

INDUSTRIAL LOAN DEFAULT: THE CASE OF BANGLADESH

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ABSTRACT

Industrial development finance institutions (IDFIs) in developing countries have been experiencing serious financial distress since the early 1970s due to persistent loan defaults. Despite the application of a number of remedial measures, industrial loan default problems continued to haunt the IDFIs. The massive loan loss has not only impaired the viability of many financial institutions, but also made them dependent on government bail-outs. The problem of persistent industrial loan default has become a most important and serious issue that has attracted the attention of bankers, financial market operators, international lending institutions such as the World Bank and policy makers in developing countries. Bangladesh is chosen as a case study because it is an interesting example of the persistent industrial loan default problem.

In the past, very few studies were carried out on industrial loan defaults. These studies have tended to concentrate on the attributes of the borrowers. How the inefficiency in the loan intermediation process and inadequate entrepreneurial guidance towards proper utilisation of credit, and inconsistent public policy regimes contributed to borrower's inability and unwillingness to repay industrial loans have received scant attention from the authors of these studies. Moreover, these studies are neither comprehensive nor complete, since they have omitted a number of significant variables relating to industrial loan defaults. The main objective of this study is to identify the determinants of industrial loan defaults in developing countries. Especially, it endeavours to identify the factors that are responsible for borrower's inability and unwillingness to repay industrial loans. A comprehensive theoretical model incorporating 23 explanatory variables was developed and tested in the light of the experiences Bangladesh Shilpa (Industrial) Bank (BSB) has had over the last two decades.

In order to test the model, both the quantitative and qualitative research methods were used to arrive at a valid and convergent conclusion about the causes of industrial loan default in Bangladesh. Various data collection methods have been employed, such as administered questionnaires, interviews, inspecting loan files and processing customised data collected from the Head Office of the BSB. In addition, case study method was also used to increase the reliability and accuracy of the research findings.

The findings of this study support the model that industrial loan default is the outcome of flawed financial role and flawed developmental roles of the IDFI, and flawed public policy regimes. This suggests that IDFI should play a flaw-free financial role and industrial or entrepreneurial development role and the government should provide flawless public policies with a view to increasing borrower's ability and willingness to repay industrial loans. It is expected that such measures would help to achieve the goal of industrialisation through reducing, if not totally eliminating, incidence of industrial loan defaults in developing countries.

DECLARATION

I certify that this thesis does not include any written material previously submitted for a degree in any university; and to the best of my knowledge and belief it does not contain any material previously published or written by any other person except those mentioned in the text.



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GLOSSARY OF ABBREVIATIONS

ADB	Asian Development Bank
ADFI	Agriculture Development Finance Institutions
ADP	Annual Development Programs
AIT	Advance Income Tax
ARMs	Automatic Rice Mills
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
BIDS	Bangladesh Institute of Development Studies
BCW	Borrowers Credit Worthiness
BDC	Botswana Development Corporation
BKB	Bangladesh Krishi Bank
BODs	Board of Directors
BOI	Board of Investment
BR	Bank Rate
BSB	Bangladesh Shilpa Bank
BSCIC	Bangladesh Small and Cottage Industries Corporation
BSQF	Bank's Standard Questionnaire Form
BSRS	Bangladesh Shilpa Rin Sangstha
CCIE	Chief Controller of Exports and Imports
CCM	Credit Control Mechanism
CD	Credit Disbursement
CEOs	Chief Executive Officers
CNA	Credit Need Analysis
CUD	Custom Duty
DCBs	Denationalised Commercial Banks
DER	Debt-Equity Ratio

DFCs	Development Finance Corporations
DFI	Development Finance Institution
DFIs	Development Finance Institutions
DI	Department of Industries
DPV	Duty Paid Value
EC	Excess Capacity
ECNEC	Executive Committee of National Economic Council
EFAS	Exchange Rate Fluctuation Burden Absorption Scheme
EIU	Economist Intelligence Unit
EOI	Export Orientated Industry
ERP	Exchange Rate Policy
FBCCI	Federation of Bangladesh Chamber of Commerce & Industry
FCR	Final Construction Report
FCR	Foreign Currency
FDR	Flawed Development Role
FER	Foreign Exchange Rate
FFR	Flawed Financial Role
FLB	Federal Loan Board
FP	Fiscal Policy
FPBs	Foreign Private Banks
FPP	Flawed Public Policy
FS	Firm Size
GDP	Gross Domestic Product
GI	Government Intervention
GOB	Government of Bangladesh
H	Hypothesis
HBFC	House Building Finance Corporation
IB	Investment Board
IBDP	Industrial Development Bank of Pakistan

IBJ	Industrial Bank of Japan
ICB	Industrial Corporation of Bangladesh
ICICI	Industrial Credit and Investment Corporation of India
IDA	International Development Association
IDB	Islamic Development Bank
IDFIs	Industrial Development Finance Institutions
IIP	Industrial Investment Policy
IIS	Industrial Investment Schedule
ILD	Industrial Loan Default
IMDBI	Industrial and Mining Development Bank of Iran
IMF	International Monetary Fund
IMP	Import Policy
IP	Industrial Policy
IPO	Import Policy Order
IPs	Industrial Policies
IRP	Interest Rate Policy
ISI	Import-Substituting Industry
KFW	Kreditanstalt Fur Wiederaufbau
L/C	Letter of Credit
LAD	Loan Accounting Department
LC	Local Currency
LRP	Loan Repayment Period
MFIs	Multilateral Finance Institutions
MIS	Management Information Service
MO	Monitoring
MP	Monetary Policy
MPIDFI	Management Policy of IDFI
MPs	Members of the Parliament
NBR	National Board of Revenue
NCBs	Nationalised Commercial Banks

NCMBC	National Commission on Money, Banking and Credit
NIP	New Industrial Policy
NOC	No Objection Certificate
OAR	Officer Application Ratio
OLS	Ordinary Least Square
PCBs	Private Commercial Banks
PH	Principal Hypothesis
PI	Project Implementation
PICIC	Pakistan Industrial Credit & Investment Corporation
PM	Project Management
PS	Project Selection
RAKUB	Rajshahi Krishi Unnayan Bank
Ras	Research Assistants
RIP	Revised Industrial Policy
RMG	Ready Made Garments
RP	Regulatory Policy
S&FU	Supervision and Follow-up
SD	Supplementary Duty
SOE	State-Owned Enterprise
TVLR	Term and Variable Loan Ratio
TVs	Trade Values
UNDP	United Nations Development Programs
VAT	Value Added Tax
WES	Wage Earners Scheme
XPL	Export Performance Licence

CHAPTER ONE

INTRODUCTION

1.1 Loan Default At Development Finance Institutions

Development Finance Institutions (DFIs¹) in developing countries are ravaged by persistent loan defaults and massive loan loss. This is evidenced by the under-capitalisation and illiquidity of a large number of banks and DFIs in developing countries. This malaise in the development finance market has not only impaired the existence of many DFIs, but also adversely affected the economies of developing nations. Manufacturing industry growth objectives remained unrealised, national economic growth stalled, financial deepening in least developed areas slowed down and external debt-dependency has grown. Despite the application of a number of remedial measures, such as supplying fresh funds under bail-out programs, loan rescheduling, imposition of penal interest rates, denial of additional credit to repeat defaulters, management take-over of problem projects, and legal actions, loan default problems continued to haunt the DFIs.

This thesis advances this argument that the default problem is related to the flawed financial role, flawed developmental roles of the DFIs and to the flawed public policies. It is asserted that unless the DFIs are reorientated with both the financial and developmental roles; unless they are supported by consistent and adequate government policies; and unless they follow the principles of efficient credit management, the loan default problem will continue to paralyse the operations of development banks in developing countries.

¹ This abbreviation was also used by the World Bank (1989).

1.2 STATEMENT OF THE PROBLEM

1.2.1 Loan Default Problems in Developing Countries

Developing countries are now ridden with loan default problems. A study by the World Bank (1993) which provided credits to 160 DFIs (Bhatt 1993) in more than 40 countries (Hu, 1981) reported that DFIs in 33 countries were in financial distress due to persistent loan default problems. An identical finding was reported by Calomiris and Himmelberg (1993). They found that the loan recovery rate which is the inverse of the default rate fluctuated between 30 to 40 percent throughout the developing world.

From an individual country point of view, loan default rates have been recorded at 75 percent in Nigeria (Njoku and Obasi 1991), at 32 percent in Costa Rica (World Bank 1995b), at 30 percent in Pakistan (Aleem 1990) and at around 95 percent in Bangladesh (World Bank 1996). The existence of such disturbingly high rates of loan defaults has led to the closure of a number of DFIs (Odedokun 1996; and Krahn and Schmidt (1994). Banks in Indonesia, Thailand, Malaysia and South Korea together lost 39 percent (US\$ 273 billion) of US\$ 700 billion they lent out (Far Eastern Economic Review 1998).

According to the World Bank (1993) record, as many as 70 financial institutions had been liquidated in Argentina by 1983, by mid-1980, the net worth of the Ghanaian banking system was negative and in the Philippines, 2 large public banks and 5 private banks were liquidated in 1996. Among those which are still in operation, many turned either into unprofitable financial organisations (Murinde 1996) or into financiers of moribund loan programs (Srinivasan 1994); some of them have become institutions resembling welfare agencies, instead of viable financial institutions (Hunte, 1992). The questions arise as to why DFIs have been experiencing such disturbing rates of loan

default and what has gone wrong in development finance markets? Finding answers to these questions, obviously, constitutes the purpose of this study.

1.2.2 Theoretical Underpinning of Development Banking

Development bank is one of the most important components of development efforts in developing countries. It functions both as a catalyst of economic development and conduit for passing local and foreign financial resources to the desired investment sectors of an economy. Though there is tremendous diversity in forms, structures and clientele of development banks depending on the political, social and economic characteristics of various nations, a number of writers (Kane 1975; Saksena 1970; Ramirez 1986; Boskey 1959; Murinde 1996; Bhatt 1993; Ligeti 1985; and Kitchen 1986) agreed that a development bank should perform both financial and developmental functions.

1.2.2.1 Financial Function

The financial function of a development bank involves providing credit to the investors like farmers and entrepreneurs. Nyhart and Janssens (1967) surveyed 340 development banks and found that they were providing medium-term and long-term finance to the investors. They found that some countries have one development bank and others have more and they were instituted either by geographic area or by economic sector such as agriculture and industry. In fact, development finance markets in developing countries have been dominated by mainly two types² of development banks, namely, Agricultural Development Finance Institutions (ADFI) and Industrial Development Finance Institutions (IDFI). Most of the DFIs are owned by the Government which arranges funds for them from Multilateral Finance Institutions (MFIs), such as the World Bank

² Other types of DFIs include Housing DFIs and Tourism DFIs which are funded by internal savings only.

which played a key role in setting up such financial institutions (Kasa-Kariisa and Murinde 1995).

ADFI's are engaged in providing mainly short-term credit to the farmers under government-directed credit programs, although there are instances (e.g., ADFI's in Guyana, Bangladesh, Dominican Republic and Nigeria) where they provide long-term credit to set up agro-based industries in rural areas. On the other hand, IDFI's provide medium and long-term credit or such credit plus equity to entrepreneurs and enterprises to promote, encourage and support chiefly manufacturing industry.

IDFI's also supply short-term or working capital loans to their clients when they are denied such loans by the commercial or trading banks. However, the demand for and supply of bank's funds are influenced by market demand and supply schedules for capital, and such 'schedules are influenced by market imperfections' (Kane 1975) in developing countries.

1.2.2.2 Developmental Function

The developmental role of a development bank involves providing: (a) guidance to budding entrepreneurs from set-up stage of industrial enterprise to the stage of liquidation of loans; (b) all back-up assistance such as providing working capital and advice for product marketing and training for managing the enterprise successfully; and (c) co-managing the client enterprise if there is need for such assistance. These promotional services are mostly required for the clients of IDFI's, although agro-based projects of ADFI's also require them. In a developing country where supply of skilled manpower at managerial level is very short; where most borrowers come from the farming or trading sector and where entrepreneurs are budding or new breed who have no or little experience of enterprise management; the developmental role which Gerschenkron (1966) defined as 'accompanying an enterprise from cradle to grave,

from establishment to liquidation through all vicissitudes of its existence' (p.14) is of utmost importance.

Kane (1975) also believes that industrial 'promotional function - identifying potential entrepreneurs, helping them to identify viable industrial projects, assisting them with back-up services during their early efforts - is also essential. Providing capital is only a part of it' (p.15).

But it should be emphasised here that both the financial role and developmental role of development banks are mutually reinforcing and one cannot be performed without the other. Bhatt (1993) and Kitchen (1986) acknowledge that such dual roles, known as 'functional dualism', is appropriate in a developing country where long-term lending, equity investment, and the 'cradle-to-grave' paternalistic involvement in all activities of client enterprise are desperately required.

Development banks, particularly IDFI's serve as an instrument of industrialisation in a backward economy where some of the factors necessary for development are not present or, if present, are not available in a form conducive to industrialisation. The development bank is intended to help stimulate the emergence of the missing ingredients necessary for development. Kane (1975) identified capital, entrepreneurship, technical, and managerial capabilities, promotional activity, capital market activity and availability of foreign exchange as the missing ingredients. He also argues that a development bank can 'further economic development by supplying catalytic increments of these missing factors on its own initiative' (p.15).

Ligeti (1985) believes that development banks 'have an important role in supporting the indigenous entrepreneurs, since in many cases the indigenous entrepreneurs are in a disadvantageous position' and 'it is the responsibilities of financial institutions to provide technical, professional, marketing, etc. consultancy to the applicants of credit' (p.311).

All these mean that unlike commercial banks, development banks 'do not simply finance development projects, but provide related supportive services' which may be 'necessary to create the conditions wherein demand for capital arises' (Kane 1975, pp.14 and 41).

It should be mentioned in this connection that commercial bank plays only the financial role while providing credit to the entrepreneurs. Since their objective is to maximise profit from credit supply, they assess credit worthiness of an entrepreneur on the basis of, how much collateral security he/she can provide against loan amount applied for. But a development bank which plays both financial and developmental roles cannot deprive a worthwhile or viable or bankable project of development finance for want of security (Saksena 1970). While a commercial bank stresses the entrepreneurial experiences, a development bank 'nurses' borrowers and graduates them as experienced entrepreneurs through both credit and entrepreneurial guidance.

1.2.2.3 Public Policy

The effectiveness as well as efficiency of both the financial and entrepreneurial roles of development banks depend on the existence of consistent public policy regimes. Kane (1975) pointed out that 'public policy is the most crucial and decisive variable influencing a development bank's operations' (p.129), since demand for development bank resources is a direct function of the level of industrial demand which, in turn, is functionally related to public policy. After surveying 31 development banks in 26 countries covering all continents, he found that development banks with higher performance ratings were backed by favourable public policy.

IDFIs in developing countries are largely dependent on government and such dependency will continue until capital markets (which are now too small and highly undeveloped) are efficient enough to provide regular loanable funds. Government intervention in the long-term credit market has been aimed at correcting the failures of

market forces - an outcome of credit market imperfections and information asymmetries (Srinivasan 1994).

Developing nations' economies are characterised by high inflation, slow or stagnant growth, persistent balance of payments deficits, devaluation and heavy burdens of external debt and these factors are not conducive to industrial development as they neither allow enterprises to plan ahead nor predict prices of inputs and outputs. Since IDFI and their client enterprises are policy-takers, they are both affected by these macroeconomic changes.

Even if all the tasks of an industrial project identifications, promotion, appraisal and implementation are properly done, unforeseeable events in the macroeconomic environment can effect the performance of the industrial project and, by implication, the development bank. As such, the onus is on the government to deliver healthy macroeconomic policies to stimulate and sustain industrial development in the country.

The macroeconomic environment in developing nations is also conditioned by global factors and by the policies of industrially advanced countries. The general worsening of global economic conditions, for example, unfavourable terms of trade and the heavy burden of external debt, adversely affect an underdeveloped economy which is unhelpful either to an enterprise or to an IDFI. Though an underdeveloped country is tied to the global economic situation, yet it can make a large difference in project as well as IDFI performance by removing inconsistencies that prevail within a particular policy or among various policies and by assuming good governance (Murinde 1996).

Inconsistencies within a policy regime or among various policy regimes can make that particular policy or policies inefficient or ineffective or both. For example, government pursued a credit recovery policy which included a provision for imposing penal interest rates on a defaulter. This policy will become ineffective if the government is engaged in

debt-forgiveness program (The Economist 1992). Such policy inconsistencies, if removed, may reduce the default problems which in turn may make the IDFI viable.

Another most significant issue is the quality of management of the IDFI. A good policy can become ineffective or inefficient without good management. According to Kane (1975), failure on the part of the development bank to promote and finance viable industrial units may be attributable to its mismanagement and flawed policies. When an IDFI plays the role of both financier and entrepreneur, it is required to apply all management principles to direct, control, supervise and guide the client enterprises. That is, to become a successful financial and entrepreneurial role-player, the IDFI should manage themselves well before they provide advice to their client-firms for efficient management.

It is apparent that by letting the development banks play both the financial and developmental roles and by requiring the government to remove all inconsistencies in its policy regimes, developing countries should be able to effectively reduce, if not totally eliminate, loan default problem to a significant level.

1.2.2.4 Determinants of Industrial Loan Default

Several authors (Donald 1976; Jaffee and Russell 1976; Braverman and Guasch 1986; and Gupta 1990) suggested that loan default may be the result either of the inability or the unwillingness of borrowers to repay their loans. It follows that even after borrowers are assisted through financial and developmental roles to become able to repay loans, there is no guarantee that they will be willing to repay loans. Similarly, borrowers willing to repay loans will not be able to repay loans if financial and developmental roles played by IDFI are flawed and public policies suffer from inconsistencies and inadequacies.

Hu (1981) mentioned that development banks in the developing countries have been playing mainly a financial role which the World Bank, the main fund-supplier, prescribed them to follow since their birth. It clearly indicates that IDFI's did not play, in most of the cases, their entrepreneurial or developmental role and finding no entrepreneurial guidance from these institutions, inexperienced and unskilled industrial borrowers had to rely solely on themselves which may have ultimately contributed to their loan default problem.

Public policy failures are important determinants of loan default. Bhatt (1993) believes that development banks fail 'largely because of lack of commitment by the governments' of developing countries 'to initiating and sustaining an accelerated process of viable and widely diffused process of industrialisation through a set of well-coordinated monetary, fiscal and trade policies and a very active developmental role of the State' (p.48). These suggest that public policy regimes are important determinants of borrowers' ability and will to repay loans.

From the above, it can be assumed that the flawed financial role and the flawed developmental role of the IDFI, and the flawed public policy regimes are the three most significant explanatory variables which are responsible for industrial loan default in developing countries.

1.2.3 Need for a Study of Industrial Loan Default Problem

Although loan default problems of ADFIs have been studied by a number of researchers (Gupta 1990; Aguilera 1990; Montiel 1983; Hunte 1992; Braverman and Guasch 1986; Nelson and Letona 1991; Turvey 1991; and Gustafson 1989), loan default problems of IDFI's in the third world countries have received very little attention from the researchers. The current work is an attempt to close this gap, to bring the issue of loan default problems in the industrial or development finance markets squarely into

focus and to provoke a more extensive dialogue between development or industrial bank operators, practitioners, financiers, and industrial policy-makers to take pragmatic measures for industrialisation in the developing countries.

This study deals with industrial loan default problems in Bangladesh. Particularly, it endeavours to test the validity of the assumptions that industrial loan default is related to flawed financial roles and flawed development roles of the IDFI, and flawed public policies on the basis of the loan default experiences of the Bangladesh Shilpa Bank – the most prominent IDFI in Bangladesh.

1.2.4 Loan default Problems in Bangladesh

The banking industry in Bangladesh is now gripped by massive loan default problems. The country's banking system is on the verge of collapse (Hoque 1999a) and by the end of 1998, Bangladeshi banks are burdened with over Taka 592 billion (US\$ 12.08 billion³) in outstanding loans (The Dainik Janakantha, 4 January 1999 and The Daily Star 31 December 1998). The Government of Bangladesh (GOB) has taken some initiative such as tightening up of the regulatory measures to enable banks to recover past loans from the defaulters. According to critics like the World Bank, these initiatives are still not fully commensurate with the gravity of the situation and the loan recovery efforts are unlikely to achieve the desired results. Everyday 30 million Taka (US\$ 0.612 million) of new deposits are being used to finance investments which are unlikely to be recovered, since there is evidence that new loans are no better than the past loans (Far Eastern Economic Review 1997).

Irrespective of its difference from the others in terms of form, structures and ownership, every financial institution in Bangladesh has been suffering from loan default problems.

³ This figure was estimated on the basis of currency exchange rate - 49 Taka = 1 US\$ - that was quoted in the market on December 31 1998.

Of them, Bangladesh Shilpa Bank - the biggest IDFI - is a noted one for its lowest cash loan recovery rate (i.e., 5 percent) in Bangladesh (World Bank 1996).

1.2.5 Bangladesh Shilpa Bank (BSB) - A Case Study

Bangladesh is an agriculture-dependent country, but the decline in agriculture's share of GDP⁴ has caused Bangladesh to place much emphasis on the development of the industrial sector. The near absence of an entrepreneurial class and the lack of efficient capital and securities markets have led the GOB to intervene in the industrial credit market to direct credit allocation to desired industrial activities. Such intervention culminated in the establishment of two IDFI's, namely, Bangladesh Shilpa Bank (BSB) and Bangladesh Shilpa Rin Sanghstha⁵ (BSRS) in 1972. Later in 1972, they were joined by the Investment Corporation of Bangladesh (ICB) which provides venture capital or bridge finance to the clients of other IDFI's. These IDFI's are expected to promote and support small, medium and large industries within government priorities; to save or earn foreign exchange; to modernise or diversify industries; to create employment opportunities; to encourage entrepreneurial activities; and to develop capital markets through supplying medium and long-term credit to the entrepreneurs in the private sector.

These IDFI's, being fully state-owned, maintain close relations with the GOB at policy level but at the same time they enjoy real autonomy and independence at the operational level, especially at the level of sanctioning and disbursing industrial credit, and setting lending and loan recovery conditions (Sobhan and Mahmood 1981).

⁴ Agriculture's share to GDP fell to 30.4 percent in 1994 from 41.8 percent in 1985 (World Bank, 1995a, p.38).

⁵ Just after independence of Bangladesh in 1971, the branch offices of Industrial Development Bank of Pakistan and Pakistan Industrial Credit and Investment Corporation in former East Pakistan (now Bangladesh) were renamed as Bangladesh Shilpa Bank and Bangladesh Shilpa Rin Sanghstha respectively.

As has already been indicated that among three IDFI, BSB is the largest in terms of operations, lending resources and the volume of credit provided to industrialists. At the beginning, it provided industrial credit to the state-owned enterprises but from 1980 entrepreneurs in the private sector emerged as the principal clients due to government's emphasis on the development of private sector to create an entrepreneurial class for speeding up industrialisation. Between 1972/73 and 1990/91, a total of Taka 10.165 billion (US\$236 million) were disbursed by the BSB and BSRS and 93 percent went to the private sector (World Bank 1992). Moreover, a little over two-thirds (76 percent) of this amount was provided by the BSB (GOB, Bangladesh Economic Survey 1992). But few borrowers repaid them in full. A study (Sobhan and Sen 1989) carried out in the late 1980s reported that as many as 29.51 percent of BSB-borrowers have not repaid their dues at all.

