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# LOAN RECOVERY IN THE RURAL FINANCE SECTOR

Rural Finance Project Phase II

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# Preface

This paper is the second in the RBBUS series dealing with Loan Recovery. The results presented in this paper covered various types of loans made by scheduled banks in rural areas. Some of the survey results on rural manager opinions are also discussed.

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# Loan Recovery in the Rural Finance Sector

Introduction: This paper summarizes and discusses some of the findings of the Rural Finance Project with respect to loan recovery. We begin with an analysis of some of the loan recovery data collected in the RFP's Rural Bank and Bank Users Survey, including the opinions voiced by regional and branch managers. This is followed by a discussion of six factors which may influence the loan recovery situation. Finally the policy approaches to improved loan recovery are discussed. Throughout, emphasize is given to two aspects of loan recovery: (1) Determining the reality of the existing situation. (2) Working out what actions are practical and effective within this reality. Much of the discussion of loan recovery is either unrealistic or is concerned with by-passing the problem: Many current programs seek to achieve major improvements in an unrealistic time frame. Reiteration of high targets to be achieved are of no value and indeed are a continuing confusion between reality and verbal pronouncements. Alternatively one despairs of any chance of improvement, putting the blame on the inevitible interference of the political authorities. The problem can be simply put: Loan recovery must be improved or the results for rural Bangladesh are a disaster. However, this cannot be done overnight or by exhortation. Instead it requires proper identification of the interrelationships of the many factors effecting the system and realistic actions over a protracted period of time...

The rural finance system in Bangladesh has four components or sources of funds :

a) The family or friends. Historically this has been important, but as development progresses this must becomes less and less important. The reduction of the share of such lending is desirable for the financial sector is most effective when it is impersonel and prices (interest rates) adjust to market conditions. Although the point is worth contemplation, economic progress must trample over relationships which are not at arms length. The replacement of the family by the market for lending is one aspect of this.

b) The traditional curb markets, which make loans outside the scheduled banking system, usually for interest rates considered very high. But this market is flexible and responsive to the borrowers needs. You pay more, you get more.

c) The formal financial institutions of which the four NCBs and BKB are those active in rural areas. Although at present there is no private banking in rural areas the development of such banks would be desirable.

d) The intermediate operations of NGOs or special banks such as the Grameen bank, which have a particular point of view as to how to effect change in rural Bangladesh and have a much greater degree of supervision over the uses of the loans.

rural history

It is useful to begin with a few comments on the rural finance system as is today and as it has evolved over the past decade. This definition of rural as applied to the formal banking financial sector means the inclusion of those branch banks which are located outside the municipal areas. This is one of the common definitions of rural used in statistical compilations for Bangladesh. However, such a definition includes areas with a very urban nature. There are also some municipal areas which have a largely rural character. There is a great deal of non-agricultural economic activity in the rural areas, perhaps one third of the labor force is employed in such sectors. Yet one finds in the rural branches a very heavy concentration on agricultural lending. Concepts of urban and rural identified with non-agricultural and agricultural economic activity are increasing inappropriate for Bangladesh. Such an identification leads to concentration on lending to farmers and comparative neglect of small businesses. One should recall that the non-agricultural labor force in rural areas is larger than the labor force in urban areas. At present the formal sector is doing relatively little in financing non-agricultural activity, particularly light manufacturing. Instead it appears that the curb markets, including the marketing system, provides the necessary finance. It is very important to realize that rural economy is far more complex than farmers growing crops and the formal banking system must expand into these areas.

Historically the money lender, in one guise or another, has supplied high price credit used by the rural population to handle emergencies or for short term credits needed for trade. A wide variety of instruments emerged in South Asia to provide such loans. The high charges and general belief in the exploitative nature of the money lending operations soon led to a recognized need to deliver formal credit to rural areas. The formal markets' access to lower cost funds and the supposed economies of scale were to make the formal markets viable at much lower interest rates. Perhaps it was also recognized that this permitted the central authorities to exert considerable political influence on a local level. By charging lower interest rates the farmers would be able to invest more in increasing crop production and to raise their productivity. Acceptance of loans to be used with a new technology at high interest rates, it was judged, would be difficult; farmers are wary of the environmental risks and are only ready to move towards more aggressive use of new production technologies when the promised returns are very high. The curb markets charge such high rates that the potential productive investments in agriculture are not feasible and agriculture remains caught in its traditional technology. The existence of new technologies: High yielding seeds, pesticides, fertilizer, motorized methods of tilling and mechanical irrigation equipment all made the need for credit more acute. However, the real money to be made in rural

Bangladesh is through land speculation where the potential capital gains are very large. This has led to a number of strategies by money lenders and development of a number of financial instruments which tend to shift control of the land to the money lenders and richer members of the population. In particular, many money lenders attempt to gain control over the economic value that a man can generate above his minimum subsistence needs without necessarily gaining legal ownership of the assets.

The expansion of the formal rural credit system has taken place in response to a number of themes in development economics :

a) The growing belief , particularly with new rice and wheat varieties, that there are very high returns to be gained from investment in new crop production. More generally the belief that there are a large number of new technologies available for rural areas, the introduction of which requires credit and supervision.

b) The disenchantment with medium and large scale industry as the basis for development and the desire on the part of many development experts to put more emphasis on investment in rural areas. In particular the idea of mobilizing resources in rural areas and investing these in urban areas has become increasingly viewed as inappropriate.

As experience was gained with a large rural banking system organized with numerous, small branch banks, each reporting to its centralized head offices, a number of problems emerged: (1) In some countries including Bangladesh mobilization of financial saving in rural areas was limited by low and often negative real interest rates. (2) Selection of borrowers was difficult due to the shortage of bankers with much knowledge of agriculture. (3) Poor recovery rates. With difficulties in recovering loans and increasing pressure from Government to disburse, the financial system never solved the problem of recovery of loans identified by persons outside the banking system. Poor loan recovery has one terrible consequence - it leads to deterioration in the quality of loan use. This is a most dangerous outcome for it undermines the single most vital aspect of a financial system-allocate resources to good projects i.e. those with high rates of return. If project quality could be maintained in the face of poor recovery then the issue would be less vital. But it is recovery of a loan that is the only real evidence of its proper use. The branch never has the knowledge to judge success of the loan to increase production; only the demonstrated capacity to repay provides evidence of loan quality.

With the somewhat disappointing experience of the formal credit expansion one response was to argue that there was need for much more supervision of the borrowers' activities. There were many arguments for supervised credit. However, the banks' capability to provide such supervision is very limited. The NGOs built their programs on the belief that greater attention to loan use was the basis for earning a high return to the borrower and insure recovery. These programs are generally reported to be successful both in project quality and the rate of loan recovery. However, as mentioned below there is some uncertainty as to the comparability of recovery rates. Also, as NGO programs are small and run by dedicated persons their sustainability and true costs are often in doubt. Put another way these programs are excellent indicators of what can be done with credit programs but it is not clear that these are expandable, reproducible, or economic.

The issue of NGO effectiveness and cost is an essential question in the development of rural finance. The assumption in this paper is that the formal banking system with profit maximization by managers, is the correct way to develop the rural finance sector. Explicitly rejected are :

1) A formal financial system subsidized by Government
2) The encouragment and development of the curb markets
3) The development of a network of NGO(non-profit) projects.

We do not in this paper argue in a detailed way why these three are rejected. But the point here is not to justify the assumption but rather to make it clear that it is an assumption. In Bangladesh the present position is the above three rejected models are all in operation: The formal system is heavily subsidized, the informal money markets thrive, and there is a widespread NGO network. What does not exist in rural areas is a profit maximizing formal financial system.

