Evaluation of the Rural Finance Project in Bangladesh

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The findings, conclusions, and recommendations are those of the authors and not necessarily those of USAID.

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EXECUTIVE SUMMARY

This report evaluates the U.S. Agency for International Development's Rural Finance Project (RFP) in Bangladesh. This $75-million project was authorized in August 1983, with a five-year life of project and project completion date of June 30, 1988. The purpose of the project was to create, through policy changes and institutional reforms, an efficient and economically viable nationwide rural financial system that would mobilize rural savings and provide credit facilities to a broader segment of private farmers and entrepreneurs. The project amount of $75 million was disbursed in three equal annual installments of $25 million each in 1983, 1984, and 1985. Prior to each disbursement, AID and the Bangladesh government (BDG) agreed on several policy changes, most of which have been implemented. For the implementation of different aspects of the project, AID has utilized the services of the following contractors and consultants: Robert R. Nathan Associates (RRNA), the principal contractor; Ohio State University; Dr. Maxwell Fry, Chairman of the Economics Department, University of California at Irvine; and Federal Reserve Bank of New York.

The main findings and conclusions of the evaluation team are summarized below.

1. To evaluate the success or failure of the RFP, one must understand what was originally intended in the project. We understand that a large block of foreign exchange was to be used to help relieve the foreign exchange constraint on Bangladesh development, thereby indicating U.S. support to the general policy direction of the BDG, and, at the same time, to enter into or continue a policy dialogue on the development of a viable rural banking system. We assume that it was not intended to try to buy the agreement of the BDG to certain specific policies; such an effort, if it were successful at all, would be only a temporary success. Even if the policies were not immediately reversed when the funds ran out, the initial changes of policy would reveal additional, deeper, problems not foreseen at the time of initiating the project. The establishment of the dialogue, with the possibility of national discussion that might lead to better understanding of the problems of the rural banking system in Bangladesh and the adoption of effective policies by the BDG to deal with those problems, is much more important than pushing a few particular policies through within a three-year period. With this understanding of the project's purpose, our general evaluation of the RFP is that it has already achieved significant success, and if the dialogue with the BDG is continued, additional success is likely to be achieved.

However, this understanding makes it more difficult to state the evidence on which we have reached our conclusions. Listing particular policy changes advocated in the original RFP project documents and then checking off those to which the BDG has agreed are useful but inadequate for evaluating the success of the project. The direction of movement in policy and whether AID is contributing by analyzing the policy options as well as the consequences of inaction, thus setting in motion a process of development in BDG policy thinking, are more important than whether 70 percent or 80 percent of specific policy suggestions in the original RFP project document have already been achieved. In these terms, the RFP has been successful. The BDG has made a number of policy changes in rural banking over the past three years that appear to be in the right direction. Many of these have been the subject of experiments and policy discussions between BDG policymakers and AID staff and consultants. Additional policy changes have been discussed and appear to be agreed.

but can only be implemented gradually; too rapid implementation would be disruptive to the institutional stability, which should be one objective of the project.

2. One main subject on which the AID/Dacca was holding discussions even before the RFP was signed was the rationalization of interest rates. After the project began, a 4-percent service charge on agricultural loans was introduced and the Bangladesh Bank (BB) established a "refinance matrix," which was calculated to encourage the banks to raise funds through mobilization of savings. After these initial moves, loan interest rates have not been further adjusted. However, the basic ideas on how loan interest rates should be calculated, as stated in the RFP project documents and in the letter of the AID/Dacca Mission Director to the Advisor Finance, BDG (now Minister, Finance) appear to have been agreed. The report of the National Commission on Money, Banking and Credit accepts the idea that the lending interest rate calculation should begin with the deposit interest rate necessary to provide a positive real return to savers and then add enough percentage points to cover the banks' cost of credit delivery and loan losses, and provide a small profit. Given this agreement on the basic method of calculating a rational structure of interest rates, the problem becomes a manageable one -- that of determining the basic facts on administrative costs and on provisions necessary to cover loan losses. These basic facts are now available through the Rural Bank and Bank Users Survey (RBBUS) conducted by the RFP consultants; the challenge before AID and the RFP consultants is to incorporate these facts in a series of short policy papers on interest rate determination for consideration by the Ministry of Finance (MOF) and the BB.

3. Neither the Interest Rate Advisory Committee (IRAC) nor the Technical Unit of the BB has functioned effectively, because of institutional problems within the BB. The effectiveness of the IRAC would be enhanced by the work to be performed by the RFP consultants to ascertain the basic facts relevant to interest rate determination. Also, the RFP consultants may associate the Technical Unit in this work. This would provide valuable guidance to the Technical Unit in the performance of its role as the staff of the IRAC.

4. Deposit interest rates have, on the whole, remained positive in real terms during the project period; this has had a favorable impact on savings mobilization. However, there is some recent evidence that interest rates on some types of savings accounts have not remained clearly positive in real terms. Hence, there is need for a continuing scrutiny of deposit interest rates to ensure that they remain positive in real terms. The short policy papers, which it is suggested that AID and the RFP consultants should prepare, might also explore the possibilities for greater flexibility in setting savings interest rates. For example, the BDG might consider allowing fluctuation of interest rates within a band or range, or set the interest rate for one type of savings instrument (say, six-month time deposits), leaving the banks free to set other rates.

While the RFP consultants have worked with one commercial bank in one experiment on how to sell existing savings services, the results of this experiment do not seem conclusive. There would need to be a follow-up experiment that incorporated the results of the first experiment and then some clear analysis of results before the banks could make some use of the conclusions. However, we have some doubts about whether experiments should test whether selling techniques should be tested before considering whether the savings instrument has the right characteristics to be attractive to people in rural Bangladesh. In particular, we would suggest that attention be devoted to finding out whether the limitations on withdrawal of savings currently in force constitute a serious psychological barrier to rural savers whose primary motivation may be to build up resources available to meet emergency needs. In other countries, allowing unlimited withdrawals of savings has proved to be the change that is most effective in encouraging rural people to keep their savings in the banks.

5. The existence of a large amount of overdue agricultural loans is considered a serious problem, and the World Bank, in particular, is applying pressure on the BDG to collect arrears. The RFP approach to this problem at the time the project started was to urge several major changes in the commercial bank accounting system that would cause failure to collect loans to show up in the banks' profit and loss statement as a decrease in profit. This would make clear in the banks themselves and to the BDG the dimensions of the arrears problem. It would also furnish the basis for a staff incentive system more directly connected to efforts to make good loans and collect them. While the accounting changes were being implemented, the RFP consultants were to study the arrears problem and make specific recommendations on how to improve loan recovery.

The seriousness of the problem of overdue loans was not fully reflected under the accounting rules existing when the RFP began. The banks showed artificially large profits by accruing interest as current income on all outstanding agricultural loans, even on those that were long overdue and obviously would never be repaid. The RFP gave priority to the implementation of several major accounting changes, the classification of overdue loans by recoverability and by age, the accrual of interest as income only on loans that were considered as likely to be recovered, the establishment of bad debt reserves (provision) for overdue loans considered unlikely to be recovered, and the write-off of bad debts. These changes are also necessary to meeting the objective of rationalizing the interest rate structure, since they would make it possible for the banks and the BDG to know what interest rates on loans would be necessary for the rural branches of the banks to break even or make a reasonable profit.

All of these accounting changes have been promulgated in reasonable form by the BB, mainly in BDG Circular No. 41 of December 26, 1985, and are to be implemented over a period of two to three years. The staff incentive systems have been tied to the results achieved under the new accounting rules. Making these basic changes in a three-year period is a major accomplishment. There remain several problems that will need to be solved if the full impact intended is actually to be achieved:

The classification of overdues into "loss," "doubtful," and "substandard," which is the basis for limiting the time on which overdue interest can be accrued as current income, is to be made by the Agricultural Credit Inspection Department (ACID) inspectors, who can inspect the rural branches on a schedule of only once in three years, given current resource constraints. Since the banks have not followed the practice of making their own classification of overdue agricultural loans, there is not yet the basis for timely implementation of the provisions of Circular No. 41 regarding establishing of provisions or stopping of accrual of overdue interest as current income.

