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INTEREST FORGIVENESS PROGRAMS FOR RURAL LOANS IN BANGLADESH: IMPLICATIONS OF RECENT PROGRAMS

by

Raka Rashid

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Agricultural Finance Program
Department of Agricultural Economics
and
Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210-1099

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Programs of interest forgiveness on rural loans, either in response to natural calamities such as floods and cyclones or as an effort to improve loan recovery, are a political tool frequently employed by the Bangladesh government. This paper reviews three recent programs undertaken during the period 1984 to 1986. An analysis is made of the impact of the programs on the clientele of financial institutions and the institutions themselves. Alternatives are explored and recommended. The author concludes that the effect of these programs on the poor is unclear. Moreover, they probably harm, rather than help, by assisting to destroy the viability of commercial banks and the financial discipline of the formal lending sector as a whole.

INTEREST FORGIVENESS PROGRAMS FOR RURAL LOANS IN BANGLADESH: IMPLICATIONS OF RECENT PROGRAMS

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Raka Rashid[1]

1. INTRODUCTION

Interest forgiveness programs on rural loans have been frequently employed in Bangladesh. They are often introduced in times of crisis. The "crises" may be precipitated by: i) a natural calamity such as a tidal bore, cyclone, or flood, in which case the objective of the program is to provide relief to distressed borrowers; or ii) a conscious effort on the part of the government to encourage borrowers to repay overdue loans through a loan recovery drive.

Three successive programs of interest forgiveness for agricultural loans were undertaken by the Bangladesh government during the period 1984 to 1986[2]. The first began in 1984 following the onslaught of country-wide flooding. The second in 1985 was in response to a tidal bore/cyclone affecting coastal areas of the country. The objective on

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[1] The author is a free-lance consultant specializing in financial and management issues. She is currently under contract with USAID/Bangladesh as the Mission's Advisor for both microenterprise and gender issues. Field work and research for this paper were mainly undertaken in 1985 as a study sponsored by the United States Agency for International Development, Bangladesh. The responsibility for the contents of this paper rests with the author and views expressed here do not necessarily represent those of USAID, the Bangladesh Bank, or any other organization.

[2] Although programs of this type are not new, only these three most recent ones are analyzed in this paper because the data are not easily available for earlier programs.

these two occasions was to provide relief to affected borrowers. The third program in 1986 sought to improve a marked decline in the rate of loan recovery. Although details are unclear, these programs covered all interest due on short-term agricultural crop loans that were in effect during a certain period of time. Agricultural crop loans are designed to finance on-farm inputs such as seeds, fertilizers, and pesticides. A short-term loan is generally repayable within a year from its date of disbursement. The 1984 program exempted interest on specific agricultural crop loans only; interest on all agricultural crop loans were eligible for forgiveness in 1985 and 1986.

This paper contains an analysis of the impact of these interest forgiveness programs on the clientele of the financial institutions and on the institutions themselves. It also explores some alternatives to pronouncements of interest forgiveness as mechanisms by which the same objectives (whether it is debt relief for distressed borrowers or a drive for better loan recovery) can be obtained without tampering with the financial discipline of institutions.

2. HISTORICAL BACKGROUND

The current structure and policies of rural credit in Bangladesh represent a gradual evolution over two centuries or more of policies and programs with their roots in British India. There is little systematic documentation to identify specific instances of interest or loan forgiveness in British India, but the practice was probably legalized by the Agricultural Loan Act of 1885. Under this Act, distressed farmers could receive loans (known as "Taccavi" loans) from the government for the purchase of farming imputs such as seeds and fertilizer. Although called "loans", they were virtual grants as repayment was not expected, and they were viewed as relief hand-outs.

Several bankers interviewed by the author in 1985 recalled interest remissions on weaver's loans in the 1960's and also following the cyclone of 1970. On the latter occasion, the Agricultural Development Bank (now the Bangladesh Krishi Bank or BKB) received interest-free refinancing from the Bangladesh Bank (the Central Bank of the country or BB) so that affected borrowers could receive interest-free loans. However, this was not strictly "interest forgiveness" as no interest was calculated on these loans in the first place.