What motivates the choice of a profit maximizing, unsubsidized formal banking system? The informal money markets cannot mobilize the volume of funds required in rural areas, nor are they able to judge projects on the basis of potential profitability nor to identify the relevance and scope for technological innovations. Thus projects aimed at raising productivity will find finance difficult and costs prohibitive. If this were not so, then the rural development problem would not exist, the curb markets would finance the technological change. The NGOs are probably very expensive and furthermore can not really provide the volume of credit required. The subsidization of the formal sector has the consequence of reducing pressure for loan recovery and consequently undermining the quality of the credit. One may believe that in theory it is possible to have good loan recovery within a subsidized system. But all of the factual evidence suggests the reverse: The consequences of the failure to recover loans are covered over by the subsidies and the financial institutions feel no real pressure within their internal management to improve recovery. In Bangladesh the true profit position has been hidden by accounting practices, so the sources of the subsidies are obscure. Although at one level everyone knows that bank profitability in rural areas is an illusion, this does not change the behavior patterns of bank staff.

To more towards a profit maximizing rural finance system which makes adequate positive profits, the first necessary but not sufficient condition is to improve loan recovery. At present recovery rates financial viability is impossible. One cannot over emphasize the tragedy for rural Bangladesh if the poor loan recovery continues. There is no more effective way to hold down and exploit the farmers than to allow them to fritter away the investible resources. At issue here one can say is the future of the nation: Without improved loan recovery the saving available for investment will be poorly used. Rather than doing the farmers a favor by acquiesing in the poor level of recoveries, the Government inadvertently blocks progress by the casual approach to recovering loans. The issue of loan recovery has become in Bangladesh the lynchpin of successful rural development.

The present situation with loan recovery

The measurement of loan recovery is quite complex. In this section results from one of the Rural Finance Project's field surveys are presented. Two types of data are given: Recovery measured from a sample of loans, and loan recovery as reported by a sample of 100 branch banks. For the first type results are given in three categories: short term agricultural loans, term loans, and overdrafts. For the second type results are given for short term agricultural loans, and medium and long term agricultural loans.

Existing data on loan recovery is usually presented as the ratio of recoveries to amount due. This data is collected through branch reports to head office. The head office aggregates branch reports; in turn the ACD/BB aggregates the individual bank returns. The resulting data is in value terms; coverage of branches is incomplete and the concept of the amount due is not always consistent. The data presented here in Tables 1-4 is based on the number of loans and the recovery ratio of individual loans (balance outstanding/ original principal).

Table 1 presents a summary of the data on the recovery position of a probability sample of approximately 6,000 loans drawn from the short term loan portfolios of the rural branches. The table arranges the data by the disbursement year and the ratio of balance outstanding to original principal. The first three rows give respectively the percentage of loans (number) repaid, loans not repaid and the percent of total disbursed loans in the sample which were disbursed in each of the six years 1979-1984. This data refers to the number of loans not to their value. As this data is organized by calender year and it was collected approximately the end of 1985, the average loan in say 1982 is 3.5 years old or 2.5 years overdue.

Interpretation of these three lines is simplest considering a model which has two concepts (1) A percent of the borrowers who are not going to repay (called hereafter defaultors); (2) A fixed probability that the remaining borrowers will repay in a given year. Using these two assumptions we estimate that 28% of the borrowers are defaultors and the probability of a loan finally being repaid by a non-defaultor in any year is 41%. This model is consistent with the data. The repayment problem now becomes somewhat simplier to describe: The number of defaultors combines willful defaultors and persons who are unable to pay due to loss of assets or loss of earning power. No evidence is currently available on how to divide the 30% of defaultors between these two categories. Those who are willing to repay do not clear their loans in a single year. Instead these payments are spread out over a 4 year period by which time more than 90% of the loans are recovered. However there remain 30% which will never be recovered. In effect a one year loan has been rescheduled, defacto, without any formal documentation within the banking system.

The next series of entries in Table 1 give the percent of unpaid loans with measured recovery ratio (balance outstanding to original principal). This data shows quite clearly the gradual shift of the recove.y ratio. To interpret this table one should consider 1984 as the starting position (about.5 years overdue). Most unpaid loans have a recovery ratio of .8 - 1.2. As one moves to the left (i.e. towards older loan portfolios) the recovery ratio becomes greater and greater[1/]; this is consistent with the view that many loans are in default and will not be recovered. The mean recovery ratio of unpaid loans increases steadily as shown. We find that the recovery ratio increases at approximately 15% per annum.

The short term loan recovery position is very unsatisfactory. Effectively 30% of the loans will never be collected. It is impossible to have a viable financial system at such a default level.

The recovery data on short term agricultural loans presented here is significantly more pessimistic than previous estimates. To indicate the difference in viewpoint the following lists the probability of a loan being recovered and loans not recovered from 1-5 year.

Percent of loans not recovered after:

| | Probability of Recovery in one year | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Years | .1 | .2 | .25 | .3 | .35 | .4 | .45 | .5 | .6 | .7 | .8 | .9 |
| 1 | .9 | .8 | .75 | .7 | .65 | .6 | .55 | .5 | .4 | .3 | .2 | .1 |
| 2 | .81 | .64 | .56 | .49 | .42 | .36 | .30 | .25 | .16 | .09 | .04 | .01 |
| 3 | .73 | .51 | .42 | .34 | .27 | .22 | .17 | .13 | .06 | .03 | .01 | 0 |
| 4 | .66 | .41 | .32 | .24 | .18 | .13 | .09 | .06 | .03 | .01 | 0 | 0 |
| 5 | .59 | .33 | .24 | .17 | .12 | .08 | .05 | .03 | .01 | 0 | 0 | 0 |

This Table indicates that for a 50% recovery rate, within 3 years one will not recover 13% of the loans. In the past it was believed that 90% of the loans were recovered in 5 years corresponding to 35-40% of the loans being recovered annually. On a comparable basis RBBUS data suggests a recovery rate of 25-30%. This is not a result of changed recovery rates but a more accurate estimate. The difference is very great, while a financially viable system is feasible at ultimate recovery rates of 90% it can never be so at 70%.

1/ A rising mean recovery ratio as defined means less repayment.

Table 1

Recovery Ratios for Short Term Agricultural Loans

(Percent of number of loans)

| | Year of disbursement | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | All |
| Percent repaid 1/ | 66.6 | 69.7 | 63.2 | 62.6 | 42.7 | 27.8 | 49.87 |
| Percent not repaid | 33.4 | 30.3 | 36.8 | 37.4 | 57.3 | 72.2 | 50.13 |
| % of disbursed 2/ | 6.3 | 13.0 | 9.8 | 15.3 | 36.0 | 19.6 | |
| Recovery ratio | | | | | | | |
| 0 - .4 | 6.7 | 3.1 | 4.4 | 2.2 | 3.3 | 6.1 | 4.2 |
| .4 - .8 | 1.7 | 5.4 | 2.5 | 4.6 | 6.5 | 5.4 | 5.4 |
| .8 - 1.2 | 7.5 | 8.9 | 11.8 | 11.4 | 20.5 | 69.7 | 31.3 |
| 1.2 - 1.6 | 15.0 | 16.1 | 17.3 | 59.6 | 66.1 | 17.5 | 42.0 |
| 1.6 - 2.0 | 18.3 | 45.1 | 40.9 | 19.3 | 2.7 | .9 | 10.8 |
| 2.0 + | 50.8 | 21.4 | 23.2 | 3.1 | .9 | .5 | 6.3 |
| % of disbursed | 4.2 | 7.9 | 7.2 | 11.4 | 41.1 | 28.2 | 10.0 |
| Mean | 2.06 | 1.81 | 1.77 | 1.52 | 1.25 | 1.02 | 1.31 |

1/ Time of observation end of 1985/early 1986

2/ Total cases 5,667

Turning next to the term loans the results are presented in two Tables: Table 2 covers term loans which are fully due i.e. at the date of data collection the loan should have been repaid. Table 3 covers term loans which are not yet fully due. The treatment of term loan as overdue, non-performing, stuck-up etc is very judgmental. The results presented here indicate extremely low recovery rates for term loans. In interpreting these two tables the reader should recall that it is the number of loans that is being counted.

