CCI and the Registrar of Joint Stock Companies and should have a Board of Commissioners in which all market participants--the Stock Exchange, ICB, representatives of listed companies and investors--are represented in addition to the Government. The Government and ICB could nominate half the members of the Board to ensure that public policy considerations are adequately taken into account. To provide its employees enough time to develop the appropriate expertise, the Securities Authority should have permanent professional staff instead of civil servants subject to frequent departmental transfers.

76. The Securities Authority would implement the Securities and Exchange Ordinance of 1969 as well as the Rules of 1971. As a consequence, the Dhaka Stock Exchange would effectively be governed by these laws and regulations. Moreover, the companies listed on the Exchange will then be bound by the substantial acoounting disclosure requirements laid out by the Ordinance and the Rules.

77. Integrating the Registry of Joint Stock Companies and the Securities Authority should be combined with improved office facilities, personnel and enforcement procedures. This would help ensure that the registration of companies would involve thorough review of the company documents being filed to check compliance with the law.

78. Accounting Standards and Financial Statements. Financial institutions in Bangladesh complain that they do not obtain adequate accounting information from their clients, a situation which leads them to require extra security/collateral from the borrowers. A step in the right direction was taken by the creation of the Institute of Chartered Accountants which seeks to set up international standards of accounting practice and disclosure. Trustworthy accounts and financial statements based on uniform and well understood principles and audited by professionally qualified auditors are indispensable. Working Paper 4 discusses accounting and auditing questions in detail.

79. Company Law. While representing a substantial improvement on the 1913 Companies Act, the draft Company Ordinance 1986 needs additional amendments to protect investors addressing the following areas:

(a) Improvement of disclosure in prospectuses, annual reports and proxy solicitation, including financial statements;

(b) Prevention of conflict of interests of Directors;

(c) Provision for voting by closed ballot rather than by show of hands; otherwise opposing stockholders might be reluctant to cast negative ballots;

(d) Provision for a minimum number of meetings of the Board;

(e) Protection for minority shareholders (cumulative voting in election of Directors, duties of Directors, etc.);

(f) Consideration of the introduction of non-voting stock such as non-voting preference shares to encourage small- and medium-scale family enterprises to broaden their ownership; this would facilitate raising additional equity without the dilution of control which discourages the owners from seeking equity from the public. To prevent abuse, however, this should be linked to enterprises below a certain size; and

(g) Consideration as to whether the participants in companies require some form of protection of their rights, through a dispute-resolution mechanism on a less formal basis than through the courts, such as through the proposed Securities Authority.

80. In addition to the policy measures required for increasing the supply of and demand for securities, the development of the capital markets also necessitates actions that would enhance the ability of the Dhaka Stock Exchange to provide orderly and open markets and foster confidence in the operations of the market. The report shall now examine such actions.

Recommendations for the Dhaka Stock Exchange

81. Organization. The private nature of the current Stock Exchange best reflects the image of a stock exchange and should be maintained. The Stock Exchange has worked successfully towards removing the unfavorable aura that surrounded its past activities and should therefore be encouraged in its efforts to activate the securities market. The institution should continue to be operated by its members who are mostly individual entrepreneurs. However, expanding the Board of Directors of the Exchange to include representatives not only of the brokers but also of public investors and practicing lawyers and accountants will strengthen the Exchange by broadening the wealth of expertise available to it. The Government should serve in a guardianship capacity, to ensure fair dealings and encourage development.

82. It is important to recognize that though the present exchange has made laudable efforts in the right direction, its activities do not yet embody genuine self-regulatory principles. Consequently, we recommend that more extensive principles of self-regulation than those currently in force be considered. Within the framework of national regulatory legislation, the stock exchange should establish more thorough rules covering the conduct of members, their ethical standards, surveillance procedures, and penalties for breaching the rules.

83. Trading Rules. Rules must be formulated to govern the conduct of trading or the "call" including the recoding of transactions, the priority of bids and offers, and the relationships between a member and his client.

84. Centralization of transactions assures that all interested buyers and sellers are brought together. Exposing their orders to the rigors of the auction process is a means of producing fair prices. Both these features can be obtained by requiring that all trading be conducted through the Dhaka Stock Exchange after a security is initially issued. This will help activate the exchange. This provision should be applicable to all institutions, so that, for instance, ICB would no longer have the authority, as now specified in its Ordinance, "to purchase and sell shares to the Investors' Deposit Account holders over-the-counter". ICB cannot, following the adoption of this recommendation, simply transfer the stock from the account of the ini-

tial purchaser to another investor's account, but would have to effect the transfer through the exchange. Since ICB is a member of the stock exchange, it can handle the transaction, but should do so only through the facilities of the exchange.

85. This recommendation would boost stock exchange activity sharply since in FY86 over-the-counter transactions of ICB amounted to over 1.2 million shares being traded compared to 670,000 shares traded through the exchange in the same period. (The corresponding FY85 trading volume figures are ICB over-the-counter transactions of 958,000 shares and Stock Exchange transactions of 380,000 shares.) These data suggest that the implementation of this recommendation can potentially triple the turnover on the exchange in addition to providing a market-determined price for a larger number of stocks.

86. Listing Requirements. In addition to the present listing rules, the Stock Exchange should insist that the accounts of listed companies comply with the accounting standards of the Institute of Chartered Accountants and that their audit repots be unqualified.

87. Financial Viability of Members. A viable stock exchange requires an active membership which devotes its time and energies to the securities business. The requirements for membership in the Dhaka Stock Exchange as spelled out in Sections 4 and 6 of the Articles of Association are vague. Most of the present members of the exchange do not spend much time on securities activities. Financial incentives for members should be strengthened in order to increase the number of members who will genuinely regard the securities field as their main business and who will be able to earn an adequate living from their activities in this field.

88. It is desirable that financial measures be taken that afford members at least a reasonable opportunity of financial success. Such measures comprise:

(a) By requiring that all transactions be executed on the exchange through these members, the opportunity for obtaining income from this source will be greatly augmented.

(b) ICB should invite the stock exchange members to participate in the consortium for the distribution of securities. The potential for a more active role by members of the exchange in this area is indicated by the recent successful underwriting of a Tk 12.3 million issue by a syndicate of 41 Stock Exchange members, an underwriting which ICB reportedly did not manage because the issuer was not a DFI borrower.

(c) Members of the stock exchange should explore activities, such as serving as dealers in repurchase agreements and commercial paper as well as providing financial advice to investors and business firms.

(d) The number of stock exchange members should be reduced and should be limited thereafter to increase the volume of transactions per member to more satisfactory levels.

89. Pricing. The reported prices on an effective stock exchange should reasonably reflect current conditions. Under the present system, the exchange has no alternative except to report the last sales price on the exchange, even if that price occurred a long time ago and no longer reflects current conditions. As a result, a new transaction might take place outside the exchange at a much different level from that reported by the exchange.

90. To some extent this condition will be reflected by the requirement that all transactions for listed securities take place on the exchange. It would still be possible, however, that the last transaction in a particular stock may have taken place a long time ago and if the exchange reports only the last sale price, it might not reflect current conditions.

91. This problem can occur on any exchange for infrequently traded stocks. To tackle the problem, well-run stock exchanges provide for dealers who are responsible for making a market in a particular stock. The dealer stands ready to buy or sell a designated amount of that stock at prices that more fully reflect current conditions. This readiness is reflected in the dealer's quotation which indicates the bid price at which he is willing to buy and the asked price at which he is willing to sell. For the dealer to serve in this capacity he generally will carry some inventory in the stock in which he is making a market.

92. As the volume of securities available has increased in recent years, it is desirable that this arrangement, initially at least for a reasonable number of listed stocks and a few dealers, be considered by the Dhaka Stock Exchange. The few dealers would be asked to keep an inventory in those stocks and provide current bid and asked quotations which would be reported by the stock exchange. Initially, special arrangements might have to be made to enable the dealers to acquire their starting inventories. Thereafter, it is expected that they will be able to keep these inventories, sometimes higher and sometimes lower, through the normal operations of the exchange.

93. The purpose of the quotation by the dealer would be to provide some realistic indication of the current price of a stock that has not traded for some time. The dealer could keep his quotation wide. If he did not want to buy a stock, he would lower his bid sufficiently to discourage sales to him and similarly if he did not want to sell a stock, he would raise his offer price sufficiently. Presumably, the auction trading on the stock exchange would tend to occur within his bid and offer ranges. Moreover, at all times a public bid or offer at the same level would take precedence over his own.

94. ICB as a member of the exchange with institutional clout should consider taking an active role as a dealer for a number of stocks. The relative role of ICB in this regard will finally depend upon the number, interest, and financial position of the other members of the Dhaka Stock Exchange.

Recommendations for ICB

95. The recommendations for ICB can be classified thus: (a) those to be implemented in the short-term, in line with ICB's current strategy; (b) those for the medium-term involving a re-orientation of ICB's strategy and the introduction of new products and services; and (c) those regarding the financial needs of ICB.

96. Recommendations for the Short-Term. Given its large arrears, ICB should adopt appropriate accounting policies for loan loss provisions and suspension of interest. This would give a more accurate picture of its financial performance and of the cost involved for the Government in providing ICB equity financing.