The BSB had taken a number of post-lending measures, such as imposing penal interest rates on the top of normal interest rates, denying access to additional credit, rescheduling loans overdue after agreed amount of loan repayment, taking over the management of client-enterprises and selling them through auctions and stringent legal actions against the defaulters. These "band-aid" programs produced little result. The loan recovery performance of the BSB during early -1990s has gone down to such a shocking level that only 4.7 percent of the recoverable amount was collected in cash from the borrowers (Hussain 1996). The World Bank (1996) reported that 80 percent of the BSB's portfolio was in arrear as at June 1996. According to BSB's own estimation⁶, loans outstanding rose to Taka 19.34 billion (US\$ 395 million⁷) as at June 1998 from Taka 16.69 billion (US 371 million) as at September 1996.

The problem of persistent industrial loan defaults has also become a matter of serious concern to the MFIs and they, particularly The World Bank, suspended credit supply to the IDFI from mid-1980s. This disturbingly high loan default rate together with the

⁶ Figure supplied by the MIS Department of BSB in January 1999.

⁷ Figure reflects exchange rate that prevailed at that time.

continuation of the freeze on new credit supply by the MFIs resulted in serious liquidity crisis in the BSB which has become totally dependent on government bail-out programs. The BSB has now very few resources to lend out. New borrowers are turned away by the bank because of drying up of its lending resource. During the 1980s it was the most crowded IDFI, now it is a sick and dying institution. It put a ban on the receipt of loan applications since February 19 1996 (BSB, Annual Report 1996-97).

The disturbingly high rates of industrial loan defaults not only made its stated objectives unrealisable but also produced decelerating effects on industrialisation in Bangladesh. The immediate negative effect has been felt in the manufacturing sector whose contribution to GDP has been locked at 9 percent since 1985 (World Bank 1995a) when acute default problems began to emerge. In other words, the manufacturing sector, which is considered as the engine of economic growth, has not increased even by a percentage mark in a country where population has increased by some 33 million during the last twenty-five years (World Bank 1995b). An empirical study (Khan 1989) also found that industrial lending and industrial growth in Bangladesh has been strongly correlated in the 60s and 70s. The World Bank (1992) indicated that slow industrial growth in Bangladesh during the 1980s was linked to the issue of credit indiscipline and very low loan recovery rate.

Now the questions that need to be resolved through research are:

1. Was loan default due to BSB's flawed financial role or flawed developmental role or to both ?
2. Were there any policy inconsistencies and inadequacies? How have these affected borrowers' ability and willingness to repay loans?
3. Were government policies incompatible with BSB's financial and development roles ? If so, how such incompatibility was responsible for industrial loan default?

1.3 Objective of the Study

Although a number of studies, as has already been indicated, has been carried out about agricultural loan defaults, a survey of the literature indicates that no study has yet been found which examined the effects of flawed financial role, flawed development role of the IDFI and flawed public policy regimes on the industrial loan defaults in developing countries, particularly in Bangladesh. Though Sobhan and Mahmood (1981); Sobhan and Sen (1989); Sobhan and Ahsan (1990); Nabi (1991); and Saha (1997) carried out studies on industrial loan default and industrial sickness in Bangladesh, they concentrated mainly on the repayment performances of the borrowers and the factors that contributed to industrial sickness in Bangladesh. None of these studies investigated the flaws in the functional roles of the IDFI, examined inconsistencies and inadequacies of public policies and their effects on industrial loan default. As such the main objective of this study is to investigate how significantly flawed financial role and flawed developmental role of the IDFI, and flawed public policy regime (which are mutually reinforcing) contributed towards industrial loan defaults in Bangladesh.

Specifically, this study will examine how the BSB's flawed financial and developmental roles and flawed government policy regimes contributed to borrowers' inability and unwillingness to repay industrial loans.

1.4 Hypotheses

The main hypothesis is that most of the BSB-borrowers defaulted in repaying loans due to its flawed financial and developmental roles and flawed public policy regimes pursued by the GOB. Following this, four principal hypotheses were developed. These are:

1. Financial role played by the BSB was flawed which contributed to industrial loan default.
2. The developmental role played by the BSB was highly inadequate and it weighted the financial role more than the developmental role which contributed to industrial loan default.
3. Monetary, fiscal and import policies pursued by the Government of Bangladesh were inconsistent and inadequate which increased the chance of industrial loan default.
4. Industrial policy regimes, regulatory policy measures and policies relating to the management of the BSB were flawed which contributed to industrial loan default.

1.5 Research Methodology

In order to test these hypotheses, a model incorporating three principal explanatory variables, such as the flawed functional role, flawed developmental role of the IDFI and flawed public policy was constructed. Altogether, 23 ordinary explanatory variables were included in the model. Both qualitative and quantitative research methods were used to test the theoretical model. Secondary data relating to as high as 304 loan-cases and as low as 89 loan cases were collected from the BSB. Primary data was collected from the 56 borrowers through filed survey. Besides, published materials and results of interviews were used to test the validity of hypotheses. The use of both research methods helped to discover commonalities across research findings on a number of variables and to arrive at a valid and convergent conclusions about the causes of industrial loan defaults in Bangladesh.

1.6 Limitation Of The Study

The study is limited to only one public IDFI in Bangladesh. The theoretical model did not include a number of explanatory variables because of time and resource constraints. The study did not deal with industrial loan default problems experienced by commercial banks. Nor did it provide a comparative analysis with other development banks in developing countries. The consequences of industrial loan defaults on the national economy was also not considered by this study. It did not examine the effect of changes in global economic conditions on industrial loan default in Bangladesh.

1.7 Organisation

This study consists of eleven chapters including the present one. Chapter two deals with literature review where an attempt has been made to identify how previous studies have dealt with the question of industrial loan default from the view points of developmental role, financial role of the IDFI, and government policy regimes. Chapter three presents an overview of industrial finance market and loan default problems in Bangladesh, Chapter four provides a model incorporating theoretical aspects of industrial loan default. Research methodology is provided in Chapter five. Chapter six contains results obtained from field survey and loan files investigations. The theoretical model developed in Chapter four was tested in Chapters seven - ten. Summary, conclusions and recommendation were provided in the last Chapter.

CHAPTER TWO

REVIEW OF LITERATURE ON INDUSTRIAL LOAN DEFAULT

2.1 Introduction

The persistent loan default problems in developing countries are now of serious national and international concern. A number of authors (Diamond 1957; Boskey 1959; Basu 1965; Saksena 1970; Perera 1968; Ramirez 1986; Murindie 1996; Schatz 1964; Kitchen 1986; Kane 1975; Ligeti 1985; Bhatt 1993; and Wison 1978 and 1986) discussed the role and functions of past and present development banks in developing and developed countries. Interestingly, the issue of industrial loan defaults has not received adequate attention from researchers, with the exceptions of Schatz (1964); Perea (1968); Hunte (1992); Sobhan and Mahmood 1981; Sobhan and Sen 1989; Sobhan and Ahsan (1990); and Wilson (1986) who at least discussed some issues relating to industrial loan default.

Apart from the above, a number of studies on agriculture and home loan default have also been carried out by a number of researchers (Gustafson 1989; Hodgman 1960; Okorie 1992; Njoku and Obasi 1991; Nelson and Letona 1991; Gupta 1990; Aguilera 1990; Hunte 1992; Montiel 1983; Lawrence et al 1992; Jackson and Kaserman 1980; Gau 1978; Vandell 1978; and von Furstenberg 1969). Though industrial loan, home loan and agricultural loans are different from each other in terms of clients, period and amount of loans, there are some common reasons for loan default which are applicable to all kinds of loans. As such, the literature relating to loan default in general is also reviewed.

This Chapter is divided into four sections. While Section 2.1 deals with introductory elements, Section 2.2 reviews theoretical literature on industrial loan defaults. Section

2.3 surveys the literature on empirical studies regarding industrial loan defaults and Section 2.4 provides a summary of the current body of knowledge in this area.

2.2 Review of Theoretical Studies on Industrial Loan Default

The early writers on development banking⁸ were Diamond (1957) ; Boskey (1959); Basu (1965); Schatz (1964) and Perera (1968). These authors discussed the role and functions of a large number of industrial or development banks in developed and developing countries. Prominent of these banks were Industrial Credit and Investment Corporation of India, Industrial Development Bank of Turkey, Nacional Financiera of Mexico, Credit Mobilier of France, Industrial Development Corporation of South Africa, Puerter Rico Industrial Development Company, Pakistan Industrial Credit and Investment Corporation, Development Finance Corporation of Ceylon and Corporacion de Fomento de la Produccion of Chile.

Drawing on the experiences of these and other banks, these authors recommended that industrial banks should play both financial and industrial development or promotional roles. However, each of these banks played these roles differently from the other and this was because ‘there has been no universal model which suited every developing country’ (Basu 1965, p.1). Diamond (1957) also believed that ‘financial institutions, like any other, reflect the background, situation and needs of the country in which they appear and they change as economic growth occurs’(p. 38).

Diamond (1957) rightly pointed out that the viability of a development bank depended on the viability of the projects it financed. Recognising the scarcity of experienced entrepreneurs in developing countries, Kane (1975) recommended that the

⁸ Development bank and industrial bank are synonymous and these terms will be used interchangeably throughout this study.

development bank should provide technical advice ‘on the preparation of projects and on their execution and management’(p. 57). Along with these developmental functions, close supervision and policy guidelines through membership on the board of the project can increase the earning capacity of the project and improve the prospect of loan repayment. These views stemmed from Diamond’s (1957, p.76) belief that the development bank should be concerned with ‘the effectiveness of its loans as with repayments’.

But the effectiveness of loans depend on many factors, prominent among which are constant entrepreneurial guidance and supportive public policy regimes to which he has given little attention. Diamond (1957) found that state-owned development banks were an instrument of government policy and as such stressed coordination among various policy instruments. Again, lack of policy can make policy instruments ineffective and this aspect escaped his attention.

Though Diamond (1957) did not explicitly identify the determinants of industrial loan defaults, it can be derived from his opinions that problems of loan repayment can crop up if the development bank is not adequately involved in developmental roles and if public policies remain inconsistent and uncoordinated. Moreover, improvement of earning capacity of the project does not necessarily guarantee better loan repayment performances unless borrowers’ willingness to repay is favourably influenced by public policy measures.

Boskey’s (1959) description of financial and developmental functions of an industrial bank is more exhaustive than Diamond’s (1957). Among the important functions Boskey mentioned were: supply of permanent working capital, financial and managerial advice, low interest rate, domestic currency loan instead of foreign currency loan, relating repayment schedule to gross sales, supervision over execution and operation of firms, procuring data relating to firms’ operation, training programs for managers and employees of the firm, technical assistance during construction and machinery

installation and maintaining close relationship with the borrowers through regular inspections and presence in board meetings.

Boskey (1959) observed that a number of industrial banks in Asia, Africa, Europe and Latin America performed these functions, but he did not mention how they were related to better loan repayment performance. Most importantly, he did not mention the effects of public policies on the efficiency of these roles of the industrial banks in those countries. It is hard to believe that these development banks in those countries insulated themselves against the adverse effects emanating from inconsistent public policy interventions. However, Boskey (1959, p.6) recognised that 'the design of the bank must be drawn in the light of its purpose and of the economic, social and political environment in which it is to function'.

Basu (1965) carried out a comparative analysis of the functions of 71 development banks. He concentrated on issues like debt-equity ratio, loan repayment period, working capital, interest rate, supervision and follow-up of loans and investment, management of development banks, and other non-financial functions. He found that there was 'no accepted or single "correct" ratio between the loan and equity capital which can be laid down for all development banks' (p.25). However, 41 out of 71 development banks he surveyed provided both debt and equity finance. But he has not examined any relationship between loan default and debt-equity ratio.

Basu (1965) agreed that enterprises should be nursed, but how they should be nursed was not explained by him. His study dealt with only interest rate policy and paid no attention to other monetary or macroeconomic policies such as exchange rate policy adopted by the development banks that he studied. He underscored the values of supervision and follow-up of loans and investment and lamented the policy of filling up the boards of industrial firms with bureaucrats since these people 'cannot contribute to the efficient and imaginative workings of these institutions' (p.77). He has rightly pointed out that a development bank will be able 'to perform its proper role only when

it is endowed with financial as well as non-financial promotional functions'(p.77). He attributed the collapse of the French Credit Mobilier in 1867 to the negligence to the 'basic principles of industrial financing - that of carefully distributing its risks of investment' (p.2), but he did not mention why some of the development banks that he surveyed were more successful than others.

Perera (1968) provided a snap-shot of the historical evolution of the industrial banking in continental Europe in the 19th and 20th century and his description matched with what was provided by Diamond (1957) and Basu (1965). According to Perera (1968), the Societe General Pour Favoriser l'Industrie Nationale established in 1822 in Belgium was the first industrial bank which met medium- and long-term needs of commercial and industrial concerns. It was followed by Credit Foncier and Credit Mobilier which 'was a model for similar institutions in many other European countries' (Perera 1968, p.152). This was only partly true as Germany invented its own brand of industrial banking by combining British deposit-banking techniques and the long-term industrial financing technique followed by French 'banque d'affaires' (Wilson 1978 and 1986).

During the 1930s 'most of these banks⁹ found themselves in a highly illiquid position' (Wilson 1986, p.337), but none of the authors except Basu (1965) provided the reasons for their collapse. However, Perera (1968) mentioned the establishment of several industrial banks such as Corporacio de Fomento de la Produccio in Chile, Nacional Financiera in Mexico and Banco Industrial de la Republica Argentina in 1943 and Corporacio Venezolana de Fomento in Venezuela in 1946 which contradicts Schatz's (1964) claim that the operations of development banks in the developing countries 'has been almost entirely a post-World War II phenomenon' (p.1).

Though Perera (1968) has inadequately dealt with financial functions, he presented an impressive description of what the developmental role of a industrial bank entails. A development bank, according to him, 'would identify, study, and assemble sound

⁹ The Society General was an exception which is a financial giant today.

investment opportunities into projects which it would guide until they were seasoned' (p.100). This definition comes close to what Kane (1975) understood about the developmental role of a development bank.

Kane (1975) opined that the developmental role of a development bank involves 'identifying potential entrepreneurs, helping them identify viable investment projects, and finally, assisting them with back-up services during their early efforts' (p.34).

However, some authors have no clear idea of what the developmental role actually involves. At least, Saksena (1970) has set an example. He mistakenly took 'creation and stimulation of security market' (p.21) as developmental function which he considered 'more important for a development bank than financial functions' (p.20).

Ramirez (1986) studied development banking in Mexico. Though he agreed with much of the concept of Kane (1975) about financial and developmental functions of development banks, he did not discuss how their flaws were responsible for delinquency or default that might be experienced by the development banks in Mexico. None of the literature except Kane (1975) so far reviewed paid any attention to the adverse effects of flawed public policies on the income generation capacity and loan repayment performance of industrial enterprises financed by the state-owned industrial or development banks.

Bhatt (1993, pp. 49-56) explained how a development bank, while playing a developmental role, should harness entrepreneurial skills among the latent entrepreneurial talents, provide management and technical guidance, and promote and extend the market for products of clients enterprises. He is convinced that it is possible for a development bank to perform its role as 'a catalyst for industrial development if this role is one of the overriding objectives of state policies' (p.56). Citing experiences of development banks in Japan, Korea and India, he argued that the 'state should evolve a policy framework that provides stimulus and incentives for effective and

efficient functioning of industrial enterprises and ensures operational autonomy of functioning to development banks' (p.57).

Bhatt's arguments gravitated towards the developmental role and state intervention. He paid insufficient attention to the financial function of a development bank without which the entrepreneurial function cannot be adequately performed. He talked about policy formulation, rather than problems associated with policy implementation in the third world economies where stacks of good policies for industrialisation have never seen the light of the day. Overlapping, inconsistent and external resource-dependent policies have been breeding impediments against successful implementation of public policies and these aspects received inadequate attention from this author. If public policies for industrialisation are not properly drawn and executed, the development bank cannot work as an instrument of development since its operation is functionally related to public policy (Kane 1975). That is, policy weakness impairs the effectiveness of the developmental and financial roles of development banks.

The financial function of a development bank involves a host of activities such as, identifying and financing bankable projects (Kane 1975), examining credit worthiness of borrowers, maintaining reasonable debt-equity ratios, providing working capital loans, disbursing credit in time and recovering credit from the defaulters. These are required for profitable operations of a development bank. The financial role of the development bank should not be allowed to go beyond this financially allowable point. Doing so will turn a development bank into a charitable organisation. The emphasis on the balance between the developmental and financial roles is absent in the above literature.

Stiglitz and Weiss (1981) provided a theoretical argument that high interest rates may attract borrowers with a high probability of default since they take risky projects having prospects of high income. On the other hand, high interest rates induce creditworthy borrowers to leave the credit market. As a loan default-deterrent technique, they

advocated low interest rates which, they believed, would attract borrowers with low default risk.

This argument of Stiglitz and Weiss appears to have validity, given the evidence found by the World Bank (1995b), Hoque (1998 and 1999c), and Sobhan and Ahsan (1990) that industrial loan default was related to high interest rates. But lower interest rates cannot provide a guarantee for low default rate if inexperienced or first generation industrial borrowers are not provided with entrepreneurial and credit usage guidance in respect of profitable operations of industrial firms and if they are not supported by the public policy regime.

Moreover, there is danger that interest rates lower than market rates may understate the true cost of borrowing and that 'it would excessively distort the financial results of the undertaking and the pattern of investment' (Diamond 1957 p.82). If a developing country persistently suffers from high inflation, the advantages flowing from low interest will be lost and in that environment it bears little significance. That is, low interest rates are necessary but not sufficient conditions for a low default rate.

Creditworthy borrowers who are also experienced entrepreneurs are not available in large numbers in developing countries (Diamond 1957; Basu 1965; Kane 1975; and Perera (1968) and hence, the development banks will have few clients to deal with and depending on these few people, industrialisation objectives cannot be achieved in these countries. When development banks harness entrepreneurial skills among the talented but unskilled borrowers, they may be able to reduce the risk of loan default. This suggests that lower default rate may be associated with the entrepreneurial role of the development bank.

Hodgman (1960) postulated that default risk was a function of loan size. He suggested that a profit-maximiser-lender should not provide credit in excess of the wealth of the borrower. But a development bank has not only a profit goal but also a development

goal. This means that the profit goal of a development bank should be lower than that of a conventional (commercial) bank. A public development bank should break even where 'a government desires no return' (Diamond 1957 p. 81) from it. In such a case, loan amounts given by it may exceed the wealth limit of the borrower. It suggests that the risks of industrial loan default can be reduced if the term loans, in excess of borrowers' wealth, is collateralised by their entrepreneurial skills and credit guidance that are to be harnessed by a development bank.

Jaffle and Russell (1976) developed a theoretical model of credit rationing where honest borrowers repay their loans even when there is a financial incentive to default, while dishonest borrowers default whenever there is any such opportunity. When a dishonest borrower defaults, honest borrowers who repay loans subsidise dishonest borrowers' loan repayment obligations. This may happen in an imperfect information environment. Since lenders cannot distinguish among borrowers, it might be best - according to the authors - to ration credit in order to limit or reduce the chances of loan default which occurs due to dishonest borrower's access to credit facilities. The authors did not solve the question: what would be the behaviour of lender and borrower if information asymmetry is reduced by public policy intervention (Srinivasan, 1994, p.14), credit and entrepreneurial guidance?

It is worth mentioning here that the problem of information asymmetry arises due to the fact that lenders do not possess adequate information about the true intent of the borrowers with regard to the fulfilment of their loan repayment commitment. Borrowers, on the other hand, are in full possession of private information regarding their true intention and ability to repay the loan. Gopal (1993, p.35) believes that informational asymmetry between borrowers and lenders can be reduced by creating a dense network of credit market and other markets (e.g., commodity market) interactions. As informational symmetry grows, the wilful defaulters have restricted access to interlinked credit markets. Here, government policy intervention has a role to play: it can increase the interaction and inter-linkages among lenders and borrowers that

may lead to reduction in information asymmetry which plays a part in loan loss reduction (Calomiris and Himmelberg 1993, p.152).

Screening out bad borrowers from the pool of applicants is the first step towards reducing the probability of loan defaults. Taslim (1995, p.969) provided a theoretical argument in this regard that the lender should not only identify and screen out individuals who do not have the requisite entrepreneurial skills from a large number of loan applicants, but also identify entrepreneurs who can run a business profitably but still have an incentive to default deliberately. The successful application of the screening process suggested by Taslim is only possible if the term loans market operates in a symmetric information environment. Eliciting information about the true intent and financial position of the borrowers is so difficult that 'even seats on supervisory boards do not seem to provide for better information than a large creditor has' (Vogel 1980, quoted from Baums 1994, p.414). Baums (1994) has rightly pointed out that 'financiers have less information about firms than the entrepreneurs or managers. Despite careful evaluation, a bank still has imperfect information about the risk of a loan' (p.415).

This suggests that the greater this informational asymmetry, the more difficult it becomes for the lender to assess 'the likelihood of the borrower being able to violate his promise to repay the loan' (Gopal 1993, p.40). Since development banks in developing countries operate in asymmetric information environments, efforts for screening out of would-be defaulters from the pool of loan applicants, as suggested by Taslim (1995), may end up with little success.

Mishkin (1992) identified bad borrowers as those who are most anxious to obtain loans and invest in risky projects. Those who have no entrepreneurial skills and /or experience are most likely to invest in high-risk investment projects - projects that pay high returns to the borrowers, if successful. The high risk, however, makes it less likely that they will be able to pay the loan back. As developing countries are plagued by

market imperfections, investment risks are always high there and these risks can be reduced by the active participation of the development banks in the management of the client-firm. Only the developmental role can provide a basis for such active participation of a development bank.

Allen (1983) presented a model which dealt with incentives to loan default. According to this model, an old debt has to be paid before new debt can be serviced. This implies borrowers' contract with only one lender: they cannot default and go to another lender because the latter knows that the previous interest must be paid before they receive anything. The lender specifies that it will deny further credit to borrowers if they default. Provided this threat is credible, the effective penalty for default may then exclude wilful defaulters from the loan market.

This model is unworkable in a highly imperfect credit market where lenders operate under the regime of asymmetric information about borrowers' loan repayment performance with other lenders. Moreover, in a directed credit market, a defaulter with strong political connections may get access to term loans provided by one lender, no matter how much he owes to another lender. Hoque (1998) mentioned several instances where several Members of the Parliament and a former Prime Minister of Bangladesh defaulted and got fresh loans from the banks. Donald (1976) also supported this view that political objectives were a general cause of high loan default.

Wilful defaulting is a common phenomenon in developing countries and this occurs after the borrower's demand for loans is fully met. In addition, slow and cumbersome bankruptcy and foreclosure procedures serve as incentives for wilful defaulting. The World Bank (1989) reported that loan recovery court proceedings in Egypt, Pakistan, Portugal and Turkey frequently drag on for several years and prolonged court cases give the impression to the borrowers that governments are reluctant to let lenders foreclose. In other words, borrowers willingly default because they believe that creditors may not take court action against them. This kind of belief is true in case of

government directed credit programs under which loanable funds are procured from external sources such as the World Bank and channelled through state-owned banks and DFIs. Schatz (1964) was told by the gleeful Nigerian industrial borrowers that ‘they have the right to default on the loan ... and that since government is the creditor, they will be able to get away with non-repayment’ (p.87). Ugandans also expressed a similar attitude which attracted rebuke from the government in the following words: ‘we deplore the general attitude that the money of the Uganda Credit and Saving Bank is Government money’ (Schatz 1964, p.87).