In 1971, after the War of Liberation, Bangladesh (formerly East Pakistan) emerged as an independent nation. The large volume of overdue loans dating from the pre-Liberation period prompted the Bangladesh government to undertake a drive for loan recovery through interest exemption. The program, begun in 1977, encouraged borrowers to repay their loans. If they did so, they would be exempted from interest payments on a graduated scale: 10 percent of accrued interest on loans whose principal portion was up to Tk. 3,000; and 50 percent on loans whose principal was between Tk, 3,000 and Tk. 10,000[3]. Thus borrowers of larger loans were provided with a greater incentive to repay. In instances where a borrower had more than one loan, the program was limited to loans for which the total sum of principal amount was at or below Tk. 50,000 per borrower. The cut-off date was extended from June 30, 1977 to June 30, 1981, then finally to June 30, 1985. Records of the Bangladesh Bank show there was some recovery of the pre-Liberation loans due to this announcement, but the exact amount is indeterminate.

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[3] Loans above Tk. 10,000 were not included in this program.

It appears, therefore, that programs of interest forgiveness on agricultural loans used either as a means of providing support to distressed borrowers or as a drive for recovering outstanding dues, are not a new phenomenon in the country and have been used frequently in the past.

3. NATURE OF RECENT PROGRAMS

The 1984 interest forgiveness program was officially defined in a Bangladesh Bank Circular (Agricultural Credit Division, ACD No.13/84) dated August 8, 1984. Its salient features were:

a) only borrowers of flood-affected areas were eligible;

b) defaulters of the '83-'84 transplanted aman[4] loans were eligible for fresh loans; and

c) Boro, broadcast aman, aus, and jute loans were granted interest exemption for a year. Moreover, these loans were rescheduled for an additional year with no penal interest[5] charged for the rescheduled period.

The program required that two accounting issues had to be resolved. One issue was reconciling the interest if the loan was repaid. The other related to the accounting method for regular and penal interest for rescheduled loans. There were, however, severe

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[4] Boro, aus, broadcast aman, and transplanted aman are names of indigenous seasonal rice crops.

[5] Penal or penalty interest is charged on overdue loans. For example, the regular (normal) rate of interest for short term agricultural crop loans is currently 16 percent per annum. These loans are repayable within a year. After that, a penal rate of 6 percent is added to all unpaid loans, bringing the effective rate to 22 percent.

interpretational problems encountered at the field level, where the program was actually being administered. For example, rural bank branch managers did not understand the geographical extent or outreach/physical coverage of the program, the date from which the exemption was valid, and the accounting procedures to be employed. A clear definition of the disaster areas was not provided until January, 1985. Under these somewhat confused circumstances, most banks simply allowed all their rural branches to forgive a year's interest on short-term loans for the above-mentioned crops.

Accounting practices for the exempted interest in the 1984 program also varied widely among the banks.[6] Sonali[7] treated the exempted interest as income to the bank. Agrani, Janata, and Rupali requested their branches to estimate interest on all eligible loans in their portfolio, but did not explain whether or not this was to be treated as income. Only BKB issued detailed accounting instructions to its rural branches. Pubali, Uttara, and the Cooperative Bank (BSBL) issued none. The Ministry of Finance (MOF) and the Bangladesh Bank have reportedly accepted all the balance sheets of these financial institutions, thereby formalizing the accounting anomalies.

The 1985 announcement of interest forgiveness (BB Circular ACD No. 911/85-3760(5) dated August 22, 1985) responded to the needs of cyclone-affected borrowers. Bank

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[6] In general, accounting practices differ significantly within the banking sector in the country, sometimes even among different field branches of the same bank. These varying methods have been noted in several reports, including those by Rashid and the papers of the Rural Finance Project.

[7] Sonali, Rupali, Janata, and Agrani are the four major nationalized commercial banks (NCBs) serving rural areas. Pubali and Uttara are denationalized commercial banks. BKB is a development financing institution specializing in agricultural lending.

field offices received notification of the interest forgiveness program about a month after it was announced, although they had heard of it earlier through the news media. This program differed from the previous year's announcement in several ways, but was also ambiguous on many issues. Whereas the 1984 exemption identified specific eligible crops, the 1985 announcement required that interest be exempted on agricultural loans, but was unclear as to which specific agricultural loans were eligible for interest forgiveness.