For those term loans which are fully due and disbursed in 1979-1983 the survey sampled 310 (Table 2). The recovery pattern is shown in Table 2. Only one of these 310 loans was fully repaid. More than three quarters (76.1%) have recovery ratios greater than 1. Even though due, only 25% of the these term loans even maintain their interest payments. About 75% of these loans seem headed for default.

For term loans not yet fully due the recovery ratio is defined as:

$$\frac{\text{Balance outstanding-Principal not yet due}}{\text{Original principal-Principal not yet due}}$$

If all payments are upto date this ratio is zero. If the ratio equals 1 then the balance due equals the original principal and interest has been paid but no progress made in reducing the principal. The tabulations are given in Table 3. There are a few old loans with repayments upto date. However 72% of the loans are not even repaying the interest on their loans. There is a slight tendency for the recovery rates to deteriorate with the time since disbursement. However, the statistical results support only the split of the loan into 70% with the recovery ratio greater than 1, and 30% less than 1.

The conclusion from Tables 2 and 3 is that recovery position on term loans is very poor, considerably worse than for the crop loans. The most favorable interpretation is that 75% of the loans will not be repaid.

Existing data coming from the banks on recovery of term loans is difficult to interpret as the classification of loans not yet fully due is uncertain.

Table 2

Recovery of Term Loans 1/

Recovery Ratio for Loans which are fully due
(Number of loans)

| | Disbursement year | | | | | |
|---|---|---|---|---|---|---|
| | 1979 | 1980 | 1981 | 1982 | 1983 | Total |
| 0 | 0 | 1.9 | 0 | 0 | 0 | .3 |
| 0 - .4 | 10.6 | 1.9 | 2.6 | 16.7 | 8.3 | 6.8 |
| .4 - .8 | 6.4 | 3.7 | 4.0 | 8.3 | 13.8 | 8.1 |
| .8 - 1.2 | 8.5 | 13.0 | 18.4 | 25.0 | 16.5 | 15.8 |
| 1.2 - 1.6 | 10.6 | 13.0 | 26.3 | 33.0 | 35.8 | 25.5 |
| 1.6 - 2.0 | 12.8 | 51.9 | 42.1 | 8.3 | 11.9 | 26.1 |
| 2.0 + | 51.1 | 14.8 | 6.6 | 8.3 | 13.8 | 17.4 |
| % of cases | 15.2 | 17.4 | 24.5 | 7.7 | 35.1 | |

1/ Recovery rates for 310 term loans which were fully due

Table 3

**Recovery of Term Loans**

Recovery Ratio for Loans which are not fully due
(Number of loans)

| Recovery Ratio 1/ | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | |
|---|---|---|---|---|---|---|---|---|
| | Disbursement year | | | | | | | |
| 0 | 1.00 | 16.7 | 0 | 0 | 0 | 0 | 0 | 4.2 |
| 0 - .4 | 0 | 0 | 2.5 | 7.3 | 1.5 | 1.9 | 3.3 | 2.5 |
| .4 - .8 | 0 | 16.7 | 10.0 | 10.9 | 10.5 | 2.1 | 5.8 | 6.7 |
| .8 - 1.0 | 0 | 0 | 0 | 4.6 | 9.1 | 19.1 | 43.0 | 18.9 |
| 1.0 - 1.2 | 0 | 25.0 | 7.5 | 10.9 | 19.6 | 54.1 | 46.7 | 39.0 |
| 1.2 - 1.6 | 0 | 0 | 17.5 | 26.4 | 52.6 | 20.6 | 25.22 | 25.22 |
| 1.6 - 2.0 | 0 | 8.3 | 20.0 | 21.8 | 5.0 | .3 | .4 | 3.9 |
| 2.0 + | 0 | 33.3 | 42.5 | 18.2 | 1.8 | .2 | .4 | 3.6 |
| % of cases 2/ | .07 | .88 | 2.93 | 8.07 | 25.07 | 45.24 | 17.74 | 100 |
| % of recovery ratio greater than 1 | 0 | 66.6 | 87.5 | 77.3 | 79.0 | 75.2 | 72.7 | 71.7 |

1/ The recovery ratio is defined as $\dfrac{\text{Balance outstanding - principal not due}}{\text{Original principal - principal not due}}$

2/ Total cases 1,364

The third class of loans common in rural branches are overdrafts. The overdraft provides the borrower funds which he can draw from his current account. The terms provide for the person to settle his account within a specified time period; usually one year. Interest charges are simply debited to the account from time to time. We assess repayment using the ratio of current balance to original principal i.e. the overdraft limit. This limit may or may not have been fully drawn. The sampling is largely from more recent loans disbursed in 1984 and 1985. The results are presented in Table 4. Of the 442 overdraft accounts studied 5% were repaid, 63% of the loans have recovery rates less than one indicating that the interest is being paid. More than 90% of the loans are within a factor 1.20 of the original principal. These results suggest (1) A significant increase in lending through bank overdrafts since 1983. (2) Although only a few loans are fully repaid, most are at least repaying interest. Relatively few loans are building up large amount of unpaid interest. The recovery position with these loans is significantly better than with agricultural loans.

From this review of the loans studied in the RFP survey we find:

i) The poorest recovery record is found in term loans. Few loans are repaid or on schedule for complete repayment. Indeed the banks seen to realize very little from these loans. Some 70-75% of these loans seen destined not to be recovered.

ii) The second worst group are the crop loans where some 30% of the loans are presently not being recovered. Furthermore there are delays of upto 3-4 years in recovering those that are repaid.

iii) Finally, the overdraft loans show better recovery rates than the crop term loans. These loans are larger and are usually connected with business activity. We expect 85-90% of these will be recovered.

The sample of rural loans indicates that the recovery position is unsatisfactory. The recovery rate for term loans is far worse than for the crop loans, yet the term loans are often those with the most technical support and also with the most potential for productive increases.

Analysis of the crop loan portfolios has indicated a number of other results which are briefly mentioned :

1) Loan recovery is not influenced by the age of the branch. There is no evidence of learning.

2) Smaller branches have better loan recovery records than larger branches (measured by total advances). There is no evidence of economies of scale in rural bank loan recovery.

3) Collateral conditions do not influence the recovery rates.

4) The most remote branches have lower recovery rates.

5) Large loans have poorer repayment records than small loans. This effect is not very strong but it is apparent in the loan records.

Table 4

Recovery of Overdraft Loans

Recovery ratio 1/
(Percent of loans 2/)

| | Disbursement year | | | | |
|---|---|---|---|---|---|
| | Prior 1983 | 1983 | 1984 | 1985 | Total |
| 0 | 4.8 | 3.3 | 4.6 | 5.3 | 5.0 |
| 0 - .4 | 33.3 | 13.3 | 9.1 | 16.7 | 15.4 |
| .4 - .8 | 9.5 | 16.7 | 11.8 | 19.2 | 16.8 |
| .8 - 1.0 | 14.3 | 36.7 | 16.4 | 29.5 | 26.0 |
| 1.0 - 1.2 | 4.8 | 6.7 | 42.7 | 24.9 | 27.2 |
| 1.2 - 1.6 | 14.3 | 13.3 | 11.8 | 2.9 | 6.3 |
| 1.6 - 2.0 | 14.3 | 0 | 1.8 | 0 | 1.1 |
| 2.0 + | 4.8 | 10.0 | 1.8 | 1.4 | 1.4 |
| % of cases | 4.7 | 6.8 | 24.9 | 63.6 | 100 |

1/ Balance outstanding to original principal

2/ 442 cases

The second set of data used is based on ~~reports by the rural~~ branches on their loan balances, disbursements, and recoveries. The data is reported for five years (1981-85).Table 5 presents the results of this calculation. We present the medians as the most reliable estimates. The difficulties in compiling aggregate numbers lead to many extreme values, so that means can be very distorted. We consider the median a more reliable estimate for the typical rural branch. The results of this calculation give the annual recovery performance. For short term loans we see that there is a decline in 1984-85 in the level of recoveries. For medium and long term loans this same decline is evident. However the recovery rates of these loans is less than the short term loans. The conclusions to be drawn are :

1) There has been a marked deterioration in loan recovery of all types of agricultural loans.