Preliminary analysis of the RBBUS data indicates the 4 percent of portfolio target for the establishment of bad debt reserves, specified in Circular No. 41 to be achieved over four years, would be grossly inadequate, given the size and age of the overdues.

Staff incentives are still calculated on the basis of the overall results of a bank. For the incentives to have the intended affect on loan collections, a rural branch will have to be treated as a profit center and a major part of the staff incentive paid on the basis of branch profits.

The penalty rate for overdue loans has been increased from 3 percent to 6 percent as recommended in the RFP project documents. It is probably too early to judge whether there is any impact on the borrowers' choice of whether to pay on time. It is doubtful that there will be much impact, since the borrowers are probably not interest-rate sensitive. The psychological impact might be heightened if, at the time a loan is made, the amount due is stated, including the penalty, and then a refund or incentive to pay on time is given to those borrowers who pay promptly. In Indonesia, this system seems to make the borrowers more conscious of the need to pay on time.

6. The full implementation of the above accounting changes will have a major impact on the financial position of the banks and on the BDG fiscal position. They would bring into the open what has been obscured by the accounting practices existing before the RFP -- that is, that the rural branches of the national commercial banks (NCBs) and the Bangladesh Krishi Bank (BKB), and possibly the banks themselves, are in a dangerously weak financial position. If they write off all their bad debts, some may show a negative net worth and have to be recapitalized. If the BDG tries to privatize more of the NCBs before their books reflect the true situation and before they have been made financially viable, there is the danger that the private investors either will not pay the price asked by the BDG or they will buy and then close down the rural branches when they find that they are unprofitable. Of course, all of this ties back to charging a realistic interest rate on loans so that the cost of funds, administrative expenses, and loan losses are adequately covered.

The 60-percent tax on gross profits and the mandatory transfer to the Treasury of the net profits of the nationalized banks yielded sums 4 percent of the average annual tax revenues during the three-year period 1981/82-1983/84. These profits appear to be largely fictitious, so that adjusting the accounting system to reflect the true position will virtually eliminate this source of BDG revenue for the first few years after the change is made. Even if the loan interest rates are increased to realistic levels so that profits are no longer fictitious, the need to make tax policy changes related to provision for bad and doubtful debts and the write-off of bad debt will delay the favorable impact on BDG revenues.

It is understandable that the BDG is reluctant to introduce all of these accounting changes suddenly, but prefers to work up to the final accounting system over a period of several years. It is not clear whether this will enable the BDG to arrive at the intended goals while avoiding any loss of confidence in the banks and, simultaneously, finding other revenues to replace those now generated by the banks' accounting system. Seeking foreign aid to assist in recapitalizing the banks while the accounting changes are instituted may be more likely to achieve success.

7. The serious problem in the recovery of agricultural loans, which has endangered bank solvency, is basically due to the bankers' having made bad loans in the first place. Aside from the lack of bank staff incentives connected with the financial results of their banking unit calculated to reflect loan collection experience, a major reason for the bad loans appears to be the haste with which many loans

were made. This was in response to the BDG's perception of an emergency, caused by flood and drought, which demanded that the farmers receive immediate credit to replant. The BDG did not have confidence that the banking system would be able to respond to this emergency if normal banking practices were followed. Union Agricultural Credit Committees were therefore set up to enlist the local government council members in choosing borrowers. The bank staff did not have time to examine the creditworthiness of borrowers with whom they had no past banking relationship. The banks staff were told to move money, and they moved it.

The BDG appears to be satisfied that this rapid release of credit was a correct decision. Indeed, if the same situation arose today, the BDG would do the same, because the country cannot afford to miss a major rice crop without experiencing misery for the people. It would make the same choice, even knowing that the consequence will be a weakening of borrower discipline and large arrears in later years, followed by a credit squeeze when the government, with the urging of international donor agencies, tries to get tough with borrowers to collect these arrears.

This choice will continue until the rural banking system has developed to the point that the government has confidence that the system will meet such routine emergencies as the need to replant after flood or drought. This involves the development of solid relationships between bank and borrower over a period of several years so that the creditworthiness of individual borrowers is known to the bank. Of almost equal importance in helping rural people to meet emergencies is the provision of appropriate savings instruments that encourage them to build up a personal financial reserve that is available immediately when it is needed.

In Bangladesh, it is difficult to have a relatively emergency-free period during which the rural bank branches can build up these long-term banker-customer relationships. However, AID and the RFP consultants can serve a useful role in continuing to emphasize the importance of building a financially viable rural banking system that is able to provide a steady, reliable flow of banking services; meeting all legitimate demand for credit for any type of rural enterprise; and providing safe reliable savings services with savings instruments appropriate to the people of rural Bangladesh. It is important to "stick to basics, keeping long-term institutional goals in mind during policy discussions with BDG and avoiding further disruption of the banking system's stability by crash programs of various kinds, including those to force the banks to collect arrears by cutting off their sources of new funds.

8. The AID-sponsored pilot project in rural credit, which preceded the RFP, and the RFP project documents both emphasized credit for all types of enterprise in the rural areas, rather than agricultural credit only. There was a recognition that there is a need for sources of employment in the rural areas in addition to agricultural production. This diversification of loan portfolio is also necessary for the financial health of the rural branches. The RFP appears to have drifted inadvertently into nearly exclusive emphasis on agricultural credit rather than general rural credit. The original emphasis of the RFP on credit for all kinds of rural enterprise needs to be restored. This will to some extent be automatic when RRNA continues its analysis of the RBBUS data on term loans and nonagricultural credit of the rural branches.

9. The work of the RFP consultants has been effective in promoting policy changes and, in general, in influencing the policy thinking of the BDG. Particular mention may be made of the work of the prime contractor, RRNA, in producing a large number of valuable analytical and policy studies and in designing and conducting the RBBUS, which is an excellent source of raw data on issues related to loan recovery, interest rate determination, and savings mobilization.

The major recommendations contained in the evaluation may be summarized as follows:

- Through the RFP and on the basis of the RBBUS data, AID should continue to provide the Ministry of Finance (MOF) and the BB with factual and analytical support; to pursue an active and continuous policy dialogue with MOF and BB, including, in particular, the preparation of policy papers regarding the appropriate interest rate spread for rural loans; and to analyze loan recovery problems.

- The BDG should keep the interest rate structure under continuous review to keep deposit interest rates positive in real terms and maintain a remunerative interest rate spread for rural lending. The BDG should consider giving the banks some flexibility while setting interest rates.

- To implement fully the accounting changes contained in its Circular No. 41, the BB should expedite the classification of overdue agricultural loans by the ACID inspectors and should require banks to undertake their own classification without delay. For the future, the classification criteria for overdue loans should be simplified and linked to objective indicators. The management information system should be reviewed to reduce the volume and frequency of data requirements. The provisions of Circular No. 41 regarding the establishment of bad debt reserves should be strengthened to reflect the magnitude of the problem as revealed by the processing of the RBBUS data.

- With the full implementation of the accounting changes, the BB should encourage banks to treat each branch as a separate accounting unit and a profit and loss center, and to link the staff incentive systems to branch performance rather than (or in addition to) the performance of the bank as a whole.

- The RFP consultants should attempt to quantify the fiscal impact of the full implementation of the accounting changes, including revenue loss and need for recapitalization of the NCBs and the BKB, and to recommend appropriate changes in the income tax rules governing provisions for bad debts and loan loss write-offs.

- The necessary reforms of the NCBs should not be postponed until the next round of privatization, so as to avert the repetition of the earlier experience that banks, after privatization, pulled out of agricultural credit.