Accounting instructions were the same as those issued with the circular for the 1984 exemption. They did not mention rescheduling of loans nor exemption of penal interest on rescheduled loans. At the branch/field level, a list of eligible upazilas or counties was provided, but this proved inadequate, as there were some villages unaffected by the cyclone in a few upazilas under the "eligible" list. Rural bank branch managers forgave interest on agricultural loans to all borrowers within upazilas cited in the circular, although they were aware that some of them were not actually in cyclone-affected villages.

The 1986 announcement of interest remission (BB Circular ACD No. 6/86-9793(8) dated October 27, 1986) was applicable country-wide for all crop loans up to Tk. 10,000 (including principal, interest, and service charges). The original cut-off date was February 28, 1987 but subsequently extended to June 5, 1987. This circular appeared to be more lucid and detailed in its instructions than the previous two. It discussed terms for borrowers who had partially repaid their dues and the forgiveness of penal interest on overdue loans. Borrowers against whom certificate[8] cases for over-due loans had been filed were declared

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[8] Certificate Proceedings (under the Public Demands Recovery Act, 1913, as amended) is the basic legal procedure for the recovery of delinquent institutional loans. This administrative-legal procedure was originally developed by the British colonial

ineligible. The circular also stated that all crop loans obtained during the pre-Liberatioı period were forgiven and the financial institutions were instructed to write off these loans

It is important to note that none of these programs addressed the issue of how tc treat borrowers who had fully repaid their loans with interest, before the programs werc launched. In effect, then, all of these schemes penalized the 'good' borrowers who fullj repaid their obligations.

4. FINANCIAL ASPECTS OF INTEREST FORGIVENESS PROGRAMS

Table 1 reports the BB estimate of the bankers' financial loss due to exemption oi interest. The total interest loss is estimated to be Tk. 4,440 million, of which the BKB's share is Tk. 1,401.6 million or about 32 percent. It is clear from the data in Table 1 that the largest volume of interest was exempted during the 1986 program for loan recovery, probably because, through repeated extensions, the program managed to cover a large volume of loans over an extended period of time. Pubali and Uttara, the two de-nationalized banks, had little involvement in rural credit so their losses were minimal. The fact that 1986 was RAKUB's first year of operations after its de-linkage from the BKB explains its negligible extent of loss. It is difficult to say precisely, however, which institution was most adversely affected since the data supplied, particularly for the 1984 and 1985 programs, are neither consistent nor dependable. Some institutions provided data including

authorities as an instrument for collecting overdue land tax revenues and was later extended to the recovery of bank loans. It is currently administered by civilian certificate officers appointed by the senior-most public sector authority heading each district administrative unit. However, this procedure of recovering loans is considered to be a cumbersome, time-consuming process.

all agricultural loans in addition to crop loans, while others had difficulty in sorting out the specific loans for which interest was to be exempted. Also, variations in book-keeping practices make inter-bank comparisons difficult, if not impossible.

There has been no estimation of total bank losses due to the write-off of penal interest and the opportunity cost of capital. Therefore, in order to obtain a more realistic estimate of the full interest loss, a standardized and accurate recovery rate for each financial institution is necessary . A program of interest exemption implies that only that portion of interest that could have been recovered, given an institution's annual recovery rate, is lost. It is of little use to assume, as bankers have done, that the entire amount of interest is lost. This would only be true if the rate of recovery had been consistently 100 percent. On the other hand, the banking sector may have purposively used an inflated loss estimate, in part to impress policy makers with the explicit harm done to the financial system because of these interest forgiveness programs. Furthermore, in the case of the 1986 program that was designed to stimulate loan recovery, the loss of interest must be balanced against the additional amount of principal that the banks recovered due to the program that otherwise might have been lost. This impact on principal recovered is difficult to estimate, especially in light of the general downward trend in overall loan recovery reported by Gregory, Meyer, and Adams.