In an imperfect credit market, borrower’s equity capital has been regarded as a solution to the moral hazard problem in debt contracts (Mishkin 1992) since it is believed that the more equity is provided by the borrower, the less likely is the chance of loan default. The World Bank (1989) has blamed many DFIs experiencing huge loan losses for permitting clients to finance investment with little equity. But this relationship between borrower’s equity and loan default has been contradicted by an empirical study undertaken by Ajayi (1992). He found that equity provided by the borrowers was not important in explaining loan default in the housing loan market of Nigeria.

Other determinants of industrial loan defaults, as per other studies (World Bank 1989; Sobhan and Sen 1989; Battacharya 1995) include non-availability of working capital; high concentration of credit into a particular borrower or a group of borrowers; denying fresh loans to repeat defaulters; rescheduling of loan repayment period and excessive loans to unprofitable projects. These factors are related to the financial and developmental roles of the development banks, in addition to supportive public policy regimes. This suggests that industrial loan default problems can be pre-empted or reduced to a significant level if a development bank plays its financial and developmental roles adequately and efficiently under the backing of flawless public policies.

2.3 Review of Empirical Studies on Industrial Loan Default

Hunte (1992) and Aguilera (1990) have conducted two separate empirical studies on some agro-based industries in Guyana and the Dominican Republic, respectively. From an empirical analysis of 504 borrowers' loan-files, Hunte found that loan default was related to flawed (borrower) screening mechanism, long (application) processing time, and poor quality projects financed by the Gaibank. This means that if an efficient pre-lending screening mechanism is in place to comb out unworthy borrowers and to choose quality industrial projects, it is highly likely that the incidence of recurring industrial loan default can be reduced to a significant extent.

However, post-lending activities such as entrepreneurial guidance for efficient use of credit, supervision for project implementation as per design and operational performance monitoring are some of the key factors that also influence loan repayment performances of borrowers. Hunte (1992) paid no attention to these factors.

Hunte (1992) found that the loan repayment performances of borrowers having infrastructure in working order were better than other borrowers. Good and efficient economic infrastructure in a developing country is treated as good public policy output. It seems that government policy is an important variable which may influence the repayment performance of borrowers to a great extent. It follows that with a favourable public policy regime, borrowers' ability to repay loans can be increased. This contention has been supported by Kane (1975) who found that development banks with higher performance ratings got benefit from favourable government policy.

Hunte (1992) did not study how government policies strengthen the financial and entrepreneurial roles of development banks and how these affect the borrowers' ability and willingness to repay loans. Srinivasan (1994) opines that if borrowers do not expect to be sanctioned or penalised for not repaying loans, they will not be willing to repay loans even though they are able to do so. There may be some policy measures either

from the Guyanan Government or from Gaibank which influenced borrowers' ability and willingness to repay loans. Although Hunte (1992) did not include government policy as a variable in his model, he left scope to do so to understand the relationship between the public policy regime and industrial loan default.

Aguilera (1990) studied credit rationing in rural credit markets of the Dominican Republic. He proposed a comprehensive model on the basis of 3,455 small farmers' loan-applications processed in 18 branches of the Agriculture Development Bank of the Dominican Republic in 1987. While it may be argued that this model represents a complete theoretical approach to study agriculture loan default, it is very complex with a low probability of it ever being tested empirically, because of the information requirement and the difficulties in information processing technology. However, he found that the number of bad-debtors associated with the lenders' flawed screening technology, loan size and collateral requirements. This bad debt or default situation was worse in a regulated environment than a deregulated environment.

The inefficiencies in regulated or government-directed credit markets are well-known and these inefficiencies may be the product of public policy inconsistencies in the Dominican Republic. How the removal of policy inconsistencies contributed to the reduction of the incidence of loan defaults was not considered in his model. Again, his model could include the developmental role of the sample bank as another important variable to examine the relationship between loan default and developmental role of a development bank.

Agulera's findings that the collateral contributes to loan loss reduction was supported by Mishkin (1992). But it may not be true in the case of industrial loans. The commercial success is the security of an industrial enterprise (World Bank 1989) and that is why a creditor relies on the success of the enterprise for recovery of its investment (Ligeti 1985), not on the collateral which is difficult to sell in a non-existent market (Koch 1988). Such commercial success for the budding entrepreneurs in the

developing countries may come when the creditor provides them with entrepreneurial guidance and when they are supported by the government's consistent policies. However, the relationship between industrial loan default and entrepreneurship can be studied by including the industrial background or ability of the borrowers to manage industrial firms successfully in his model.

Schatz (1964) studied the Federal Loan Board (FLB) which provided term loans to the industrial entrepreneurs in Nigeria. Despite supervision over the use of loans, recipients frequently tended to misapply their loans. He also found that 'three of five projects in which loans were misapplied have been unsuccessful and other two seemed in imminent danger of failing' (p.84). These findings suggest that along with adequate credit guidance which traces the use of credit in every stage of project implementation, entrepreneurial guidance was not there which allowed the borrowers to divert the credit to other use. Moreover, a large proportion of loan recipients have not been able to make commercial successes of their business (Schatz 1964, p.86). These resulted in loan default.

The other reason for loan default was quite bizarre; many wealthy borrowers were unwilling to repay loans since they considered defaulting as their right (Schatz 1964, p.47). There were some policy lapses which created the above evasive and lukewarm mentality among the borrowers. None of these points received attention from the author. The loan repayment problem in Nigeria has lead the author to put forward the thesis that 'instead of large number of viable projects vainly seeking capital, the situation has been one of capital vainly seeking viable private project' (p.97). This thesis is wrong because so-called capital abundance was estimated on the basis of the relative shortage of viable projects (which is opposite to badly conceive projects) in a country where 'inefficient entrepreneurial ability' (Schatz 1964, p.89) was present.

It is known that most entrepreneurs in developing countries are not 'capable of identifying, assembling, and financing sound industrial projects' and 'lack processing,

manufacturing, and often efficient marketing skills' (Perera 1968, p.200). It is the responsibilities of the industrial or development bank to identify promising investment opportunities as well as potential entrepreneurs, help them identify viable projects, arrange technical and professional guidance and back-up services for successful implementation and operation of projects. Had the FLB been engaged in the developmental activities, abundant viable projects would have vainly sought capital in Nigeria.

Kane (1975) empirically studied the role of industrial banks in the process of economic development on the basis of aggregate data. He extensively studied 31 development banks - half of them were industrial development banks - in 26 developing countries. He was one of the very few authors who dealt with a number of issues related to development finance. His findings are listed below.

1. Proper public development policy facilitates the emergence of better viable investment projects which facilitates development activities. Weak or improper policy tends to reduce the effectiveness of performance of industrial development banks (p.171).
2. The shortage of viable investment projects is more significant than the shortage of capital from the development bank (p.87).
3. The performance of development banks is heavily influenced (e.g., co-efficient of multiple correlation of sample banks is $R=.639$) by the level of industrialisation (p.88) which means that the demand for development bank credit is a direct function of the level of industrial demand which, in turn, is functionally related to public policy (p.121).
4. Development bank can serve as an instrument of economic development, if public policy towards the bank is positive (p.129).

Kane's findings about public policy effects on development banking are thought-provoking. In his model, public policy was singled out as the most important variable

which influenced the functions of development banks in developing countries. But, his model has a number of lapses. He did not explain how and to what extent: (a) policy inconsistencies within a policy regime (intra-policy) and between or among various policy regimes (inter-policy) affect the developmental and entrepreneurial role of an industrial or development bank; (b) how bad management of a development bank can make a good policy unworkable; and (c.) how convergences and divergences between public policies and industrial bank's financial and developmental roles affect the profitability of the project or borrowers' ability and willingness to repay loans.

Kane provided a model of development banking with the following characteristics: it should be involved both in financial and development activities; it 'must of necessity restrict itself to financing only those development projects which are bankable', 'by doing otherwise it would cease to function as a bank.' (p.17). He also defined a bankable project as one for which the principal and interest can be expected to be repaid according to a pre-determined schedule. This means that, as a development institution, it should deal with those projects which strike a balance between the developmental goal and the profit or financial goal.

Kane's model of development banking is blended with ideas of Gerschenkron (1966), Diamond (1957) and Boskey (1959). His advocacy for financing a bankable project sharply contrasts with his following suggested role of a development bank;

"Industrial entrepreneurs often come from non-industrial sectors and often, too, with little or no capital. This is where the development bank can play a major role...helping them to identify viable investment projects, assisting them with back-up services during their early efforts.. and providing capital is only part of it" (p.34).

It seems from the above that bringing a balance between the developmental goal and the financial or profit goal by a development bank will be impossible if public policy regimes are not consistent and adequate. Because public policy inconsistencies may turn

a would-be profitable project into a non-bankable project by raising the cost of banking which may make the borrower both unable or unwilling to repay the loans. Market failures and information asymmetries in developing countries (Srinivasan 1994), if they go uncorrected, will encourage the able borrowers not to repay loans. By including market imperfection in his model he could examine its influence on borrowers' willingness to repay loans.

Perera (1968) visited and studied the Development Bank of Philippines, Industrial Development Bank of India, Nacional Financiera in Mexico, Japan Development Bank and Industrial Development Bank of Pakistan (IDBP). He found that the high loan component and low owner's equity investment in projects put the IDBP in a risky position. The borrowers were generally inexperienced, lacked technical and managerial ability and 'needed guidance of the way' (Perera 1968, p.210). Delayed loan disbursement, lack of essential economic infrastructure and high burden of capital expenditure in the projects due to over-stated value of imported machinery were responsible for loans outstanding in the IDBP.

Though his study was not exhaustive, the above results indicates that loan outstanding in the IDBP was due to its flawed financial role and flawed developmental roles. Perera (1968) did not consider how flaws and inefficiencies in public policies filtered down to firm level and how they have contributed towards industrial loan defaults in Pakistan. Again, he did not report the results of his study of the other banks that he visited.

Njoku and Obasi (1991) empirically examined loan repayment performances of farmers in Imo State in Nigeria on the basis of: (a) secondary data on loan disbursement, repayment and interest charges collected from commercial and merchant banks; and (b) primary data collected from 69 agro-based enterprises (e.g., poultry, rice, palm oil, yam, cassava, maize, and plantain). They used an ordinary least squares (OLS) regression model in estimating the relationship between loan repayment and a number of explanatory variables. They tried four functional forms : linear, double-log, semi-log

and exponential and out of these, only the linear form was used for analysis of loan repayment performance.

They found that: (a) low output and low profitability contributed to poor loan repayment rate (i.e., default rate being 66.28 percent); and (b) amount of loan received and interest charged on the loan were significant determinants of loan default (i.e., high interest rates reduce loan repayment). Their results showed that R-square was 0.70 with the linear form and 0.34 with the exponential form which meant that some unexplained factors, other than those identified by them, were responsible for loan defaults. The developmental role of the development bank and/or government policy could be included in the model which could be used to examine what portion of the variability in loan outstanding was explained by these two factors. It may be that these two variables were the most significant variables in explaining variation in the loan repayment performance of Nigerian borrowers.

Boyes et al (1989) have provided a model wherein they argued that the goal of credit assessment should be to provide accurate estimates of each applicant's probability of defaults and the pay-offs that will be realised in the event of default. This model did not provide a theoretical basis for the analysis. This model is not suitable for the underdeveloped credit market where information of borrowers and lenders is asymmetrical (Srinivasan 1994).

Gau (1978), Lawrence et al (1992) and Jackson and Kaserman 1980 (cited from Lawrence et al 1992) carried out empirical studies on the home loan defaults. Jackson and Kaserman (1980) found that negative equity value provided incentives for the borrower to default and that the mortgagors who have sufficient cash flow refrain from defaulting on the loan. Lawrence et al (1992) studied home credit in the USA empirically. They reported that higher probabilities of loan default were associated with poor payment history, small loans, older borrowers, higher current loan-to-value ratio and short period loans.

Though these results are related to home loans, some of them are relevant to industrial loan defaults and this is because of the fact that both home and industrial loans are term loans. Since home loans require little developmental role from the development banks, these reasons for loan defaults cannot be fully applied to the industrial loan defaults. Moreover, home loan borrowers are less affected than industrial borrowers by the public policies and all of these results cannot be taken as the determinants of industrial loan defaults. However, they provide some insight and support for financial variables which may be responsible for industrial loan defaults.

Sobhan and Mahmood (1981) and Sobhan and Sen (1989) investigated trends in loan repayment performances of the borrowers of the BSB and BSRS. For the first time, these studies highlighted loan default problems in Bangladesh. The authors found that loan repayment performances of industrial borrowers declined to 10 percent in late 1980s. However, how the industrial loan defaults was related to flawed financial and developmental roles of the BSB and BSRS and flawed public policies was not the subject of investigation of these studies.

Sobhan and Ahsan (1990) conducted a field survey on 42 industrial enterprises financed by the BSB and BSRS in Bangladesh. They used administered questionnaires to procure and process data relating to loan repayment performance of these sample enterprises. A little over 50 percent of the sample enterprises (23 projects) responded to all of the questions.

They found that poor loan repayment was associated with inexperienced borrowers, delayed loan processing, lack of equity capital, high costs of construction materials, low gross profits of the firm, under-utilisation of productive capacity, problems with raw materials, infrastructures, marketing of products and management, and unavailability of working capital.

The authors have paid almost no attention to the inconsistencies and flaws in the public policy regimes which had adverse effects on the successful operations and earning capacity of the firms and their loan repayment performance. There was a contradiction between policy expectations and policy instruments employed to achieve those and such inconsistencies obstructed the profitable operations of the firm. There was no credit guidance and no adequate entrepreneurial guidance from the set-up stage of the firm to the liquidation of the loans. These factors along with other were not considered in their studies.

Sobhan and Ahsan (1990) have not studied the relationship between loan defaults and a number of explanatory variables relating to financial and developmental roles, public policies, and management of the BSB. Some of the important missing independent variables were: size of the loan, size of firms, loan repayment period, term and variable loan ratio, debt-equity ratio, regulatory policy, monetary policy, industrial policy, loans to repeat defaulters, loans to over-saturated industrial sectors and policy relating to the management of the IDFI.

Sobhan and Ahsan (1990) conducted their study in 1986 and since then a number of policy initiatives have been taken by the BSB and BSRS and by the GOB. It may be that the results they obtained from their small sample firms may not be valid in the changed circumstances. The relevancy and validity of the results of their study to the present changed circumstances need to be tested again to arrive at conclusions regarding the loan default problems in Bangladesh.

It would not be out of place to mention here that a number of studies (Saha 1997; Habibullah 1980; Begum 1990; Rahman 1991; Sen 1989; Saha and Dey 1992; Momin 1994; and Nabi 1991) were carried out on industrial sickness in Bangladesh. Authors of these studies found that shortage of working capital, high import costs of raw materials, deficiency of managerial skills, high interest rates, under-utilisation of productive capacity, unavailability of raw materials, currency devaluation, fiscal anomalies,

approval of more projects in the same industries and smuggling were responsible for industrial sickness (i.e., non-performing conditions) of industrial enterprises in Bangladesh. Though these studies did not directly investigate the relation between industrial sickness and industrial loan defaults, they provided useful information for analysing and understanding reasons behind borrowers' inability to repay industrial loans.

2.4 Summary

This literature review has highlighted the difficulties experienced in finding a model which adequately explains the reasons for industrial loan default problems in developing countries. Few studies were carried out on industrial loan default and all of them were incomplete and inadequate. None of the studies has examined how financial variables, developmental variables and policy variables together influence industrial loan default. Some authors stressed financial variables, others weighted development variables over financial variables. Policy variables hardly received adequate attention except from one author (i.e., Kane 1975).

A number of studies were found on development banking and they provided a good discussion on the roles and functions of industrial banks in a number of countries. Additionally, a number of studies on agricultural and home loans were reviewed which helped to draw conclusions about the inclusion of some variables into the possible industrial loan default model.

During mid and late 1980s, three studies were carried out about trends in industrial loan repayment performance in Bangladesh and they highlighted the low loan recovery rate in the IDFI. One of these studies was empirical in nature. This twelve-year old study did not consider the development role of an IDFI at all. Moreover, highly insufficient attention was given to financial and policy variables and their influence on industrial loan default. In brief, all studies fell short of recognising the importance of a model

incorporating flawed financial role, flawed developmental role and flawed public policy as most important independent variables which can adequately explain the reasons for industrial loan defaults in Bangladesh.

There were eight studies which dealt with industrial sickness in Bangladesh. Though the study of how flawed financial and developmental roles of the IDFI and flawed public policy regimes contributed to industrial loans defaults in Bangladesh was not the subject-matter of these studies, their findings are useful in understanding the reasons behind borrowers' inability to repay loans. In a nutshell, all studies reviewed provided a better understanding of the loan default problem in developing countries, not to mention Bangladesh.

CHAPTER THREE

OVERVIEW OF INDUSTRIAL FINANCE MARKET AND LOAN DEFAULT PROBLEMS IN BANGLADESH

3.1 Introduction

The banking sector in Bangladesh has been experiencing financial distress since early 1980s. There was hardly any bank there which was not touched by loan default and loan loss. Data released by the central bank - Bangladesh Bank - and reported in the national newspapers showed that Taka 191 billion (US\$ 3.90 billion) was overdue loans and Taka 21 billion (US\$ 429 million) was bad loans as at December 1998 (The Daily Star, 31 December 1998 and The Janakantha, 4 January 1999). Consequently, the banking sector is on the verge of collapse (Hoque 1999a). Such a depressing condition was the outcome of imperfections, distortions and inefficiencies in the banking sector, and borrowers' unwillingness and inability to repay loans.

Persistent industrial loan default has created a crisis in the industrial finance market to such an extent that DFIs, particularly IDFI, have become moribund organisations. The growing demand for industrial credit has increasingly remained unmet due to this problem of persistent industrial loan default. This debt crisis as well as a slump in the supply of industrial credit has contributed towards declining private manufacturing investment in Bangladesh where economic growth via private manufacturing investment growth has always been the target of the GOB. The cost to the economy of Bangladesh has been enormous and incalculable. It means that discipline in the industrial finance market should be established in the interest of accelerating the growth of the industrial sector of Bangladesh.

In this chapter the state of the industrial finance market in Bangladesh is reviewed. This review is divided into five sections. Apart from an introductory note in Section 3.1, an introduction to the Bangladesh economy is presented in Section 3.2. Industrial credit in Bangladesh is mainly provided by public IDFI's though Nationalised Commercial Banks (NCBs) entered into this market since the late-80s. The Bangladesh Bank (BB) regulates financial markets and financial policies under the directives of the GOB and it influences the operations of both NCBs and IDFI's. The financial regulations of the BB and loan recovery performance of NCBs and IDFI's are presented in 3.3. Section 3.4 contains an analysis of the loan recovery performance of a public IDFI, namely, Bangladesh Shilpa (meaning industrial) Bank (BSB). The summary is provided in Section 3.5.

3.2 Bangladesh Economy

Bangladesh is one of the world's poorest countries with an area equivalent to that of Victoria, Australia. It is the eleventh most populous nation on earth with half of the population of the United States. Though 27 years have passed since its independence in 1971, per capita Gross Domestic Product (GDP) hovered around US\$ 250 until 1998. Poverty remains pervasive; almost half of the population is below the poverty line¹⁰ (GOB, Fifth Five Year Plan 1998), and the absolute number of the poor has grown every year since independence, even though the incidence of poverty declined slightly over the 1980s (World Bank 1995b).

Despite very limited natural resources and only a 44.3 percent literacy rate (GOB, Fifth Five Year Plan 1998), annual GDP growth rate has averaged about 4 percent¹¹ between 1985 and 1994 (Table 3.1).

10. The World Bank calculates poverty line which varies from country to country. For Bangladesh, it was US\$ 370 for early 90s.

¹¹ It was also mentioned in the Fifth Five Year Plan 1998-2002 (GOB 1998).

Table 3.1
Average Annual Growth of GDP 1984 - 1994

Year	Average Annual Growth Rate
1985 – 90	3.8
1990 – 94	4.2

Source : The World Bank (1995a)

However, this average GDP growth rate has fallen considerably short of the GDP growth of 6-7 percent estimated to be required for substantial and lasting poverty alleviation. This slow GDP growth is due to lacklustre performance in several crucial areas, particularly private investment, which remains below 8 percent of GDP (World Bank 1995a).

Low investment continues to remain a problem in both public and private sectors of the economy. Private investment in real terms has failed to show much upward trend (GOB, Fourth Five Year Plan 1995) and low private investment growth has been attributed to uncertainty caused by sudden policy changes with the change in government and slow implementation of policy changes (World Bank 1995b).

Also, public investment, which is incorporated in the Annual Development Program (ADP) has not grown. This is because the GOB attaches less importance to public sector growth than private sector growth - an outcome of the pressure from the donor countries on the GOB to promote private investment. Since over 80 percent of its ADP is financed by foreign aid, Bangladesh has to follow and swallow the economic prescriptions of aid organisations and donor countries to accelerate economic growth via private manufacturing investment growth.

Historically, agriculture has been a key sector of the Bangladesh economy. Since its contribution to the GDP (Table 3. 2) has been declining, the GOB has been placing

more importance on the growth of the manufacturing sector. Unfortunately, the manufacturing sector has failed to register any substantial growth over the last decade.

Table 3.2
Contribution of GDP by Economic Sector (% of GDP)

Sector	1985	1990	1992	1993	1994
Agriculture	41.80	36.80	34.50	30.50	30.40
Industry (All)	16.00	15.80	16.60	17.50	17.70
Manufacturing	9.90	8.70	9.10	9.70	9.90
Service	42.3	47.4	49.0	52.0	51.8

Source: World Bank (1995a, p.38)

Table 3.2 shows that the contribution by the manufacturing sector to the GDP has been locked at 9.9 percent since 1985. It means that despite the annual average 4 percent growth of GDP between 1985 and 1994, the share of the manufacturing sector in it has remained unchanged in percentage terms. Though its share to the GDP rose to 11.36 percent in 1995-96 and 11.08 percent in 1996-97 (GOB, Fifth Five Year Plan 1998), such growth was largely due to a rise in foreign direct investment which comprised 44.55 percent in 1995-96 and 44.93 percent in 1996-97 of the total private manufacturing investment during the period under review (GOB, Fifth Five Year Plan 1998). This suggests that domestic private manufacturing investment did not grow as per plan target until 1997.

Concerned by this stalemate in the domestic private manufacturing sector the GOB tried to reform monetary, fiscal, trade and industrial policies and regulatory regimes to encourage private sector manufacturing investment. It intervened in the direction and intermediations of industrial finance, pursued a policy of import liberalization covering both quantitative restrictions and tariff rationalisation and offered various monetary and fiscal incentives. Further, the GOB moved away from controlling private manufacturing investment to facilitating it through continuous changes and improvement in various

policy measures. Despite these policy interventions, the growth of private industrial investment remained below the expected mark. This was largely due to the non-repayment of loans which 'has come to threaten recycling of funds and has become an enormous impediment to resource mobilisation' (GOB, Fifth Five Year Plan 1998, p.123) to speed up activities of industrialisation in Bangladesh. This suggests that persistent industrial loan defaults created inhibitions against rapid industrialisation in Bangladesh.