- In policy discussions with BDG, AID should help clarify ideas about the characteristics of a rural banking system that can meet the needs of the people of rural Bangladesh. The people should be able to depend on the rural banking system to provide the capital they require for any legitimate enterprise by which they can increase their incomes, so long as they show themselves creditworthy by repaying loans on time. They should be able to place their savings with the banking system knowing that their savings are safe, not only from theft of fraud but also safe from inflation, and available in full when needed. For the rural banking system to be dependable, it must be financially viable.

- Financial viability involves setting loan interest rates high enough to cover cost of funds, administrative expenses, and loan losses. It also involves broadening the loan portfolio of the rural branches beyond agricultural credit and the BDG's allowing the banks to build up capital as reserves, retained earnings, or additional stock distributions from after-tax profits.

- To ensure close coordination, AID should keep the other donors fully informed of the progress of RFP. Particularly useful will be the supply of data analysis produced by the RFP consultants, after clearing its release with BB.

- To incorporate the results of the RBBUS in the AID policy dialogue with MOF and BB, RRNA should be given an additional extension of one year until September 1988. As long as the policy changes are in the desired direction, AID should find ways to extend the RFP activities beyond September 1988.

BACKGROUND

The $75 million Rural Finance Project (RFP), based on the results of the earlier implementation of the RFP, was authorized in August 1983, with a five-year life of project (LOP) and project completion date of June 30, 1988.

The purpose of the project was to create an economically viable nationwide rural financial system, through the adoption and implementation of policy changes and institutional reforms designed to streamline and improve the operational efficiency of the Bangladesh rural financial system and to eliminate existing economic distortions. Through the achievement of this purpose, the rural financial system would mobilize savings and provide credit facilities to a broader segment of private farmers and entrepreneurs, and thus attain the project goal of accelerating food production and expanding employment opportunities in rural areas.

The project amount of $75 million was disbursed in three equal installments of $25 million each in 1983, 1984, and 1985. Prior to each disbursement, AID and the Bangladesh government (BDG) agreed on several policy changes that were to be undertaken. Most of the policy changes have been implemented.

Various contractors/consultants have been utilized by AID for the implementation of the project:

- Robert R. Nathan Associates (RRNA), under a contract with the Bangladesh Bank (BB), has carried out studies and has provided consulting services to improve rural financial markets including savings mobilization measures, a comprehensive plan for improving loan recovery, a lending efficiency survey, and a financial sector review.

- Ohio State University (OSU), under a Cooperative Agreement for Rural Savings for Capital Mobilization with AID/ST/MD, has consulted with BB, the Advisor to BB (Dr. Fry) and the consultants from the Federal Reserve Bank of New York (FRBNY), has carried out continuous project review and advisory functions, and has undertaken specific studies and research.

- Dr. Maxwell Fry, chairman of the Economics Department, University of California, Irvine, under a host country contract with BB, has provided consulting services to review monetary and financial policies with the objective of improving the two key functions of the financial system, namely, providing an efficient payments mechanism and conducting efficient financial intermediation.

- The FRBNY under a Participating Agency Services Agreement (PASA) has provided advisory services to improve the efficiency of BB operations.

In order to conduct an evaluation of the RFP, AID contracted for the services of the consulting firm Development Alternatives, Inc. (DAI), which sent an Evaluation Team, consisting of M. Haris Jafri and Richard H. Patten, to Bangladesh in November-December 1986.

Scope of Work

In the original scope of work drafted by AID in Spring 1986, the purposes of the evaluation were enumerated as follows:

a) To review and assess whether actions agreed on by the BDG affecting the interest rate structure, savings mobilization, and loan recovery, have been effectively taken.

b) To review the project performance against the project purpose, goal and strategy as stated in the May 1983 project paper.

c) To assess performance of the technical assistance advisory consultancies as measured against outputs specified in the project paper.

d) To recommend the steps to be pursued and the focus of project implementation during the remaining years of the project.

To accomplish the above purposes, the Evaluation Team was expected by AID to focus on and to provide answers to the following evaluation questions:

a) What policy and procedural changes, have occurred in the rural financial system since project inception? Are these positive changes? Can they be attributed to the RFP?

b) Are these changes likely to lead to a better financial system? To what extent have they already done so? Is the financial system reaching a broader segment of farmers and entrepreneurs? Is the financial system more economically viable now than it was when the project began?

c) Was the technical assistance approach effective in achieving project outputs? How could the technical assistance be more effectively utilized in project implementation? How could the policy dialogue effort have been improved?

d) Are there policy changes or administrative reforms that can be implemented during the remaining LOP?

e) How does USAID's assistance to the rural financial system complement the efforts of other donors? To what extent can the effects of USAID's efforts be isolated from those of other donors? Does the impact of USAID involvement justify the commitment of $75 million?

In order to provide answers to the above questions, the AID mission in Bangladesh prepared, in November 1986, a revised scope of work to be performed by the RFP Evaluation Team. This revision takes into account developments in the Bangladesh financial sector as well as in the RFP since the original scope of work was drafted in spring 1986. The revised scope of work, which was given by the AID mission to the Evaluation Team on its arrival in Bangladesh, amplified Tasks A to H in the original scope of work as follows:

Task (A): Review briefly the role of the key donors in the policy dialogue process relating to the rural financial system.

Addition: How can RFP objectives be incorporated into World Bank and Asian Development Bank programs involving rural finance? What is the potential for furthering RFP objectives via these programs?

Task (B): Review the policy dialogue issues addressed over the LOP and assess the appropriateness and effectiveness of the project in precipitating structural and procedural changes in the rural financial system.

Addition: Are there remaining tranche conditions and policy issues that RFP should focus on?

Task (C): Review the quality and appropriateness of the studies, research, and technical assistance provided by the contractors to the project.

Addition:

- How can the project ensure that completed studies are used to the fullest?
- Is the planned work schedule for continued analysis of research data appropriate? Should the research plan be modified? What is the best means of presenting and distributing future research analysis?
- Does the plan for continued technical assistance by RRNA and OSU make optimal use of these consultants?

Task (D): Determine if the effects of the project's policy dialogue, technical assistance, research and studies contributed directly or indirectly toward achieving the intended outputs.

Addition: How can RFP technical assistance, research, and studies be further used to attain the expected project outputs? Is there still scope for policy dialogue under the RFP or in conjunction with other USAID projects/programs?

Task (E): Determine which structural and procedural changes in the rural financial system should be addressed by this project.

Addition: Response to the Task B addition will indicate to some extent structural and procedural changes in the rural financial system that the project should pursue between now and completion of the project.

Task (F): Assess the development and effectiveness of the Technical Unit within the Bangladesh Bank. Make recommendations for strengthening the role of this Unit, if appropriate.

Addition: What options exist for institutionalizing the Technical Unit within the BB? What role can the project's technical assistance play in strengthening and institutionalizing this unit?

Task (G): Review the contractual arrangements and roles of all four contractors, particularly that of RRNA, and determine if the functions and responsibilities of each are appropriate and should be continued as presently organized or in an arrangement of another type.

Addition: Some comment on the effectiveness of the contractual arrangements and roles of the four contractors would be useful in terms of evaluating the project. To provide future direction for the project, however, the Evaluation Team should review the current PASA with the Federal Reserve system. Should the project work of the Federal Reserve system be re-defined? Does the planned agenda for U.S. and in-country training still make sense? How can this resource best be used?

Task (H): Given the analyses requested above, make recommendations for improving the effectiveness of this project.

Addition: Does the record of the RFP indicate that USAID should continue to be involved in the Bangladesh financial sector after project completion? Offer some preliminary assessment of what future role, if any, USAID should play in this sector.