For purposes of illustration, however, a rough estimate of the relative impact of the programs on a few of the banks can be made by relating the magnitude of the estimated losses (shown in Table 1) to a bank's total interest income for that year as reported in their respective Annual Reports. As a proportion of total interest income, losses incurred during the 1986 program represented about 40 percent for BKB, 30 percent for Sonali, 15 percent for Agrani, and 17 percent for Pubali. In 1985 (for which BKB and Pubali's profit and loss statements were not readily available), Sonali and Agrani each lost less than one percent of their total interest income. Whatever may be the actual proportion of loss, one can deduce that in 1986 the two largest banks, Sonali and BKB, suffered from significant loss of interest income, while the remaining institutions had far less adverse exposure to the program.

5. WHO BEARS THE BURDEN?

Bankers interviewed in 1985 were pessimistic. They did not expect the issue of who was ultimately going to "pay" for the interest forgiven under these programs to be resolved. BSBL's manager remarked that the interest exempted on pre-Liberation loans was still being maintained in a separate ledger in anticipation of a government decision. Long and exhausting negotiations have been conducted between the BB and the participating banks on the one hand and between the BB and the Ministry of Finance on the other. Several alternatives have been presented. An excerpt from a current proposal (and one that the BB thinks is likely to be accepted) can be found in a Ministry of Finance letter (No. 58/86/138 dated April 12, 1988) which reads as follows:

> "In the context of the budget announcement, the government has decided it will bear 1/3 of the loss due to agricultural credit remissions, 1/3 will be borne by the Bangladesh Bank and 1/3 by participating banks. The BB will accordingly determine the extent of loss due to pronouncements of forgiveness."

At the time of interview (May, 1989), the BB had prepared the estimate of loss reported in Table 1 and apportioned shares in accordance with MOF instructions. It appears that a resolution of this issue is in sight. However, negotiations will probably continue regarding the timeframe over which the financial loss will be adjusted in the accounts of the banks.

6. PLAUSIBLE ALTERNATIVES TO INTEREST REMISSION PROGRAMS

Ideally, interest forgiveness programs should be avoided. They interfere with financial discipline and establish bad precedents with negative implications for future loan recovery. Given the fact that the Bangladesh Government has historically forgiven interest and is likely to do so in the future, this section analyzes some alternatives or solutions. An important issue for bank viability is whether the "lost" interest should not be borne by someone other than the commercial bank's? It must be borne in mind that administrative reforms cannot solve political problems. The efficiency of the alternatives suggested below is therefore debatable:

a) Funds within the Bangladesh Bank. Statutes 60 and 61 of the BB Ordinance mention two special funds - the Agricultural Credit Stabilization Fund (ACSF) and the Rural Credit Fund. The former was set up to help the apex cooperative institution (BSBL) in case of defaults by its constituent cooperative units on bills of exchange, promissory notes, etc. It has apparently never been used, nor has its mode of utilization been clearly spelled out in any BB Circular. The objective of the Rural Credit Fund included the provision of term loans to cooperatives as well as rural credit agencies including some scheduled banks.

This fund also has reportedly never been utilized. Perhaps these funds can be tapped to cover these interest losses.

b) Agricultural Credit Rural Guarantee Fund (ARCGF). This fund is an idea floated in the 1983 World Bank Agriculture Credit Review. At the time of interview (May, 1989) with the General Manager of the Agriculture Credit Division, the BB had submitted a draft proposal for the ARCGF to the Ministry of Finance for review. Under this proposal, a fund of Tk. 500 million would be set up jointly by the BB and the Government of Bangladesh to be capitalized at a specified annual rate. It would initially guarantee up to 30 percent of the principal loan amount. This facility would be available to participating credit institutions (PCIs, defined as any bank involved in agricultural credit operations) that sustain losses due to loan defaults on crop loans because of natural calamities. An ARCGF committee, consisting of representatives from the BB and the MOF, would be responsible for evaluating the validity of claims and indemnities payable. In terms of outreach, the guarantee would only cover loans within a specified "calamity area", as determined by the ARCGF committee on the basis of reports submitted by the PCIs and relevant government ministries such as the Ministry of Agriculture. The amount made available against the claims of PCIs would, in the first instance, be treated as an interest-bearing loan from the ARCGF until the loss is written off as a bad debt by the PCI. In other words, the guarantee under the ARCGF would be actually invoked from the date the loss is written off as a bad debt by the PCI. On that occasion, the "loan" to the PCI would concurrently be written off from the books of the ARCGF.

c) Crop Insurance Program (CIP)[9]. In 1977, the Sadharan Bima Corporation, a Public Insurance Company, launched a pilot project for crop insurance. The experiment ran at a loss. It was quickly identified that one of the reasons was adverse selection of clients. Only high risk farmers bought the insurance. Thus, the indemnities paid far outweighed the premiums received and the program could never become a viable proposition.