97. To the extent that the appraisal reports ICB obtains are primarily prepared by the DFIs whose interest in arranging debt financing may not always be identical with that of ICB's interest in equity financing, there is need for ICB to obtain a "second opinion" on these reports. Personnel limitations in Bangladesh make it unfeasible for ICB to maintain the staff necessary to carry out appropriate independent financial analyses. Because of the limited financial analysis skills presently available in the country, it is recommended that ICB use an independent institution like IPDC to provide such a service in return for a fee; IPDC has indicated its interest in such a cooperative arrangement. It should be emphasized, however, that although the analysis function might be subcontracted, ICB would still be responsible for making the investment banking decisions as to its willingness to proceed and the suitability of an issue for a public offering, the amount of securities that the market can absorb, the extent of underwriting risks involved and the most suitable offering price.

98. Currently, the actual distribution of securities is made jointly by the issuing company and ICB. We recommend that the distribution of securities should be undertaken by ICB rather than by the issuing company to improve the prospects for a successful sale and to reduce the chances that the public might be misled. Moreover, ICB should be responsible for the advertising and dissemination of information and literature. While the cost of the prospectus could be borne by the issuing company, ICB should be responsible for its preparation. In view of these additional responsibilities, ICB would have to undertake (a) a training program to ensure high professional standards for its staff and (b) a revision of the present underwriting fees.

99. At present, ICB receives an underwriting commission of 2-1/2% and an additional commission of 2-1/2% on the amount of the issue it actually takes up. These commissions apparently are fixed by virtue of the Capital Issues (Continuance of Control) Act of 1947. It is recommended that new rates be set at a level sufficient for ICB to carry out its distribution and underwriting functions while earning a reasonable profit. While more detailed study should be undertaken to determine appropriate rates, discussions with ICB management suggest that for a best-efforts distribution, ICB might receive 5% for each share or bond sold; when an underwriting responsibility is also assumed, an additional charge of 5% would be imposed for an overall charge of 10% of the entire issue. The recommended higher rates could make the possibility of competition from private investment banks feasible. We would not, however, recommend that limitations be placed on what investment banks might charge as underwriting fees.

100. Since the absence of up-to-date audited accounts makes it difficult for ICB to monitor its portfolio and prevents it from taking many companies it has financed to the public, ICB should devote more effort to obtaining these financial statements, by legal action if necessary.

101. At present, in its Investors' Scheme, ICB makes no distinction between the initial margin it grants and a maintenance (ongoing) margin. In developed markets, investors must keep a maintenance margin or be exposed to a call for additional margin if the value of the securities drops, which if not met could result in the liquidation of the collateral (the stocks purchased with the loan) by the securities firm making the loan. ICB has no mechanism for issuing a call for additional margin or liquidating the account when the value of the collateral stock drops substantially. The absence of maintenance margins made sense in the early days of ICB to the extent that ICB's main concern was to encourage the entry of more investors in the market. However, since a secondary market is beginning to develop, ICB should review the Investors' Scheme to distinguish between initial and maintenance margins, raise the initial margin requirement, and develop procedures for obtaining additional margin deposits or liquidating the account if necessary.

102. To enhance further its role as an investment banker introducing new financing instruments in the country, ICB should implement the decision reportedly approved by its Board to replace its bridge loans with convertible bonds. The bonds could be given a medium-term maturity (i.e., five years) and be convertible into common stock at the option of the holder (ICB and the consortium at the initial stage) at any time after, say, three years. If the project financed proved successful, ICB presumably would convert the bond into stock and effect a public distribution. If the project were unsuccessful, as under present arrangements a public offering would have to be deferred until it is turned around. During this period, ICB and the consortium would be holding an interest-bearing obligation. If the rate were sufficiently attractive, the instrument might even prove saleable as a convertible bond rather than as stock.

103. Recommendations for the Medium-Term. ICB presently functions primarily as a development finance company and an underwriter. It performs the former role when it provides either bridge or debenture financing to new companies; in so doing, it augments the lending of BSB and BSRS. Only the form of operation is different. BSB and BSRS provide term loans, part of which may be in foreign currency, while ICB gives local currency loans that are in the form of a "bridge" between a term loan and equity at the time of a later public offering or are in the form of debentures. In essence all three institutions provide development loan financing. The ICB program also provides for the public distribution and underwriting of the development loans that it originally arranged. In this capacity, it performs an investment banking function essential for the securities market. It is recommended that the framework of financing in Bangladesh be modified to permit ICB to lighten its developmental financing role in relative terms and strengthen its investment banking function. This would involve ICB becoming primarily a merchandiser of securities, arranging for their distribution from the issuer to the general public.

104. BSB should consider granting some of its larger term loans in the form of debentures that would at some stage be offered to the public; this might enable ICB to reduce its own financing in this area. These debentures would eventually be sold to the public through ICB which would assume the distribution and underwriting functions. At the same time, the public distribution of the debenture issues would allow BSB to recycle its funds and provide the public an alternative long-term savings instrument. As for already established, financially sound companies needing funds for expansion, BSB should be encouraged to go directly to ICB which, however, would not provide the financing directly, but would arrange to distribute and underwrite the company's debentures. The debentures should also be listed on the Stock Exchange in order to create a secondary market for them.

105. Not all securities brought to ICB would be suitable for public distribution, because the underlying projects are too risky, small or too specialized. It is recommended that ICB should, when appropriate, undertake private placements of such securities, finding private buyers for a fee.

106. ICB's knowledge of business opportunities coupled with the Government's continuing divestment program should open opportunities for ICB to assist over the longer term in mergers or acquisitions. ICB could tap its network of business relationships to assist in bringing potential buyers and sellers together, helping to negotiate final agreements, and advising on the emerging corporate structures.

107. The commercial banks hold substantial amounts of Government securities. If Government securities are made transferable, as recommended later, anyone with excess short-term funds might purchase these securities under an agreement that provides for the bank to repurchase them at a specified price after several days. Alternatively, one bank may effect such

a repurchase agreement with another bank. Or a business firm or wealthy individual that holds securities of this sort might sell them to a bank with a repurchase provision. These repurchase agreements represent a potentially useful source of short-term financing. By serving as an intermediary in this type of arrangement, bringing buyer and seller together, ICB could help develop the market for this money market instrument.

108. The Financial Needs of ICB. The financial position depicted in paras. 34 to 37 is far from rosy. Over the long run, as ICB's role shifts from that of a lender to that of an intermediary merchandising securities, its future levels of new disbursements may decrease. Moreover, as more of the companies it has financed make public issues to "repay" bridging loans, ICB will be able to increase its cash inflow to meet its financing requirements. Nonetheless, over the shorter-term, ICB is likely to be short of funds and may not be able to fully service its debt for some time. We recommend that the following avenues be explored to improve its financial situation:

(a) The Government will need to agree to reschedule some of ICB's outstanding debt.

(b) ICB consortia should be enlarged, if possible, to include foreign banks, stockbrokers, and the new finance companies (IPDC, NCL and BCI). If the level of financial participation of the other members of the consortium is increased, it would ease the financial burden on ICB.

(c) Raising ICB's underwriting fees as suggested in para. 107.

(d) Extending ICB's activities as already recommended in paras. 112-114.

Private Sector Investment Banking Institutions

109. Growth of viable private sector capital market intermediaries should be encouraged to reduce the ICB monopoly in investment banking activities and foster competion. Consequently, the Government should encourage private investment banks such as NCL, BCI and IPDC to get more involved in investment banking activities and participate in ICB consortia. These financial institutions should be encouraged to generate fee income by offering services such as underwriting, project packaging and financial consultancy. They should also continue their efforts to develop close relationships with sound business groups, and use this base for concerted project promotion efforts. They should be encouraged to seek, and be given for a fee, a seat on the Dhaka Stock Exchange. In the long run, their viability will depend on the size and quality of their investment portfolio and on the development of fee-earning business.

Recommendations for Improving Contractual Savings

110. Experience in most countries shows that life insurance is an important component of the financial system, even in countries that have a central social security system. For example, life insurance premiums average about 1% of GNP, ranging (in 1980) from 5%-7% in the industrialized Western countries to 0.3%-1.0% in countries such as Brazil, Thailand, Mexico, Indonesia and Turkey. Another indicator--the ratio of life insurance in force to national income--varied widely (in 1980): 280% in Japan, 150% in the United States, 125% in Holland, 36% in Korea, 24% in India and 7% in Thailand. Life insurance is particularly important because it is one of the main sources of longer term savings which lend themselves to being invested in long-term investment instruments whose development in turn is essential for the financing of enterprises' equity capital and long-term borrowing requirements.

111. As for general (non-life) insurance, the newly set-up private companies should not be restricted, as they currently are, to private sector business. They should be allowed to compete with Sadharan Bima for the insurance business of public sector corporations to increase competition and enhance efficiency.

112. Sadharan Bima has an unfair "monopoly" because all private sector insurance companies are compelled to reinsure with it, thus enabling it to obtain information on its competitors' business. To prevent this unhealthy conflict of interest, the Government should examine the feasibility of setting up an independent reinsurance company whose ownership would be shared by the government, the private sector and an international reinsurance company which would be the technical partner.