Given the time constraint (since the Evaluation Team was scheduled to stay in Bangladesh for barely 4 weeks) and in view of the fact that the AID Mission had already extended the contracts of RRNA and OSU for one year (up to August 31, 1987), the priorities of the AID Mission with respect to the issues involved in the scope of work are summarized in the following excerpt from the "Addendum to the Evaluation Scope of Work" of November 1986:

> "In the light of the recent turn of events, the evaluation team's views on how the loan recovery problem should be tackled would be particularly useful . . . . Generally speaking, recent events underscore the need for a "forward-looking" evaluation, one that assesses the future direction of the Rural Finance Project, rather than the progress to date. In addition, as USAID looks beyond project completion, it welcomes the evaluation team's views on whether and how USAID should continue to be involved in the Bangladesh financial system."

Methodology

The Evaluation Team reviewed the enormous volume of available data on the RFP, including the project paper, the project documents such as the scope of work, progress reports and technical studies related to the work performed by each contractor. The two-volume final report and 18 technical papers prepared by RRNA, as well as the reports drafted by OSU and by Dr. Maxwell Fry, were studied. The

Evaluation Team also studied various reports and papers prepared by BB, MOF, NCBs, BKB, and the Grameen Bank, as well as the reports of the IMF, ADB and the World Bank. In addition to the review of the written material, the Evaluation Team discussed policy issues in meetings with officials from USAID-Bangladesh, BB, MOF, NCBs, BKB, IMF, World Bank and the RFP contractors (RRNA and OSU).

Composition of the Evaluation Team and Timetable

The evaluation was conducted in Dhaka (Bangladesh) during the period November 18-December 16, 1986, by a team assembled by Development Alternatives, Inc., consisting of Mr. M. Haris Jafri and Mr. Richard H. Patten. Before leaving Bangladesh, the Evaluation Team presented its findings, conclusions, and recommendations to the USAID Project Committee. While part of the evaluation report was drafted during the team's stay in Bangladesh, the report was drafted in Washington by Mr. Jafri during December 1986-January 1987. The draft report was sent for review to Mr. Patten in Indonesia in February 1987, and the final version incorporating Mr. Patten's comments was prepared by Mr. Jafri in Washington in March 1987.

FINDINGS AND CONCLUSIONS

Overall Assessment of RFP

Based on a review of what has been accomplished with the RFP, as discussed below for the major problem areas of rural finance, it is the view of the Evaluation Team that the RFP can be characterized as having achieved significant success in terms of its objectives and purposes. In some problem areas, success must be measured in terms of progress in analyzing the problems, in bringing out the serious consequences if some of the current policies and practices are allowed to continue, and in convincing the BDG to undertake an urgent consideration of corrective policy actions. In other areas, the solution of one problem, or analysis of data gathered during the project, tends to reveal a deeper problem not fully understood at the time the RFP began. The project should continue to produce significant improvements in the rural banking system of Bangladesh as a result of continuing the already established dialogue with the BDG.

By way of perspective, the Evaluation Team wishes to point out that the three-year time-frame for the realization of some of the objectives and purposes of the RFP was too short to be realistic. Given the structural problems of Bangladesh agriculture, the political constraints, and the long-standing institutional and administrative deficiencies, a much longer period is needed for the achievement of the objectives and purposes enumerated in the project paper.

Another factor that may, in part, have slowed the pace of policy reforms is that the BB has been the exclusive focus of the technical assistance provided under the RFP, and consequently the policy dialogue has been conducted largely with the BB authorities. In fact, the Ministry of Finance (MOF) also has real decision-making authority, even with respect to credit and interest rate policies that are technically within the competence of BB. If means could have been found to associate the MOF on a more regular basis in the RFP program of technical assistance and policy dialogue, progress in achieving policy reforms might have been faster.

The Evaluation Team feels that the basis approach of the RFP, that is, the disbursement of rather large amounts of foreign exchange by AID to help relieve the foreign exchange constraint on Bangladesh development and, simultaneously, to support the BDG in undertaking policy reforms with regard to rural banking, has produced many of the desired results. Considerable progress has been made (as discussed in the rest of this section) toward the attainment of the outputs expected by the end of the project. The ferment in policy thinking and the ensuring process of change set in motion by the RFP is likely to have far reaching consequences in the years to come, provided AID does not get fatigued and withdraw from the project too quickly.

Interest Rate Policies

In the RFP project paper, movement toward the objective of interest rate rationalization involved two policy change activities, an increase in interest rates and the establishment of an Interest Rate Advisory Committee.

Interest Rate increase

The project had initial success in the increase of interest rates. A service charge of 4 percent was added to the basic 12 percent interest rate on agricultural loans. A "refinance matrix" was instituted with respect to rates charged by BB to the commercial and agriculture banks; the refinance rates plus the banks' head office charges to the rural branches are high enough to encourage the rural branches to try to mobilize savings.

The 16 percent interest including service charge for agriculture loans was less than the 24 percent which AID estimated would be necessary to cover lending costs and provide a small profit, but it was a significant step in the right direction. More important, the BDG has accepted the basic idea that the interest rate calculation should begin with the rate necessary to provide a positive real return to savers and then add on enough to cover the banks' cost of administration, a charge to cover loan losses, and a small profit to arrive at the bank lending rate.[1] This reverses the customary method followed in many countries of first setting a lending rate with which political leaders and government bureaucracies feel comfortable, then calculating subsidies and underestimating costs to arrive at a cost of funds which implies paying a negative real interest rate on savings. Agreement on the basic method of calculating a rational structure of interest rates shifts the problem to one of finding the basic facts on administrative costs and on provisions necessary to cover loan losses.

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[1] As stated in the Report of the National Commission on Money, Banking and Credit.

The 16 percent interest including service charge is still too low to cover the actual cost of administration and loan losses in rural lending in Bangladesh. Because of the Rural Bank and Bank Users Survey (RBBUS) conducted by the RFP main consultant, AID now has available the basic facts about actual administrative costs and loan losses on which the BDG might make further adjustments to the interest on rural loans.

Hence, it would be worthwhile for AID and the consultants to prepare a paper for consideration by BB and the MOF detailing the actual cost of funds, administrative costs and loan losses in rural lending as found in the RBBUS survey and the interest rate which would need to be charged to cover these costs plus a small profit.

This calculation will indicate a lending rate which will probably not be acceptable to the BDG, mainly because the loan loss rate is still higher than they will be able to accept for the long term. This would be a useful line of thought and conclusion. The analyses should go on to show the same calculation of final interest rate based on lower loan losses. If, according to the RBBUS, 30 percent of loans are defaulted after a period of four years from the time of lending, the calculation should indicate lending rates which would be required if this rate could be lowered to 20 percent and to 10 percent. Lowering the loss rate almost certainly implies an increase in the administrative costs of the rural branches. The calculation should assume that 6 percent to 8 percent administrative costs would be required to reduce rural loan loss rates to 10 percent.

At present, the data in the RBBUS for short-term agricultural loans and data on administrative costs have been analyzed. Data for term loans is being analyzed and data for non-agricultural loans of the rural branches will be analyzed in the future. While the Evaluation Team would urge that AID re-emphasize lending for all types of rural enterprise, rather than only agricultural lending, the suggested paper to the BB and MOF should not wait until analysis of all types of lending is complete. As the other RBBUS data is analyzed, additional papers of the same basic type, plus one showing rates for a blend of different types of lending will provide an opportunity for continuing dialogue on interest rate policy. The subject of short-term agricultural loans is currently in the forefront of discussions within the BDG and between the government and various international donor agencies. AID has a real contribution to make to these discussions because of the work of the consultants which provides the most solid data available on the actual situation at the level where loans are made.

The RFP project paper assumes that the BB or the government will continue to set interest rates in detail. It does not suggest that the commercial banks might be given some flexibility in the setting of interest rates. Consideration should be given to the government's setting only one interest rate on savings, say the six-month or one-year time deposit rate, and allowing the banks to set the other savings rates above or below this rate. Alternatively the government might allow fluctuation of interest rates within a band for each type of savings instrument or loan. The resultant movement of interest rates within the band or around the basic rate would provide additional information to the authorities in their rate setting decisions.