2) The recovery of medium and long term loans is worse than for short term loans.

The second conclusion is consistent with the data from the loan ledger sample.

The analysis of the 100 branch reporting has led us to believe that there are severe problems in branch reporting of loan recovery data. Particularly for term loans there are major discrepancies and inconsistencies in the Branch reporting. There is an acute need for improved effort by branches to report properly the loan recovery position. We are skeptical that available reporting is adequate. This originates not from the aggregation of the data but rather from the Branch's handling of their accounts. Establishing consistent reproducible data at the Branch is the necessary input to a continuing assessment at the national level of how the system is performing.

Table 5

Loan Recovery from Branch Reporting

(Ratio of recoveries to amount due).

| | Short Term Agriculture | | Medium and Long Term Agriculture |
|---|---|---|---|
| | Mean | Median | Median |
| 1981 | 30.0 | 22 | 20 |
| 1982 | 33.2 | 27 | 18 |
| 1983 | 36.2 | 30 | 23 |
| 1984 | 23.9 | 22 | 16 |
| 1985 | 24.3 | 16 | 7.5 |

In summary, loan recovery in rural branch banks:

1) Deteriorated for both short, medium and long term agricultural loans in 1984 and 1985.

2) Term loans show very poor recovery rates with less than 5% of loan fully due recovered. 70% of the loans do not repay enough to cover their interest costs.

3) Overdraft loans are repaid in to 85-90% of the amount due.

4) Short term (crop) loans are recovered to 70% over a 4 year period.

An approximate measure of the recovery rate is given by weighting the asset mix with the presumed ultimate recovery rate. The data is sparse for some categories so we use the following:

| | Share in portfolio | Ultimate recovery |
|---|---|---|
| Short term agriculture | 40% | 70% |
| Medium & LT agriculture | 34% | 30% |
| Non-agricultural loans | 26% | 85% |

With these ratios and shares we find that potential bad debts are 40% of the loan portfolio. The rural branch banks are in serious difficulty. The extent of the difficulty is masked by the current accounting practices.

Attitudes of rural bank managers

This section reviews the viewpoints expressed by rural bank managers and rural elites on loan recovery. The analytical basis of this section is that the views of the elites and the bank managers are of value in assessing problems of loan recovery.

The attitudes of the rural elites towards the rural financial sector were surveyed. The respondents were asked to list up to four reasons for poor loan recovery of loans made in rural areas. This was an open ended question and the responses were reviewed and coded in 27 response categories, further reduced to 11. Out of potentially 2,000 responses, 1,475 responses were obtained, coded and tabulated. The analytical assumption is that the rural elites are accurate observers of problems encountered. In particular their responses on loan recovery problems should be a reasonably accurate picture of the difficulties that the banks face in loan recovery. Of course when such a question is posed one should anticipate that most responses will be instinctive; however, with enough responses the main issues should be exposed. The four responses are tabulated separately and totalled. The following analysis will draw on the totals and on the rank order in the responses. The data are given in Tables 6 and 7. Examining the totals there are five answers that contain most of the responses:

| Rank | | % of respondents |
|---|---|---|
| 1st | : Loan used for unproductive purposes | 65% |
| 2nd | : Natural calamity | 51% |
| 3rd | : Willful default | 49% |
| 4th | : Poor selection of borrowers and poor loan management by bank | 44% |
| 5th | : Poor rate of return | 43% |

The order of the total of the response ranks and of total responses is the same for these five factors. These five are clearly the dominant responses.

The misuse of loan procedes is a common complaint in rural credit programs, 22% of the responses fell in this category. The argument is that in their anxiety to obtain access to funds the borrower misrepresents the intended use of the loan. The actual use of the loan is not very productive and so when it is time to recover the loan there is no additional production to finance repayment. This is related to the 5th ranked reason, poor rate of return. However, the use of the loan for unproductive purposes is more than selection of a poor project, it is a deliberate effort to exploit the banks, as one can assume there is normally no intent to repay. The usual corrective action called for is increased supervision by the banks. But whether this is really feasible for small crop loans is doubtful. For term loans where checking to insure equipment is purchased and installed is relatively easy, such supervision is clearly warranted.

Much current thinking on rural finance emphasizes the fungibility of money. This has the consequence that the connection between funds and purpose is impossible to establish. Instead one should concentrate on repayment and be little concerned with the use to which the loan is put and consequently with its supervision. The rural elites see a different aspect: If one does not put some funds to work on some productive activity then there is simply no surplus available to repay the bank. If capital resources were embedded in a project which was not yet producing it would be less disturbing; eventually there would be a surplus produced. But if the borrowed funds are used for basically consumption purposes then there simply is no surplus generated and the low consumption level which the rural population experiences provides little scope for repayment though reduction of future consumption.

The second most important difficulty identified by the elites is the impact of natural disasters; 17.3% of the responses pointed to the prevalence of such disasters as a reason for poor loan recovery. The perception of the importance of natural disasters in loan recovery rates is a pervasive theme from rural respondents. This problem is central to any loan recovery program which must be seen to be fair.

Table 6

Elite Group Views on Loan Recovery
(Percentage of responses)

| Reason for poor loan recovery | Response # 1st | 2nd | 3rd | 4th | Total |
|---|---|---|---|---|---|
| 1. Natural disasters | 19.2 | 18.3 | 16.3 | 13.4 | 17.3 |
| 2. Poverty of borrower | 5.6 | 2.6 | 1.6 | 5.4 | 3.7 |
| 3. Loan spent for unproductive purpose | 18.1 | 23.1 | 26.6 | 20.5 | 22.0 |
| 4. Loan funds insufficient | .7 | 1.7 | .5 | 2.9 | 1.3 |
| 5. Wilful default | 16.1 | 16.0 | 14.9 | 21.8 | 16.7 |
| 6. Malfeasence in loan procedures and procurement | 4.9 | 4.9 | 6.3 | 5.9 | 5.2 |
| 7. Poor rate of return | 15.6 | 15.2 | 13.0 | 13.4 | 14.5 |
| 8. Ignorance of banking system | 1.8 | 1.9 | 1.6 | .8 | 1.6 |
| 9. Poor selection of borrowers/ wrong timing/poor followup | 16.3 | 15.0 | 13.9 | 13.8 | 14.9 |
| 10. Rate of interest too high | 1.1 | 1.7 | 5.2 | .8 | 2.2 |
| 11. Government does not take sufficient measures against | .7 | .5 | 0 | 1.3 | .5 |

Notes : 1,485 responses by elite group members

Third most important is the <u>wilful defaulter</u>, suggested as a factor in 16.7% of the responses or 49% of the respondents. The existence of those wilful defaultors is judged as very important by elites.

Fourth, the elites point to <u>poor loan management</u> by the branch banks. This includes poor borrower selection and poor follow up for loan recovery. Some 44% of the elite group mentioned this reason. This does not deal with bribes, brokers etc. but with the general administration of the banks. If almost 50% of the rural elite feel that some aspects of bank operations are unsatisfactory, this should be taken as an indication of difficulty.

Finally 43% of the elite group respondents thought that there was difficulty in borrowers earning an adequate rate of return from their use of the loan. This is a point of great importance. Recovery obviously depends upon the quality of the loans made by the banks. The rural elites expressed this in many ways but almost half of them felt that loan quality is a problem.