113. Pension or provident funds, i.e., funds which are constituted by payments from employers and employees and which are managed independently from the accounts of the individual enterprise establishing them, are of greater importance than life insurance as a source of long-term savings in some countries. For example, in the United States, 1984 pension fund assets are estimated to total some US$1,500 billion and to be growing at 20% p.a.; Japan US$72 billion equivalent, with a similar growth rate; United Kingdom US$100 billion equivalent; Switzerland US$60 billion equivalent; rest of Europe US$175 billion equivalent, all growing at a rate of about 12% p.a. Substantial development financing has been generated in South East Asia by pension schemes and provident funds. Consequently, independent, funded pension funds should be encouraged. However, the Government should monitor them. As a first step, pension fund legislation should be introduced setting out, among others, (a) fiduciary responsibilities, (b) financial disclosure requirements and (c) minimum percentage of investment in various instruments to ensure diversification of fund assets. With respect to the last item, some flexibility would be required at this stage since it will take some time for Bangladesh to offer a wider spectrum of investment alternatives.

6. The Money Market

114. The Current Situation. Chapter II discusses the economic role of a money market. Bangladesh already has institutions which ought to be normal borrowers and lenders in a money market, and some of the short-term financial instruments through which such borrowings and lending is made. Potential money market participants, in addition to the existing financial institutions, would include non-financial enterprises with the need to invest short-term money in the normal course of business. However, secondary market trading in these instruments, and hence a money market providing liquidity as well as access to a broader range of investors, does not exist. Because a secondary market is absent, there are no specialized brokers and dealers in money market instruments.

115. The main money market instrument in Bangladesh is the Treasury Bill, issued by the Government as a means of financing its deficits, and to provide an income-earning liquid asset for commercial banks and corporations. As of September 30, 1986, Tk 14.4 billion on treasury bills outstanding was distributed as follows:

Table 19: DISTRIBUTION OF TREASURY BILLS

	Holders	Amounts (Tk million)	% of Total
3-month T-Bills	Scheduled Banks	11,022.0	76.3
	Bangladesh Bank	3,408.0	23.6
		14,430.0	99.9
Non-banking T-Bills	Corporations	8.8	.1
	Total	14,438.8	100.0

116. The scheduled banks held 76% of the treasury bills while the Bangladesh Bank held most of remainder

117. Pricing of the treasury bills is, as of now, pre-fixed by the Bangladesh Bank. There is no tender system. Dealings in treasury bills can be conducted only with the Bangladesh Bank, effectively eliminating the development of a secondary market to provide liquidity for investors. Currently, liquidity can only be obtained through rediscounting at the Bangladesh Bank.

118. The second money market type instrument in Bangladesh consists of various Short-Term Drafts and Bills of Exchange used by business enterprises in the normal course of business. These include crop finance bills, import and export bills and promissory notes. The banks and other financial intermediaries advance short-term credit against these instruments. The Bangladesh Bank provides facilities to the banks to: (a) rediscount export bills; and (b) refinance overdrafts against export bills to the extent of 50% and 100% for traditional and non-traditional exports respectively. The outstanding amounts of overdraft and rediscounting facilities provided by the Bangladesh Bank amounted to Tk 125 million as of June 30, 1985. The financial institutions that hold the short-term bills do not discount them through third parties outside the Bangladesh Bank.

119. A relatively active inter-bank overnight call market for cash does exist in Bangladesh, with the interest rate ranging from 10% to 14%.

120. To mobilize savings from the general public, the Bangladesh Bank has recently allowed the commercial banks to issue transferable and negotiable certificates of deposit (CDs) with maturities of 3, 6, 9 and 12 months and denominations of Tk 25,000, Tk 50,000 and Tk 100,000. The noteworthy feature of the CD scheme is that the interest rate is determined be each bank on the date of issue of the CDs based on the demand and supply of funds in the money market. No data are available to enable proper evaluation of this scheme but we view it as a worthwhile experiment with market interest rates.

121. Commercial paper does not exist in Bangladesh.

122. Potential for Development of Money Market. The development of a broader money market in Bangladesh is needed to increase domestic savings, promote specialization of financial institutions, and improve the allocation of such savings. The money market could improve the overall efficiency of the Bangladesh financial system by diversifying the means by which both government and private sector and financial institutions can raise and invest short-term funds, by providing liquidity to such investments, and by fostering more competition. More specifically, an improved money market would provide the following benefits:

(a) Treasury bill tenders would make these instruments attractive to more investors. This would in turn provide more flexibility in the management of Government deficit financing. Eventually a secondary market could be expected to emerge, which would add more liquidity to the bills;

(b) Freely determined short-term interest rates would provide the Bangladesh Bank a better and more timely indication of overall credit conditions and a sounder basis for monetary policy decisions;

(c) A money market may provide a cheaper alternative to the banking system for major private and public sector companies in raising short-term funds. By so reducing their financing costs their return on investment will be improved, increasing the incentive to undertake more investments;

(d) Financial institutions would have an outlet or recourse for liquidity, which would improve the efficiency of financing intermediation and resource allocation;

(e) It will increase the ways in which the savers can invest, thus encouraging more saving; and

(f) A money market gives the Bangladesh Bank flexibility to conduct operations, thus adding an efficient instrument of monetary policy.

123. The potential for establishing an active money market in Bangladesh which will in the long-term achieve the goals outlined above, will need to start with treasury bills of which Tk 14 billion are presently outstanding. However, as long as treasury bills are held outside the Bangladesh Bank, almost entirely under statutory liquid asset requirements, developing an active money market will be difficult. The first issue therefore is to issue government securities in primary issues at market rates. At a later stage secondary markets will evolve. A secondary market or an appropriate rediscounting facility available to provide investor liquidity would require a wider range of maturities of treasury bills than is currently available. This could be supplemented by primary issues and secondary trading in private instruments, mainly negotiable certificates of deposit, bankers acceptances and commercial paper. As a rough indication, based on the experience of more developed money markets, it is estimated that these private instruments could together amount to between 60% and 80% of the volume of outstanding treasury bills when fully developed. Negotiable certificates of deposit at market rates of interest and bankers acceptances are likely to be the most important private instruments initially because of the fairly well developed commercial banking system. Commercial paper issued by private companies requires some care in its introduction to mitigate potential abuses.

124. Recommendations for the Development of the Money Market. Actions by government to promote money market development should focus on the markets in treasury bills, and BB securities as well as in the interbank market. Subsequently the emergence of short-term private sector instruments should be encouraged. Much later the development of intermediary institutions and financial support for such intermediaries could become important.

125. The first set of recommendations relate to Bangladesh Bank securties and treasury bills and are aimed at making these more attractive and marketable. Specifically, the following measures are recommended:

(a) The failure to develop marketable bankers acceptances, in spite of the existence of short-term bills of exchange, appears due to the unwillingness of financial institutions to provide unsecured credit by adding their names and reputation through acceptance of papers drawn on them by borrowers. To stimulate the development of negotiable bankers acceptances, it is recommended that incentives be provided to banks to accept certain categories of bills of exchange drawn by non-financial enterprises without recourse to security. One incentive to be considered would be more flexible and guaranteed discountability of such bills by the Bangladesh Bank.

(b) Consideration should be given in the longer-term to allowing creditworthy non-financial corporations to issue commercial paper. This would create an "inter-company" market for temporary surpluses and deficits of "blue chip" companies. Detailed criteria governing eligibility, financial disclosure and borrowing limits would need to be developed before these instruments are introduced. The experience of other countries suggests that the introduction of commercial paper is a long-run proposition: it is a relatively new instrument even in Europe. Moreover, its successful introduction would require the commercial banks to provide stand-by lines of credit to the issuers. In Bangladesh, the development of this financial instrument in the immediate future would not be easy because the number of "blue-chip" companies is limited.

127. Finally, for a money market to develop with adequate investor confidence, the Bangladesh Bank, as the ultimate source of money in the economy, should stand ready at all times to provide liquidity to the market by discounting various instruments and providing loans to market intermediaries. The interest rates at which the Bangladesh Bank does this should, of course, be high enough to discourage the use of these facilities unless absolutely required to maintain liquidity.

C. Training Program

128. Implementation of the various recommendations made in this report will require the acquisition of new skills and knowledge through an extensive training program. An indicative training program is presented in Table 20.

129. It is difficult to be specific at this time because actual formulation of a program would require selecting the institutions to be assisted, establishing relations with them, getting their ideas as to the areas to be covered as well as time spent, and making similar arrangements with the regulatory agencies. This is a substantial undertaking since a number of firms and agencies located in different countries are involved. Moreover, travel plans would have to be worked out to conserve time and costs. A small

working group should be drawn from ICB, the Dhaka Stock Exchange and the Office of the Controller of Capital Issues to prepare a detailed program. UNDP and other bilateral or multilateral aid agencies might be approached to finance the training program.