Interest Rate Advisory Committee

The RFP project paper set the establishment of an Interest Rate Advisory Committee (IRAC) as the second part of the interest rate rationalization process. This committee was supposed to meet regularly to advise the governor of the BB on the adjustment of interest rates on lending, savings, and refinance according to trends in inflation, administration costs and loan recovery.

The IRAC was established, but does not appear to have functioned effectively because of institutional problems within the BB. What changes in the interest rates have been made since the initial increase in the agricultural lending rate appear to have been decided elsewhere and endorsed ex-post by the IRAC.

The IRAC was to be supported by a technical unit which would prepare the studies and recommendations required by the committee. Five members of this Technical Unit were trained under the RFP, but their training appears to have been largely confined to econometrics. This has enabled them to produce a regular statistical series but has not prepared them independently to undertake the needed policy studies and recommendations There seems to be no economist in charge of the group responsible for directing studies which would be appropriate for consideration by the IRAC when making interest rate recommendations.

As suggested above, the material from the RBBUS is the basic material which should be considered in the near future by the authorities who make interest rate decisions. In preparing the paper setting out the RBBUS findings on actual administrative costs and loan losses, the AID consultants may involve the members of the Technical Unit and help them to understand the type of analysis on which interest rate decisions should be made. By the time this work is finished, the composition of the upper-level management of the BB for the next five years will be clear and the question of how to institutionalize the Technical Unit within BB can be considered more rationally. We would emphasize that the key to the unit's usefulness is management by an economist who is capable of anticipating the information needs of the interest rate setting authorities and designing studies to meet these needs.

Savings Mobilization

Before one becomes euphoric over the phenomenal growth of savings and time deposits during the past 10 years (a 22-fold increase in nominal terms), one may look at this growth in real terms (with a tripling of total deposits in the same period). The latter comparison certainly provides a better perspective. It is clear that there has been a significant trend towards monetization of the rural economy and spread of banking habits in the countryside.

Much of this growth has obviously been induced by the enormous expansion of rural branches (four-fold in the same period) and of rural credit (13-fold in the past 8 years), even without reference to the textbook adage, "loans create deposits" (subject to several important qualifications). The savings growth that has taken place has merely scratched the surface of the known savings potential (through RRNA surveys) in Bangladesh. Certainly much remains to be done.

Deposit interest rates have, on the whole, remained positive in real terms during the project period. However, for savings accounts, the most important category for rural branches, the rates have been negative (for savings bank accounts with checking facilities) or barely positive (for other savings banks accounts). As a result, the weighted average of deposit rates have varied in the range of 8-9 percent in recent years, which is hardly positive compared to an inflation rate of roughly 9-10 percent.

The RFP Evaluation Team believes that the maintenance of positive real deposit interest rates is basic to savings growth. If this interest rate policy is maintained, rural savings would steadily grow over time. This process would be accelerated if imaginative efforts were made to utilize the existing infrastructure of rural branches, such as various types of "outreach" programs and experimental/pilot projects undertaken and/or proposed by RRNA and Ohio State University (OSU). The concept of mobile banking facility is an interesting one, especially in the geographical context of Bangladesh, but the estimated costs/benefits need to be carefully examined before it is initiated.

Experience in a number of less developed countries (LDCs) indicates that the absence of any restrictions on the frequency and amount of savings withdrawals has stimulated rural savings and has not led to greater or more frequent withdrawals. The key factor here is the confidence of the rural depositor in the availability or liquidity of the deposit. Given this confidence, the rural depositors, on the average, may not feel the need to exercise this option. It would be interesting to test this hypothesis under Bangladesh conditions through an experimental project.

Loan Recovery Improvement

Since the loan recovery rate for short-term agricultural loans has gone down during the project period, it would be easy to jump to the conclusion that the project has been a failure in this policy objective. The Evaluation Team feels that this would be a superficial interpretation. Under the heading "Loan Recovery Improvement," the RFP - project paper lists accounting changes, revised penalty interest, and a new incentive system as the initial activities which would be undertaken before technical services were made available. Studies to be undertaken by the consultants would provide the basis of a loan recovery review which would indicate additional activities to improve loan recovery.

The questions which should be asked in evaluating the project are: (1) whether the policy change activities related to loan recovery suggested in the project paper have been undertaken; (2) whether they have been completed; (3) whether studies by the RFP consultants have indicated additional activities beyond those originally projected and have these have accepted; and (4) when these policy changes could begin to show effect in improved loan recoveries.

Accounting Changes

The RFP project paper suggests several accounting changes which would clarify the commercial and agricultural banks' profit or loss position as a result of loan recovery or losses. Thereafter, the system of incentives to the banks' management and employees would be adjusted to encourage loan recovery.

The first of the accounting changes listed was the development of a ". . . standard system of defining, classifying and reporting overdue loans." The Banking Control Department (BCD) of Bangladesh Bank's Circular No. 41 of 24 December 1985, and the previous circulars incorporated by reference in Circular No. 41 set out a standard system of defining and classifying overdue loans. From the standpoint of the RFP, two problems with the classification system remain. First, the circular states that the inspectors of BB will do the classification. Since the BB inspection teams get to a rural branch about once in three years, classification will be delayed. The banks themselves have not yet started to classify loans from their rural branches. Second, the criteria for classification are somewhat subjective and will be difficult for branch managers to apply when the banks themselves begin to do the classification.

The second accounting change was to be ". . . requiring financial statements to footnote interest accrued on overdue loans and amounts of overdues by age." Circular 41 appears to go somewhat farther than suggested by directing that interest on loans classified as "doubtful" or "loss" not be shown as income or even accrued in a suspense account from the moment of classification. On loans classified as "substandard," the banks may continue to show accrued interest as income for two years after classification and then stop.

A reporting system, management information systems (MIS), has been established by the Agricultural Credit Division (ACD) of BB for agricultural loans. This reports overdue loans, but does not age them. The ACD is supposed to receive these reports monthly directly from the rural branches of the banks.

ACD is beginning to process the immense volume of data, which will be a time-consuming task. The implementation of the MIS will represent significant progress toward compiling an adequate data base regarding loan portfolio and loan recovery. With the experience gained in this first run in terms of the time needed for processing and analysis, ACD may wish to review the desirability of requiring the monthly submission of data, as at present, or at somewhat longer intervals (e.g., quarterly). Also, in the light of experience with the results of the processing and analysis, the ACD may be in a position to determine whether the data requirements can be simplified or reduced.

The third accounting change suggested in the project paper is the ". . . development of a standard system for establishing reserves for classified loans and for writing off bad debts." Circular 41 states that provision of 50 percent shall be made against loans classified as "doubtful" and 100 percent against those classified as "loss". The minimum level of provision against the total outstanding will start at 2 percent at the end of 1985 and rise to 4 percent by the end of 1989. In the balance sheet of the banks, the provision is subtracted from loans outstanding and only the net amount of loans outstanding is shown on the asset side, rather than showing the provision as a reserve on the liability side. Provision for bad and doubtful debt is not allowed for tax purposes except for a maximum of 1 1/2 percent on total overdue agricultural or rural loans. Write-offs are normally not allowed for tax purposes except after time-consuming litigation.

There have been no changes in the rules for the write-off of bad debts. The present system results in carrying loans which have practically no possibility of recovery, for example those to people who left Bangladesh at the time of liberation.

It must be stressed that appropriate classification of overdue loans is the starting point for the proper implementation of the above accounting changes. In other words, their full implementation is impossible in the absence of such classification.

The cumulative impact of the above accounting changes, when fully implemented, would be far-reaching. At present the poor financial situation of the NCBs and the Bangladesh Krishi Bank (BKB) is obscured by the existing accounting practices. The full implementation of these changes would clearly show the desperate financial situation of at least some of these banks and the need for recapitalization (as discussed further in the section on the viability of the rural financial system).