Although five response categories dominated the answers, it should be recalled these were open ended questions. The other responses are therefore of some interest. There were a number of responses that interest rates are too high, reflecting a common view that the higher interest rate is a burden. There were a considerable number of answers, approximately 35% of respondents, which suggested that there was some malfeasence between borrower and the bank. This took the form of brokering loans, paying bribes to branch bank staff, or making loans to "ghosts". Since the elite groups were randomly selected from a list prepared by the Bank manager it is remarkable that so many of the respondents would put forth this reason for poor loan recovery. Only 2% suggested that Government's measures are too weak; 4.8% thought the borrower is ignorant about repaying loans to the banks.

Table 7

Rank ordering of five most important reasons for poor loan recovery

(Elite group responses)

| | Response # 1 | 2 | 3 | 4 | Total ranks | Rank of ranks | Rank of total |
|---|---|---|---|---|---|---|---|
| 1. Natural disasters | 1 | 2 | 3 | 4.5 | 9.5 | 2 | 2 |
| 2. Poverty of borrower | - | - | - | - | - | - | - |
| 3. Loan spent for unproductive purpose | 2 | 1 | 1 | 2 | 6 | 1 | 1 |
| 4. Loan funds insufficient | - | - | - | - | - | - | - |
| 5. Wilful default | 4 | 3 | 3 | 1 | 11 | 3 | 3 |
| 6. Malfeasence in loan procedures and procurement | - | - | - | - | - | - | - |
| 7. Poor rate of return | 5 | 4 | 5 | 4.5 | 18.5 | 5 | 5 |
| 8. Ignorance of banking system | - | - | - | - | - | - | - |
| 9. Poor selection of borrowers/wrong timing/ poor followup | 3 | 5 | 4 | 3 | 15 | 4 | 4 |
| 10. Rate of interest too high | - | - | - | - | - | - | - |
| 11. Government does not take sufficient measures against | - | - | - | - | - | - | - |

Notes : Only the five highest rank reasons are tabulated here.

The opinions of Regional Office and Branch Managers was sought on ten measures which have been suggested as useful to enhance loan recovery. The results are tabulated in Table 8. There were four policies which were ranked highest with little difference among the four. All four sounded a common theme: Reduce the role of persons outside the bank in the lending process and increase both the size and responsibility of bank staff. The significance of this finding is of some importance: The regional and branch managers have limited authority to increase staff or to take control of borrower selection. Obviously these managers feel this is a major factor in their inability to recover loans. The middle group of four policy changes were all adjustments in rules that control the branch operation: Treatment of interest as income; crop loan insurance; conditions for filing law suits; and graduated penalties on overdues. The two policies considered least attractive both reduced the branch role in loan collection. The conclusion to be drawn is that the rural bank officers believe that the best way to improve loan recovery is a more active effort by the banks. There is only moderate confidence that polic' changes will improve loan recovery and there is little support for reducing responsibility of the Branches.

A number of additional questions dealing with loan recovery were posed to the Branch Managers. The responses are tabulated in Table 9. The factor judged as most serious of the three specific issues was the lack of transportation; followed by long delays in legal action, and finally external influences. The Branch Managers were also asked to assess seven general operational problems. The most important were lack of staff incentives, lack of training, and low staff salaries. Excessive paper work and lack of office space followed; the least important factors were lack of operating funds and lack of autonomy.

Finally, an open ended question was posed to the Regional Managers as to what should be done to improve loan recovery. They were asked to provide two suggestions. The responses are tabulated in Table 10. There is a wide range of responses. Generally the same themes emerge: The need for transportation (Responses2,10); incentives and more supervision of loans (Responses 4,12,14,15,16); better coordination with or elimination of influence of outsiders (Responses 5,17,18); and finally a stronger use of the legal sanctions (Responses 1,7,9,13,19).

The following summarizes these different response categories:

| | Topic | Reasons for poor loan recovery<br>Elites | What actions would be effective<br>Rural Bank Managers |
|---|---|---|---|
| 1. | Better transportation facilities | N | Y |
| 2. | More loan supervision/ unproduction use of loan | Y | Y |
| 3. | Better loan quality | Y | N |
| 4. | Reduce malfeasence at banks | Y | N |
| 5. | More effective use of legal system | N | Y |
| 6. | Natural disasters | Y | NA |
| 7. | Poverty of borrower | N | NA |
| 8. | Rate of interest too high | N | N |
| 9. | Wilful default | Y | NA |
| 10. | Less outside influence | N | Y |

Y = Yes
N = No
NA = Not applicable

Table 8

Attitudes of Branch and Regional Managers Towards Loan Recovery Policy

(Percent of managers ranking)

| Possible action | Ranking 1/ 1 | 2 | 3 | 4 | 5 | Overall 2/ |
|---|---|---|---|---|---|---|
| 1. Shift responsibility for collection of large overdues to regional office | 34 | 29 | 12 | 16 | 8 | 2.32 |
| 2. Charge all interest to suspense accounts until loans are fully repaid | 28 | 22 | 26 | 14 | 10 | 3.63 |
| 3. Assign life of loan responsibility to specific loan officers, reward on time repayments | 0 | 2 | 7 | 31 | 60 | 4.49 |
| 4. Hold financially accountable UACC and other technical appraisal agencies | 7 | 4 | 5 | 17 | 67 | 4.33 |
| 5. Introduce a compulsory crop loan insurance system | 7 | 17 | 14 | 31 | 31 | 3.62 |
| 6. Sell loans that are overdue to a collection agency | 22 | 20 | 18 | 22 | 18 | 2.94 |
| 7. Make filing of law suits mandatory | 5 | 12 | 15 | 32 | 36 | 3.82 |
| 8. Employ more collection officers | 1 | 1 | 8 | 26 | 64 | 4.51 |
| 9. Introduce graduated penalties on overdues | 11 | 11 | 22 | 28 | 28 | 3.51 |
| 10. Eliminate all non-accountable external participation in loanee selection | 4 | 3 | 2 | 24 | 67 | 4.47 |

1/ The higher the ranking the more effective the proposed action is judged to be.

2/ Computed by weighting ranking with percentage.

Source : Computed from Robert R. Nathan Associates, Final Report Rural Finance Project Vol 2, P 130.

Table 9

Branch Manager Views on Loan Recovery and General Operations

| | Responses | | | |
|---|---|---|---|---|
| | Not important | Somewhat important | Very important | Weighted total 1/ |
| Question: Is lack of transportation a problem in loan recovery? | 3 | 19 | 78 | 4.49 |
| Question: Are external influences a problem in loan recovery? | 11 | 41 | 48 | 3.75 |
| Question: Are long delays in bringing about legal actions a problem in loan recovery? | 10 | 15 | 75 | 4.3 |
| Question: Are the following a problem with respect to general operations: | | | | |
| Excessive paper work | 16 | 29 | 55 | 3.79 |
| Low staff salaries | 8 | 29 | 63 | 4.09 |
| Lack of operating funds | 30 | 37 | 33 | 3.04 |
| Lack of autonomy of Branch | 22 | 47 | 32 | 3.19 |
| Lack of staff training | 5 | 15 | 80 | 4.49 |
| Lack of incentives | 2 | 16 | 82 | 4.59 |
| Lack of office space | 24 | 22 | 54 | 3.61 |

1/ Weights 1,3,5 for not important, somewhat important, very important respectively.