130. It is hoped that, as a result of the training program, long-term relationships could be developed as a base for future exchanges and training. The participants in the program should be required to present papers at workshops to other officers on their respective areas of study upon their return. The Government should consider requiring that participating government officers remain in capital markets related functions for a minimum of three years after their return.

Table 20: CAPITAL MARKETS TRAINING PROGRAM

Subject and Personnel Selected	Location of Training	Firms of Agencies	Time Spent with each Firm by One Trainee	Total Time
Stock Exchange Operations and Regulations:				
DSE - 2 staff ICB - 1 staff Securities Authority - 2 staff	London Seoul Singapore Bangkok	Stock exchanges	1 month	5 month
Securities Law				
Securities Authority lawyers - 2 staff	Washington D.C.	Securities and Exchange Commission	1 month	1 month
	London or Seoul or Bangkok	Regulatory Authority	1 month	1 month
Investment Banking				
ICB - 3 staff DSE - 1 staff Securities Authority - 1 staff	London	1 merchant bank	2 months	2 months
	Seoul Bangkok	4 investment banks/Securities firms	1 month	5 months
Government Bond and Treasury Bill Issues				
BB - 2 staff	Colombo/ Kualalumpur	) Central Bank)		
	Washington D.C./ London	U.S. Treasury Dept.) Bank of England	2 months	2 months
14 Individuals				18 months

REASONS FOR FINANCIAL MARKETS IN DEVELOPING COUNTRIES

MACRO ARGUMENTS

More Efficient Competitive Financial System

- Alternatives for savers and borrowers/issuers are provided.
- Fewer opportunities exist for oligopolistic behaviour of banking institutions
- Financial markets stimulate market orientation and liberalized interest rate policies.
- There is more specialization, marketing and innovation.
- More "mobility" of capital rather than hoarding of funds within existing enterprises.

Better Savings Mobilization

- Market rates are more likely to be positive real rates than "administrative" rates.
- With positive rates there are better incentives to save rather than consume or export funds.

Better Resource Allocation

- More decentralized decision making closer to day-to-day reality.
- Banks/development banks do not have to carry alone the burden of providing term finance.
- Liquidity induces savers to invest longer term.

Greater Solvency

- A variety of financial instruments each with different risk characteristics can be developed.
- Various types of risk taking require different types of institutional framework.

MICRO AGRUMENTS

Equal Access

- The State does not automatically have privileged and subsidized access to funds, and must compete with others, including non-state-owned enterprises.

Stronger Corporate Balance Sheets

- Beter debt-equity ratios.
- Better long-term/short-term debt ratios.
- Less dependence on overdraft financing.

SOCIAL EQUITY ARGUMENTS

Wider Participation in Attractive Opportunities

- Small savers are not limited to bank controlled ceiling rates.
- "Threshold" investment in risk capital is lower.
- Workers can participate in the country's economic growth.
- Pension funds/ insurance companies have wider opportunities for investment.

De-concentration of Ownership

- State-owned enterprises to be sold or needing equity can be offered to the public.
- Links between financial and industrial interests can be limited.

More Equitable Tax Collection

- Better disclosure of financial information may lead to improved tax collection in the long term.

PRODUCTIVITY ARGUMENTS

Improved Access to Finance for Young Companies

- Subsidized credit often crowds out young companies without a long history, family contacts or collateral.
- Venture capital thrives best in an active financial market environment.

Better Management Information

The need for disclosure of financial information is a strong incentive for the improvement of internal financial information.

Adapted from "Emerging Securities Markets" by Antoine W. van Agtmael, Euromoney Publications, London, 1984, page 5.

THE MONEY MARKET

DESCRIPTION AND ECONOMIC ROLE

1. In the broadest sense, a market is an institutional arrangement in which demand and supply meet to establish exchange of goods or service at a price. The money market refers to such an arrangement for short-term credit instruments. It is not a place but an activity: transactions are carried out by telephone among people who may never meet one another. The money market serves to redistribute cash balances among economically sound institutions consistent with their liquidity needs. A successful money market mechanism, by inference, is one that performs this task efficiently and at the least economic cost to the community.

2. Money market instruments typically have four key characteristics. First, they are short-term credit notes with a time horizon ranging up to one year, but usually created for periods of one month, three months, six months, nine months and one year. Second, money market instruments are created by institutions--government, financial and non-financial corporations--with good credit ratings. Third, the instruments are relatively liquid and are of low risk compared to equities. Instruments issued by governments with government guarantee are in particular virtually risk free, while private-sector instrument issues by banks or with bank guarantees also have low risks. Investors in such instruments purchase them in the belief that the paper and promise they acquire will be redeemed at maturity without default and, to the extent that a secondary market for the instrument exists, that they may dispose of it prior to maturity without significant loss of value. Fourth, money market instruments are normally bought and sold in relatively large denominations and thus usually by banks, institutional investors and companies. This derives principally from the desire of issuers to minimize transaction costs. The specific characteristics of money market instruments and their quality level varies from country to country. In the more developed money markets, the main types of instruments which meet these characteristics are treasury bills, negotiable certificates of deposit, commercial paper and bankers acceptances.

3. The prices (interest rates or yields) at which money market instruments are issued and traded generally reflect supply and demand conditions. Normally there are price differentials between instruments reflecting (a) differences in maturity; (b) differences in marketability prior to maturity; (c) differences in tax treatment of income; (d) differences in the size of issues that affect transaction costs; and (e) differences in the reputation of the issuer. While displaying spreads that reflect the sum of

the factors listed above, money market rates tend to move in the same direction over fairly long periods of time, largely because the instruments are highly substitutable for one another in the minds of the buyers.

4. Governments, commercial banks, some non-bank financial institutions (NBFIs) and well-known non-financial corporations of the highest credit standing are the main borrowers in the money market. Suppliers of funds include all those economic units that can realize a significant gain through arranging to meet future cash requirements by holding interest-bearing liquid assets in place of non-earning cash balances. The major participants on the lending side of the market are commercial banks, large non-financial businesses and non-bank financial institutions such as insurance companies and pension funds. The basic trading machinery is provided by these institutions as buyers and sellers and by specialized dealers and brokers as market makers in these instruments.

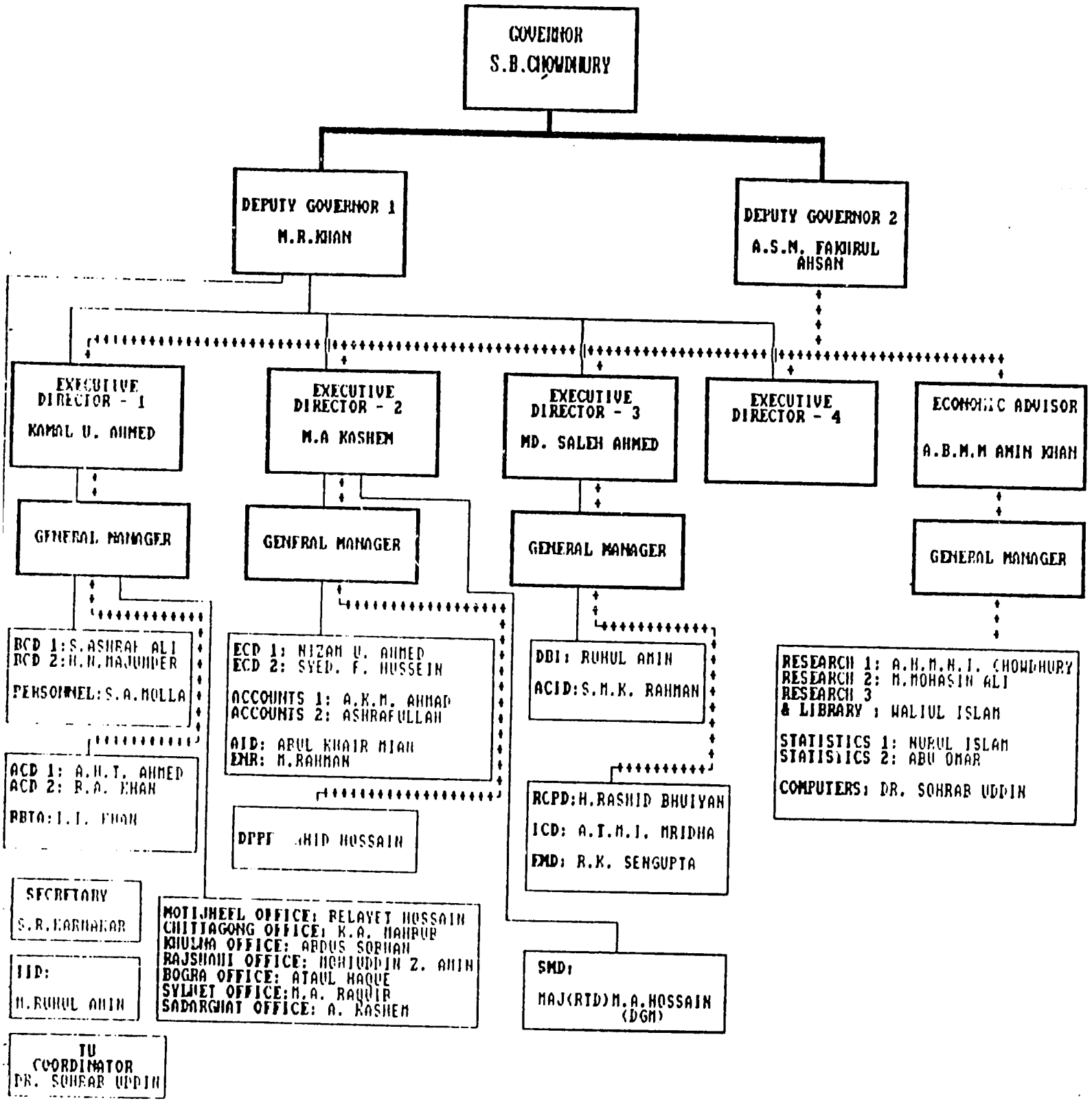
5. The money market serves economic purposes. First it adds to the efficiency of overall financial intermediation, and hence to the savings and investment process, by providing for economic units an important source of short-term borrowing on cheaper terms than bank credit. By providing a continuous flow of funds in sufficient volume, it is possible for borrowers, through successive renewal of loans, to raise funds on a more or less continuous basis, and in this fashion to finance not only their immediate cash requirements but also their working capital needs. Second, by bringing together quickly, conveniently, and to their mutual advantage those units with cash surpluses and those with cash deficits, the market promotes a more intensive use of the cash balances held in the economy. Third, the market is an important vehicle for commercial banks to manage their money positions, permitting a more intensive use of bank reserves and enhancing the ability of the commercial banking system to allocate funds efficiently. Fourth, conditions in the money market provide an important guide for monetary policy. The market is a free and competitive market with frequently adjusted and widely quoted yields. As a result, the behaviour of the money market provides perhaps the most immediately available indication of the current relationship between credit supply and credit demand, and the realistic levels of interest rates.