3.3 Financial Markets in Bangladesh

The formal financial sector in Bangladesh comprises the central bank, deposit banks, development banks, investment companies, leasing companies, insurance companies and two stock exchanges. As of 1995, there were four NCBs, two denationalised commercial banks (DCBs), ten domestic private commercial banks (PCBs), six foreign private banks (FPBs), four state-owned DFIs, two of which are in the industrial sector and the remaining two serve the agricultural sector, one state-owned investment company, two private leasing companies, two large state-owned insurance companies, several private insurance companies including one foreign owned and the Dhaka Stock Exchange¹². The contribution of the financial sector to the GDP has been around 2 percent¹³ (Choudhury et al 1996).

This low level of contribution to GDP by the financial sector mirrors the unhealthy and inefficient financial sector laden with an industrial loan default problem. The positive relationship between a healthy and efficient financial sector and economic growth is undisputed. Comprehensive evidence from across 119 developed and developing

¹² Another small stock exchange company, namely, Chittagong Stock Exchange was established in 1995.

¹³ The contribution of the banking and insurance sector to the GDP rose to 2.05 percent in 1989-90 from 1.27 percent in 1983-84, but it fell to 1.95 percent in 1991 and again, rose to 2.14 percent in 1994-95 (Choudhury et al, 1996, p.44).

countries over the 1960-1989 period shows that the larger the financial sector and the greater the share of lending by depository banks, the greater is the rate of economic growth (World Bank 1995b). The health and efficiency of the financial sector in Bangladesh can be clearly visualised from the following discussion about the functioning of selected constituents of the banking industry.

3.3.1 Bangladesh Bank (BB)

The chief regulator of the Bangladesh financial sector is the BB which is the central bank of the country. It was established by the Bangladesh Banking Order of 1972, immediately after the independence of Bangladesh in 1971. It assumed the central banking functions from the State Bank of Pakistan which was formed in 1948 as an offshoot of the Reserve Bank of India. It is the most powerful arm of the Ministry of Finance where inexperienced bureaucrats decide most issues of monetary policy. Although the BB initiates and advises the Ministry about monetary policy, it suffers from an image of a weak and ineffective organisation, without much autonomy or authority or independence (World Bank 1995b). However, it co-ordinates and implements monetary policies adopted by the government (Rahim 1977) and it does not take any action which may bring retribution from the Ministry of Finance (Cookson 1997).

The Banking Companies Act (1991) and Financial Institutions Act (1993) have given the BB a wide range of powers to direct and supervise all banks and financial institutions in Bangladesh. These Acts introduced sweeping reforms regarding cash and liquid asset requirements, agriculture credit ceiling, margin requirements and administered interest rates (Hassan 1995).

Prior to the enactment of these Acts, the financial sector in Bangladesh was characterised by inadequate supervision, weak managerial and internal control

processes, lenient loan provision rules, inadequate capital requirements, fixed interest rates, massive loan defaults and inefficiencies in loan allocation and distribution. However, following the recommendations of National Commission on Money, Banking and Credit (NCMBC)¹⁴, the GOB enacted these Acts and implemented a number of deregulatory measures in 1991 to increase the effectiveness of monetary policy instruments, and to reduce widespread loan defaults and delinquencies.

The most significant deregulatory measures undertaken by the BB in 1991 and 1993 include the abolition of administered (fixed) interest rates and the introduction of flexible schedules of lending and deposit rates driven by market forces, the replacement of the re-finance facility by a rediscount facility, the imposition of measures to restrict lending to borrowers with poor repayment records, the introduction of bad loan provisioning, classification of poorly performing loans and suspension of interest on non-performing loans, etc. (Hassan1995).

Prior to 1990, BB relied on administered interest rates to control both deposit and lending activities in the commercial and non-depository DFIs. These interest rates, which were virtually fixed, were far below the costs of money (Cookson 1977) which attracted a large number of borrowers who would not have had access to loans with market-determined interest rates. The credit-rush to banks and DFIs has out-paced their resources and, consequently, inefficiencies crept into the loan approval and disbursement mechanism. Bad borrowers got access to the credit market and banks experienced an extremely high incidence of loan default.

In order to establish credit discipline the BB, following the recommendation of NCMBC, introduced flexible interest rates in January 1990. Under the reform programs, BB quotes only the floor deposit rates so that the real deposit rate of the bank does not go negative (Choudhury et al 1996). All banks including the IDFI's have

¹⁴ The Commission was set up in 1984 to undertake a major study of the financial sector and it made recommendations for financial sector reform in 1986

been given full freedom in determining their own rates for different financial products. They were also given autonomy by the BB to charge different rates for different borrowers depending on the risk and maturity period involved.

Despite these reform measures, both lending and deposit interest rates remain high due to the oligopolistic behaviour of NCBs, and to the distortions in the interest rate structure which is the outcome of the mispricing of some savings instruments and tax breaks on interest paid (World Bank 1995b). In fact, the BB could not lower floor deposit rates with the decline in inflation due to high interest rates offered by the National Savings Directorate on its savings instruments¹⁵ and, consequently, lending rates remained high.

Between 1972 and 1989, the BB used to refinance the banks, especially the NCBs, in response to losses caused by non-performing loans. This meant that the BB's refinancing activities were a function of the de facto default rate. Hassan (1995) mentioned that refinancing caused by the default rates helped to increase inflation by increasing the money supply at a rate greater than the growth rate of real output. This practice of refinancing has been discontinued since the beginning of 1990 and it has been replaced by general rediscount facility at the bank rate - a rate BB charges on its loans to the banks.

The rediscount facility provides short-term loans to banks from the BB regardless of their loan direction to various economic sectors. It helps them to maintain an adequate short-term liquidity position and the BB no longer serves as the permanent source of funds. The objective of such policy is that the banks should rely on their own funds for lending programs (Huda 1991). In order to achieve this objective, the banks are indirectly compelled to reduce their loan losses or loan defaults.

¹⁵ The savings instruments of the National Savings Directorate include National Savings Certificates, Postal Savings Certificates, National Investment Bonds and Wage Earners Development Bonds which carry higher interest rates than their risks and maturity warrant and offer high after-tax yields.

Under the financial sector reform program, the BB was given more supervisory powers to help banks and financial institutions in improving efficiencies in lending and depository activities. Prior to 1989, loan classification¹⁶ was not heard of, loan provisioning was highly inadequate¹⁷ and reported profits of most banks were substantially overstated year after year (Huda 1991).

Banks are now required to classify their loans at least annually and the BB reviews their accuracy when necessary. Loans that are overdue by one year, three years and five years are classified as substandard, doubtful and loss loans, respectively, and interest on all classified loans must be suspended. The aim of such loan classification is to restore financial health of the banks and DFIs which previously masked their profitability by showing interest earnings on irrecoverable loans.

As a part of the supervision of banks, BB evaluates the performance and financial soundness of commercial banks in terms of capital adequacy to buffer the deposit liability in the face of high loan default. Cookson (1997) provided the theory which explained the reasons for the imposition of capital adequacy requirements on the banks as under:

"maintaining adequate capital is the first and essential defence against the loss of depositors' money. If the banks always have the capital that is required by the central bank then it implies that the other parts of the bank's operations such as loan recovery are working all right. In the event of poor loan recovery the commercial bank would have to post the increase in provisions as cost; this would reduce the capital of the bank; if there was insufficient capital then the owners of the bank would be required to inject enough capital to cover the gap. So long as (sic) this is done promptly, one will find that owners of the bank taking actions with their managers to improve the situation and reduce losses" (p.3).

¹⁶ Classification of loans means yearly classifying loan on the basis of period of overdues (e.g., one year, two years, etc.), and classifying loan into performing, non-performing, bad and doubtful loans.

¹⁷ The transitory measure introduced in 1985, requiring banks to maintain a general provision of 2.5 percent of their total loan portfolio outstanding, has been abolished (Hassan 1995).

Since the ownership of the NCBs which dominate the depository banking system in Bangladesh lies with the State, the BB could not enforce capital adequacy requirements as efficiently as expected. In fact, in 1996, none of the NCBs met its capital adequacy requirement and there were at least five PCBs that failed to do so (Cookson 1997). Whenever NCBs and DFIs experienced fund shortages, the government came forward to rescue them through budgetary allocations and, consequently, depositors have never experienced the loss of their savings in the event of loan defaults. This indicates that the survival of NCBs and DFIs depends on the flow of funds from the national purse rather than on their own profitability from their commercial operations.

3.3.2 Commercial Banks and Industrial Loan Default in Bangladesh

As stated earlier, there are four types of commercial bank in Bangladesh and, of them, NCBs were born just after the independence of Bangladesh in 1971 through the execution of Bangladesh Bank (Nationalisation) Order 1972. Ten banks owned by Pakistani entrepreneurs and two banks owned by Bangladeshi entrepreneurs were nationalised by the socialist government which regrouped and renamed them as Table 3.3.

Table 3.3
Names of Nationalised Commercial Banks (NCBs)

Names of Pakistani Banks	New Names after Nationalisation
The National Bank of Pakistan The Bank of Bahawalpur Ltd. The Premier Bank	Sonali Bank
The Habib Bank Ltd. The Commerce Bank Ltd.	Agrani Bank
The United Bank Ltd. The Union Bank Ltd.	Janata Bank
The Muslim Commercial Bank Li The Standard Bank Ltd. The Australasia Bank Ltd. ¹⁸	Rupali Bank
The Eastern Mercantile Bank*	Pubali Bank
The Eastern Banking Corporation*	Uttara Bank

Note: * These banks were owned by the Bangladeshis

Among these six NCBs, Pubali Bank and Uttara Bank were denationalised and returned to the original Bangladeshi owners in 1984. The remaining ‘big four NCBs¹⁹’ dominate the commercial banking sector with nearly two-thirds (63 percent) of total bank deposits and more than half (53 percent) of total advances in 1993 (World Bank 1995b). Starting with 1,116 branches in 1972, they grew by 241.49 percent with 3,811 branches in 1994 (GOB, Bangladesh Bureau of Statistics 1995). Equipped with huge branch power, these NCBs are able to reach every nook and corner of Bangladesh. Since inception, these banks have been engaged in short-term lending. They also act as

¹⁸ This was an independent bank and was neither related to nor served as a branch of any foreign bank.

¹⁹ In December, 1986, the GOB converted Rupali Bank into a public limited company by retaining 51 percent of its paid up capital in state-ownership.

conduits to distribute subsidised credit to priority sectors including farming and small enterprises under GOB's directed credit programs.

The involvement of NCBs in long-term lending to medium and large firms²⁰ started from 1985 as a result of the GOB's direction, in the face of a downward trend in the supply of industrial credit from IDFI, to provide industrial credit to the entrepreneurs to accelerate private sector manufacturing investment. In compliance with such directives, the NCBs disbursed Taka. 22.69 billion (equivalent to US\$ 567.25 million²¹) by June 1996 as shown in Table 3.4. But the borrowers paid back only Taka 5.19 billion (equivalent to US\$129.75 million). They owed Taka 25.67 billion (equivalent to US\$ 641.75 million) to the NCBs during the same period under review.

Table 3.4

**Disbursement and Recovery of Industrial Loans by the NCBs as at June 1996
(Taka in Billion)**

Name of the NCB	Amount Disbursed	Amount Due for Recovery	Amount Recovered	% of Recovery	Amount Outstanding
Agrani Bank	7.36	3.73	1.26	33.78	8.89
Janata Bank	3.65	2.15	1.09	50.70	4.05
Rupali Bank	2.20	1.79	0.78	43.57	2.28
Sonali Bank	9.48	5.03	2.06	40.95	10.45
Total	22.69	12.7	5.19	40.87	25.67

Source: Agrani, Janata, Rupali and Sonali banks. The author personally collected and compiled these data through a field visit in January 1997.

This indicates that 40.87 percent of long-term industrial credit was realised from the

²⁰ Small and cottage level firms are financed under GOB directed credit program and the fund for such firms are distributed through the NCBs under the supervision of the BB and at the request of the BSCIC.

²¹ Calculated on the basis of exchange rate, Taka 40 =US\$ 1

defaulting borrowers most of whom were big firms. Until September 1998, debt liability of 300 big firms to the NCBs rose to Taka 40.15 billion (The Dainik Inquilab 23 December 1998). It has also been mentioned by the GOB that '90 percent of the overdue loans (Taka 126.28 billion as at June 1997) amounted to 41 percent of the total revenue and advances by the commercial banks implying a locked-in-rigidity of the system as a whole' (Fifth Five Year Plan 1998, p.123). The existence of industrial loan default problem certainly tells upon the profitability of NCBs. Chowdhury et al (1996) reported that profitability of NCBs in total fell to 0.26 percent in 1994-95 from 0.32 percent in 1973-74.

There was a number of factors which might have contributed to the unsatisfactory recovery of industrial loans provided by the NCBs. Prominent among them were government intervention and direction to provide credit to: (a) loss-making State-Owned Enterprises (SOEs); (b) commercially non-viable or sick industries in the private sector; and (c) borrowers having political influence over the loan sanctioning and disbursement mechanism. Additionally, GOB's decision to waive out repayment liabilities under debt forgiveness programs (World Bank 1995b) encouraged borrowers not to repay loans even when they were able to repay loans.

Such intervention in the loan intermediation process has provided little incentive to make good loans and has obstructed the bank management in exercising lending practices based on commercial criteria. For example, GOB's directives to apply a high debt-equity ratio attracted would-be defaulters who would not have access to credit had commercial criteria been applied. Consequently, NCBs suffered a high loan default rate.

The high loan default rate has made the NCBs unable to meet the capital adequacy requirements imposed by the BB. This capital inadequacy was the outcome of the fact that most deposits in the NCBs were short-terms and industrial loans were long-terms; such short-term borrowing against long-term lending was not supportable from a

commercial view point. But the NCBs had to follow the GOB's directives to supply long-term credit to the industrialists who may have been able but unwilling to repay the loans.

These lending practices exposed the NCBs to the risks of default. The NCBs carried a lot of risks in a highly vulnerable market where most of the advances they made were not adequately secured against collaterals. Borrower provided collateral which was highly overvalued and bad loans were masked by inadequate accounting practices. The World Bank (1995b) reported that it was nearly impossible to foreclose on collateral and liquidate it. Moreover, a weak legal enforcement mechanism frustrated bankruptcy laws and only a small percentage of loans could be recovered by taking possession of the collateral.

NCBs still continue to provide long-term credit, because of their implicit obligation, to the manufacturing sector prioritised by the GOB. Although the GOB reduces the financial burden of industrial lending by providing subsidies, there is every likelihood that they will continue to suffer from loan default due to the existence of huge non-performing assets, misuse of credit by the borrowers and inefficient management mechanisms. The GOB still owns and controls NCBs and directs them to implement directed credit programs and use them as conduits for supplying industrial credit to entrepreneurs who have little or no entrepreneurial experience. The NCBs play only the financial role and do not play a developmental role since they are concerned with commercial lending.

Unless industrial credit sanctions, disbursement, use and recovery mechanisms are improved, it may be anticipated that NCBs will continue to suffer from high loan default problem. The DCBs (i.e., Uttara Bank and Pubali Bank) have also been plagued by identical loan default problems. The persistent default problems, the rapid increase in the level of outstanding loans, inefficient management, corruption among the bank employees and the deterioration of customer services in the NCBs led the GOB to

allow operations of private commercial bank (PCBs) in 1983²² (Uddin et al 1985). The PCBs are engaged in activities performed by a trading bank. Apart from deposit-taking activities, they provide short-term loans to borrowers under the surveillance of the BB. They also provide long-term industrial loans to the borrowers, but their long-term lending activities are in no way as large as those of the NCBs.

Regardless of their ownership in private hands and operational independence, PCBs suffer from a number of problems including high loan default which contributed to their failure to meet capital adequacy requirements (Cookson 1997). The PCBs are also plagued by insider-lending. The directors of the PCBs not only obtain loans for their own enterprises but also gets loans for their friends at low interest rates by abusing power and exerting undue influence over the loan approving authority. For example, the owner-managing director of Arab Bangladesh Bank was suspended by the BB in 1997 for his involvement in improper lending activities²³. and several directors of National Bank and City Bank were reprimanded by the BB on several occasions. This suggests that there was not a single domestic bank which was free from loan default problems.

3.3.3 DFIs and Industrial Loan Default

The formal development finance market in Bangladesh is dominated by two²⁴ types of DFIs: agricultural DFI (ADFI) and industrial DFI (IDFI). While the former provides

²² Five PCBs, namely, National Bank Limited, United Commercial Bank Limited, City Bank Limited, Islami Bank Limited, and International Finance, Investment and Commerce Bank Limited were allowed to operate as private trading banks in 1983.

²³ This was reported by a general manager of the Bangladesh Bank to the author in January 1997 in course of an interview. This report was also published by the daily national news papers at the same time.

²⁴ There is housing DFI, namely, House Building Finance Corporation (HBFC) which provides long-term loan to the real state-owners. Until June 1996, it disbursed Taka 2.68 billion and recovered only a quarter (25.45 %) of dues which included principal and interest from the borrowers who owed Taka 1.51 billion to it.

short to medium-term credit to the farming sector²⁵, the latter supplies medium- and long-term credit to industrial entrepreneurs. Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB) which are owned by the state fall under the category of ADFIs. Agricultural credit is also provided by the NCBs under GOB directed agriculture credit programs and by a variety of other government organisations.

Irrespective of their structural differences, both the BKB and RAKUB and all other lending institutions²⁶ have been experiencing a high incidence of loan defaults. Jaim and Rahman (1991) found that the percentage of agricultural loan defaults increased from 51 percent in 1980-81 to 80 percent in 1988-89. Meher (1997) reported that the GOB has been able to recover only about 21 percent of the agricultural loans it disbursed to the farming sector between 1991-92 and 1995-96. This means that the loan default culture has become so deeply entrenched that around 80 percent of total farm-credit remained uncollectable from the defaulting farmers.

According to the World Bank (1995b), the reasons for the staggering rate of agricultural loan default in Bangladesh are too much government intervention in borrowers' selection, outstripping the ability of ADFIs to maintain the quality of lending and recovery programs, mixed signals created by loan amnesty and interest remission programs, the use of credit for relief or patronage, lax credit discipline and political pressure.

IDFIs have suffered from many of the same problems as the ADFIs and NCBs. Formal industrial finance in Bangladesh is provided mainly by two public IDFIs - BSB and

²⁵ ADFIs provide also long-term credit to the entrepreneurs in the farming sector.

²⁶ Investment Corporation of Bangladesh (ICB) - an investment company - was able to recover only 2.09 percent of recoverable dues which included principal and interest by 1996. Borrowers' outstanding loan-liability has grown to Taka 2 billion by June 1996.

BSRS. Before 1985 when the NCBs entered into the long-term credit market, BSB and BSRS were the main providers of industrial finance to Bangladeshi entrepreneurs.

Both the BSB and BSRS have been engaged in all developmental finance activities since 1971. At the beginning, these two public IDFI's provided long-term finance to the public sector borrowers since the socialist regime was not interested in the continuation or development of private sector enterprises (Sobhan 1991b). Between 1971-72 and 1974-75 the public sector received Taka 82.09 million while the private sector received Taka 23.28 million from both the IDFI's (GOB, Ministry of Finance 1992, pp.322 - 325).

In compliance with the directives of all post-1975 political regimes, BSB and BSRS opted for providing industrial finance to private entrepreneurs in order to speed up private manufacturing investment in the country. Such policy change was the outcome of the recommendations of the donor organisations such as the World Bank and Asian Development Bank (ADB) which supplied finance to BSB and BSRS for re-lending them to private entrepreneurs.

It would appear from Table 3.5 that BSB and BSRS recovered Taka 1.218 billion in cash which comprised about 8.77 percent of amount due for recovery as at June 1994. This means that both the BSB and BSRS experienced a staggering rate of loan default.

Table 3.5

**Recovery of Loans by the Public IDFI's as at June 1994
(Taka in Billion)**

Item	BSRS	BSB	Total
Loan due for recovery	5.506	8.383	13.889
Cash Loan recovered	0.336	0.882	1.218
% of loan recovered	6.10	10.52	8.77
Loan overdue	5.170	7.501	12.671
Loan outstanding	9.014	13.607	22.621

Sources: BSRS, Annual Report - 1994-5, pp.49-50 and
BSB, Operational Statistics 1994-95, p.255

However, the BSB performed relatively well in 1994 since its cash loan recovery was 10.52 percent of recoverable amount against 6.10 percent of recoverable amount collected by the BSRS. The overdue loan amounts for both banks which included both principal and interest was Taka 12.671 billion as at June 1994. As borrowers defaulted at such a high rate, the outstanding loan amount grew to Taka 22.621 billion as at June 1994.

Industrial loan default problems surfaced from the very beginning of the operations of the IDFI's. Between December 1971 and June 1982, the IDFI's were able to recover around one-third of what they lent to private sector borrowers. Sobhan and Mahmood (1981) found that the rate of loan recovery was 25.6 percent during 1981 and that, at the end of June 1981, about Tk.1.5 billion was overdue from private entrepreneurs. As the IDFI's continued, in compliance with the GOB's instructions, to sanction and disburse industrial loans, both cash and non-cash loan recovery performance of both the IDFI's deteriorated further.

Being concerned by the existence of this persistent loan default, international finance organisations such as the World Bank and ADB discontinued the supply of loanable

funds to the IDFI and engaged Price Waterhouse of Australia in 1983 to review the lending operations of IDFI. Along with this, the GOB commissioned the NCMBC to deal with the issue of loan default and financial reform. Following the recommendations of these investigative and review organisations, the GOB has taken various measures like enactment of bankruptcy laws, instituting financial law court and denying fresh credit to the defaulter, etc. But the end result was very distressing as the cash loan recovery rate²⁷ dived to an alarming level with a collection rate of only 5 percent (World Bank 1996).

Although the default rate calculated by the World Bank is debatable and not in conformity with what this author found (i.e., 10.52 percent for the BSB in 1994), it is true that the loan default rate at both the IDFI was disturbingly high. As such, the industrial loan default problem in Bangladesh warrants an in-depth study and the BSB has been chosen for the purpose.

3.4 Bangladesh Shilpa Bank (BSB) - A Case Study

The BSB is the leading IDFI in Bangladesh. It owes its origin to the IDBP which operated in Bangladesh before its independence in 1971. In 1949, the Government of Pakistan (GOP) instituted the Pakistan Industrial Finance Corporation to provide long-term credit to private entrepreneurs and, in 1961, it was replaced by the IDBP which set up its head office during the late 1960s in Dhaka, the capital of Bangladesh.

Soon after the separation of Bangladesh from Pakistan in 1971, the GOB established the BSB on October 31 1972 by the Bangladesh Shilpa Bank Order (1972) which was amended in 1992 to provide more operational autonomy in its management. Its chief functions are to 'provide credit facilities and equity support to industrial concerns in Bangladesh' (GOB, BSB (Amendment) Act 1992, p.1).

²⁷ Cash loan recovery is different from non-cash loan recovery. Loans collected through share certificates and bank cheque are considered as non-cash recovery.