Source : RBBUS, Branch Manager Survey

Table 10

Regional Manager Responses

Q : What should be done to improve loan recovery?
(Number of regional managers responding)

| Response | 1st response | 2nd response | Total (%) 1/ | |
|---|---|---|---|---|
| 1. Regional Manager/Branches should have judicial power (i.e. be certificate officer) | 5 | 1 | 6 | (8.7) |
| 2. Establish mobile recovery team | 7 | 2 | 9 | (13) |
| 3. Commission agent appointed | 0 | 1 | 1 | (1.4) |
| 4. More staff for disbursement and recovery | 1 | 0 | 1 | (1.4) |
| 5. Local elites and local Government should assist banks in loan recovery | 5 | 3 | 8 | (11.6) |
| 6. Taking bond from borrower | 1 | 0 | 1 | (1.4) |
| 7. Greater cooperation from police | 4 | 1 | 5 | (7.2) |
| 8. Interest rates should be reduced | 2 | 1 | 3 | (4.3) |
| 9. Certificate cases should be settled | 3 | 3 | 6 | (8.7) |
| 10. Provision of transport | 1 | 2 | 3 | (4.3) |
| 11. Renewal of loan on recovery | 0 | 2 | 2 | (2.9) |
| 12. Personnel persuasion,follow up | 6 | 0 | 6 | (8.7) |
| 13. Arresting influential defaulters | 2 | 3 | 5 | (7.2) |
| 14. Improved loan supervision | 2 | 7 | 9 | (13) |
| 15. Branch manager should have more administrative power | 1 | 0 | 1 | (1.4) |
| 16. More incentives to bankers | 2 | 3 | 5 | (7.2) |
| 17. UACC should be abolished | 4 | 0 | 4 | (5.8 ) |
| 18. Help from Ministry of Agriculture | 1 | 0 | 1 | (1.4 ) |
| 19. Lack of proper legal action | 1 | 0 | 1 | (1.4) |

1/ % of Regional Managers surveyed (69)

Source : RBBUS, Regional Manager's Survey.

In conclusion the rural bank managers and elite groups are in broad agreement as to the problems in improving loan recovery: There is overwhelming importance attached to procedural questions, i.e. greater responsibility of the banks for loan recovery. The elite groups were generally not interested in tougher legal measures but a substantial percent saw corrupt practices at the branches as a deterrent to loan recovery. On the other hand the regional managers saw the need for greater support from the legal system. The elites found loan quality unsatisfactory; not surprisingly the bankers were silent on this point.

## Factors which influence loan recovery

This section discusses six aspects of loan recovery. The analysis deals with rational reasons for poor loan recovery. Ultimately one is dealing with a type of behavior by individuals which reflects three considerations: 1) The belief that one can "get away with it" i.e. not paying. 2) The calculation that it is rational to forgo repayment for the moment and repay later. 3) The inability to repay. All individuals decide whether to repay based on these considerations. To improve recovery rates one must deal with each aspect of these motivating factors.

### 1. Political attitudes

It is characteristic of democratic systems that issues of availability and terms of credit in rural areas feature regular intervention by the political authorities. When most people are living in rural areas and of these most are engaged in agriculture, the availability and terms of credit are political issues. In Bangladesh this tendency has gone further and retroactively politicians are eager to reduce the immediate debt burden felt by the farmers. The behavior of the Government in the past two years has certainly signalled that loan recovery from small farmers is not of high priority concern. Elite group members in rural areas repay at least as poorly as the poorer farmers. There is no question that there is a generally permissive attitude encouraged by the Government towards loan recovery. Although everyone in rural Bangladesh recognizes that loans must be repaid to money lenders, there is a widespread attitude that Government sponsored loans are not real obligations. Indeed, there is considerable historical experience that this pyschological attitude has existed for a long time. Changing this attitude and building widespread acceptance of the universality of debt obligations is important, but will require years of effort and borrower education.

One point of some importance is the existence of the wilful defaultor. Some individuals simply resist repaying their loans. These individuals will prove recalcitrant until the full legal power of the state is used to enforce the loan agreement. When the Government is slow to use its legal authority to do so then others may decide to join the group of wilful defaultors. Suppose that the chance of a person joining the wilful defaultors group depends upon the number of defaultors. Then the number of defaultors will grow exponentially. This would be manifest as a sudden and almost complete breakdown in loan recovery. The result would be a virtual collapse of the rural banking system other than as a source of collecting funds for lending to the towns.

2. <u>Bank behavior and loan recovery</u>

The matter of banks' willingness to collect loans is very complex. Despite the many claims that loan recovery is important there is a strong case that banks are not seriously interested in loan repayment.There are a number of arguments for this controversial position.

2.1 Loan recovery is very poor for advances for agricultural purposes. If the banks do not take responsibility for this then one must identify some other major factor which causes poor repayment performance. The other sections of this part of the paper argue that political interference, natural disasters and general poverty are not sufficient explanations of the low recovery level. Although a case can be made that monetary policy and rational farmer attitudes contribute to poor recovery,neither of these is of sufficient power to exempt the banks themselves from major responsibility.

2.2 Under existing accounting practices there is little motivation to collect agricultural loans. First, interest accruing from the loans is treated as income for all loans not classified as "stuck-up". Second, there are few agricultural loans classified as "stuck-up". Henceforth in this paper the term "non-performing" will be used as equivalent to "stuck-up" or "substandard" or "doubtful". The bank has the right to classify loans as non-performing, but in fact there has been very limited use of the authority to so classify. After all why voluntarily reduce income? Loan classification is consequently left to the Bangladesh Bank's inspection system and this is unable to deal with the proliferation of branches and the great expansion in the number of loans. Thus most loans are treated as performing. Third, loan collection costs money. The rural bank managers are saying that to improve loan recovery they need more people, better salaries, and incentives. It is reasonable to assume that with the present application of resources by banks to recovery one obtains the low levels actually achieved. Improving loan recovery means greater expenditures by the banks. Finally one sees that loan recovery adds to costs but not to revenues. Bank management anxious to earn high profits <u>within</u> the accounting rules would be foolish to add to their costs.

There are two subsidiary arguments:

(a) How does improving loan recovery contribute to the banks' sources of funds? There are three methods of getting funds: Increasing deposits, borrowing from the central bank (refinancing) or collecting loans. Increasing deposits costs rural banks 10-12% i.e. 9-10% for the cost of funds plus 1-2% for operations costs (minimum). Borrowing from the central bank costs about 6-11% depending on the refinance channel used. What does loan recovery cost? Who knows? In principle it should be possible to increase loan recovery by allocation of 5% (e.g. collection bonuses; having more staff etc). But the banks face a great deal of uncertainty. Can one be sure that incurring these costs will improve the situation? Will Government refuse to back up a program that the banks initiate leaving the bankers with all of the costs and none of the recovered funds? There is great uncertainty here and it is easy to understand the banks' reluctance to take a large front end risk.

(b) Reduced liquidity in the rural branches, to which poor loan recovery contributes, prevents the branch from making fresh loans. The poor recovery rate may draw a head office credit restriction. Does the bank perceive this as a bad thing? The Government is driving the banks to extend vast volumes of credit to the rural sector. The banks are not going to do this of their own accord. With reduced liquidity and poor recovery induced credit restriction, the bank's head office can reduce its rural lending; this is precisely what the banks want to do. BKB is certainly an exception here, but even BKB has many channels for putting out funds and certainly has some flexibility in doing so. It is possible to emphasize larger, more industrial type loans. The conclusion is that perhaps the banks do not want to extend all these loans to rural areas and welcome the possibility of escaping Government pressure to lend. Put another way Government can drive the banks to lend or to recover but not both. Furthermore, driving the banks to recover the loans works only when the loan recovery is in the direct interest of the bank.

2.3 Recovery rates differ greatly among branches. Data from RBBUS is given in Table 11. This Table indicates that there is a wide spread in the performance of individual branches. If some branches can recover at rates of 60% of the amount outstanding why do other branches recover at only 5-10% per year? The existence of this great spread is clear evidence that the branch level does matter.

2.4 The responses of the rural elites and rural bank managers point directly to the conclusion that more action by the banks is needed.

2.5 It is instructive that the Government and Bangladesh Bank are currently taking the lead in loan recovery. Obviously the banks do not feel competing pressure to improve loan collections.