D. ADMINISTRATIVE ANALYSIS

AA1. Bangladesh Bank Organogram
AA2. Team Leader Description
AA3. PSC Project Coordinator Description
AA4. TA Training Consultants Description

ANNEX AA1.

FOR BANGLADESH BANK



ACRONYMS: ACD = AGRICULTURAL CREDIT DEPARTMENT
AID = AUDIT & INSPECTION DEPARTMENT
EMD = EXPENDITURE MANAGEMENT DEPARTMENT
BCD = BANKING CONTROL DEPARTMENT
ECD = EXCHANGE CONTROL DEPARTMENT
DBI = DEPARTMENT OF BANKING INSPECTION
TU = TECHNICAL UNIT
SMD = SECURITY MANAGEMENT DEPARTMENT
ICD = INDUSTRIAL CREDIT DEPARTMENT
ACID = AGRICULTURAL CREDIT INSPECTION DEPARTMENT
RCPD = RURAL CREDIT PROJECTS DEPARTMENT
BBTA = BANGLADESH BANK TRAINING ACADEMY
DPPR = DEPARTMENT OF PUBLICATIONS AND PUBLIC RELATIONS
EMR = ENGINEERING DEPARTMENT
IID = INSPECTION IMPLEMENTATION DEPARTMENT

Y: - - - - - DY. GOVERNOR 1 RESPONSIBLE FOR DEPARTMENTS CONNECTED BY SOLID LINES

******** DY. GOVERNOR 2 RESPONSIBLE FOR DEPARTMENTS CONNECTED BY CROSSED LINES

le Compiled:JUNE 12, 1989.

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Personnel:

Team Leader/Chief of Party
Technical Assistance

Time Frame : Starting approximately November, 1990, Fifty two person months

The Chief of party/team's leading expert on bank management and administration, will be based in Bangladesh Bank and supported by a local administrative staff paid out of project funds.

Qualifications:

A. Academics: Ph. D. in Economics/Business.

B. Experience: At least ten years of post - Ph. D. experience in bank management/administration accounting and MIS, credit analysis, loan administration, performance planning and budgeting of commercial bank with agencies in development countries preferably South Asia. Matured personality, quality work, and promising characteristics are desirable.

Duties: The team leader will:

1. Plan and guide the implementation of the project and be responsible and accountable for its progress.

2. Coordinate and supervise the long-term and short-term consultants, expatriate and national.

3. Maintain close coordination with the Project Manager/Director, a senior officer appointed by Bangladesh Bank as counterpart, with respect to all activities of the FSC project in all of its phases.

4. Maintain similar collaboration with the PSC coordinator and the staff of USAID/Bangladesh.

5. Work both in the Bangladesh Bank and in the Nationalized Commercial Banks of Bangladesh , Sonali, Janata, Agrani and Rupali Bank.

6. Render Technical Assistance and Training to the Banks and help them in their work, and see that their work is accomplished within the scheduled time according to the Terms of Reference.

7. Report the progress of the work of the group of consultants to the USAID Office of Economics and Enterprise and to the Project Director/Project Manager.

8. Arrange for support facilities for the rest of the TA/Training Team.

PSC Project Coordinator,

Qualifications:

A. Academics: Ph. D. in Economics Business, or other suitable discipline. Quality and/or length of experience may be substituted for academic training.

B. Experience: At least five years of experience working with government or the position of Monetary Economist. The Monetary/private sector agencies in developing countries. Experience in project development and management, and in working with a variety of government/non-government agencies is essential. Ability to maintain liaison with cooperating organizations is helpful. Excellent communication and writing skills are highly desirable.

Duties: PSC Project Coordinator will:

1. Be placed in USAID, and responsible for Implementation and Administration of the project.

2. Cooperate TA team, IDA to jointly develop parameters of the systems for project Monitoring and Evaluation.

   - update the quanifiable indicators for both Monitoring and Evaluation purposes, as needed, to permit the measurement of progress toward meeting benchmarks, attaining outputs and achieving project objectives.

3. Service as liaison person between A.I.D. and: the TA/Training Consulting Firm and Team, BB, NCBs, IDA, and IMF, as well as with the A.I.D. IPP Project Manager.

4. Vet the work of the Consulting Firm and Team to insure proper compliance with A.I.D. rules and regulations as well as the substantive progress of the project.

5. Arrange for facilities to support the Chief of Party/Team Leader.

Training Specialist, Training Component

Time Frame: The Project will provide two long-term expatriate consultants for 24 months. Total 48 person months under Training Component. Training Consultant arrives Dhaka approximately by January 1991.

Qualifications:

A. Academics: Advanced degree in Social Science. Selection will be based on training specific experience.

B. Experience: At least five years experience in coordinating training activity is required. Ability to cooperate and to maintain liaison with related organization is helpful. Excellent writings, communications and pleasant personality are desired.

Duties: One of these two Training Specialists will:

1. Coordinate the entire training activity of the program.

2. Maintain liaison with BIBM and the NCB management.

3. Cooperate with the training academies of BB and NCBs on upgrading their courses and improving their course material.

4. Collaborate with other training institutes and with the Managements of BB and NCBs in pinpointing the need for in-country and overseas training.

5. Participate in the candidate selection process.

The other Training Specialist will be assigned to BIBM:

6. To train NCB and private bank personnels.

7. dTo develop new courses and up-grade existing course material.

8. To work with the faculty in implementing the new course offerings.

Both consultants:

9. Would be engaged in up-grading Bangladesh Bank Training Academy.

10. Will make training available to private Banks, BB and NCBs.

11. Will strengthen the skills base of the bank training academies plus BBTA in areas such as accounting and MIS; Credit Analysis, Loan Pricing, Loan Administration, and Portfolios Supervision. Among other areas of Training are Performance Planning and Budgeting, Term Lending, Public Sector Lending, and Agricultural Lending.

E. SOCIAL ANALYSIS

SA1. Social Soundness Analysis

SOCIAL SOUNDNESS ANALYSIS

I. General Attitudinal Issues:

As with all policy reform projects, the FSC-TA efforts to support financial reform can only demonstrate their actual feasiblity during the course of Project implementation. The Project strikes at one of the central problems of the society and the economy and, as such, there are in the Government and the banking system both gainers and losers. Even after nominal BDG acceptance of the Project, its actual outcome could be decided on the basis of a protracted conflict among these interests during implementation. The Mission believes there is a very good chance of success; however, given the power of those who would like to avoid such changes, the possibility of failure has to be taken into account. One must recognize that the implementation process will prove a continuous struggle.

It must be recognized that in Bangladesh any program of privatization could lead to potential labor problems. Over the years, bank employee associations have grown up; these are generally well organized and able to mobilize employees to support wage and other demands: frequent 'Hartals' or strikes attest to that ability. These organizations have, as primary goals: preservation of their jobs; establishing, where possible, promotion through seniority rather than performance; and increasing compensation. These employee organizations currently perceive that divestiture of the NCBs would weaken their ability to achieve the above goals.

However, there are some persuasive arguments that can be made to the employees that neither jobs nor salary levels need be diminished as a result of Project operations: first, the need for more debtor information and loan collection efforts will tend to increase both the amount of work available and the skill level, hence compensation, of such work; second, the expanded volume of loans made possible by improved cost recovery will require more and better qualified employees. Moreover since, during the lifetime of the Project, the number of shares of the NCBs to be marketed will be limited, nor will any substantial adverse personnel changes be made, there should be ample time to head off any potential labor unrest.