7. ANALYSIS

The recent interest forgiveness programs implemented in Bangladesh have had the following characteristics:

a) The programs either have been part of relief pronouncements brought forth in the wake of natural calamities such as floods or cyclone, or have been part of loan recovery drives undertaken in response to a decline in loan recovery. The BB circular for the 1986 program began with the following words "You are aware that the recovery rate for agricultural loans has shown an alarming decline during FY 84-85 and FY 85-86 ....."

b) Announcements about the programs are usually made by the President during field visits and public rallies.

c) The programs have had strong political undertones. In 1986, for example, the announcement was made a week prior to the presidential election during negotiations between the Bangladesh government and the World Bank concerning further disbursement of funds under the Industrial Program Credit-13 (IPC-13) Project.

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[9] The information presented here is based on meetings in 1985 with Mr. Z. Huq, Manager, Sadharan Bima Corp.

Neither the BB nor representatives from participating banks appeared to have been consulted during the decision-making process leading up to the forgiveness programs. The lack of involvement by bankers probably had greater adverse effects on the banks in 1984 than on any other subsequent occasion. The nature of the disaster (country-wide flooding) coupled with inadequate instructions to the branch banks created administrative anomalies, general confusion, and financial mismanagement, particularly at the field level.

The two interest forgiveness programs associated with the provision of relief (1984 and 1985) appear to have had less impact on the borrowers than did the 1986 program undertaken as part of the loan recovery drive. The relief-oriented programs seem to have had a limited effect, probably because during times of distress an implicit relief measure such as interest forgiveness brings no immediate, tangible, benefits to the sufferers. Many borrowers reported the programs did not help them. Perhaps they were unable to repay or had no intention of repaying, or they may have been good borrowers and were thereby penalized. In any case, the effect of these two programs on the loan recovery system is difficult to evaluate because the loans became due in 1986, precisely the year of another forgiveness program.

The 1986 loan recovery drive seems to have had some success. A probable reason is that it had specific cut-off dates. Also, borrowers were not under the additional financial pressure which follows a natural disaster. The interest exemption on pre-Liberation loans did bring in some loan payments that otherwise might not have been paid. A perceptible increase in the loan recovery rate occurred. BB statistics show that the rate of loan recovery changed from 34 percent in FY 84-85 and 26 percent in FY 85-86 to 41 percent in FY 86-

87. Subsequently, the recovery rate plummeted to 24 percent in FY 87-88. It is perhaps safe to attribute at least part of the rise in loan recovery during 1986-87 to the interest forgiveness program. The loans paid, however, were skewed towards small, short-term credit. The recovery drives did not target delinquent longer term loans in agriculture nor industrial loans with their dismal rate of loan repayment.

The costs of the forgiveness programs to the financial institutions include:

a) explicit cost - loss of interest income;

b) administrative costs due to additional paper work, accounting, etc.;

c) implicit (psychological) cost to the system, which manifests itself as low morale among bank personnel. Bankers resent the pressure to participate in a program that they view as having been imposed on them by the government; and

d) its negative impact on long-term banker-client relationships.

These programs have helped perpetuate the belief that the delinquent borrower is always rewarded. Repeated extensions of the final date for loan repayment under the 1986 interest exemption program indicated an adverse recovery trend.[10] Borrowers were reported to have waited in front of a particular bank branch in expectation of another extension on the last date of the program. When their hopes materialized and an extension of the repayment date was announced, they reportedly went home without paying any part

[10] An internal BB study of the 1986 Program of Interest Forgiveness substantiates this point. It shows that loan recovery peaked in February 1987, the first cut-off date, and then again at the end of the interest remission program. After that, the rate of loan recovery dropped sharply.

of their due loans. On the other hand, the good borrower is penalized, because nowhere in the system is there a provision to refund or compensate him/her for the interest paid or hardships faced that were avoided by the defaulters.