In conclusion this argument comes down to the observation that there is little motivation for banks to recover loans. Of course the bankers work rationally within the framework provided. This framework does not encourage loan recovery. Yet the rural bank managers are reporting that with more resources they would be able to do more.

Table 11

Distribution of Recovery/Outstanding Ratio for Short Term Agricultural Loans

(Percentage)

| Fractile | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|
| 95 | 325 | 209 | 503 | 267 | 265 |
| 90 | 180 | 102 | 200 | 134 | 148 |
| 70 | 58 | 47 | 87 | 44 | 53 |
| 50 | 36 | 35 | 45 | 32 | 25 |
| 30 | 19 | 22 | 29 | 20 | 13 |
| 10 | 8 | 11 | 14 | 3 | 4 |
| 5 | 6 | 8 | 3 | 2 | 2 |

Source : Table 1, P 12 in Robert R. Nathan Associates, Recovery of Short Term Agricultural Loans RFP Phase 2 October,1986.

## 3. The individual borrower

When is it rational for a person to defer repayment while still recognizing the loan as an obligation?

3.1 We begin with a few comments on the "bad guy" or wilful defaultor. Earlier remarks on the free rider problem cover the dynamics i.e. how the number of such persons may change under the impact of Government policies. Some people are simply unreliable and will have difficulty in repaying the loan. Although the local money lenders know who these persons are, the branch bank does not, at least initially. It is a long and expensive business to learn who are these persons and to avoid lending to them. The pressure on the rural branchs to disburse has made it difficult to learn. Indeed there is no improvement in recovery rates with the age of the bank. It may be that the number of unreliable persons is growing as a consequence of Government Policy. So that the learning is particular difficult. Various substitute systems have been used: e.g. pass books and UACCs. The UACCs failed and it is premature to determine if the pass book system will improve this screening out of unreliable borrowers.

3.2 The person who plans to repay his loan may defer doing so if the cost (the penalty rate) is less than the benefit that he gains from not repaying. He may have an opportunity to purchase an asset which will generate a greater return than the penalty rate. He may owe to the money lender at a higher rate so it is sensible to defer payment on the low interest loan. The value of present consumption relative to future consumption may be so high that he prefers to consume now rather than in the future. This means that the borrower perceives the interest rate as low and repayment is put off. Analysis of the interest rate effect on loan recovery in RBBUS loan data indicate that there is a definite effect: The higher the real interest rate the better the recovery performance. The common belief is that the interest rate is a burden so that reducing it will make recovery easier. All data points to the opposite view: Higher interest rates improve loan recovery.[1/] The relevant comparision is between the nominal borrowing rate and the highest return the farmer can get in an alternative use of the funds. Consequently the higher the nominal rate the more likely it will be repaid.

3.3 Another rational reason for not repaying is the belief that another loan will not be forthcoming. Indeed the average number of loan renewals (1984/85) determined from the RBBUS survey was 79 per branch out of 363 sanctioned (1983/84) or 22%. Analysis of the recovery of the branches shows that the level of disbursements is an important explanatory factor.[2/] There is informal evidence through observers that at present the declining disbursement levels in rural areas are reducing loan repayments, i.e. that borrowers are explicit in giving this as a reason for postponing repayment.

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1/ The analysis of the interest rate effects will be included in a forthcoming report in the RFP Phase II, RBBUS series.

2/ The analysis of the disbursement impact on recoveries will be included in a forthcoming report in the RFP Phase II, RBBUS series.

4. Poverty of rural households

It is often argued that rural households are too poor to repay the bank loans. This proposition has two alternative versions:

1) The loan procedes are diverted to urgent consumption needs instead of productive use. These consumption requirements are mandatory for survival and so cannot be postponed. Distribution of resources to persons or households in such extreme need to be used for consumption through loans is obviously undesirable. We distinguish between the loan being used for urgent consumption and the loan being diverted to consumption purposes which cannot be considered as vital.

2) The loan is used for production purposes and the resulting surplus is divided between consumption and repayment in such a way that there are insufficient resources for repayment. Comparing the situation without the use of the loan, consumption has increased. However, the unsatisfied minimum consumption needs are not met; the greater income available from use of the loan permits the consumption shortfall to be met. If this situation exists it suggests two points :

   i) A larger and longer term for the loan(as is indeed the reality of the rural lending) would enable the family to first meet these minimum needs and then produce the surplus needed for repayment.

   ii) If there are households in this position then they are experiencing declines in nutritional status and ultimately health.

There is little evidence that the formal banking system is involved in lending to households in such desperate straits. Term loans are virtually all made to farmers with above average land holdings. Crop loans are usually made to land owners; preliminary data from the RFP surveys of bank customer households suggests that the banks are dealing with the upper half of the rural income distribution.

That there is widespread, desperate poverty in rural areas is without question. But the number of bank loan customers in this condition is probably very limited.

5. Natural disasters

Evidence from crop loss data indicates that average rice or jute losses come to 3-5% of the total crop. Farmers who have borrowed and who lose their crops from such natural causes never come to more than 10% of the area planted. Furthermore, the risk of natural disasters is slightly less for the large landowners than for the marginal farmers who often will cultivate in the most exposed and vulnerable locations. It is consequently difficult to believe that on the average more than 5% of the borrowers are unable to repay due to these floods etc. This is unlikely to be an explanation of very much of the poor loan recovery reocrd.

6. Monetary policy

One final possibility exists for poor loan recovery. The Government determines targets for loan disbursements in agriculture. These targets are then assigned to banks and branches. Such targets are further established by program. If the demand for loans is not sufficiently great (at existing interest rates) to take up the volume of credit that the Government is distributing then the real interest rate must be driven down. This can be done by low recovery rates.

Low recovery rates and widespread belief that loans are not used for the prescribed purposes and that project quality is poor are consistent with this picture. This argument would conclude that reducing the volume of lending would ultimately raise recovery rates.

Policies for loan recovery

This section presents a number of actions which are judged to be necessary to improve loan recovery. It is not possible to have successful rural development programs unless there are associated provision of credit and such credit is repaid by the borrower. The data on loan recovery presented in this paper broadly support the belief that the loan recovery is unsatisfactory. Indeed the quantitative estimates indicate a far worse recovery position than generally believed.

1. Loan recovery is the responsibility of the bank: The banks need to try harder. This means the application of more resources to loan recovery. Loan recovery is inhibited* for the next few months by the Exemption on Interest Rates. Nevertheless, the banks and their branches can prepare for the world on March 1, 1987, which is not so far away. The application of resources to loan recovery means: 1) More staff; 2) Use of loan recovery task forces to improve recovery at the worst branches; 3) Bonuses linked directly to loan recovery as an interim measure; 4) Improved contact between borrower and branch, which of course means additional staff.

   Such measures will raise expenses significantly. The additional cost of loan recovery could easily come to 3-4% of the value of the loan, i.e. approximately doubling current costs.

2. Accounting policy change

   Present accounting policy serves to obscure the true profitability position of the bank and the branch, not clarify it. Accounting policy needs to be adjusted until the stated profits of banks and branches result in a clear picture of profitability. This means: 1) Loan classification carried out on mandatory rules by banks and branches so that income will not be inflated by unrealistic expectations of recovery. 2) Accounting for bad debt reserves at the Branch as well as at the Head Office.

These changes must be made promptly but over a sufficiently long period to permit the banks to devote resources to loan recovery before the full impact of such changes is felt.

If loan recovery cannot be improved under the spur of branches and banks acting to improve profitability, then the tremendous amount of bad debt in the rural branches will continue as an overhang from which the banks will never recover.

3. Selection of borrowers

Good projects lead to good recovery. Good recovery leads to good projects. Both of these sentences are true and the recognition of the meaning for Bangladesh is essential to improved loan recovery. At present the rural finance system has a large number of lending programs, these programs all impose purposes, targets, and often project appraisal. The bank is little more than a mailbox. If the banks are to be more aggressive in lending, then the banks must also gain full control over the process of granting the loan.