The financial sector is characterized by substantial skilled bank officer cadres (almost exclusively male - even in the Grameen Bank, which is primarily oriented toward making small loans to female-run enterprises). Many of these officers have been recruited into banking activities elsewhere, particularly the Middle East. For day to day branch management and basic mid-level banking skills, the Bangladesh financial system is in good shape.

However, in addition to the financial and technical problems discussed earlier in this Project Paper, the present financial system supports three types of social and political behavior which work against Bangladesh's objective of constructing a prosperous, equitable society:

(a) There is frequent intervention in the financial system by the politically or economically powerful to sanction loans to or block loan recovery from favored persons.

(b) The financial system has been used to co-opt the rural elites to support the center. This phenomenon began in colonial times and has continued ever since in one guise or another. This approach is incompatible with the development of a banking system able to direct resources to projects yielding the highest returns.

(c) There is a widespread belief that banks should not be profit making institutions but, instead, have an important role to play in distributing benefits to the general population, irrespective of whether the recipients are productive, or involuntarily non-productive, or simply greedy. This attitude has contributed greatly to the erosion of basic financial discipline. The viewpoint is manifest both in the positive sense of willingness to lend to the genuinely disadvantaged (except for women, who remain effectively outside the system), and the negative sense of unwillingness to force existing establishments, no matter how uneconomic, into bankruptcy (or even increased efficiency), on the ground that such actions could increase unemployment. The Directors of the NCBs often support the view that it is the banks' responsibility to protect the poor (and/or the improvident), rather than recover funds for future on-lending or maximize profits.

(d) There is an extremely myopic time horizon among the vast majority of the banking sector. They are simply unable to project the ways in which the forgiven or uncollected loan of today relates to the loan that will not be able to be made tomorrow, because the funds have all dried up.

II. Gender Issues:

Two areas of women-in-development concern will be addressed in the course of implementation of this Project.

A. Employment Opportunities:

At Project inception, a data profile will be established, analyzing the rates of hiring, promotion, areas of substantive responsibility and decision-making authority, as well as the actual numbers of professional and clerical female employees in BB and the NCBs. The data will be broken out by individual bank in comparison with its male employees. This baseline data will be re-examined at the time of the first fomal Project Evaluation to determine if improvements are being made in these areas as a result of the emphasis to be placed on reforms therein in the implementation of Project TA and Training. Necessary remedial steps in areas of hiring, training, promotion, etc. will be identified.

It must be recognized at the outset that the entire area of womens' rights presents some extremely intractable problems, going far deeper into society than the workplace itself. It begins with differential access to scarce food supplies for male and female children, with the latter far more likely to suffer the long term effects of malnutrition. It continues with access to even the most basic education, which is frequently denied to girls. And it is expressed throughout the life cycle in social attitudes limiting the place of women to the home and a few traditionally acceptable "female" occupations. Therefore, the task of finding qualified women to hire, train and promote will be one for the long term. A fine line will have to be drawn between pushing as hard as possible to achieve the maximum equity in the minimum time, without pushing so hard as to engender a reaction that could actually retard desirable progress.

As the financial sector grows and employment opportunities increase, access to jobs, at least in entry level positions, e.g., as accountants, bookkeepers, tellers, and financial analysts, must be the subject of such affirmative action programs as are possible in the real world of Bangladesh. The demonstration of female ability to do these jobs as well as male counterparts will lead, eventually, to an increase in the number of job opportunities for women seeking managerial and other advanced positions.

B. Access to Credit:

The second area of gender consideration will be to establish a framework to determine if women loan applicants and eventual borrowers are receiving equal treatment in obtaining credit. At Project inception, baseline data will be developed to ascertain the proportion of women to men as applicants for and successful recipients of loans; differential rigor in evaluating applications; differentials in the purposes for which loans are approved; differentials in repayment rates.

In Bangladesh, as in many other developing countries, part of the problem in women's access to credit is the unsatisfactory performance of the financial sector as a whole, a situation which the Project will attempt to alleviate. Beyond that, certain specific constraints to formal credit have been found worldwide to be particularly limiting to women:

(i) Collateral requirements may be impossible to satisfy when they are in the form of a house, land or other property, which women are frequently not in a position to own.

(ii) Formal credit institutions may not have programs responsive to the types of work done or businesses run by women. The Grameen Bank is the exception in Bangladesh that helps prove the rule worldwide.

(iii) Social customs frequently restrict women's participation in formal credit systems.1

(iv) Large transaction costs for servicing small or new borrowers may discourage lending to women because they are often both new and relatively small borrowers.

(v) Due to sex segregation in labor markets and occupation structures, women are more likely than men to lack profitable investment opportunities. In some cases, women may be unfamiliar with the concept of borrowing money in the formal sector, since credit programs tend to be publicized through men's networks.

To the extent that these constraints apply largely to women involved in very small or cottage industries, this Project (unlike Grameen) will not have immediate impact. However, as the country's economy grows and the role of the formal financial sector becomes more important, access to credit for both sexes and all size businesses will become critical. It is at this time that gender discrimination, as derived from analysis of results flowing from the Project measured against the baseline data previously developed, must become the object of such affirmative action programs as are possible in the political and social context of Bangladesh.

F. COMPUTER ANALYSIS

CA1 Computerization Plan for NCBs
CA2. Analysis of Computerization Bangladesh Bank
CA3. Analysis of Computerization Rubali Bank
CA4. FSC-IRM Approval
CA5. IRM-Analysis of Computerization Component
CA6. Electrical Installation

This is a summary of the Computerization Plan for the NCBs, USAID/Dhaka Office of Economics and Enterprise.

COMPUTERIZATION PLAN FOR NCBs

1. BACKGROUND

One of the major objectives of the Technical Assistance (TA) and Training to be furnished to nationalised commercial banks (NCBs) under the Financial Sector Credit - Technical Assistance (FSC-TA) Project is the development of computer-based management information and accounting systems.

The need for such systems flows from the fact that there are currently major information inadequacies within the basic accounting systems of the NCBs, which are compounded through the whole process of aggregating financial results and preparing MIS reports. Consequently, the statements of affairs produced regularly at branch level, and consolidated by head offices, frequently fail to contain vital information relating to disbursements and recoveries, overdues, principal and interest components, and funds committed but not yet drawn down. Furthermore, each NCB branch is self accounting, which gives rise to a problem in reconciling inter-branch problems. The MIS systems are extensive, but largely unfocused. In particular, there is inadequate data on loan performance. The NCBs aggregate most accounting data manually in a time consuming process. For example, Janata Bank utilizes approximately 9,000 man-hours and six/eight weeks to aggregate branch statements of affairs. Even after all this effort, the outputs are not in a useful form. The reports do not integrate accounting, MIS and performance budget data so that they can be easily used for management control purposes. Also there is little structured feedback to branch and zonal offices. Under such circumstances, a network of microcomputers could be set up at NCBs to handle the aggregation of branch level data and the preparation of reports that can be utilized for management control, structured feedback and performance evaluation.

Some NCBs have been using a program of branch computerization, with certain transactions of several branches being processed centrally on the HO computer, and one branch going live with an interactive system, again using HO computer. Eventual computerization of the larger branches in all of the NCBs is essential for adequately handling the volume of transactions.

In order to determine needs more precisely, a Mechanisation Committee comprising officials of the Bangladesh Bank (BB) and NCBs identified the areas for computerization and determined a phased programme of computerization according to the priority of jobs.

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As a result of the assessment, some corrective steps have already been taken: Among the NCBs, Agrani Bank has computerized a number of jobs. Sonali Bank and Janata Bank have designed computer development programs identifying the hardware and software requirements and the cost likely to be involved for installation of computers having the required configuration. The Rupali Bank has computerized several jobs using the services of the Bangladesh Bank computer.

2. OBJECTIVES

The objectives of this Technical Assistance are to: (i) examine the extent to which the present computer facilities and those expected to be available in the near future would meet the data processing requirements of the NCBs, keeping in view the recommendations of the Mechnisation Committee and the reforms to be carried out in the financial sector; (ii) assess the needs, if any, for additional hardware and software requirements, in particular for the computerization of branches and/or regional offices, ascertaining whether the main NCB computer systems can be interlinked with on-line terminals/micro computers of a number of branches, given the existing telecommunication system; (iii) examine whether the existing and expected computer facilities of the NCBs would enable them to have direct access to the Credit Information Bureau computer file maintained in the Bangladesh Bank through on-line terminals and, if not, suggest an alternative plan; (iv) review the manpower requirements and available training facilities and recommend appropriate training, in particular the feasibility of establishing specialized computer training for financial institutions at Bangladesh Institute of Bank Management (BIBM) as well as the need for external training.