Broadly speaking, it lends money to industrial concerns for medium- and long-term periods; underwrites issues of stocks, bonds or debentures issued by the industrial concerns; receives deposits; accepts title deeds; draws and accepts bills of exchange; issues letters of credit; converts loans into equity; and provides equity support to private sector industrial concerns.

The BSB participated in three forms of finance: debt-finance; equity finance and stock finance. Its operational performance has been highly unsatisfactory in all these forms of finance.

3.4.1 Debt-Finance

Debt finance has been the main activity of the BSB. Between December 1971 and June 1996, it disbursed term loans amounting to Taka 8.375 billion (BSB, MIS Department 1996). On the other hand, it provided equity finance amounting to Taka 140 million and invested Taka 23.65 million in shares of private and public companies (BSB, Central Account Department 1996). This suggests that debt-finance constituted 99.71 percent of total investment (Taka 8.399 billion) in the public and private sector industries.

The BSB is fully owned by the State and serves as a conduit to implement the GOB's industrial policy to accelerate industrial growth in the country. It maintains close relations with the Ministry of Finance and with other Ministries and Departments such as Ministry of Industries and Board of Investment which have to give final approval to some of its projects. It also follows financial guidelines and policies set by the BB.

Though it maintains close connections and co-operation with these and various other government organisations, it enjoys autonomy and independence at the operational level, especially at the level of borrower selection, credit assessment, loan appraisal, loan approval and disbursement, project implementation, project supervision and

monitoring, and setting lending and recovery conditions.

The operation of the BSB are carried out, as Appendix - A shows, through 5 Divisions, 21 Departments²⁸, 3 Regional offices and 14 Branch Offices covering 14 greater administrative districts of Bangladesh. Its head office is located in the business district of Dhaka. The operation of the BSB is manned by about 1000 employees.

In line with the nation's dependence on external economic assistance for above 80 percent of its total development expenditures, the BSB used to draw, until 1982, above 70 percent of its lending resources from MFIs such as the World Bank, ADB, Islamic Development Bank (IDB) and Kreditanstalt für Wiederaufbau (KfW) of Germany.

The lending activity of the BSB begins with the acceptance of loan applications from the entrepreneurs in the Bank's Standard Questionnaire Form (BSQF). Until early 1980s, investigation relating to credit worthiness of the borrowers commenced soon after acceptance of the BSQF²⁹. But from mid-1980s, the borrowers were required to lodge completed BSQF along with project feasibility reports prepared by any of the listed private firms at their cost. During late 1980s, applicants were further required to pay 10 percent of the estimated project cost as a proof that they had equity capital that could be invested during various stages of project implementation.

As soon as the fully documented loan application is accepted by the bank, it is sent to the appraisal teams for assessment of viability of the project. Usually, loan processing involves the following sequence of activities.

²⁸ The names and number of departments change frequently due to intermittent internal re-organisation of work. Particularly, it happens with the changes of Managing Directors.

²⁹ The BSQF is accepted only after it is found that all relevant papers and documents are provided by the applicants.

Table 3.6**Steps Relating to Loan Processing and Approval by the BSB**

No.	Steps
1	Expression of interest by the entrepreneurs by lodging fully documented BSQF and feasibility studies.
2	Screening of borrowers as per credit worthiness criteria
3	Technical feasibility study
4	Economic and market feasibility study
5	Financial feasibility study
6	Placement of project report to Loan Committee
7	Placement of loan proposal to the Board of Directors, if required
8	Placement of loan proposal to the Board of Investment, if required
9	Issuing loan sanction letter and asking sponsors to start project building construction work and deposit equity for opening of letter of credit for foreign machinery where required
10	Machinery installation and commencement of operation

Source :BSB

The loan application from the borrowers first goes through, as Table 3.6 shows, the loan screening process where credit worthiness of the borrowers is investigated. After borrowers' credit worthiness is established, the technical viability of the project proposal is at first examined by the project-engineer. If it is found technically viable, its market and economic viabilities are assessed by the project-economists. If it is found feasible from economic and market points of views, a financial analyst examines the financial viability of the project. If the project fails to show viability at any stage, the loan proposal is rejected.

Once the technical, market, economic and financial viabilities of the project are established, it is placed to the Loan Committee headed by a General Manager and

participated in by the concerned Heads of the Departments of the BSB. If the loan is found sanctionable by the Loan Committee, it is referred to the Managing Director who accords final sanction if it falls within the financial limit of Taka 30 million. Any project seeking more than Taka 30 million must be passed on to the Board of Directors for approval. Additionally, any project proposing to import more than half of its total raw materials must be approved by the Board of Investment (BOI).

Once a project's loan is sanctioned, borrowers are required to complete documentation. After the loan is fully documented, the selection of project machinery commences. The tender is invited from the machinery suppliers or from their local agents and once machinery or equipment is selected, the letter of credit (L/C) is opened. If the loan is sanctioned in foreign currency, the L/C is opened after foreign currency is arranged from the donors via the GOB which makes loan agreements with the MFIs such as the World Bank. Since mid-1980s, MFIs ceased supply of foreign currency to the BSB on the ground of extremely high loan default rates. From early 1990s, the BSB provides only local currency loans and borrowers use these monies to buy foreign exchange from the local market to import machinery and equipment. After the arrival of machinery, it is inspected by the BSB and installed mostly by the entrepreneurs with or without the help of the suppliers of the machinery. The project starts commercial production after building construction is completed and machinery is installed.

Until September 1996, the BSB supplied term loans to 1490 industrial concerns employing over 125,000 people. These industrial concerns covered a wide range of industries such as food and allied industry, jute industry, textile industry, leather industry, transport industry, service industry, metal and non-metal industry, and chemical industry. Of them, nearly half (605 projects) of the total financed projects belong to the food and textile sectors.

As of September 1996, 863 industrial concerns have been liquidated and the BSB had 627 loan cases in its investment portfolio and their operational composition is shown in Table 3.7.

Table 3.7

**Operational Status of Industrial Concerns Financed by the BSB
as at September 1996**

Operational Status	No. of Firms
In operation without litigation	221
In operation with litigation	83
Under construction	121
Non-existent	1
Stuck up after implementation	71
Stuck-up and under litigation	130
Total	627

Source: MIS Department, BSB. Data were computed by the author.

It would appear from the Table 3.7 that as at September 1996, about half (304 units) of these industrial concerns were in operation, about one-third (201) of them were stuck-up (meaning a firm left in the lurch or about to be abandoned) after implementation and 121 concerns were in various stages of implementation. Even there is one project which has no physical existence though a loan was provided to the cheater-borrowers. It also indicates that law suits were filed against 213 (33.97 percent) projects of which 83 were in operation. Information collected as at January 1999 shows that no significant changes, except increased incidence of litigation against defaulters, occurred in the above position since the data in Table 3.7 were collected.

This operational status of the industrial projects has an important bearing on the loan recovery performance of the BSB. Table 3.8 shows that the BSB was able to recover only about one-fifth (21.48 percent) of the loan amount which fell due by September 1996. It should be mentioned here that all loans collected were not in cash and a substantial portion of loans was collected through bank cheque and forfeited share

certificates. As such, cash loan recovery rate was extremely poor which hovered around 5 percent during mid-1990s (Hussain 1996 and World Bank 1996).

Table 3.8

**Loan Recovery Performance of the BSB as at September 1996
(Taka in billion)**

Operational Status	Amount due for Recovery	Amount Recovered	Amount Overdue	Amount Outstanding
In operation	6.572	2.157 (32.82)*	4.416	8.478 (25.44)
Stuck-up & Under Construction	5,438	0.423 (7.78)	5.015	8.207 (5.15)
Total	12.01	2.58 (21.48)	9.431	16.685 (15.46)

* Figure in parenthesis indicates percentage.

Source: MIS Department, BSB. Data was compiled and computed by the author.

The aggregate recovery rate (21.48 percent) may be misleading in the sense that it included loan recovery rate of the enterprises which were either under implementation or stuck-up. These projects did not commence commercial operations by September 1996 and were not in position to repay the loans. Yet they repaid Taka 0.423 billion which comprised 7.78 percent and 5.15 percent of the amount due for recovery and the amount outstanding respectively.

It is the policy of the BSB to count interest as soon as the loan is disbursed and, consequently, projects under implementation face the burden of interest payments well before they are able to commence commercial operations. As such, 201 stuck-up loan cases (Table 3.7) and 121 projects which were under construction could not repay Tk.5.015 billion which accrued as overdues as at September 1996.

Thus, in calculating the recovery performance of the BSB, it would be rational to exclude the loan burden of the projects which are under implementation. On this basis, it is found that the BSB recovered Taka 2.157 billion from the projects in operation which comprises about one-third (32.82%) of the amount due for recovery. If total loans recovered are compared against total loans outstanding, it appears that loan recovery rate stands at 15.46 percent. This shows that that the loan default rate shown by different organisations, such as the World Bank (1996), is over-stated and does not reflect the true loan default situation in Bangladesh, not to speak of the BSB. In fact, the World Bank (1996) and Hussain (1996) reported only the cash collection rate which varied between 5 percent in 1990-91 and 4.61 percent in 1995-96. This cash collection rate was computed against amount of outstanding loans, rather than against amount of loans which was due for recovery. But the BSB recovered a substantial amount of loans through non-cash method which went unreported.

Nonetheless, the BSB was to collect half (Taka 8.478 billion) of the total outstanding loans amounting to Taka 16.685 billion from the performing firms which were able but not willing to repay loans. All these indicate that the BSB has been haunted by persistent industrial loan defaults.

3.4.2 Equity and Stock Investment

Data collected from Central Account Department of the BSB shows that it provided Taka 140 million as equity finance to 37 industrial concerns and invested Taka 23.65 million in stocks of 19 private companies as at December 1998. It got back only Taka 3.5 million from the equity participation during this period which shows that the return was only 2.5 percent. This return was provided by only one company and among the remaining 36 companies, 12 were under litigation and 11 firms have been running at a loss. All other companies did not announce their dividend as yet. However, the BSB has been receiving dividend against the shares it bought from 12 companies, although the remaining 7 companies have not yet declared dividend. This suggests that the return

on its equity and stock investment was much disappointing.

3.4.3 Existing Conditions of the BSB

As debt-finance constitutes 98 percent of its lending activities, the persistent high rates of loan defaults has put the BSB in peril now. It could not earn any net profit since 1994-95. 'Due to fund constraints, it put a ban on the receipt of new loan applications since 19.2.1996' (BSB, Annual Report 1996-97, p.17). It suspended supplying finance to 171 sanctioned projects which require Taka 14.30 billion (BSB, MIS Department 1999). The management apprehended that there would be a deficit of Taka 2 billion by June 1999 and unless the bank substantially improves its loan collection performance and reconstitutes its lending and investment activities, the existence of this largest IDFI would be at a stake.

3.5 Summary

The banking sector in Bangladesh is in malaise due to non-repayment of Taka 21 billion by the defaulter-industrialists. The persistent high rates of loan defaults have stalled industrialisation in Bangladesh. There was hardly any local bank which did not experience loan defaults. Regardless of ownership and operational differences, loan defaults adversely affected all local banks. Billions of Taka were lent to the industrial entrepreneurs by the commercial or trading banks and only 40.87 percent were recovered. The worst affected banks are IDFI's, of which BSB is most prominent. As of September 1996, it was to recover Taka 12.01 billion from defaulting borrowers, but it recovered Taka 2.58 billion which constituted 21.48 percent of the amount due for recovery as at September 1996. At that period of time, loans outstanding to the borrowers were Taka 16.685 billion and cash loan recovery rate was around 5 percent. Its return from equity investment was even more perilous. Only 2.5 percent return on the equity investment was the achievement. Since debt-finance constituted 99 percent

of its lending resources, persistent high loan default rates ultimately led to such a position where it could not earn even a net profit since 1994. It now suffers from budget deficits which made it dependent on the GOB's bail-outs. Unless it improves its loan recovery performance and reconstitutes its lending operations, its existence may be extinguished from development finance market with a consequent devastating effects on the industrialisation in Bangladesh.

CHAPTER FOUR

THEORY OF INDUSTRIAL LOAN DEFAULT

4.1 Introduction

Industrial development banks are devoted to stimulate industrial investment in both private and public sectors. They inject capital and skills of enterprise development and management into an economy. Unlike commercial or trading banks, they offer combined banking and industrial development services. A great variety of development finance institutions has been established in the developing countries³⁰ since 1945, 'many following independence in the late 1950s and 1960s of former British and French colonies' (Kitchen 1986, p.123), to provide both medium- and long-term loans to industrial and agricultural projects (Perera 1968, p.152; Schatz 1964, p.16; Ramirez 1986, p. 22). There is hardly any developing country where there is not at least one development bank. Regardless of their variations in the set and functional roles, a large number of development banks in Asia, Africa and Latin America are now jaundiced by persistent loan defaults. In fact, there are few development banks in developing countries which have not been adversely affected by persistent loan defaults. The default-prone industrial development finance institutions in Bangladesh are such examples.

This Chapter is an attempt to construct a theory of the causes of industrial loan default experienced by the industrial development banks in developing countries. In the process of doing this, Section 4.1 presents an introduction, while Section 4.2 concentrates on the role and functions of industrial development banks in general. Section 4.3 focuses

³⁰ Development banking is not only a developing country phenomenon. To-days' industrialised countries have had development banks at the early stage of their industrial development. The Credit Mobilier and Credit Foncier (which still exists) in France, Reconstruction Finance Corporation of the USA (in the early 1930s), Industrial Development Bank of Japan (established in 1902 and which exists today), Industrial and Commercial Finance Corporation, and Finance Corporation for Industry in the United Kingdom, and Kreditanstalt fur Wiederaufbau in Germany (which exists today) are some of those development banks.

on the determinants of industrial loan defaults. Section 4.4 is devoted to the building of a model of industrial loan defaults. The summary is provided in Section 4.5.

4.2 Role of Industrial Development Finance Institutions (IDFIs)

4.2.1 Meaning of Development Bank

The term ‘development bank’ carries a wide range of different meanings. Diamond³¹ (1957) defined a development bank as ‘an institution to promote and finance enterprises in the private sector’ (p.2) although there are a number of development banks³² which finance industrial enterprises in public sector. Kane (1975) believes that development banks should not only simply provide medium- and long-term funds to ‘bankable economic development projects’ (p.14), but also provide supportive services which make them real catalysts of industrial development. Ramirez (1986) defined development banking as ‘a financial intermediary providing productive financing and related services to a developing economy’ (p.24). This definitional diversity reflects the fact that each bank is structured ‘with the political, social and economic fabric of the country in mind’ (Kane 1975, p.13). Regardless of their institutional variation, they are common in one aspect: they provide medium- and long-term credit to borrowers.

Although investment banks play similar roles to the development banks in stimulating and broadening industrial growth, their focus on industrial development is not the same. Development banks supply finance preferably to new enterprises and, by providing supporting service, help them to mature into successful enterprises. Investment banks, on the other hand, deal principally with seasoned securities of established corporations,

³¹ Mr. William Diamond was the chief advocate of the Development Finance Corporations (DFCs) in the World Bank (Hu 1984) and he marketed the concepts of development banking in developing countries.

³² IDBP of Pakistan, BSB of Bangladesh and Industrial Development Bank of India are a few examples which provide credit to enterprises in the public sector.

which they underwrite and sell to the general public. However, their role can be complementary. By creating enterprises, seasoning them and then selling their securities to a wide range of individuals and institutional investors, ‘development and investment banks can be important catalysts in industrial development’ (Perera 1968, p.148). Many development banks establish industrial enterprise and arrange for their operations ‘until such time as private capital can be induced to take them over’ (Boskey 1959, p.6).

Development banks also function differently from commercial banks. They do not enter the arena of commercial banking by expanding short-term loans except when working capital ‘is coupled with fixed capital requirements and is not easily forthcoming from other sources’ (Saksena 1970 p.19). There are also development banks which undertake commercial banking functions along with development banking functions. Instances of such institutions are National Credit Bank of Laos, Nepal Industrial Development Corporations, Industrial Bank of Iraq (Saksena1970), and Industrial Bank of Japan (Bhatt 1993). Also there are instances where commercial banks provide term loans to industrial enterprises side by side with the industrial development banks. The nationalised commercial banks (NCBs) in Bangladesh are such examples.

It is because of these functional differences that it is very hard to find a universally accepted definition of development or industrial banking. Boskey (1959) rightly said that

“This great variety among existing banks indicates that no single model is suitable to all, perhaps not even to any two, countries. The design of the bank must be drawn in the light of its purpose and of the economy, social and political environment in which it is to function” (p.6).

However, there is a close similarity in the scope of their basic functions and purposes’ (Basu 1965, p.1).

4.2.2 Types of Development Bank

The lack of definitional clarity of development banking is linked to the diversity in the form and type. Nyhart and Janssens (1967) found, after surveying 340 development banks, that some were constituted on the basis of particular economic sectors such as agriculture and industry and that some were established on the basis of particular geographical areas. Agriculture Development Finance Institutions (ADFI) are engaged in providing mainly short-term credit to the farmers under government-directed credit programs, although there are instances (e.g., Bangladesh Krishi Bank, and Guyana Agriculture and Industrial Bank) where they provide medium- and long-term credit to agro-based industrial enterprises.

On the other hand, Industrial Development Finance Institutions (IDFI) provide medium- and long-term credit or such credit plus equity to entrepreneurs and enterprises to promote and support industries of various types. IDBP of Pakistan, BSB of Bangladesh, Industrial Development Corporations of Nepal, Hellenic Industrial Development Bank of Greece and Industrial Development Bank of Canada are such IDFI.

Again, development banks³³ or IDFI are classified as Industrial Development Finance Corporation or Company (e.g., Industrial Credit and Investment Corporation of India) and Industrial Development Banks (e.g., IDBP of Pakistan). While the former provides not only medium- and long-term loans to industrial concerns but also undertakes 'the underwriting of and subscribe to its equity, preference shares and debentures' (Saksena 1970, p.15), the latter does everything except equity participation³⁴.

³³ Perera (1968) believes that 'the term development bank has become the most common label for medium- and long-term lenders to industry' (p.236).

³⁴ There are instances (e.g., BSB) where the industrial development bank provides equity to the private sector enterprises.

Both types of development banks can be classified by ownership and nature of functions. In terms of ownership, they can be classified as private IDFI, public IDFI, private-leaning IDFI and public-leaning IDFI. Private IDFI are those whose entire capital stock is provided by individuals or institutions operating in the private sector of the economy. A good example of such institutions is the Corporacio Financiera de Caldas in Colombia (Ramirez 1986). Private IDFI are motivated by profit and, hence, 'place relatively more emphasis on banking goals seeking to finance projects with a high ranking on the interest- rate scale, and are relatively less concerned with seeking projects which maximize development impact' (Kane 1975, p.24). They prefer to promote projects on an equity basis, where they buy shares directly or are given 'options to convert a part of a loan into shares' (Perera 1968, p.236).

On the other hand, Public IDFI - which are owned by the state- 'plan, finance and carry out investment projects or programs on government account' (Diamond 1957, p.3). They choose and finance industrial projects complying with national priorities and seek to maximise both the monetary and developmental objectives. Though they do not expect monetary returns as high as privately-owned IDFI, they expect maximum social and economic benefits from financed projects in the form of creating job opportunities, reducing import-dependencies and supplying relatively cheap products and services.

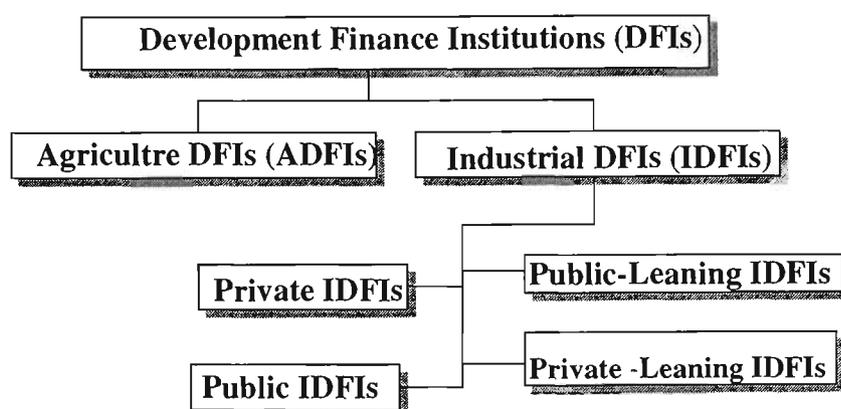


Figure 4.1: Types of Development Finance Institutions

³⁴ There are instances (e.g., BSB) where the industrial development bank provides equity to the private sector enterprises.

There are, as shown in the Figure 4.1, IDFI which may be either private-leaning or public-leaning depending on the ownership of majority capital stock. The majority capital stock in the private-leaning IDFI belongs to the private sector and these privately owned IDFI expect relatively more monetary return from projects than their counterparts in public-leaning IDFI where majority capital stocks are owned and controlled by the government.

Among these IDFI, this study is concerned only with the purely public IDFI which, according to Kane (1975, p.20), 'must seek to achieve its purpose as a development institution simultaneously with achieving its purpose of functioning as a banking institution'. In fact, industrial development financial markets in developing countries are dominated by public IDFI which are solely owned by the state.

4.2.3 Objectives of Public IDFI

The objectives of public IDFI differ from country to country. According to Saksena (1970), these also differ from one region in a country to the other and from the objects at some stage of economic development to the other. Whatever differences they have in terms of forms and structures, they have one common objective: industrialise the country in accordance with national economic plans through mobilising and channelling financial resources from local and foreign sources.

4.2.4 Functions of Public IDFI

A development bank, particularly a public IDFI, is one of the most important strategic devices or instruments for creating and speeding up industrialisation in developing countries. In order to overcome the economic problems, especially industrial backwardness from which an underdeveloped country suffers, the public IDFI are expected to initiate and support industrialisation efforts in the private sector through

inducing investors and the entrepreneurs to get involved in developmental activities. The public IDFI's serve as instruments of government policy and are expected to create employment, save or earn foreign exchange, diversify industry, encourage entrepreneurial activities, develop capital markets and redistribute income (Kitchen 1986).

In order to attain the stated objectives and realise the above expectations, development banks particularly public IDFI's, are required to perform two functions: financial and developmental or entrepreneurial. This functional dualism of development banks is ranked on a broad spectrum which Kane (1975) explains as under.

“On the one end of the spectrum would be those financial institutions that have only a marginal and indirect influence on economic development. As one moves across the spectrum, development becomes a progressively more important aspect of the financial institutions' activities. At the other end of the spectrum are those development institutions that are marginally concerned with finance. As one moves across the spectrum from this end, financing becomes progressively more important aspect of the development institutions' activities. Development banks ought to be found around the centre of such a spectrum of financial and development institutions” (p.16).

The financial institutions falling in to the first spectrum are commercial banks, savings institutions, insurance companies and so forth, and investments made by these institutions are likely to have a supportive effect on economic development. The development institutions in the other spectrums are public development corporations, development funds, ministry of planning and various conduit agencies for administering government budgetary allocations in developing countries. Public IDFI's sit in the middle of these two kinds of institution since they blend financial and developmental functions together to stimulate industrial development through industrial project financing. In other words, an IDFI serves as a conduit to industrialise a developing country and it will be able to 'perform its proper role only when it is endowed with financial as well as non-financial promotional functions' (Basu 1965 p.16).