<u>Revised Penalty Interest</u>

The RFP project paper suggests that the penalty interest on overdue loans should be increased from 3 percent current at the time the project began. The rate was increased to 6 percent. This penalty is being collected where possible, i.e., in cases where there are loan and interest recoveries. Its impact on loan recovery so far is imperceptible, other than adding to the amount of overdue loans. It is too early to judge its impact on the pace of loan recovery. The BDG might consider charging the 6 percent on all loans and returning this amount to those borrowers who pay on time. This would have several beneficial effects. The main one would be to turn the penalty, which has negative connotations, into an incentive to pay on time, which has favorable connotations. The borrowers are probably not interest-rate sensitive, but might respond to paying in time to receive the incentive bonus. It would also make the 6 percent apply automatically to the original period of the loan for those who do not pay on time, not just the period during which they are in default. This would help to cover the large extra costs of having to pursue them to collect payment.

<u>New Incentive System</u>

According to the project paper, after accounting changes were in place, a new bankers' incentive system was to be developed based upon true profits, savings mobilization, loan recovery, and efficient administration. A circular letter from the BB, dated 26-12-85, conveys a decision of the top level of the BDG that bonuses will be paid on the basis of actual recovery and not on the accrual basis. The circular adds the instruction that the bonus will be calculated only after making provision for bad and doubtful debt, according to a formula derived from a BB audit of ten representative branches of each of the nationalized commercial banks (NCBs).

The incentive system is still based on the profits of a bank as a whole. Most of the banks provide an additional incentive at the branch level on the basis of savings collected; some also now give an incentive based on the branch's loan recovery rate.

The need to adjust the accounting systems of the banks to treat each branch as a separate accounting unit was not included in the original project paper, but has become abundantly clear from the studies conducted by the RFP consultants. The individual branches now produce separate profit and loss statements and the banks can say how many of their rural branches are profitable and how many are unprofitable, but these statements are on the basis of accruals, unless the particular branch has been visited recently by the BB auditors to classify loans. The provision is obviously made for the bank as a whole, since it is based on a sample of ten branches.

Until the branch managers or the banks' regional offices classify all loans at least once a year, the accounting system of a branch will not be based on actual loan recoveries. Branch or regional office classifications will depend on development of objective, rather than the present subjective, criteria for classification. A system of classification by performing and non-performing, based on objective criteria, has been suggested by the RFP consultants.

The decision to treat each branch as a separate accounting unit would be the responsibility of each of the banks, rather than the BB. For this purpose, a major focus of the RFP consultants during the next phase of the project should be to work with the individual banks to assist them in: 1) revising their accounting systems to treat each branch as a separate accounting unit; 2) instituting a system of classification based on objective criteria and applied at the branch level by branch mangers under supervision of the regional office; and 3) adjusting their incentive systems to be based on the branch performance rather than (or in addition to) the performance of the bank as a whole.

Loan Recovery Review

The RFP consultants have presented a large amount of findings on the reasons for poor loan recoveries and have made suggestions for improvement. There has not been a formal "Loan Recovery Review" as a result of the work of the RFP consultants. However, the recently completed report of the National Commission on Money, Banking and Credit is likely to be the basic operating document on reforms of the banking system for the next few years. Because of the close connection of the staff of the commission and the BB officers who work with the RFP, a number of the ideas from the RFP studies have been incorporated into the Commission reports. The Action Plan for Recovery of Agricultural Loans recently produced by the BDG also includes many of the ideas suggested in RFP consultant reports, though these were probably arrived at independently.

There is sufficient pressure on the BDG from the World Bank, which is refusing to release commodity import loan funds until the Action Plan is implemented. The contribution of AID and RFP consultants does not require additional pressure or the ability to withhold funds until conditions are met. The contribution can be in providing facts and ideas about the actual progress of loan collections and how to improve these. The contribution of the RFP in this field has already been significant and will continue to be significant in the future.

Fiscal Impact of Accounting Reforms

Before determining the fiscal impact, the major relevant income tax provisions governing commercial banks and development fnancial institutions (DFIs) are summarized below:

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

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

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

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

Hence, it is clear that the accounting changes ushered in by the BCD in its Circular No. 41 regarding interest accrued and loan loss reserve will, when fully implemented,[2] have a serious impact on treasury revenues. To give an idea of the magnitudes involved, the BDG received an annual average of almost T700 million during the three-year period 1981/82-1983/84 from the 4 NCB's and the BKB as the yield of the 60 percent tax on gross profits and the mandatory transfer of net profits. This amounted to 83 percent of the profits of these five institutions and to 4 percent of the average annual tax revenues during this period.

The fiscal impact of these accounting changes, once fully implemented, would be even greater than mentioned above. In due time, the NCBs and the BKB would be shown to be, at least, undercapitalized and on the verge of collapse. The MOF will have to consider the allocation of fiscal and/or external resources to the recapitalization of these institutions.

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[2] So far, a relatively small part of the rural loan portfolio has been classified into the prescribed categories by the banks themselves or by the Agricultural Credit Inspection Department (ACID) of BB.

Hence, it is important to seek the approval by the MOF of the accounting changes, after briefing it explicitly about the fiscal consequences mentioned above, as well as to bring to MOF attention the need to make appropriate changes in the tax treatment of provision for bad debts, transfers to special reserves and loan loss write-offs. For example, it is clear that the 1.5 percent provision allowed for bad debts is grossly inadequate.

Legal Aspects

The Evaluation Team agrees with the conclusion stated in the RFP consultants' studies that, with the exception of the changes in income tax laws proposed above, no significant changes are needed in the legal provisions affecting loan recovery and savings mobilization.

One issue was left unresolved in the legal studies, which has since been clarified by local lawyers -- namely that the banks' legal recourse against borrowers is not affected by the fact that the loan may have been written off under internal accounting procedures.

Viability of the Rural Financial System

Since the late 1970s, the BDG has followed a policy of extending large amounts of low-interest credit to the agricultural sector through the rural financial system. The mechanisms adopted for credit delivery have led to an erosion of the viability of the rural financial system, as explained in the following observations which are based on experience in Bangladesh:

a) Generally, the rural financial institutions have, under instructions from the BDG, had to distribute rather large volumes of credit funds to the agricultural borrowers over a period too short to permit a careful selection of creditworthy borrowers. The problems have been compounded because, frequently, the selection of borrowers was made not by the banks but by the Union/Upazila Agricultural Credit Committee (UACC). Thus, in the case of agricultural credit delivery, the intermediary banks have, by and large, not been able to select creditworthy borrowers because of governmental actions. Although it is a statement of the obvious, it needs to be stressed that if good loans are not made in the first place, the result is bound to be poor loan recovery. This result is basically attributable to government policies, not to the poor performance of banks. No rural financial system can be viable unless serious attention is paid to the creditworthiness of the borrowers.

b) The BDG has recently adopted several important corrective measures, including a reduction in the role of the UACCs in the selection of rural borrowers and the introduction of the passbook system designed to give banks the primary role in the selection of rural borrowers. However, given the present relatively low ceilings on loan interest rates, banks try to keep down the costs of agricultural credit delivery largely by not performing or inadequately performing certain important banking functions related to the administration of agricultural credit. These functions include the selection of creditworthy borrowers, loan analysis, credit supervision, follow-up visits and various quasi-technical assistance activities designed to encourage close contact between banks and borrowers. The nonperformance or inadequate performance of these functions bears a causal relationship to low rates of loan recovery. The relatively low ceilings fixed by BB on loan interest rates do not permit adequate performance by banks of important agricultural credit functions.