The patron-client relationship towards rural credit does not appear to have changed over the years. A loan tends to be viewed as patronage granted and implicitly does not have to be repaid. A government loan, in particular, is viewed by the borrower as a grant from foreign donors. Almost by definition, the borrower feels he does not have to repay these loans. Repeated announcements of forgiveness entrench these notions. Not only are borrowers skeptical about the necessity to repay loans, but so it seems is the government.

The wider implication that goes beyond financial losses is the effect that these interest forgiveness programs generally have on financial discipline. When borrowers think that they can get new loans even though they are defaulters or that their interest can be exempted by non-bank personnel, then the credibility of the banking system and financial discipline are undermined. Strong borrower-client relationships are destroyed.

One supposed objective of President Ershad's 1986 interest remission program was to prosecute defaulters of large loans and those borrowers who did not respond to the amnesty. How far this objective was pursued and achieved can not be determined. There was little evidence at the time of writing this paper that the incidence of certificate cases for loan recovery had increased.

9. RECOMMENDATIONS

Commercial banks are not social welfare organizations. They will fail unless they operate on anything other than proper and strict financial norms. Programs of interest forgiveness only assist in destroying their viability. If banks are utilized to further political ambitions through interest forgiveness programs, their role in the future should be restricted to loan recovery drives only, which appear to work somewhat. But two key factors must be included. First, there should be finite cut-off dates for the program. Second, the drive should be for recovery of both agricultural and industrial overdue loans.

The ARCGF should be established so that losses incurred by financial institutions due to political announcements of interest forgiveness and natural calamities can be covered in this manner. The ARCGF provides a way to insure that the government, rather than the banks, pays for government-announced programs of interest forgiveness. In fact, if the ARCGF works effectively, programs of interest forgiveness may become redundant.

Funds such as ACSF and RCF should be activated as soon as practically possible. A way to capitalize them would be tax-exempt annual contributions/transfers to the fund from operating surpluses of banks.

Certificate cases should be immediately filed against those borrowers who did not repay their due loans under the most recent program. The actions taken as a result of these legal suits should be widely publicized. This is absolutely necessary to prevent perpetuation of the belief that it is not worthwhile to repay, not even when interest is forgiven.

TABLE 1

ESTIMATES OF INTEREST EXEMPTED BY PROGRAM

Name of Lending Institution.[a]	1986 Program	1985 Program	1984 Program	Total Amount[b]
		(in million Takas)		
1. Sonali	1,093.0[b]	1.5	109.0	1,203.5
2. BRDB	250.1	-	-	250.1
3. Janata	418.4	-	24.2	442.7
4. Agrani	325.9	0.6	24.9	351.3
5. Rupali	208.4	e	6.3	214.8
6. Pubali	130.6	-	12.7	143.3
7. Uttara	45.5	-	1.7	47.2
8. BKB	1,145.1[c]	30.1	226.5	1,401.6
9. RAKUB	32.7	-	-	32.7
10. BSBL	346.8[d]	0.2	5.9	353.0
TOTAL[f]	3,996.5	32.4	411.2	4,440.1

Notes: US $1 = approx. Tk.34

[a] Sonali, Rupali, Junata, and Agrani are nationalized commercial banks. Pubali and Uttara are de-nationalized commercial banks. BRDB - Bangladesh Rural Development Board is a parastatal involved in poverty alleviation programs for which credit is provided through the Sonali Bank. BKB, RAKUB - Bangladesh Krishi Bank and the Rajshahi Krishi Bank are development financing institutions for agricultural credit. BSBL - Bangladesh Samabay Bank Ltd. is an apex cooperative bank.

[b] Includes interest on Tk. 256.9 million in BRDB loans.

[c] Includes interest on loans worth Tk. 35.6 million made during the pre-Liberation period.

[d] Includes interest on loans worth Tk. 59.3 million made during the pre-Liberation period.

[e] Less than 0.1 million.

[f] Totals may not add due to rounding.

Source: Unpublished data. BB/Agricultural Credit Department; May, 1989.

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