It should be mentioned here that though development banks do exist in advanced economies, their role is not similar to those in developing economies. In advanced countries business or entrepreneurs are facilitated by the most developed capital markets and by sound commercial banking systems. According to Nevin (1961), development banks in advanced countries are required 'only for marginal and relatively unimportant fragments of the economy' (p.74).

The relative importance of the development banks and an understanding of their functional differences between developed and developing countries may be well gauged from the following discussions.

4.2.4.1 Financial Functions of Public IDFI

Investment capital shortage is a much known feature of an underdeveloped economy. Unlike the developed countries where the major source of finance for private investment has been the plowing back of entrepreneurial profits³⁵ (Diamond 1957) and developed capital markets, the investment finance in developing countries is to come from the development finance institutions, since there has been a shortage of entrepreneurs and entrepreneurial profits. Added to these problems are the existence of underdeveloped and narrow capital markets in developing countries and the non-availability of intermediate and long-term finance from the commercial banks which provide, in most of the cases, short-term loans.

The public IDFI aim at removing these deficiencies in long-term finance market (Diamond 1957) in the developing countries. Though some commercial banks (e.g., NCBs in Bangladesh) do provide long-term finance to the industrial entrepreneurs, their lending is limited to those clients who are experienced and established in business. They

³⁵ During the nineteenth century, the great English businesses were built up and extended out of profits and private borrowing (Diamond 1957).

do not provide long-term credit to the untried lines of industrial investment activities. On the other hand, the public development banks provide medium and long-term finance, apart from established and tried lines of industrial enterprises, to the unexplored lines of industrial entrepreneurial activities. They endeavour to overcome the shortage of industrial entrepreneurs by making long-term loans available to skilled, knowledgeable and talented entrepreneurs.

Public development banks provide finances both in local and foreign currencies and some of them draw their foreign exchange funds from the MFIs such as the World Bank, the Asian Development Bank, the African Development Bank, etc. Public development banks arrange local currency loans from several sources: equity capital, government budgetary allocations, amount of loans recovered from the client-projects and profits from existing projects. These, including foreign exchange, are supplied to the entrepreneurs in a variety of forms and among them, debt-finance is the most prominent.

Regardless of its type, industrial development finance is used for the creation or acquisition of fixed assets such as land, buildings and machinery (Diamond 1957). Normally, a local currency loan is used to buy land and finance the cost of project building and local machinery. It is also used as a working capital to finance inventories. A foreign currency loan is used to import, assemble and install project machinery.

The IDFI's disburse loans to the entrepreneurs in several instalments upon evidence of their equity investment in the project. For example, the BSB disburses loans only after obtaining concrete evidence that the borrowers invested equity capital in the construction of a part of the project buildings.

It is the financial function of the public IDFI to determine the debt-equity ratio so that it is not exposed to high risk of debt-default. The debt-equity ratio is not uniformly followed by all IDFI's. It varies from country to country. For example, the Industrial

Development Corporation of South Africa normally finances up to about one-third of an applicant's capital requirements, Industrial Development Bank of Turkey provides up to 40 percent of the capital requirement, Nepal Industrial Development Corporation requires that the entrepreneurs invest up to 50 percent of the cost of the project and the Banco Nacional do Desenvolvimento Economico of Brazil limits its participation to 60 percent of the cost of the project (Boskey 1959). On the other hand, the BSB used to provide loans up to 80 percent of the total cost of the project until the late 1980s.

Another most important financial function of the public IDFI is to provide variable loans (i.e., working capital) to the industrial enterprise which receives term loans from it. The term and variable loan ratio is also not the same among the IDFI's. Basu (1965) found some development banks which considered 'the provision of working capital a part of their usual functions' (p.34). The Industrial Development Corporation of South Africa and Nacional Financiera of Mexico are two institutions which provide permanent working capital to their clients. On the other hand, the BSB of Bangladesh and Industrial Credit and Investment Corporation of India (ICICI) provide temporary working capital when entrepreneurs approach them.

The term loans provided by the IDFI's are recovered in annual or semi-annual instalments spread over a number of years. The period of loan repayment and the number of instalments vary from project to project and from bank to bank. For example, the Industrial Development Bank of Canada is authorised 'to make loans for as long a period as 25 years' (Basu 1965, p.66). The maximum period allowed by the IDBP was 20 years, by the BSB was 15 years and by the Nepal Industrial Development Corporation was 15 years.

In addition to debt-finance or equity-finance or both, an IDFI may subscribe to shares and debentures of industrial companies; provide guarantee for loans raised by the borrowers from other sources; and underwrite the issue of industrial stock, bonds, and debentures. Also development banks in certain countries such as the Industrial

Development Bank of Turkey try to induce capital markets by selling their own portfolios (Saksena 1970).

4.2.4.2 Developmental Function of Public IDFI

The role of a development bank, particularly a public industrial development bank, is not solely confined to the supply of medium- and long-term loans and/or equity. Unlike other financial institutions such as trading or commercial banks, development banks are expected to direct and guide the use of loans; to nurse an enterprise (Basu 1965); and to play a developmental or promotional role in addition to their financial role. Kuiper (1968) believes that a public development bank is an 'activist institution interested in development and unafraid of change and fully aware that there can be no development without new ideas' (p.7).

Basu (1965, p.83) believes that 'a half-baked inadequate project proposal' may be transformed into a 'well-conceived, well-planned and financially well-disciplined enterprise' by a development bank. According to Akintola-Arikawe (1990), the developmental or promotional role of an industrial development bank means

“getting involved in the formulation, initiation and organisation of industrial development; behaving like an entrepreneur who, perceiving or seeking out profitable investment opportunities, actually takes the initiative and leadership to conceive, fashion proposals and organise finance for new enterprises and actually execute them. Briefly put, it involves the entrepreneurial activity of taking the initiative of shaping up a business and getting it started” (p.63).

There are two extreme sides of this promotional or developmental role. At one extreme spectrum, Kuiper (1968) believes that a development bank 'originates an idea, translates it into a financeable project (using consultants and other experts as necessary in the process), arranges financing, organizes the company and, if only for a time, manages the new enterprise'(p.7).

The other spectrum of the developmental role is the involvement of the industrial bank in the assessment of the viability of an industrial project submitted by the entrepreneurs and giving decisions whether to accept or reject the investment proposal. Between these extremes developmental or promotional role lies which, according to Akintola-Arikawe (1990), include the following:

“ (a) organising general industrial surveys and carrying out feasibility studies for specific projects; (b) evolving proposals for new enterprises; (c) helping to find technical and entrepreneurial partners for local clients or investors; (d) taking equity shares and underwriting securities in order to attract other investors; (e) organizing mergers in order to evolve more efficient industrial /production units; (f) nurturing a capital market by broadening ownership and by other methods; (g) encouraging the adoption of innovations in the economic sectors; (h) providing management and consultancy services to both client and non-client enterprises; (i) training and development of manpower to meet the needs for highly skilled staff with a broad professional orientation; (j) taking the initiative to identify and develop projects of critical importance to the economy or sector of involvement” (pp. 63-64).

Along with these promotional role, development banks are expected to provide guidance to budding or new generation entrepreneurs in respect of selecting viable projects consistent with country's industrial development objectives. While selecting industrial projects, a development bank should examine the 'ability and integrity of the top management of the enterprise' (Bhatt 1993, p.50).

Supervision of an enterprise both at the initial developmental stage and at the operational stage constitutes part of developmental role. The commercial or economic environment within which an enterprise operates changes from time to time and inexperienced management of the enterprise may not be able to withstand such

changes which may affect the profitable operations of the enterprise. Bhatt (1993) believes that it is

“essential to have vigilant supervision of the project or enterprise even during its operational stages so that timely adaptive action can be taken to ensure its profitability and success. Such supervision requires a fairly close connection between a development bank and the enterprise. It is easier to have such supervision if a development bank also provides short-term finance and is represented at the board of directors of the enterprise as in India, Botswana, Iran and Germany” (p.50).

Enterprise supervision places a development bank in a position by which it can sense imminent or emerging problems of an enterprise. In changing circumstances, it can provide timely and appropriate suggestions to the entrepreneurs to overcome them successfully.

The necessity for entrepreneurial guidance from the industrial development bank emanated from the fact that developing countries lack ‘a substantial nucleus of entrepreneurs’ (Ramirez 1986, p.34) ‘capable of identifying, assembling, and financing sound industrial projects’ (Perera 1968, p.200). Though the supply of entrepreneurial talent is abundant³⁶ in these countries (Nienhaus 1993), there is acute shortage of experienced entrepreneurs ‘to set up and operate’ (Diamond 1957, p.51) firms there.

However, ‘a new ‘entrepreneurial class’ can emerge only if talented people get a chance for access to financial resources which exceed their present capacity by far’ (Nienhaus 1993 p.9). Bhatt (1993) argued that the ‘available talents should be harnessed in a development bank’ (p.48). In Japan, as Partick (1967) mentioned, the industrial banking system was the locus of much of the early promotional and entrepreneurial talent which initiated the industrial spurt. The Credit Mobilier implicitly contributed to the economic

³⁶ Nienhaus (1993) found that established elite of a country comprises ‘hardly more than 10 % of the population’ (p.9).

development of France during the nineteenth century by embodying the spirit of enterprise.

Perera (1968) argues that ‘by locating and channelling missing elements - such as know-how and capital - to local businessmen, (p.200) development banks which are de facto agents of the government can play invaluable roles. At the same time he believes that

“to justify its title as well as its institutional existence, the (development) bank should be a strong supplier of both know-how and capital to local entrepreneurial endeavour; otherwise, it would only serve in the same capacity as a commercial or investment bank...Only advanced industrialized nations can afford to de-emphasise the promotional role of the development bank” (p.201).

Kane (1975) identified capital, entrepreneurship, technical and managerial capabilities, promotional activities and availability of foreign exchange as missing ingredients for industrialisation in developing countries. By supplying catalytic increments of these missing factors on its own initiative (Kane 1975), development banks can further industrialisation efforts in developing countries.

From the opinions of these authors it may be asserted that an industrial development bank cannot remain passive in a developing country where latent entrepreneurial talents have to be activated through technical, managerial and entrepreneurial guidance. Such a role was undertaken by, as Bhatt (1993) mentioned, the most successful development banks in developing countries, e.g., by the Development Bank of Singapore, ICICI of India, Industrial and Mining Development Bank of Iran (IMDBI), Long Tern Credit Bank of South Korea and the Botswana Development Corporation (BDC).

The developmental role was also played by the development bank in the industrialisation of the relatively backward countries of Europe during the nineteenth

century. The Credit Mobilier and Universal Bank played a momentous role in the industrialisation of France and Germany, respectively (Bhatt 1993).

Gerschenkron (1968) described the role of German investment banks as under:

“ in Germany, the various incompetencies of the individual entrepreneurs were offset by the device of splitting the entrepreneurial function: the German investment bank - a powerful invention, comparable in economic effect to that of the steam engine - were in capital supplying function ...Banks participated actively in shaping the major - and sometimes even minor -decisions of individual enterprises. It is they who very often mapped out a firm's path of growth, conceived far-sighted plans, decided on major technical innovation, and arranged for mergers and capital increases” (p. 137).

Japan adopted the German model in its industrialisation process (Cameron 1972) - a leading example being the formation of the state-owned Industrial Bank of Japan (IBJ) which initiated the industrial spurt through promoting entrepreneurial talent (Patrick 1966). France also adopted this functional dualism of an industrial bank in her own way (Hu 1981).

The public development banks have also played a vital role in adopting and absorbing technological change in the country where they are located. They ‘goaded the enterprises to adapt, diffuse and improve upon the technology borrowed from the advanced countries’ (Bhatt 1993, p.50) like England and, in many cases, emphasised the latest technology that was not even adopted elsewhere. All these indicate that an IDFI ‘do not simply finance development projects’, (Kane 1975, p.14) but accompany an enterprise ‘from cradle to grave, from establishment to liquidation through all vicissitudes of its existence’ (Geschenkron 1966, p.14).

Thus, the developmental role of an IDFI constitutes entrepreneurial and managerial guidance, supervision and direction; and technical assistance to new enterprises. At

least the success of the universal banks in Germany, IBJ in Japan, IMBDI in Iran, BDC in Botswana and Industrial Development Bank of India in India and Korea Development Finance Corporation in South Korea bear ample testimony to the importance of the developmental role of the an IDFI in initiating and sustaining industrial development in a developing country.

4.3 Determinants of Industrial Loan Default

Several authors tried to identify the determinants of loan defaults. Donald (1976) and Gupta (1990) believe that loan default occurs due to borrower's inability or unwillingness to repay loans. It may be that there are borrowers who are willing but not able to repay loans. Again, there are borrowers who are able but not willing to repay loans. Industrial loan default arises in both the cases.

The ability and willingness of an industrial entrepreneur to repay industrial loans are influenced by a number of factors relating to industrial financing. Particularly, what industrial project is financed; how it is financed; how its management from the set up stage to loan liquidation stage is helped by an IDFI and what policy affecting the operations of it was delivered by the government are very important. As regards what type of industrial project is to be financed, Kane (1975) advocated that the development bank must of necessity restrict itself to financing only those development projects which are bankable. He defined a bankable project as

“that investment which will generate enough income within a specific period of time to : (1) cover the cost of operation once the plant begins operations; (2) repay the principal of the bank's loan; (3) pay the interest charge of the loan; and (4) have residual profit large enough to induce the entrepreneur(s) to undertake and remain with the operation” (pp.17-18).

At the same time, such a project should have the largest catalytic impact on economic development of developing countries. The choice of a project lies with in the

developmental role of an IDFI. As a development institution, an IDFI should deal with 'those projects with the highest ranking on the development-impact scale and as a banking institution, it should finance those projects with the highest ranking on the interest-rate scale' (Kane 1975, p.20). It means that a bankable project should satisfy both developmental and financial criteria unlike a commercial bank which stress the financial role rather than the developmental role.

It appears from the above that loan default may arise if the development bank finances non-bankable projects which are not capable of generating enough income within a reasonable time to cover the costs of operation, repay the principal loans, meet costs of borrowing and earn enough profit to motivate its promoters to remain in operations. Not only that, if development bank, driven by greed, charges a bankable project the high interest rates as do commercial banks, there is a chance that the project will be unable to keep the repayment commitment and loan default will be the result. This suggests that the chances of loan defaults may be reduced if the credit policy strikes 'a balance between developmental concern and the need to keep the institutions as viable and profitable as possible' (Manzano 1990, p.33).

Industrial projects having both commercial viability and development-effects deserve term loans from the IDFI. Failure to identify commercially viable projects may lead to loan defaults problems. Selection of a viable project does not guarantee the success of firm unless the industrial entrepreneurs are skilled enough to manage overall affairs of the firm. Given the lack of skilled entrepreneurs in developing countries, the IDFI should provide guidance to the unskilled entrepreneurs in respect of credit use and management of the firm. When credit remains unguided, it may leak from the investment flow (Hoque 1999b) or it may not be used as it is supposed to be used. Inexperienced industrial entrepreneurs, being left unguided regarding the proper use of credit while acquiring fixed or variable assets of the firm, may experience cost-overrun or operational problems. Or it may be that the firm remains unimplemented and with

such conditions, it is not in a position to commence commercial production and repay debts. This means that unguided credit may lead to loan defaults.

The industrial loan default may be associated with high debt and low equity (World Bank (1989), insufficient working capital loans from the IDFI (Saha 1997), inefficient borrowers' screening mechanism (Aguilera 1990; and Hunte 1992), short loan repayment period (Price Waterhouse 1984), delay in project implementation (Sobhan and Ahsan 1986) and failure of the IDFI to provide assistance to the efficient management of the firm (Kane 1975).

All these indicate that if the IDFI fail to play both financial role and developmental role which are mutually reinforcing, it is highly likely that borrowers in developing countries who are budding or first generation industrial entrepreneurs will not be able to use the industrial finance in the way it is supposed to be used. Consequently, there is high probability that these borrowers, being left unguided or inadequately financed, may not be able to generate enough income to service the debt and may experience persistent loan default. This suggests that flaws in the financial and developmental role of an IDFI contain the germs of industrial loan default.

The effectiveness as well as efficiency of both the financial and developmental roles of development banks depend on the existence of consistent and adequate public policy regimes. A commercially viable projects may not sustain for reasons other than an inherent defect in the conception, execution or operation (Raghavan 1982). Industrial firms may experience changes in the economic and business environment such as changes in exchange rate policies, interest rate policies, import policies, tariff policies, protracted interruptions in utility services and political unrest. Since IDFI and their client enterprises are policy-takers, they are both affected by these macroeconomic and political changes. For example, where industrial credit is denominated in foreign currency, 'devaluation of the exchange makes debt service almost impossible' (Murinde 1996 p.226). Basu (1965) reported that 'a devaluation of the national currency would

seriously affect the bank's capital' (p.22). This suggests that frequent public policy changes may serve as determinant of industrial loan defaults.

According to Schatz (1964), difficulties in economic environment such as problems in securing proper equipment in reasonable time and in good working order and problems of human resources, of infra-structure, of supplies, of adequate markets, etc. impinge upon the operations of a business. Unless these difficulties in the economic environment are removed by public policy intervention, industrial loan default may become an in-built problem of an enterprise. For example, bad loans problems³⁷ in the Japanese economy arose from the 'prolonged weak conditions of the Japanese economy in several years' (Taniuchi 1997, p.226).

Inconsistencies within a policy regime or among various policy regimes may make borrowers unwilling to repay loans. For example, if policy directives set an example of debt forgiveness, borrowers may become unwilling to repay loans (Harris 1983; and The Economist 1992). Such policy inconsistencies, if removed, may reduce the incidence of loan defaults.

It appears that flawed financial and developmental roles of IDFI's and flawed public policy regimes are most important sources of industrial loan default in developing countries.

4.4 Model of Industrial Loan Default

Drawing on the arguments provided in the previous sections, a model of industrial loan default is constructed as under.

³⁷ For the 21 major Japanese banks, non-performing loans rose to 12.8 trillion yen in 1993 from 8.0 trillion yen in 1992 (Taniuchi 1997).

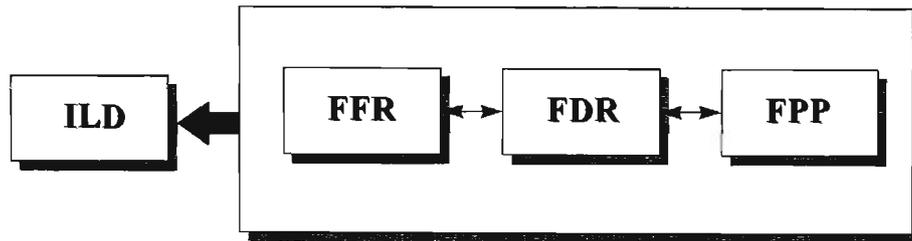


Figure 4.2: Industrial loan default model

Where,

ILD = Industrial Loan Default

FFR = Flawed Financial Role

FDR = Flawed Developmental Role

FPP = Flawed Public Policies

The model states that the Industrial Loan Default (ILD) is associated with the Flawed Financial Role (FFR), Flawed Developmental Role (FDR) of an IDFI and Flawed Public Policies (FPP). The term ‘flaws’ carries a very important meaning in the model. By flaws it is indicated here that the financial role and the developmental role played by the IDFIs, and various public policies set by the government, are defective, inadequate and inconsistent.

Since these explanatory variables are inter-related and mutually reinforcing, industrial loan default will be influenced by the existence of flaws in any variable. For instance, if government policy suffers from flaws, i.e., inadequacies and inconsistencies, there is a high probability that the efficiency level of developmental and financial roles played by the public IDFIs may go down from higher scale to lower scale. Consequently, industrial loan default may surface. This means that the level of industrial loan default depends on the extent to which developmental and financial roles played by the IDFIs, and various policies taken by the government are flawed.

A full explanation of the model is provided as follows.

4.4.1 Industrial Loan Default (ILD) and Flawed Financial Role (FRR)

The first component of the model states that Industrial Loan Default (ILD) is related to the Flawed Financial Role (FFR) of an IDFI. However, these flaws in financial role come from inadequacies and inconsistencies present in a number of associated financial variables as shown in Figure 4.3.

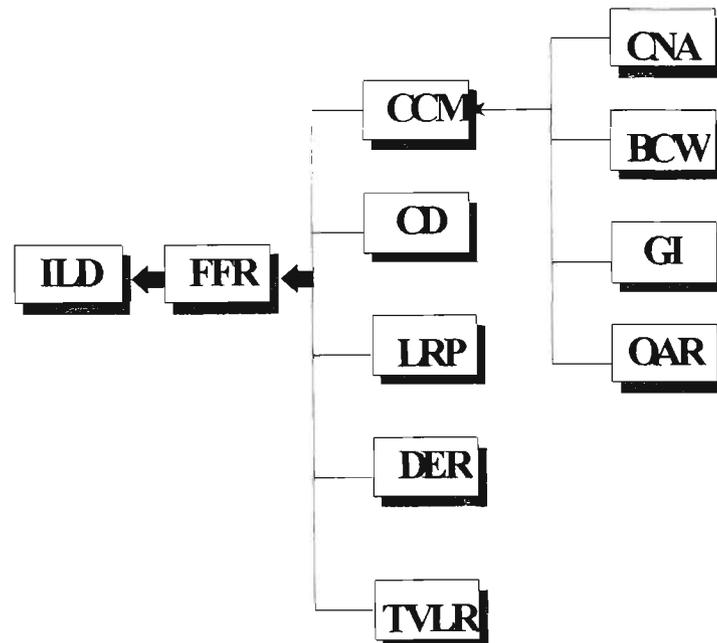


Figure 4.3: Industrial loan default and flawed financial role

Where,

ILD = Industrial Loan Default

FFR = Flawed Financial Role

CCM = Credit Control Mechanism

CD = Credit Disbursement

LRP = Loan Repayment Period

DER = Debt-Equity Ratio

TVLR = Term and Variable Loan Ratio

CNA = Credit Needs Assessment

BCW = Borrowers' Credit Worthiness

GI = Government Intervention

OAR = Officer-Application Ratio

4.4.1.1 Credit Control Mechanism (CCM)

As shown in the Figure 4.3, industrial loan defaults can be an outcome of flaws in Credit Control Mechanism (CCM). The flaws in the CCM consist of combined flaws in Officer-Application Ratio (OAR), Borrowers Credit Worthiness (BCW), Credit Need Assessment (CNA) and Government Intervention (GI). When there is low OAR, the number of loan applications awaiting processing far exceeds the number of loan officers. As a result, quality of the loan is deteriorated which contributes to loan default. If BCW is not properly assessed and established by applying efficient screening mechanism to exclude bad borrowers from a pool of loan applicants, there is possibility that unworthy or bad borrowers would receive loans and would default. In other words, loan default is associated with defective borrowers' screening mechanism.

The CNA is carried out in the form of technical, economic, market and financial feasibility studies and if these reports are incomplete and inadequate, the CNA will be faulty and viable project will not be selected for term loans. This means that flawed CNA will select non-viable firm and the inevitable result will be loan default. Even if a viable project is selected for term finance, flawed GI in loan intermediation process can undermine the quality of a loan which may contribute to loan default.