c) The BDG policy of channeling large amounts of agricultural credit to rural borrowers through the financial system in a relatively short period has another important drawback. As indicated in the preceding paragraph, such a policy results in high rates of loan default. Over a period of two or three years, the cumulative effect of the loan delinquencies is to place increasingly greater strains on the financial system. As a result, the BDG launches a loan recovery campaign and cuts down on the amount of new agricultural credit, as seems to be happening in 1986-1987. This "stop-and-go" cycle of agricultural credit delivery militates against the policy objective of achieving sustained increases in agricultural production.

d) For the typical small farmer in Bangladesh as in other developing countries, it is of the utmost importance that he/she can count on a stable volume of agricultural credit, year after year. If the farmer had to make a choice, they would prefer the certainty of receiving a stable volume of credit to the erratic nature of cheap credit and would be willing to pay higher interest rates, which would still be substantially lower than the rates charged by the money lenders in the informal market, in order to have assurance of the availability of a stable volume of credit.

e) Looking at the same issue from the point of view of the lending institutions, they would be in a position to provide a stable volume of agricultural credit over time, if and only if such lending was profitable. This means, in the context of the preceding discussion, that the banks should:

- Be allowed to choose the rural borrowers on the basis of their creditworthiness;

- Build up their institutional capability to develop a long-term banker-customer relationship with their rural clientele -- a relationship that would foster the creditworthiness of the borrowers; and

- Be allowed to charge renumerative interest rates.

Based on the above analysis of the experience with the BDG agricultural credit policies, it is clear that the results of these policies have run counter to the crucial long-run policy objective of promoting the viability of the rural financial system. At present, the rural financial system in Bangladesh is far from viable. Given the massive loan losses (and preliminary RBBUS data show a lower recovery rate in 1986) experienced in the banks' agricultural credit portfolios and if all the proposed accounting changes are implemented, the rural branches of the NCBs and the BKB (and possibly the NCBs and the BKB themselves) would be shown to be in a dangerously weak financial position. Some may even show a negative net worth and may need recapitalization.

In order to remedy this highly unsatisfactory state of affairs and to attain the policy objective of promoting the viability of the rural financial system, the basic strategy for the BDG would be to undertake policy adjustments which would make it profitable for banks to extend agricultural credit to small farmers. The key policy measure would be to usher in a renumerative structure of interest rates. The implementation of the policy measures supported by the proposed administrative and accounting reforms would go a long way toward achieving a viable rural financial system.

The severe domestic and external resource constraint makes it impossible for the BDG/BB to continue providing the bulk of resources for agricultural credit on a subsidized basis. It is therefore, imperative that the NCBs and the BKB (as well as private banks) be given sufficient incentives such as an adequate interest spread to provide agricultural credit out of their own (deposit) resources. Consequently, in the next round of privatization of the NCBs, the new private banks would not make it their first order of business to pull out of agricultural credit to rural borrowers (as happened with the earlier privatization).

Role of Other International Donor Agencies

International donor agencies, besides AID, are active in Bangladesh, providing financial resources and influencing policy change.

The International Monetary Fund (IMF) is active in the field of short-term macroeconomic management, with emphasis on fiscal, monetary and balance of payments policies. However, given the importance of the loan recovery problem, the reinforcement of loan recovery policies is included in the BDG "Letter of Intent" that serves as the basis for the current IMF standby arrangement. The World Bank has the leading role, as part of its financial sector review, in trying to persuade BDG to adopt sound agricultural credit policies. The World Bank has withheld disbursement of a rather large amount of its program credit funds, pending agreement with BDG on an action plan for the recovery of overdue agricultural loans. There is the possibility of a sizable financial sector adjustment loan from the World Bank, depending on policy action of the BDG. The Asian Development Bank (ADB) is also active in the agricultural credit field and generally follows the leadership of the World Bank.

The AID mission in Bangladesh maintains close links with the local representatives of other international donors. For close coordination, it is necessary for AID to keep these donors fully informed about the progress of the RFP, including supplying them with data and analysis prepared by the RFP consultants, after clearance with the BB officers in charge of hte project. Such coordination is particularly important at this time since these donors are in a position to provide a large amount of resources to Bangladesh as a quid pro quo for sound agricultural credit policies, while the AID involvement under the RFP in the future is likely to be limited to technical assistance and analytical support.

Work Performed by the Contractors under the RFP

Robert R. Nathan Associates

Robert R. Nathan Associates (RRNA), the prime contractor who was assigned the largest share of the tasks under the RFP for a two-year period, has performed very well amidst rather difficult circumstances (for example, the delay of several months in getting the computer released from Customs and having it installed properly). It has produced 18 high-quality studies, covering statistical, analytical and policy aspects, in addition to a final report in two volumes. Probably RRNA's most valuable contribution to rural finance policy making has been the conduct of the RBBUS. The statistical data, when fully processed and compiled, would give insights not available previously on key aspects of the rural financial system and the behavior of rural bank branches, rural borrowers and rural savers.

While AID has already extended the RRNA contract for an additional year until September 1987, the Evaluation Team believes that another one-year extension of the RRNA contract up to September 1988 is necessary. In the judgment of the Evaluation Team, this additional period will be needed in order adequately to process and analyze the data and bring out the policy implications. The additional period would be particularly useful:

- In having the policy dialogue with the ACD on a regular and continuing basis, since the RRNA unit is now physically located close to ACD; and
- In implementing recommendations (presented elsewhere in this paper) regarding the initiation of an effective policy dialogue with the MOF on a wide range of rural finance policies (e.g., interest rate policies, fiscal and financial implications of postponing action to improve bank solvency, and fiscal impact of proposed changes in bank accounting).

Given the excellent relationship Dr. Cookson (RRNA) has built up within the BB, it will be desirable if his services can be available for the additional one-year extension. Also, it will be useful if Mr. O'Donnell can return to Bangladesh for 2-3 months, to analyze the RBBUS results, given his familiarity with the Bangladesh banking system, particularly rural branches.

Ohio State University

In the original two-year period of the contract, Ohio State University (OSU) was largely concerned with planning and implementing pilot projects for savings mobilization, and with a monitoring role in terms of the progress of the RFP including occasional written comments on the material prepared by RRNA. OSU has adequately performed the assigned activities. Its contract also has been extended by AID for one year. During the extension, OSU is focusing its activities on analysis of transaction costs through the processing of RBBUS data and to organize and conduct seminars on rural finance issues in Bangladesh.

Dr. Fry

Under the RFP, Dr. Fry worked as the Interest Rate Advisor to the BB and was responsible for the training of the Technical Unit at the University of California at Irvine. The outcome of this part of the RFP has not been up to expectations. Neither the IRAC nor the Technical Unit has functioned effectively for reasons mentioned earlier, such as institutional problems within the BB and the inadequacy of the training received by the Technical Unit to prepare it for the analysis of interest rate determination.

Federal Reserve Bank of New York

Activity in this part of the RFP has been rather slow. The Federal Reserve Bank of New York (FRBNY) sent one specialist to Bangladesh to evaluate the bank inspection work of the ACID, who gave the ACID high marks for proficiency. The FRBNY also sent a foreign exchange specialist to Bangladesh, who conducted a short course on foreign exchange techniques.

Apart from these two areas, it has proved difficult for the FRBNY to determine areas where it can really be of help, given the Bangladesh conditions. While the benefits of another foreign exchange course are easy to see, other areas of possible FRBNY assistance to the BB are not so clear, in view of the vast gap separating the two institutions. While the BB obviously needs institutional strengthening, especially in the policy making and implementation functions, such needs would possibly be better served if the BB could work out arrangements with other central banks in South and South-East Asia. Also, the BB may try to make more intensive use of IMF Institute training courses as well as of the technical assistance provided by the IMF through its Central Banking Service.

RECOMMENDATIONS REGARDING FUTURE AID POLICIES

1) Through the RFP, AID should continue to provide the BDG with factual and analytical support, so as to narrow the gap in policy positions between the BDG and international donors such as the World Bank. AID should pursue an active and continuous policy dialogue with the MOF regarding the RFP, since MOF is the prime decisionmaker on rural finance issues. In particular, it is recommended that AID, through the RFP consultants, prepare a policy paper for consideration by BB and MOF regarding the appropriate interest rate spread in the case of rural loans.