3. TASKS

3.1. Evaluation of NCB computer operations:

a) Review the present computer facilities and the proposed facilities of the NCBs.

b) Evaluate the available and planned hardware and software based on the Mechanisation Committee's recommendation and the Financial Sector Reform Credit - Technical Assistance (FSC-TA).

c) Examine the flow of information from the NCBs to the Bangladesh Bank and determine the possibility of providing such information in computer-readable form. Determine additional hardware or software at both BB and the NCBs necessary to achieve this transfer, including use of the telecommunications system.

d) Review the existing plans of the NCBs for maintenance and servicing of their installations and comment on their adequacy.

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3.2. Assess the needs for additional equipment:

a) Based on the above evaluation, the consultant will identify any additional equipment requirements needed to meet the Mechanization Committee's program.

b) In preparing the equipment requirement (including software) the specifications for equipment would be given; a capital cost estimate would be prepared (purchase price, shipping, insurance, and import duties); and the necessary maintenance and service programs defined.

c) Examine the feasibility of using micro-computers at branches. This will include: (a) Use of the micro-computer as a terminal linked to the bank Head Office (HO) computer; (b) Use of the micro-computer standing alone to maintain branch records, transfering data to the Head Office through computer readable media, possibly, but not necessarily, utilizing the telecommunications system. If the assessment for the branch computerization is favorable, the capital and maintenance costs will be estimated.

d) Recommend criteria to the NCBs on the selection of branches for computerization. Based on discussions with NCB officers identify 2-3 candidate branches for each NCB consistent with the recommended criteria.

e) Examine the feasibility of using micro-computers at regional bank offices to maintain records, and aggregate branch data. The micro-computer would produce diskettes containing information which would be inputted into the main HO computer. If the assessment for the regional office is favorable, estimate the capital and maintenance costs.

f) Recommend criteria to the NCBs for selection of regional bank offices for computerization. Based on discussions with NCB offices, identify 2-3 candidate regional officies for each NCB consistent with the recommended criteria.

g) If requested, make recommendations on hardware and software requirements for the computer set up of the Bangladesh Bank.

3.3. Linkage to Credit Bureau:

a) Examine the data flows expected between the banks and the BB with respect to the Credit Bureau operated by BB. Determine the feasibility of linking the bank computers with the BB mainframe to manage this data transfer.

b) If the linkage examined under (a) is feasible, recommend any equipment required not previously suggested (under Task 2). This should include capital and maintenance cost.

c) If the linkage examined under (a) is not feasible, recommend alternative systems by which input data to the Credit Bureau is provided to BB and credit checks can be quickly made. In designing such alternative systems, the Consultant shall consider the cost of different speeds of answering credit check requests (e.g. 2 hours, 4 hours, 1 day etc).

3.4. Manpower requirements and training:

a) Based on (i) the NCBs' computerization plans and the Mechanization committee's phased program of tasks to be computerized and (ii) Bangladesh Bank's computerization plan, the Consultant shall determine the manpower requirements necessary to implement the programs. Manpower categories will be identified by the Consultant, but will be consistent with the National Computer Council's manpower schedules.

b) Based on the manpower requirements, the Consultant shall examine the hiring and training need to meet such targets. Training will include the effort needed to introduce computerization into the present system as well as the continuing training requirements as computerization continues. Explicit assumptions shall be made as to the rate of computerization of branches and regional offices.

c) Alternative methods of providing the training will be examined and recommedations made. In particular, the establishment of a "computer training for financial insitutions" wing at BIBM will be considered. This review will include: faculty requirements, computer requirements, space availability at BIBM, training materials etc. The Consultant will make recommendations on the feasibility of using BIBM or other organizations for such training.

3.5. Staffing Requirements and Schedule:

One international expert (System Analyst) is required for 4.5 person months, plus one national expert (sub-contract) for 4.5 p/m. The work will be divided into three stages:

Stage I:	Dhaka 2.5 p/m Research, discussions, meetings.
Stage II.	Washington, D.C. 1 p/m Cost analyses and specifications/report drafting.
Stage III.	Dhaka 1 p/m Presentation of draft report, revisions, and final report presentation.

This work will be in conformity with the above three stages; during stage 2 the local expert will concentrate on analysis of maintenance and service costs as well as cost elements of the training programs.

FSC-TA

ANALYSIS OF COMPUTERIZATION

BANGLADESH BANK

THE EXECUTIVE SUMMARY OF THIS ANNEX IS APPENDED HERETO - THE ENTIRE ANNEX IS IN THE BULK FILE OF THE USAID/BANGLADESH OFFICE OR PRIVATE ENTERPRISE, LABALED DETAILED COMPUTERIZATION PLAN FOR BANGLADESH BANK AND NCBs.

1.0 EXECUTIVE SUMMARY

In the attempt to improve the banking system and develop an accurate and effective information system on the financial sector, the Financial Sector Reforms Project has diverted part of its activities to upgrading the computing capabilities of the Bangladesh Bank. Coupled to this is the assistance to NCBs in providing fast and accurate supporting information to the statistical requirements of the central bank.

The present mainframe in the bank has technically reached obsolescence with the strain on resources providing the necessary lifeline for the upkeep of the system. High maintenance costs merged with low utility factors have rendered the system economically and operationally unfeasible.

The studies on the running of present applications and the future of computerisation at Bangladesh Bank have clearly indicated a complete changeover to a modern on-line mode of operations (as opposed to the present batch mode) creating the possibilities of on-line Management Information Systems. The new system will allow phased upgrades in the future in the form of physical add-ons allowing for a longer systems life and reduce the risks of application obsolescence.

The recommendation is to decentralise the present operations making each department responsible for its own inputs and outputs while a central monitoring system oversees data integrity and compiles management information systems for administrators. This ensures a continuous running of applications and a smooth changeover to the new system averse to shutting down the computer for an extended period of time while hardware is exchanged and systems adapted to the new computer.

As real-time on-line processing requires uninterrupted power, the cost of smaller uninterrupted battery operated power backup systems on decentralised systems has been a major point of consideration.

FSC-TA

ANALYSIS OF COMPUTERIZATION

RUPALI BANK

THE EXECUTIVE SUMMARY OF THIS ANNEX IS APPENDED HERETO - THE ENTIRE ANNEX IS IN THE BULK FILE OF THE USAID/BANGLADESH OFFICE OR PRIVATE ENTERPRISE, LABALED DETAILED COMPUTERIZATION PLAN FOR BANGLADESH BANK AND NCBs.

PART — II

RUPALI BANK

1.0 *Executive Summary*

The Nationalised Commercial Banks are an integral part of the Financial Sector Reform Project, a portion of its activities being the improvement of monitoring procedures within the banking sector. Raw data and processed information are used and cross-referenced by the Bangladesh Bank while processing statistical information for decision making purposes.

Rupali is presently running some applications on the Bangladesh Bank's mainframe. Obsolescence of this mainframe is imminent making it imperative for Rupali Bank to off loads its work either onto another existing system or to install its own configuration to meet its' present and future requirements.

The studies on the running of present applications and the need for further computerisation clearly support the recommendation that Rupali have its own installation with a view to supporting its own Management Information System in the near future. Rupali then carried out its own feasibility study and approached the National Computer Board (NCB) for permission to purchase a mini-computer and upgrade it in a phased approach to computerisation.

The NCB, after scrutinizing documents produced by Rupali Bank supporting it's need to computerise, suggested that the bank consider a micro-computer approach to real-time, on-line banking at the local and head office levels. Without any supporting evidence of the methodology to this approach, these recommendations are considered unrealistic by the authors of this report.

The recommendations in this report on hardware are based on the interest of maintaining a standard within the banking industry and are similar to recommendations made to other NCBs after carrying out studies on their computerised banking requirements.

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E.O. 12356: N/A
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SUBJECT: FINANCIAL SECTOR CREDIT - TECHNICAL ASSISTANCE PROJECT (388-0078), STRATEGIC PLANNING WORKSHOP

REF A) KEMP TDY 5/15-5/26
... B) DRAFT TDY REPORT 5/25/89

1. AS DISCUSSED DURING REF A), IRM CONCURS WITH THE OVERALL AUTOMATION PLAN ESTIMATED TO COST USDOLS 2 MILLION FOR HARDWARE/SOFTWARE AND 1.2 MILLION FOR COMPUTER TECHNICAL ASSISTANCE. TO ENSURE THE EVENTUAL PROCUREMENT IS CONSISTENT WITH THE CURRENT COMPUTERIZATION PLAN, WE SUGGEST THAT THE COMPUTER TENDER DOCUMENTS BE REVIEWED AGAIN BY IRM WHEN THEY ARE IN THE FINAL STAGES. FURTHER, IRM WILL ENSURE THAT THE TECHNICAL TOPICS DISCUSSED IN REF B) HAVE BEEN ADEQUATELY ADDRESSED.

2. ALSO AS DISCUSSED DURING REF A), IRM WOULD BE DELIGHTED TO ASSIST IN PUTTING ON AN ADP STRATEGIC PLANNING WORKSHOP FOR HOST COUNTRY PARTICIPANTS INVOLVED IN THE BANKING SECTOR IN BANGLADESH. WE ARE FORWARDING A COPY OF THE COURSE TEXT FOR YOUR REVIEW. PLEASE ADVISE.