4.4.1.2 Credit Disbursement (CD)

The IDFI's disburse credit to the borrowers in a number of instalments subject to evidence that the borrowers invested their equity capital in the fixed assets of the firm. The IDFI's conduct inspection to verify such equity investment. If borrowers are unable to invest their equity capital as per loan conditions, CD will be delayed which may delay the full implementation of the project and this may be a potential cause of loan default. If there is delay in pre-disbursement inspection or loan processing, CD is will also be delayed which will delay firm's commercial operation. Because of such delay, the project will not be able to generate sufficient income in time to repay the loan and, consequently, loan default may occur.

4.4.1.3 Loan Repayment Period (LRP)

Short Loan Repayment Period (LRP) rather than long LRP may contribute to loan default. The longer the maturity of the industrial loan, the smaller is the periodic instalment and, conversely, the shorter the LRP, the larger is the periodic instalment that is to be repaid by the borrowers. Since industrial projects in developing countries are to compete with their counterparts, and since there are market imperfections, the projects financed by the IDFI may take time to generate cash flows. Granting them long LRP will provide them with a breathing space or time to generate income to repay the loan. With shorter LRP 'the loanee concerned may not be able to earn such a surplus income as to be able to meet the repayment of the principal together with interest in a short period' (Basu 1965, p.66). That is why, the model assumes that loan default is associated with shorter LRP.

4.4.1.4 Debt-Equity Ratio (DER)

The model assumes that loan default risk is associated with high debt-equity ratio (DER). 'Where the risks of investment are great, the capital structure of the banks should not be made up of a high proportion of loan capital' (Basu 1965, p.25). According to Zysman (1983), firms operating with heavy debt will periodically find themselves extremely vulnerable. If the debt portion is greater than borrowers' equity, the risk of getting even the principal loan back will be enormous. This may lead to debt default. Moreover, when borrowers are required to invest only relatively small amounts of equity finance and the greater part of the total project finance is provided by an IDFI, there is every likelihood that it may attract would-be defaulters. Deliberate defaulting occurs when the cost of non-repayment is less than the benefit of non-repayment of loans and high DER may provide an incentive to the dishonest borrowers to get away without repaying loans.

4.4.1.5. Term and Variable Loan Ratio (TVLR)

Variable or working capital is required by industrial enterprises to procure raw materials from local and foreign markets; to maintain sufficient stocks of raw materials, semi-processed and finished products; to bear the cost of goods-under-process; to pay wages and salaries; and to meet all other costs to keep the enterprise in operation at all times. The entrepreneurs in developing countries are not financially sound enough to supply working capital from personal sources. This makes them dependent on the banking sector for the supply of working or variable capital. If an enterprise suffers from shortage of working or variable capital, it will not be able to generate enough cash flows to repay the loan, no matter what amount of term loans is provided to it. Basu (1965) recommends that banks should satisfy 'both short-term and long-term financial requirements of industry' (p.68).

IDFIs supply term loans to the industrial borrower to procure land, construct project buildings, and to buy and install machinery. If working capital is not adequately supplied either by the IDFI or by other financial institutions, firms' fixed capital will remain unused or under-used. Moreover, the requirement for working capital increases with the increase in fixed capital investment. If increased fixed investment is not matched by increased level of supply of working capital the firm will not be able to generate enough income to repay the loan. That is why industrial loan default can be caused by disproportionately high amounts of term loans and low amounts of variable capital loan. In other words, the higher the term and variable loan ratio (TVLR), the lower may be the level of cash-flows which may lead to loan default.

4.4.2 Industrial Loan Default and Flawed Developmental Role

The model assumes that if the developmental role is flawed, the entrepreneurs will not be able to choose viable projects; will not be able to implement and run the firm as

efficiently as it ought to be. They will not be able to generate sufficient cash flow to service the debt. Ultimately, they may end up with loan default. If the development role is plagued by inadequacies and inconsistencies, inhibitions may be created to make the financial role of the IDFI ineffective which may lead to loan default. These flaws in the developmental role may be the outcomes of the flaws in a number of developmental variables as shown in Figure 4.4.

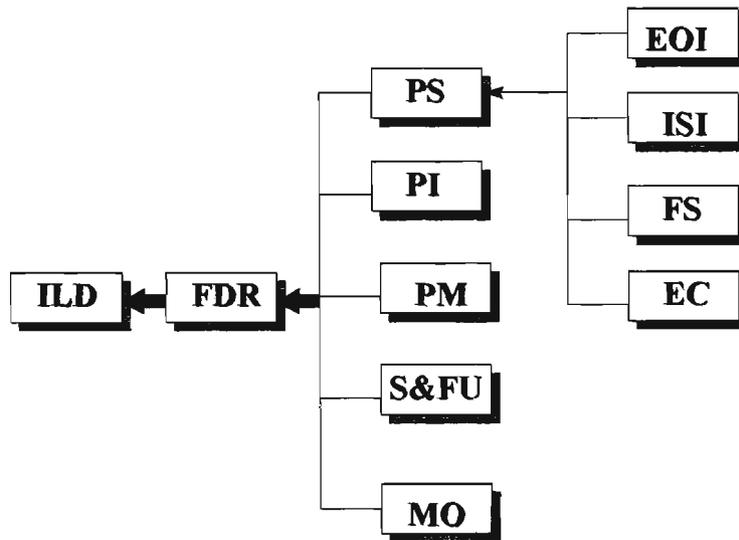


Figure 4.4 : Industrial loan default and flawed developmental role

Where,

ILD = Industrial Loan Default

FDR = Flawed Developmental Role

PS = Project Selection

PI = Project Implementation

PM = Project Management

S&FU = Supervision and Follow-up

MO = Monitoring

EOI = Export-Orientated Industry

ISI = Import Substituting Industry

FS = Firm Size

EC = Excess capacity

4.4.2.1 Project Selection (PS)

The model deals with the relationship between ILD and Project Selection (PS). It is assumed that PS happens in terms of types of firms, size of firms and capacity of firms. As regards types of firms, it is assumed in the model that the earning prospect of the firm belonging to the Export-Orientated Industries (EOI) and Import-Substituting Industries (ISI) is better than all other types of firms and hence, they are expected to repay more loans than other firms. The size of the firm (FS) is also an important variable. Since the big firms are better managed than small firms, their loan repayment performance should be better than small firms. However, firms belonging to an industry having excess capacity (EC) may suffer from idle capacity which are responsible for low level of income. The low level of income may cause them to default in making repayment to the bank. This suggests that loan defaults is associated with firms other than EOIs and ISIs and firms having no excess capacity. In other words, loan default is related to flawed PS.

4.2.2.2 Project Implementation (PI)

The loan default risks of a project can be reduced or eliminated if it is implemented in schedule time. If excessive time is taken to acquire land, construct buildings, procure and assemble machinery, the interest burden will continue to grow. The IDFI is required to provide assistance to the entrepreneurs at the time of project implementation, given that they lack adequate experience in factory building construction, machinery selection, erection of plant and assembling of machinery, etc. Unless they are given assistance and guidance by the IDFI, they may end up with long construction periods, improper assembly or installation of machinery, cost over-runs and inordinate delay in commercial operation. It is assumed in the model that delayed PI contributes to loan default.

4.4.2.3 Project Management (PM)

The model assumes that ILD may be positively related to inadequate participation by the IDFI in the management of the project it financed. Given the shortage of managerial skills and people in the developing countries, it is expected that IDFI should provide effective guidance and assistance for efficient management of the various affairs of the project. These affairs may be related to production, marketing, sales, finance, human resource and response to competition. Moreover, it can organise and conduct training programs for entrepreneurs to impart the skills required for PM. Diamond (1957) also believes that the quality of the enterprise management is 'of paramount importance in assessing the prospect of repayment' (p.51). This suggests that if the enterprise is ravaged by persistent mismanagement due to inadequate attention of the IDFI to such problems, it is highly likely that the enterprise will not be able to generate sufficient income to service the debt. That is, loan default may be an outcome of inadequate engagement of the IDFI in the management of the client-enterprise.

4.4.2.4 Supervision and Follow-up (S&FU)

Supervision and follow-up (S&FU) of loans and investment are 'an essential part of the work of development banks' (Basu 1965, p.70). The objective of S&FU 'is to keep bank informed of programs and to provide an opportunity for advice in anticipation of difficulties and for assistance if trouble nevertheless arises' (Boskey 1959, p.97). The model assumes that if an IDFI fails to supervise and follow-up at the various stages of the implementation and operations of the industrial firms, inexperienced entrepreneurs may commit costly mistakes, such as cost-overruns and delayed commencement of production, which may contribute to loan defaults. The model suggests that loan default is related to the flawed S & FU.

4.4.2.5 Monitoring (MO)

An effective monitoring of the firm's overall performance is helpful to detect difficulties 'as early as possible so that advice and assistance if accepted may not come too late' (Diamond 1957, p.77). An IDFI should treat monitoring as 'an important conduit for technical advice and financial accommodation' (Diamond 1957, p.77). If there is insufficient monitoring of the activities of the firms, it is highly likely that credit will not be used for the purpose for which it was granted, main risks for the firms will remain undetected and poor operational and financial position of the firm will go unnoticed. This model suggests that poor monitoring may lead to loan defaults.

4.4. 3 Industrial Loan Default and Flawed Public Policy

The model proposes that Flawed Public Policy (FPP) may cause loan default problems. Public IDFI's are linked with the government which sets the direction of industrialisation through policy formulation and policy delivery. The IDFI's should be deeply knowledgeable about the public policy on the one hand and about the practical effects of such policy on the business sector on the other hand. The senior development bankers deserve to be close to the government's policy making apparatus and to be consulted on policy changes.

According to Kitchen (1986), 'government themselves are responsible for many of the distortions anyway' (p.125). Understanding public policy and closeness to policy-makers enable development banks to foresee probable policy distortions and new policy directions and to consider consequent adjustments in their own strategies. These are necessary to minimise the inconsistencies and inadequacies in public policy regimes and to correct flaws in public policies which may contribute to reducing loan defaults in developing countries.

The FPP are related to multiple variables as shown in Figure 4.5.

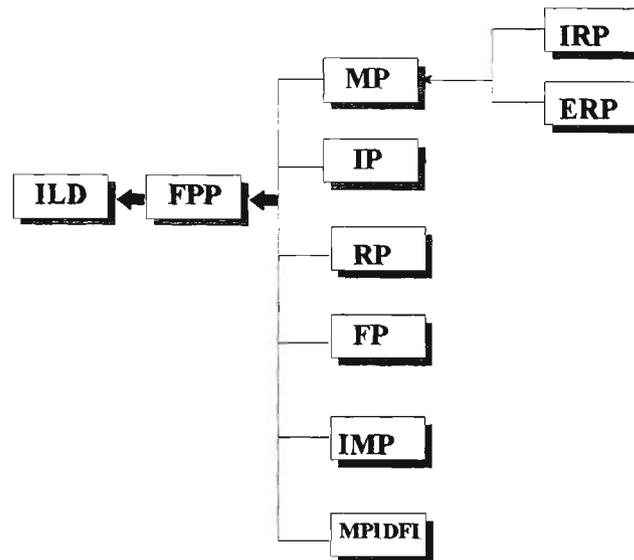


Figure 4.5 : Industrial loan default and flawed public policy

Where,

ILD = Industrial Loan Default

FPP = Flawed Public Policy

MP = Monetary Policy

IP = Industrial Policy

RP = Regulatory Policy

FP = Fiscal Policy

IMP = Import Policy

MPIDFI = Management Policy of IDFI

IRP = Interest Rate Policy

ERP = Exchange Rate Policy

The model assumes that the minimisation of flaws in policy regimes (i.e., policy inconsistencies and inadequacies) will improve the efficiency and the effectiveness of the financial and developmental roles of the IDFI which may contribute towards reducing ILD.

4.4.3.1 Monetary Policy (MP)

The model proposes that Monetary Policy (MP) is directly related to ILD. IDFI's are the policy-takers rather than policy-providers and they have to operate under the policy directives of the government. For instance, if the government imposes high interest rates on industrial loans, it raises the cost of borrowing. In a highly inelastic industrial credit market, borrowers have no other viable alternative but to bear this high cost. Not only that, the cost of operations escalates if the government pursues a high Interest Rates Policy (IRP) and such costs-increase may not be recovered by way of increased income. This means that a high interest rate may be positively related to ILD.

The exchange rate policy (ERP), a component of MP, can also influence the repayment behaviour of borrowers. If the ERP is flawed, the economy suffers from the problems associated with frequent appreciation and devaluation of local currencies. When borrowers receive foreign exchange loans to import items like project machinery, they are exposed to the risks of devaluation of the local currency in relation to foreign currency. Loan default risks may increase with every devaluation of local currency since borrowers are required to spend more local currency to repay foreign currency loans in the post-devaluation period than with pre-devaluation period. Boskey (1959) argues that 'banks which are capitalised entirely in domestic currency are not confronted with the special problems associated with lending foreign exchange' (p.85). This suggests that borrowers having foreign currency loans are exposed to more default risks than their counterparts taking local currency loans. Given this background, it is assumed in the model that flawed ERP contributes to loan defaults.

4.4.3.2 Industrial Policy (IP)

Industrial Policy (IP) sets the guidelines for industrialising a country and the government encourages or discourages a particular industry through it. State-owned IDFI's act in terms of IP directives and provide credit to the industry recommended in

the IP. If IP is flawed, then credit may be provided to non-viable industrial concerns which in the long run will not be able to repay the loan. For example, if IP allows further capacity development in an industrial sector where excess capacity has already been created by indiscriminate sanctioning of loans, providing loans to an industrial enterprise belonging to such an industrial sector will increase the probability of default. As the concerned enterprise will suffer from under-utilisation of its productive capacity, it will not be able to repay loans. The inevitable result is loan default. Given this circumstance, it is assumed in the model that flawed IP increases the risks of loan default.

4.4.3.3 Regulatory Policy (RP)

Regulatory Policy (RP) influences the will and ability of the borrowers to repay loans. According to Allen (1983), borrowers default if the costs of default are less than the principal loan and interest payment combined. If the government frequently changes the regulatory policy, it may increase or decrease the costs or benefits of not repaying the loans. For example, if there is a prospect that government will announce debt forgiveness or interest waive-out, borrowers will become unwilling to repay loans, even if they are able to repay loans. Because of this, the model assumes that loan default can be an outcome of flawed RP.

4.4.3.4 Fiscal Policy (FP)

Fiscal Policy (FP) of a country consists of policy towards taxes, duties, rates and charges imposed on imports, production, and the use and supply of goods and services. Industrial growth and profitability are very much affected by the FP pursued by the government from time to time. Fiscal anomalies may reduce the competitive edge of an industrial concern or may turn a profitable industrial unit into a losing concern which may make it unable to repay the loan. For example, if the duties on the imported raw materials used by IDFI-financed enterprises are greater than the duties imposed on the

import of finished goods the enterprise may be driven out of the market by cheap imported finished products. In such a situation, the enterprise will not be able to keep its loan repayment commitments and will default. That is why it is assumed in the model that flaws in fiscal policies may increase the risks of loan default.

4.4.3.5 Import Policy (IMP)

The model assumes that ILD is linked to flawed Import Policy (IMP). If the IMP is not consistent with the industrialisation policy, it may adversely affect the operational performance and profitability of the industrial firm. If IMP is not supportive of the firm, its products may be competed out or its productive capacity may remain unused and under these circumstances it is highly possible that the firm will not be able to generate sufficient income to repay debts.

4.4.3.6 Management Policy of IDFI (MPIDFI)

It is assumed in the model that loan default can be an outcome of the flawed policy relating to the management of public IDFI. In state-owned development banks, the management function rests with the government policy directives. If these policy directives are not consistent with efficient management of the IDFI, then its financial and industrial developmental activities will be severely constrained. Then, it is highly unlikely that the IDFI will be able to provide quality loans or will be able to contribute to industrial development. This suggests that if the government policy relating to the management of IDFI is flawed, loan default will become an in-built problem.

4.5 Summary

Though a great variety of industrial development banks was established in developing countries with a view to stimulating industrial investment in both public and private

sectors, many of them have been experiencing financial distress due to persistent loan defaults. Theoretically, loan default arises when borrowers are unable or unwilling to repay loans. There is a number of factors which influence borrowers' ability and willingness to repay loans. Among these, flaw-free financial and developmental roles of the development banks, particularly, IDFI and consistent public policies are very prominent.

For having a flaw-free financial role, a public IDFI is supposed to provide quality loans to the entrepreneurs. In order to maintain quality of the loan as well as to insulate them against loan defaults, the public IDFI ought to employ efficient borrower screening mechanism; select and fund viable firms; determine appropriate debt-equity ratio, term and variable loan ratio and loan repayment periods; in addition to minimising delays in loan processing and loan disbursement.

Since the developing nations are under-resourced in terms of experienced industrial entrepreneurs, the public IDFI is required to assume developmental role to increase the loan repayment ability of the borrowers. The entrepreneurs should be nursed from the set-up stage of the firm to the liquidation of the loans. Especially, at the stage of selecting, implementing, supervising and monitoring and managing industrial firms, the IDFI should provide guidance and play paternalistic role.

Again, the efficiency and effectiveness of the financial and developmental roles of the IDFI are influenced by government policy regimes. If the public policy regimes suffer from inconsistencies and inefficiencies, it may trigger flaws in the financial role and developmental role of a public IDFI. Being deprived of the benefits associated with flawless financial role and developmental role of IDFI, the entrepreneurs will not be able to implement and run the firm efficiently to generate sufficient income to repay loans. As such, flawed public policies contribute to industrial loan defaults.

Based on these arguments, a model of industrial loan defaults is developed in this Chapter. The proposed model states that industrial loan default is the outcome of flawed financial role and flawed developmental role of the IDFI and flawed public policies. It is assumed that unless these flaws are removed, industrial loan defaults will continue to reign in the industrial finance market in the developing countries.

CHAPTER FIVE

RESEARCH METHODOLOGY

5.1 Introduction

The loan default problem in developing countries is one of the worst problems in modern history. Bangladesh represents all other developing countries as a true replica of loan default problems. It, also, being a developing country, possesses all the characteristics of underdevelopment. As such, the industrial loan default problem in Bangladesh is a good subject for this study. The thesis deals with Bangladesh Shilpa Bank (BSB) as a case study since most of the industrial development finance institutions (IDFIs) in developing countries experienced more or less similar problems of industrial loan default. The objective of the study is to gain a better understanding of the area of research (Zikmund 1991) and to advance knowledge through theory building (Sekaran 1992).

The theoretical model of industrial loan default presented in Chapter 4 sought to answer three research questions. First, how was industrial loan default associated with the flawed financial role played by the BSB? Second, to what extent was the developmental role played by the BSB flawed and how did they contribute to industrial loan defaults? Third, how did flawed public policy regimes influence industrial loan default problems experienced by the BSB?

This Chapter is divided into several sections. In addition to introductory note in Section 5.1, the model and associated variables are reproduced in Section 5.2. The research design is presented in Section 5.3. Section 5.4 focuses on quantitative research methods and data collection from primary and secondary sources. Section 5.5 deals with qualitative research. The validity and reliability of survey instruments and data are

discussed in Section 5.6 and the statistical tools applied to process data are explained in Section 5.7. Section 5.8 presents a summary drawn from all the sections.

5.2 The Model and Variables

The theoretical model of industrial loan default described in Chapter 4 was developed on the basis of the extensive literature survey presented in Chapter 2. The model was built on three principal explanatory variables and these were: flawed financial role; flawed developmental role; and flawed public policy. Each principal variable encompasses a number of ordinary variables and altogether 23 explanatory variables, as described in Chapter 4, were included in the model. The distribution of these variables is shown in Table 5.1.

Table 5.1
Names of Explanatory Variables

Principal Variables	Ordinary Explanatory Variables
Flawed Financial Role	Officer-Application Ratio, Borrower Screening Mechanism, Credit Need Assessment, Government Intervention, Credit Disbursement, Debt-Equity Ratio, Term and Variable Loan Ratio, and Loan Repayment Period
Flawed Developmental Role	Export-Orientated Industry, Import-Substituting Industry, Excess Capacity, Firm Size, Project Implementation, Supervision and Follow-Up, Monitoring and Project Management
Flawed Public Policy	Interest Rate Policy, Exchange Rate Policy, Import Policy, Tariff Policy, Industrial Policy, Regulatory Policy and Management Policy of IDFI

The relationship between industrial loan default - the dependent variable - and the above-stated independent variables was investigated using both qualitative and quantitative research methodologies.

5.3 Research Design

Both quantitative and qualitative research methodologies were adopted to improve the research design. A combination of research methodologies, termed triangulation research method by Denzin (1978), was preferred to a single research methodology by several authors (Crano 1981; Jick 1979; Somer and Somer 1986; Patton 1990; Fielding and Fielding 1987; and Wilson and Hutchinson 1991). Cambell and Fiske 1959 (cited in Jick 1979) argued that more than one research method should be used in the validation process to ensure that the variance reflects that of the trait and not of the method. Bryman (1988) believed that multiple research methods strongly support the claims of researchers for validity of their research findings. Creswell (1994) thinks that combined methods lead to convergent conclusions on research findings. Fielding and Fielding (1987) stressed multiple triangulation since it 'is the equivalent for research methods of correlation in data analysis'(p.33).

These observations suggest that both qualitative and quantitative research methodologies work as complementary to each other when conducting an investigation and answering the same research question. But Hammersley and Atkinson (1989) cautioned against such naive conclusion. They said that even if the results of both the methodologies were identical, it provided no guarantee that inferences involved were correct. Ianni and Orr (1979) argues that the use of a particular research method depends on the 'kinds of questions asked, the way they are asked, and the way in which answers are interpreted and presented'(p.91). Reichardt and Cook (1979) believed that the researcher should not be restricted to either the quantitative or qualitative paradigms. Rather, s/he should be flexible while using both methodologies to answer research questions.

Following the above opinions and suggestions, quantitative research methods were adopted for dealing with one set of research questions and qualitative research methods were used for another set of research questions. For example, the relationship between industrial loan default and debt-equity ratio was investigated by using quantitative methods, while the relationship between industrial loan default and flawed industrial policy was studied through qualitative methods. In some cases, both methodologies were used to reinforce each other's findings. For example, the influence of high interest rates on industrial loan default was studied through both quantitative and qualitative methodologies. This indicates that the nature of the research questions and the characteristics of the variables - mainly independent - influenced the choice of research methodologies.

5.4 Quantitative Research Methods

The quantitative study involved primary data collection through a field survey and secondary data collection from various institutions in Bangladesh, particularly from the BSB. For this purpose, the researcher visited Bangladesh at the beginning of November 1996 and stayed there until early February 1997. Quantitative research was carried out to test some of the directional and non-directional hypotheses advanced in Chapters 7, 8, 9 and 10. These hypotheses were developed from the theoretical model presented in Chapter 4. However, the theoretical model developed by the researcher was tested using both quantitative and qualitative research methods.

5.4.1 Secondary Data Collection

The BSB was chosen for the study since it is the largest public IDFI in Bangladesh in terms of size, lending operations and the number of borrowers. Between December 1971 and September 1996, the BSB supplied term loans to 1490 industrial firms and, out of them, 627 firms were in its loan portfolio as at September 1996. However,

among these firms in the portfolio, 304 firms were in operation and 323 firms were under various stages of implementation. The study deals with data - both secondary and primary - collected from the 304 operating firms. Non-operating firms as well as firms which were sanctioned loans after September 1996 were excluded from the study though some data on these firms were collected. The reason for exclusion of non-operating firms from the study was that sufficient data could not be obtained from these firms to test both the directional and non-directional hypotheses³⁸. Since these firms were under various stages of implementation and were not in a position to generate any income to service the debt obligations, their data would have little relevance to the current study. However, information regarding reasons for non-operating and stuck-up conditions of some of these firms were collected and included in the study.