This means a major effort by the banks, supported by the Government to build up technical staff able to assist the Branch Manager in appraisal of loan application. It also means that Government and donors should stop trying to build parallel systems which by-pass the banking system.

4. Uncoupling disbursements and loan recovery at the Banks and branchs

At present there is a linkage between loan recovery and disbursements. A branch with a high level of disbursements will obtain more repayments than one with a low level of disbursements. The present linkage encouraged by the Bangladesh Bank and imposed by the NCBs and BKB on their branchs has the effect of reducing rural lending due to lower recoveries.

This in turn lowers recoveries further. The inability to lend due to poor recoveries hurts farmers who are willing to repay but it does not create any motivation in the branch to increase collections. This linkage is probably reducing loan recovery rather than improving it.

5. Interest rates and penalties

There is a strong case for raising interest rates and penalty rates.

1) Higher interest rates encourage recovery of short term loans. The data from RBBUS indicate this indeed is the way Bangladesh farmers behave - the higher the real interest rate the more recovery.

2) Higher interest rates will increase the spread between borrowing and lending rates.

3) Higher interest rates will reduce the malfeasence in the banks by reducing the gap between informal and formal money markets.

4) Ultimately higher interest rates will improve resource allocation.

The public relations aspects of the increase of interest rates are very difficult to manage. It is better therefore to leave interest rates as they are but to require a compensating balance to be maintained with release of these retained funds when the loan recovery is satisfactory, interest accumulating on the entire loan rather than the net amount disbursed.

The best strategy would be a temporary move to establish a compensating balance while a real drive on loan recovery took place. Once recovery rates had reached a satisfactory level then the required spreads would be better established and the effective interest rate could be further adjusted.

## Competition and decentralization of the banking system

The proposed change in accounting policy and the shifting of more direct responsibility to the branches and regional bank offices are the essential aspects of further decentralization of rural banking. This decentralization would permit branch managers to make their own decision on staff, allocation of staff to different tasks, training needs, and even loan terms. The highly centralized system now characteristic of Bangladesh banking is essentially an outcome of two ideas: (1) The British banking system use of a branch network to mobilize savings and to centralize such saving to finance investments in the center. (2) The belief that the Government can direct in detail the functioning of the economy and more particularly the investment choices. The first reason is no longer valid and the second has been shown to work poorly everywhere.

Further decentralization will provide incentives for branch staff to be good bankers, where effectiveness is measured by true financial profitability. Along with decentralization should come encouragement of competition among banks. Only competition will produce economic efficiency. This only indirectly influences loan recovery so there is no need to dwell on it in this paper.

7 <u>Mandatory crop loan insurance</u>: The above discussion of the elite group perceptions and of the environmental risk as an influence on loan recovery indicates that natural calamities are a problem in two senses:

1) There is a considerable risk facing particular farmers.

2) Everyone believes that the losses from natural calamities is a problem.

Although Government has developed a crop insurance program on an experimental scale, it has been not been compulsory. The modalities of such a program will not be discussed here. However a few brief points are in order:

i) The environmental risks are not uniform over the country. If insurance is not mandatory then the costs will be greatest in those areas with highest risk and resources will tend to concentrate in those areas where crop risks are lowest. From a purely economic viewpoint this is the most efficient way to procede.

ii) If the nation wishs to bear these risks more uniformly then a compulsory insurance crop loan insurance program is required. This has the effect of raising the cost of loans to the extent the Government does not supplement out of the general revenue.

iii) Crop losses run 3-5% per annum so a full insurance program would cost 2-4% per annum depending on how much of the crop value was financed by the loan. This would represent an additional charge on the crop loans.

iv) The bank cannot recover the loans from crop loss except by taking over assets owned by the farmer should there be any. Thus the cost of these loans has to be covered somewhere in a viable banking system. The availability of crop loan insurance would ultimately mean a lower level of bad debt provision.

8. Profit based bonuses: Ultimately the bonus paid rural bank staff should be dependent upon branch and region profitability with sound accounting policy, which corrently estimates financial profitability. The branch and regional staffs should believe that their financial rewards will be dependent upon their performance. With a different accounting policy, the branch will tackle the loan recovery problems and with greater flexibility in application of resources (see 6 above) one can be confident the Branch will tackle the loan recovery in a suitable way.

Other reward methods are much less efficient:

1) Bonuses based only on bank (rather than Branch) profitability create no incentive for a Branch Manager to improve his particular Branch. The use of the bureaucratic system's awards of good reports on an individual's performance and promotion or assignment has not worked so far for rural areas.

2) Rewards for some particular activity e.g. loan recovery, are less efficient than profit based awards. The Branch Manager has the best information available for deciding what will create the most profits. Any directive from Head Office which selects some particular objective, other than maximizing profits will reduce the overall effectiveness of the banking system.

9 Collateral and collection: The use of real collateral is a necessary aspect of good loan recovery. First, there is in effect no collateral now offerred for crop loans; for term loans land is usually offerred. It is necessary to do two things: (1) Use land as collateral for crop loans as much as possible. (2) Do not hesitate to act to take control of land. The point is obvious, land is the most valuable asset in rural areas. The power of the money lender to collect rests with his willingness to take control of the land. For most farmers losing ones land is the worst thing that can happen. There will be few wilful defaultors in the face of the possibility of loss of land. The argument that land collateral is not appropriate is wrong. However, it is mandatory that the bank take control of the land. Banks have historically been reluctant to take land as this is such a serious step. A particular effort must be made to make foreclosing acceptable to the public. This is not so difficult:

1) The bank should settle for the right to use the land without necessarily taking ownership.

2) The branch should develop a list of landless farmers in the area and rent the land to the landless farmer, including appropriate credit. There is no shortage of persons anxious to have land to cultivate.

These steps would relieve the bank of owning land but would provide an asset which would produce income for the bank and would also serve a useful function in redistributing land.

For landless persons the collateralization of land rights would not be effective. In this case the branch has to make a judgment as to whether it is acceptable to make loans without collateral.

Strengthening the legal aspects of loan recovery: The Regional Managers indicated their belief in the strengthening of the legal enforcement procedures. This theme has occurred in most of the implemented or proposed loan recovery programs. The procedures for using the legal system (certificate process established under Public Demands Act) to collect overdue loans is obviously not working in an acceptable way. The problems are well known: Slow action, lack of police support arising from a natural reluctance to become involved in loan recovery, high front end cost to the bank, interference by the political authorities to instruct the police not to support loan recovery. There are a number of actions that could be taken to make the certificate process more effective. Whether this would take more resources is uncertain: Once the banks show a serious intention to use the courts to collect overdues, then the recovery performance will greatly improve and the number of cases passing through the court will drop. As the equilibrium level of court cases that must be handled under a tough recovery policy is so uncertain the most appropriate way to begin is to organize special teams to clear up the case load, one district at a time. Demonstration of the willingness to use the legal system for debt collection will have an influence far beyond the particular district. This procedure will be painful but it is necessary. The necessity of validating the society's will to collect debt will not go away.

In summary, this paper has argued as follows:

1) The loan recovery position is very unsatisfactory. No viable financial system can be established until loan recovery is significantly improved.

2) The responsibility rests with the banks and it is these that one must look for effective action. The Government is not going to direct improved recoveries. What the Government can do is to establish a framework within which loans will be recovered because the bankers want to do so.

3) There is one course of action that can trap the Bangladeshi farmers in poverty forever. That course is to use the banking system in a soft way giving away resources. Such a course will reduce the quality of investment, reduce intermediation of saving, and demonstrate to all that innovation, effort, work discipline are values of no relevance to rural Bangladesh. This course of action will lead to continued poverty and occa-ssional famine.