3. IF WE CAN BE OF ADDITIONAL ASSISTANCE OR YOU HAVE ANY QUESTIONS, PLEASE DO NOT HESITATE TO CONTACT MITCHELL KEMP OR MYSELF AT (703)875-1552. REGARDS.
(DRAFTED BY M/SER/IRM: [redacted]OE GUERON) BAKER
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FSC-TA

IRM ANALYSIS OF COMPUTERIZATION COMPONENT

Summary:

IRM analyst Mitchell Kemp conducted a two week TDY (5/16/89-5/26/89) to review the automation component of the FSC-TA project. The overall automation strategy is sound and IRM concurs with the efforts automation plan estimated to cost $2 million for hardware/software and $1.2 million for computer technical assistance. To ensure that the eventual computer procurement is consistent with the current computerization plan, IRM suggests that the computer tender documents be reviewed again by IRM when they are in the final stages. In addition, IRM suggests that the Computerization Plan discuss the topics detailed below:

1) Procurement Plan:

Responsibilities of the Procurement Services Agent:
Finalize RFP
Develop Evaluation Criteria
Assemble Evaluation Committee
Conduct Fair and Open Competition

2) Information Requirement Specification Between BB and NCB's:

A critical task which will eventually facilitate data communications between the Bangladesh Bank and the National and private banks is the establishment of agreed upon information requirements. That is, what information is required by the central bank to fulfill its management information goals. In order to accomplish this, a task must be identified to formally: a) identify data requirements; b) create a data dictionary; c) specify data exchange mediums; and d) define the data administration policy.

3) Training Personnel:

A need has been identified for a person to lead the training effort directed at the Bangladesh Bank and the NCB's.

4) Strategic ADP Planning Exercise:

5) Resource Allocation:

Develop a plan which allocates personnel resources by task.

6) Use of CASE tools and 4GL:

Discuss the introduction of CASE tools into BB.

7) Operating System Specifications:

Multiuser/Multitasking
Virtual Storage
Communications Support
Security
Audit Functions
Error Recovery
Language Support
Device Support
Editors, Compilers, Utilities
Number of Users

8) Data Base Management Specifications:

SQL Based
Report Generator
Data Entry Screen Generator
Menu Generation
Import/Export Formats (Dbase, ASCII, Lotus, etc.)
Auditability Requirements
Record Locking, Before Image Mapping Requirements
Transaction Processing
Language Support (Cobol, C, Assembler, etc.)
Spreadsheet Support

9) Data Communications:

Internal
- LAN Support
- Support for Local PC's

External
- Asynchronous Communications Support
- X.25 Support

10) Hardware Specifications:

Specify memory requirements as those above that required by the operating system and system software
Bilingual Capability (only if necessary)
If advertised in the States, be sure to specify 220/50hz power supply

11) Terminal Specifications:

Function Keys
Lines per screen, characters per line
Color,
Language support
Graphics

Strategic Computer Planning Workshop

The Bangladesh Bank and the National Commercial Banks are in a position where top managers need to begin strategizing on how to introduce or improve the use of computers within their organizations.

IRM has developed a course for ADP strategic planning which recently was successfully piloted within the Indonesian Ministry of Education. The course is designed to help host country managers learn how to introduce and manage automation in their institutions.

The couse is designed for middle to senior level managers and applies a critical success factor methodology to computer systems implementation and management. Attendees of the workshop learn methods of how to identify automation goals and objectives, and how to design and implement organizational strategies to achieve those goals. The workshop can be customized for a specific application, such as banking, or for various durations - usually three to five days.

Recommended class size for the workshop is 18 persons. IRM suggests that two to three individuals from each bank be invited and that invitations be extended to the Bangladesh Bank, the NCB's and the private banks.

The costs associated with running the course are typically:

Reproduction/Transportation of Course Materials	$2500
Salary, Travel and Expenses for two instructors	10000
Rental of meeting rooms	2500
Customization of materials (if required)	5000

*Under some circumstances IRM has been able to assist with some of the costs.

Automation Procurement Strategy

Several key transitions are taking place in the next few months which escalate the importance of a sound procurement strategy. Among the transitions are: the project officer - scheduled departure July 1989; and the current project team - phased departures in July thru December 1989. The new project officer is scheduled to arrive in September 1989.

1) TA - It has been determined that the new TA staff needs to be on-site prior to the procurement of hardware and software for the NCB's, but not before the procurements for the Bangladesh Bank. It is currently unclear as to when the actual procurement for the TA will take place and when TA will arrive on-site. It is hoped that the TA will be in Bangladesh before the end of 1990.

2) Procure Hardware/Software for the Bangladesh Bank - The bank's existing computer system will not be supported after the end of 1990. Therefore, in order to ensure that the new system is installed prior to this time, an RFQ for the BB hardware/software should be prepared now, so that when the project is approved, tenders can be solicited immediately. To guarantee continuity for the procurement, a computer specialist should be retained to finalize the procurement documents and oversee the procurement and installation process.

3) Procure Hardware/Software for NCB's - The TA contractor will act as a Procurement Services Agent to conduct these procurements. Given the varying nature of the four banks, these procurements may be conducted seperately or together. To facilitate the procurement process, it is suggested that the TA contractor be given authority to procure off the GSA schedule.

- A6.3 -

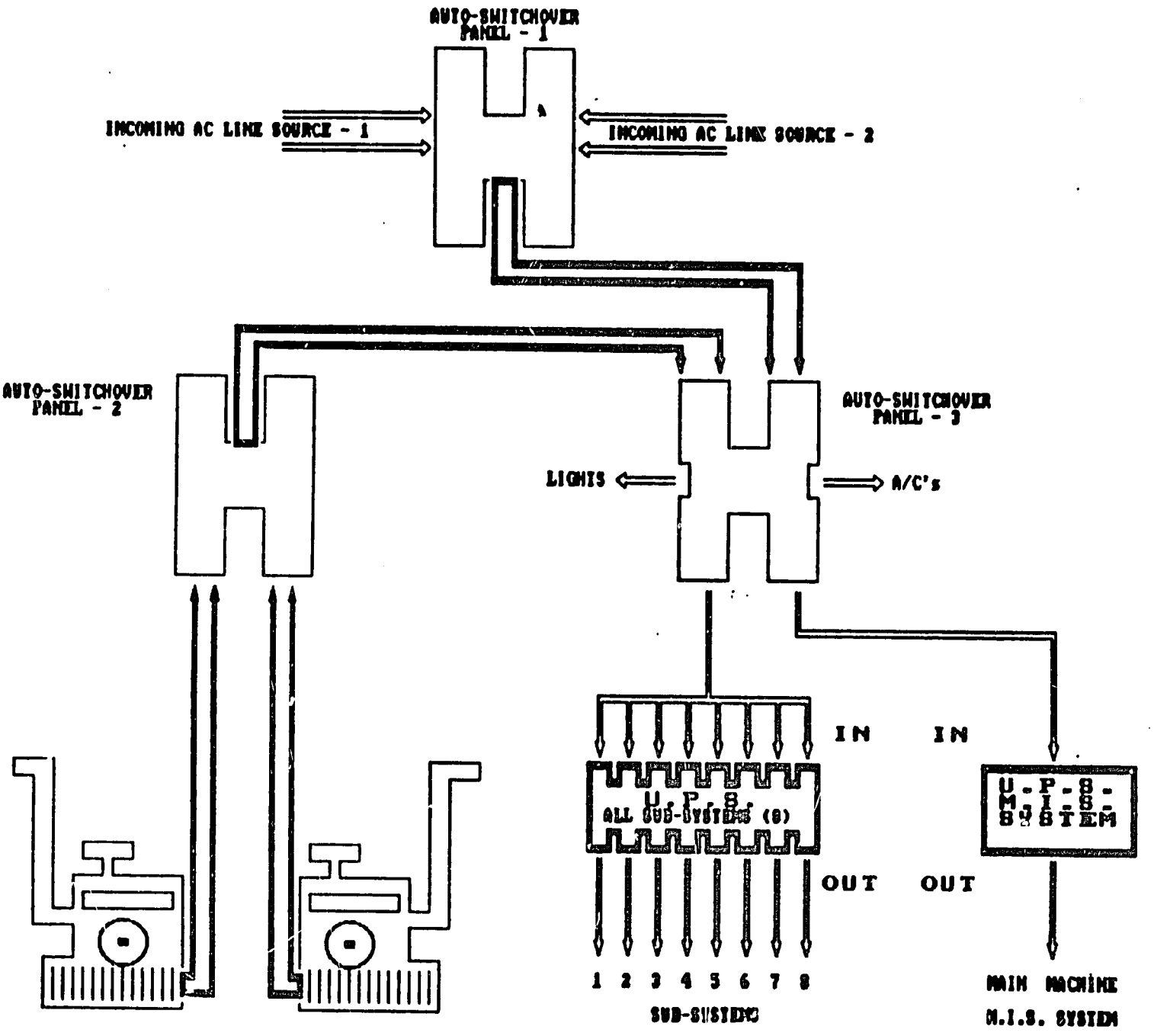

FIGURE SHOWING THE BASE ELECTRICAL CIRCUIT DIAGRAM FOR THE NEW INSTALLATION

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