2) The Evaluation Team recommends that the BDG consider giving the banks some flexibility while fixing interest rate ceilings. This may take the form of the BDG setting only one time deposit rate and allowing the banks to set other time deposit rates, or the BDG specifying a band or range within which the interest rates for different types of savings or loans may fluctuate.

3) It is recommended that the IRAC of BB meet regularly and function more effectively, as originally envisaged in the RFP. The Technical Unit of BB, which has received special training under the RFP should be institutionalized appropriately within BB and should be fully utilized as staff for the IRAC.

4) With respect to savings mobilization, the Evaluation Team recommends that deposit interest rates be kept under constant review so as to keep them positive in real terms, and that any restrictions on the frequency and amount of savings withdrawal be eliminated in an experimental project, in order to monitor its impact on the frequency and amount of savings withdrawals.

5) With respect to the accounting changes mentioned in the RFP and implemented to a great extent by BB, the Evaluation Team makes the following recommendations:

a) For the implementation of the BCD Circular No. 41 of December 24, 1985, which seeks to set out a standard system of classifying overdue loans, it is of vital importance to build up the inspection capacity of ACID so that:

   i) It can complete the first inspection of all rural bank branches in 1987;

   ii) It can increase the frequency of its inspection of rural bank branches from once in three years to once in two years starting 1988; and

   iii) The classification criteria specified by ACD, BCD, and ACID should be made more precise through the inclusion of objective indicators;

b) Pending the implementation of (a) above, the banks should be instructed to classify the overdue loans from their rural branches (without waiting for ACID officials to classify the loans) and to report such classification to BB by the end of 1987. Thereafter, the banks should classify overdue loans at least once a year.

c) The BB should review the existing classification criteria for overdue loans, in order to establish a simplified classification system by performing and nonperforming loans, based on objective criteria as suggested by the RFP consultants.

d) The strict provisions of BCD Circular No. 41 regarding the treatment of accrued interest on overdue loans should be properly implemented.

e) The MIS, designed to give detailed information about overdue agricultural loans, is currently being implemented by ACD. The Evaluation Team recommends that, after the initial experience with processing the MIS data, the ACD may review the system in order to explore the possibility of reducing the volume and the frequency of the data requirements.

f) The provisions of BCD Circular No. 41 regarding the establishment of bad debt reserves, while representing a good beginning, should be strengthened so that the reserves may adequately reflect the magnitude of the problem of overdue loans, as revealed by the processing of the RBBUS. Also, MOF and BB should review the income tax rules in order to facilitate the establishment of adequate reserves for bad debts as well as the write-off of proven bad debts.

6) The banks should be encouraged by BB to treat each branch as a separate accounting unit and a profit and loss center. In the case of the NCBs, the rural branches already prepare profit and loss statements, which would become acceptable with the implementation of the recommendations regarding the classification of overdue loans (to be undertaken at the branch level). The staff incentive systems of banks should be based on branch performance rather than (or in addition to) the performance of the bank as a whole.

7) It is recommended that AID and the RFP consultants continue to analyze loan recovery problems on the basis of the RBBUS data, as a significant contribution to the formation of BDG views on this issue. As an interim measure, the existing 6 percent penalty on delinquent loans should be made applicable to all loans and should be deducted from the principal before disbursement, with the penalty refunded to borrowers in case of loan repayment on time.

8) The Evaluation Team recommends that the RFP consultants attempt to quantify the fiscal impact of the accounting changes already implemented or proposed. The RFP consultants should also assess the need for fiscal and/or external resources to strengthen the NCBs and the BKB through recapitalization. The RFP consultants should also recommend appropriate changes in the income tax rules governing provision for bad debts, transfer to special reserves, and loan loss write-offs.

9) The Evaluation Team strongly recommends that the necessary reforms of the NCBs not be postponed until the next round of privatization. Even without the accounting reforms, the financial weakness of the NCBs should be obvious to the potential bidders. Also failure to undertake these reforms before privatization may lead to the repetition of the earlier experience, that the banks under the new ownership pull out of agricultural credit.

10) It is recommended that the BDG take the broader concept of rural credit, rather than agricultural credit, as relevant for policy action. It is clear that rural development is an important development policy objective. The provision of credit for rural transport, marketing and handicrafts is as important for rural development as credit to expand agricultural production.

11) The prime contractor (RRNA) has been given a one-year extension under Phase II of the project. The Evaluation Team feels that: (a) one year is too short a time for the proper processing and analysis of the vast amount of data collected in the RBBUS (for example, classification of overdue loans by age); and (b) the AID policy dialogue with the BDG will be more meaningful and more effective on the basis of the facts brought out in the RBBUS. Hence, it recommends an additional extension of the RRNA contract by one year until September 1988. It is hoped that

Dr. Cookson will be able to stay for the additional year and that Mr. O'Donnell will be available to continue his studies of the banking system, but now on the basis of the RBBUS, for up to 3 months in 1987.

12) The Evaluation Team recommends a modest amount of funding out of available technical assistance funds. No recommendation is made for large infusions of AID money at this time, since substantial funds are available from other donors such as the World Bank.

13) The Evaluation Team recommends that the time-frame for the implementation of the needed policy changes be viewed as extending beyond September 1988. As long as policy changes are in the desired direction, the RFP activities should be continued beyond September 1988.

14) The proposed extension of the RFP will cover the activities of technical assistance, policy dialogue and training. It is recommended that AID explore all the avenues to extend the technical assistance and policy dialogue to include the MOF in addition to the BB. For this purpose AID will need to receive from the contractors a series of clear and concise policy papers for the BDG authorities, in addition to the usual detailed studies.

15) The facilities of the Bangladesh Institute of Bank Management (BIBM) and the staff colleges of commercial banks seem to be adequate with respect to banking training. However, there is need to supplement the BIBM courses with regard to problems of rural credit, particularly appraisal of rural creditworthiness, loan analysis and supervision, and appraisal of rural investment projects. These courses would be directed towards credit agents/farm agents of commercial banks in the countryside, who would be responsible for performing field work with rural borrowers.

16) It is recommended that AID keep other international donors fully informed about the progress of the RFP. In particular, AID should transmit the material prepared by the RFP consultants, after receiving the clearance of BB officials in charge of the project.

17) The Evaluation Team considers all the 43 recommendations contained in RRNA Final Report, Vol. 1, to be important. However, the Evaluation Team has included in this report those recommendations which it considers to have higher priority.

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ANNEX A

ACRONYMS

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ACRONYMS

ACD	Agricultural Credit Department of Bangladesh Bank
ACID	Agricultural Credit Inspection Department of Bangladesh Bank
ADB	Asian Development Bank
AID	United States Agency for International Development
BB	Bangladesh Bank
BCD	Banking Control Department of Bangladesh Bank
BDG	Bangladesh Government
BIBM	Bangladesh Institute of Bank Management
BKB	Bangladesh Krishi Bank
DAI	Development Alternatives, Inc.
DFI	Development Financial Institutions
FRBNY	Federal Reserve Bank of New York
IMF	International Monetary Fund
IRAC	Interest Rate Advisory Committee
LDC	Less Developed Country
LOP	Life of Project
MIS	Management Information System
MOF	Ministry of Finance
NCB	Nationalized Commercial Bank(s)
OSU	Ohio State University
PASA	Participating Agencies Services Agreement
PDE	Project Development and Engineering Office of USAID-Bangladesh
RBBUS	Rural Bank and Bank Users Survey

RFEP	Rural Finance Experimental Project
RFP	Rural Finance Project
RRNA	Robert R. Nathan Associates
UACC	Union/Upazila Agricultural Credit Committee(s)
USAID	United States Agency for International Development