Since most of the industrial firms take at least two years³⁹ to commence commercial operations, those firms which were sanctioned loans after September 1996 were also excluded from the survey. In brief, any firm which was in operation as at September 1996 was included in the survey and, based on this criterion, 304 firms were taken up for study. Another reason for selecting operating firms for the study was that operating or performing firms provided sufficient information for better assessment of reasons for loan defaults than non-operating firms which were not yet implemented. For example, firms under implementation did not require working capital and, hence, the relationship between working capital loans and industrial loan defaults could not be studied with these firms. The survey instruments involved in respect of data collection from secondary sources were inspection and examination of loan files and visits to various departments of the BSB.

³⁸ Sproul (1988) states that the direction of the research outcome is predicted in directional hypothesis. However, the direction of the outcome cannot be predicted in a non-directional hypothesis.

³⁹ This period is also called gestation period which is allowed by the BSB.

5.4.1.1 Audit and Inspection of Loan Files

Since the BSB is a state-owned IDFI and under the administrative control of the Ministry of Finance, access to loan files required permission from the Government of Bangladesh (GOB). As such, before data collection commenced, a letter from the Director of Research and Graduate Studies, Victoria University of Technology was sent during October 1996 to the Minister for Finance, GOB, requesting him to instruct the BSB to grant the necessary access to all loan files and to supply all necessary information to the researcher. Soon after arrival in Bangladesh during the first week of November 1996, the author personally approached the Minister and obtained the written permission, shown in Appendix - B, which facilitated access to all necessary loan files maintained by the BSB.

It is to be mentioned here that a loan case has several loan files. The files of a loan case were kept by various departments in the head, regional and branch offices of the BSB. Because of financial resources and time limitations involved in visiting, procuring and compiling data from various regional and branch offices scattered all over Bangladesh, only loan files stored in the head office of the bank were examined and inspected. Even then, it was an arduous task to piece together relevant information after inspecting several files of a loan case maintained by several departments. For example, the Inspection and Evaluation Department maintained inspection reports of a firm, the Loan Accounting Department maintained loan repayment records of that firm while the General Banking Department had a file regarding its working capital loans. The Final Construction Report (FCR) of the firm was kept by the Library and Training Department. If the firm was under litigation, the Law Department would have another file on this particular firm.

Considering the time and manpower constraints, the researcher recruited four paid graduates to work as Research Assistants (RAs). Two were economics graduates. However, RAs were trained for three days about various aspects of data extraction

from the loan files. For example, they were briefed about various symbols used by the bank. The BSB used FC and LC, for example, to denote foreign currency and local currency loans respectively. The RAs were educated about how to handle and read the files and extract data and process them by applying simple statistical and mathematical tools such as addition, subtraction, multiplication, averaging and frequency distribution. For example, data regarding the time period taken to start commercial production were not maintained by the BSB. The RAs were trained in how to search and find this information from the loan files which contained information regarding loan sanction date and date of commencing commercial operation. RAs were shown by the researcher how to extract these data from the files and subtract production commencement date from loan sanction date to find out the time taken to start commercial production after the loan was sanctioned to the firms. Afterwards, they were shown how to organise this type of data from 304 firms by following frequency distributions and putting them against loan amounts repaid to find out the loan repayment performance of operational firms.

The researcher supervised them constantly to ensure and verify reliability, authenticity and accuracy of the data. In the process, 2,640 man-hour (220 man-hour X 12 weeks) were spent to inspect and extract data from the loan files of 304 firms and process these data in accordance with the requirements of the study.

However, all loan files of each of the 304 firms could not be inspected due to the location of some of them in the court, regional and branch offices of the bank and, due to the costs and time involved. In some cases, the researcher had to rely on data from a lower number of firms than 304 loan case files while examining a particular hypothesis. For example, the relationship between loan defaults and months taken for disbursement of first instalment of loans was examined on the basis of information available for 215 loan cases. Another example is information relating to the level of compliance with loan conditions by the borrowers and, in this instance, files of only 89 loan cases were

available for inspection. However, data on most of the variables relating to the financial and developmental roles of the BSB were obtained from the files of 304 firms.

The inspection of loan files facilitated access to hard data relating to a wide range of banking transactions normally unavailable from any department or source. Important materials, e.g., internal memorandum, circulars, letters, project reports, correspondence between banks and borrowers, and official notes, were also available in the loan files which provided pertinent information.

It should be mentioned here that access to loan files was not sufficient to find all required information. There were many occasions when assistance was sought from the dealing officers to clarify pertinent data. Sometimes, they could not give sufficient explanations and time because of changes of the dealing officers and time constraints. Another problem was the lack of cross-referencing to files in other departments. Data in one file were linked to data in another file of the same firm and in this case enquiries were made about the location of that linked file, but the complexities of the filing system have frustrated some of these enquiries. Problems were also experienced in accessing files, since the authorised officers were, in some instances, either absent or busy with their official work.

5.4.1.2 Visits to Departments of BSB

Apart from examination and inspection of loan files, secondary data were to be collected from the loan records and loan registers maintained by the various departments of the BSB. These data, again, were to be processed given the fact that few of these data fit the format used in the study. For example, data relating to the disbursement of the instalments of loans were maintained by the Loan Accounting Department under loan number and currency type. The researcher had to inspect each loan card for each loan case, sum up date-wise and currency-wise loan disbursements into a total amount of loans disbursed to a particular firm and then present them in a

table under the headings of foreign and local currency loans. Another example was the data on working capital from the General Banking Department. Information on working capital disbursement was recorded by the date of disbursement and all firms were grouped within particular date. The author had to organise and process the total amount of working capital loans received by a firm after procuring data from date-wise lists. Again, this was to be compared against term loans to determine the term and variable loans ratio; and to examine the relationship between this ratio and loan defaults. This problem was repeated in all departments.

Similarly, secondary data collected from the Management Information Service Department, the Project Implementation Department, the Loan Accounting Department, the Training Department, the Law Department, the Central Recovery Department, the Inspection Department, the Central Accounts Department, the Secretary's Department and the Documentation and Machinery Procurement Department of the BSB were to be processed and organised as per research requirements.

Apart from the BSB, secondary data were also collected through personal visits to Bangladesh Bank - the central bank - all nationalised commercial banks, Bangladesh Institute of Development Studies (BIDS), Bangladesh Bureau of Statistics, World Bank Resident Office, Ministry of Finance, External Relations Division, Board of Investment and Planning Commission of Bangladesh.

These organisations, except the World Bank Resident Office and BIDS, were directly or indirectly associated with the formulation of those public policies that influenced the operations of industrial firms and their loan repayment performance.

5.4.2 Data From Primary Sources

As adequate data could not be gathered from the institutional or secondary sources, additional data were to be collected from primary sources. Data collection from primary sources involved a field survey since it has the capacity for generating data from a large number of people to test hypotheses (Bryman 1988). The survey was limited to the owners of the 304 operating industrial firms which were selected for secondary data. This research strategy was deliberately chosen to see how results from primary data compared with the results obtained from secondary data. Research on the basis of primary data provided a different way of examining the same research problem examined by the secondary data. It meant that primary data served as complementary to secondary data.

Survey Design and Survey Instruments

The survey instruments applied to collect data from the primary source were a structured questionnaire, firm and borrower visits and interviews. Since there were only 304 operating firms in the loan portfolio of the BSB as at September 1996, a census - instead of a sample survey - of these firms was conducted which helped to yield sufficient data about a number of variables.

A. Questionnaire

In order to generate data from the primary sources, a written and self-administered questionnaire which was relatively cheap, time-efficient and free from interviewer bias was developed. Considering the time and costs involved in other instruments, this instrument was chosen despite objections from several authors (Moser and Kalton 1981; Oppenheim 1966 and Kidder 1991) on the ground that it yields incomplete responses, contains confused questions and lacks spontaneity. However, given the

circumstances that constrained the use of other efficient instruments, the researcher believed that the advantages of a self-administered questionnaire far outweighed the disadvantages associated with it. With this understanding, self-administered questionnaires, shown in Appendix - D, were mailed to the 304 firms during the first week of December 1996. This questionnaire was developed covering many aspects of the defaulting firms. The objectives of this questionnaire were two. One objective was to collect additional data to support findings about hypotheses which were either accepted or rejected on the basis of secondary data. The other objective was to elicit information which was not available from secondary sources to accept or reject particular hypothesis.

With this end in view, the questionnaire was structured into several parts. Part A provided the introductory aspect of the firm and Parts B and C contained questions relating to problems experienced by the entrepreneurs at the stage of project identification and credit disbursement. Part D focused on issues relating to project implementation and Part E dealt with questions relating to project supervision and monitoring. The questions relating to capacity utilisation, working capital and project management are provided in Parts F, G and H, respectively. The last part focused on public policies.

B. Pretesting

A pretest of the questionnaire is required for uncovering weakness or detecting problems in the questionnaire design (Zikmund 1991) and reducing missing responses for any question asked. The objective of having a flawless questionnaire was to increase the response rate. As a part of pretesting exercise, ten borrowers were contacted and the questionnaire was discussed with them. It was found that most of the respondents desired to remain anonymous and preferred close-ended questions. Based on such pretest results, the questionnaire was modified to increase response rate.

In some cases the respondents were asked to indicate priorities by providing a numerical ranking. The author experienced subdued responses from most of the pretest respondents about certain questions regarding loan repayment performance such as earning and repayment ratio, and operating expenses⁴⁰. Following this experience, any item having the probability of a high rate of missing response was dropped from the questionnaire. This reflected the recommendation of Tabachnick and Fidell (1989) that variables with missing values should be omitted since 'they affect the generalizability of results' (p.61). That is, questions having the prospects of high missing response rates were not included in the questionnaire.

Though Linsky (1975) found that short questionnaires did not necessarily increase response rates over long questionnaires, the researcher found that pretest respondents favoured a short-length questionnaire containing the attributes of easy understanding and interpretation. Such response was in line with the opinion of Lussier (1995). He believed that limits should be placed on the number and length of the questions and the questionnaire should be concise and easy to understand to improve the response rate. Foddy (1994) argued that

'long questions are more likely to elicit biasing response effects. Complicating phrases and clauses are often ignored by respondents. All questions should comply with the principles of brevity, grammatical simplicity, specificity, and correctness' (p.50).

The feedback underpinned the framing of the questionnaire instrument. It helped to redesign the questionnaire with a revised format and sequence of items and a reasonable number of uncomplicated questions; to re-word questions to ensure the attributes of correct understanding and interpretation. These revisions were also done taking into consideration that the respondents were reluctant to invest time and attention in

⁴⁰ The intention of the researcher was to use operating expenses as a proxy variable to rate of capacity utilisation and loan repayment.

responding to a long questionnaire and that loan default was a sensitive issue⁴¹ in Bangladesh.

Additionally, several elements were incorporated in order to bolster the response rate. These include, anonymity and confidentiality of the respondents, personalised covering letter indicating purpose as shown in Appendix- C, the promise of a summary report to the respondents, reply-paid and pre-addressed envelopes and a follow-up reminder letter two weeks after the original letter was mailed out. Anonymity and confidentiality were promised to allay any fear on the part of the respondent and to increase the response rate though Kanuk and Berenson (1975) do not believe that this technique has substantial influence on increasing the response rate.

The questionnaire was mailed directly from the office of the researcher to the chief executive officers of the 304 firms which were taken up for study. By the last half of December, only 6 self-administered questionnaires were received by the researcher which supported the apprehension of Moser and Kalton (1981), Oppenheim (1966) and Kidder (1991) that such questionnaires deliver low response rates. Following the suggestion of Worsely (1984) that administered questionnaires can yield reliable and valid information, the researcher resorted to direct contact with the respondent-borrowers through repeated telephone calls to administer questionnaire. The researcher made repeated follow-up phone calls to 216 firms by following Linsky's (1975) suggestion that follow-up boosts response rate. Additionally, personal visits permitted by the time and available resources were also undertaken to selected non-responding firms. Because of time and cost constraints, only the 11 firms located in Dhaka, Chittagong, Noakhali and Dinajpur could be visited by the researcher. These efforts

⁴¹ Loan default was a very sensitive issue to the borrowers since they feared that some of the data or opinion may be used as a basis to sue them for not repaying loans. The questionnaire was designed to allay such fear among them and it did not include any question which might have disadvantaged them in the future.

resulted in obtaining completed questionnaires from 56 firms which constituted a 18 percent response rate.

Among these firms, 36 firms answered all questions while the remaining firms did not answer some questions. Because of this missing responses to some questions, some hypotheses were examined on the basis of responses from less than 56 firms.

5.5 Qualitative Research

The qualitative research method was considered as a means of gaining access to unquantifiable facts. This method uses 'words as data' (Miles and Huberman 1984; and Tesch, 1990, p.56) and it allows the researcher 'to share in the understanding and perceptions of others' (Berg 1995, p.7). Qualitative methods unfold events over time which provide additional information often untapped by static quantitative methods (Insch et al 1997). Das (1983) pointed out that certain organisational phenomenon cannot be validly measured at all without using qualitative techniques. As the current study deals with an organisation, called the BSB, the qualitative research method was incorporated in the research design. However, the qualitative method is used in conjunction with the quantitative method as a multiple research strategy to increase the depth of understanding of the results of an investigation (Berg 1995; Denzin 1978; Fielding and Fielding 1987; and Miles and Huberman 1984) into the determinants of industrial loan defaults in Bangladesh. The reason behind the application of both or multiple research methods was to discover the commonalities across various findings to increase validity and reliability of the conclusions about the causes of industrial loan defaults in Bangladesh.

5.5.1 Interview

As a part of the qualitative research method, interviews were conducted by the researcher with a number of bankers and policy makers regarding the loan defaults in Bangladesh. Prominent among them were the Governor of the Bangladesh Bank, Managing Directors and General Managers of nationalised commercial banks (e.g., Sonali Bank, Janata Bank, Agrani Banks and Rupali Bank), IDFI, such as BSB and BSRS. The aim of such interviews was to find out the perceptions of these bankers and high officials about the overall industrial default situation in Bangladesh.

As regards interviews with the officials of the BSB, it is to be pointed out that prior to conducting interviews, attempts were made to gather information through a structured questionnaire. A pretest to this effect was conducted on 11 officers and managers. It was found that only one officer agreed to participate in the task of completing of self-administered questionnaire. It was due to this poor support for a questionnaire-based survey among the BSB employees that the idea of employing a questionnaire was abandoned. Instead, informal interviews were conducted with a total of 26 senior managers⁴² and officers of the BSB to obtain additional and descriptive information regarding variables included in the study.

Following the suggestion of Crabtree and Miller (1992), questions regarding variables were written before face-to-face interviews took place. These questions were mainly open-ended which elicited a variety of free response. Interviews were conducted during January 1997 in the interviewees' offices.

However, at the insistence of the interviewees, interviews were conducted without tape recorder. As such, all informal answers and statements of the interviewees were recorded in the form of hand-written notes. The researcher also agreed that the identity

⁴² They include 2 General Managers, 7 Deputy General Managers, 5 Assistant General Managers, 5 Senior Managers, 3 Managers and 4 Officers.

of these interviewees would remain obscured in the thesis and data would be processed and presented in a form which would maintain confidentiality and anonymity of the respondents. Questions were centred on the 23 variables. However, interviewees other than BSB staff were asked more questions about policy-related variables than about variables related to the financial role and development role of a development bank. Since the interviewees in the BSB were involved in the financial and developmental role of the BSB, they were asked more questions about variables relating to these roles than policy related variables such as import and tariff policies. Opinions expressed in response to informal and open-ended questions were used to support or reject particular hypothesis and to aid data analysis for particular variable.

In addition to interviews, written materials, reports published in the national and international newspapers, serious published research articles and books, documents, gazettes and published reports of the GOB, and international organisations such as the World Bank, Price Waterhouse and UNDP were used to support or reject hypotheses about industrial loan default in Bangladesh.

5.5.2 Case Study Method

Though this study was not based on the case study method to investigate a phenomenon within its real-life context, it developed and provided cases as examples of compelling evidence in support of relationships between a particular explanatory variable and loan default. These case studies were used to substantiate research findings obtained by following either quantitative or qualitative research methods. This thesis contains ten case studies which provided compelling evidence in support of accepting or rejecting particular hypothesis.

5.6 Validity and Reliability of Survey Instruments and Data

Questions may arise as to the validity and reliability of the survey instruments employed for collecting data on the industrial debtors and loan default in Bangladesh. Thomdike and Hagen (1969) defined validity and reliability as under.

“Validity refers to the extent to which a test measures what we actually wish to measure. Reliability has to do with the accuracy and precision of a measurement procedure. Indices of reliability give an indication of the extent to which a particular measurement is consistent and reproducible (p.162)”.

Both quantitative and qualitative research methods were deliberately used ‘to relate different sorts of data in such a way as to counteract various possible threats to the validity’ (Hammersley and Atkinson 1989, p.199) of the survey instruments used in the current study. Nunnally (1978) suggested that any survey instrument becomes reliable when it shows consistent results. Reliability, according to Emory (1980) ‘is a contributor to validity’ (p.132). In the current study, there was consistency between or among survey results obtained through the application of primary and secondary data. As such, survey instruments used in the current study were reliable and valid.

5.7 Statistical Tools and Analysis

Data gathered from primary and secondary sources were arranged and presented by using statistical tools. Answers to questions included in the questionnaire were transformed into data by assigning numerical values to each of the questions asked. Descriptive statistical techniques were used to check and summarise data under various statistical tables. These tables used frequency distributions to show how data were spread across the range of occurring values (Reid 1991). The conversion of proportion into percentage in some categories of data was also done in these tables. The

standardised data were compared with similar information from other sources. The measure of central tendency was also applied in the study.

The class interval, which implies both an ordering of categories and a measure of difference between them (Reid 1991), was also shown in the Tables. However, class intervals were related, sometimes, to significance of period of time or group of borrowers rather than to uniform range of values. For example, the class interval for loan applications received was shown according to period of political office of a government rather than 3-year or 5-year intervals. Data so organised and presented were used to interpret data. These assisted in examining the relation between industrial loan default and one variable at a time. The data were processed using Excel for Windows 97. After data were keyed in, checking of data was carried out to correct omissions and errors by comparing keyed data with those manually processed and kept in written form. Power Point of Windows 97 was used to construct figures of the model incorporating 23 explanatory variables.

5.8 Summary

This chapter contains a detailed description of how the study was planned and carried out. Though the banking industry in most of the developing nations is jaundiced by massive loan defaults, this study deals with Bangladesh. Considering the level of loan default and its prominence among the IDFI's, the BSB was chosen as a case study.

In order to test the theoretical model developed in Chapter 4, a research design incorporating both qualitative and quantitative research methods was provided. The objective for resorting to multiple research methods was to have convergent, valid and reliable conclusions on research findings.

Quantitative research was carried out on the basis of data collected both from primary and secondary sources. Data collection from secondary sources involved eliciting pertinent information regarding 304 loan cases, apart from procuring and processing data from various institutions and departments of the BSB. The primary data were collected through a mostly administered questionnaire as the self-administered questionnaire yielded very poor response from the respondents.

Qualitative research was carried out, in addition to primary and secondary data, on the basis of interviews and published materials. It unfolded events which provided additional data untapped by quantitative research methods. The application of both research methods helped to arrive at valid and reliable convergent conclusions about the causes of industrial loan defaults in Bangladesh.

CHAPTER SIX

RESULTS OF FIELD SURVEY AND LOAN-FILES INVESTIGATIONS

6.1 Introduction

This chapter reports the results of the field survey which was conducted by the author during January 1997. It covered 304 firms financed by the BSB. Each firm is represented by a borrower surveyed⁴³. The objective was to test the validity of the industrial loan default model explained in Chapter 4. Though the model incorporates 23 explanatory variables, primary data on 11 explanatory variables were collected through the field survey of borrowers. Data on the rest of variables could not be collected due to time and resources constraints and borrowers' reluctance to provide information on them. However, these 11 variables are related to financial role and developmental role of the BSB, and public policy regime pursued by the GOB.

Some secondary data obtained through loan files investigations are also provided here, although most of the secondary data are presented in Chapters 7 – 10 while testing the hypotheses. Additionally, while administering questionnaires, comments were also sought from the borrowers and these comments were tallied against the comments made by the loan officials of the BSB. These data and comments will be used to accept or reject hypotheses provided in the Chapters 7-10.

This Chapter is organised in the following way. In addition to the presentation of introductory note in Section 6.1, data and comments of borrowers and BSB officials relating to financial variables are provided in Section 6.2. While Section 6.3 deals with

⁴³ Firm and borrower are synonymous and will be used interchangeably for interpreting the survey results.

data and comments relating developmental variables, Section 6.4 focuses on data and comments relating to policy variables. The summary is provided in Section 6.5.

6.2 Financial Role Variables

Respondents were asked a number of questions relating to four financial role variables incorporated in the Model. Whilst data relating to debt-equity ratio are presented in Section 6.3, data relating to credit disbursement, term and variable loan ratio, and loan repayment period are provided in this Section.

6.2.1 Credit Disbursement

The respondents were asked about timely disbursement of credit by the BSB. Nearly three-fourths (74 percent or 40 firms) of the 54 responding firms confirmed that they experienced delays in disbursement of credit by the BSB (Table 6.1).

Table 6.1

Frequency and percentage distribution of the firms responding to the question relating to disbursement of credit by the BSB in due time

Response	f	%*
Yes	14	26
No	40	74

Note: f=frequency; % = percentage which was rounded in some cases

Source: Field Survey

There were 14 firms (26 percent) which received credit in due time. As the number of credit instalments varies from firm to firm, delay in credit disbursement also varies from firm to firm. Those who received credit disbursement in more than one instalment experienced more delays than those who received credit by single instalment. Firms (26

percent) experiencing no delays in credit disbursement may have received their loans in a single instalment.

When asked to list the reasons for delayed credit disbursement, 40 firms provided multiple answers. Of these 40, 10 firms (25 percent) cited delay in pre-disbursement inspection as the reason for not receiving credit in time. About one-tenth of them indicated that credit disbursement was delayed due to the BSB's demand for documents supporting owner's equity investment (Table 6.2).

Table 6.2

Frequency and percentage distribution of the firms responding to the question relating to reasons for delayed disbursement of credit from the BSB

Response	f	%
Delayed inspection by the BSB	10	25
Demand for documents regarding pre-investment	3	8
Delayed loan processing	25	62
Inadequate pre-disbursement equity investment	6	14

Source: Field Survey

Even after lodgment of documents relating to equity investment, credit disbursement was delayed for 25 firms (62 percent) of responding firms due to delayed loan processing by the BSB. But 6 firms (14 percent) could not invest enough equity capital which delayed credit disbursement to them. Though the majority (86 percent) firms did not admit that inadequacy of equity capital was responsible for delayed disbursement of credit, the existence of 201 stuck-up firms in the BSB's loan portfolio as at September 1996 support the answer of the 6 responding firms that inadequate equity capital was a factor for delayed disbursement of loans (Table 6.2).

The firms receiving delayed credit disbursement (40 firms) were asked to state the effects that delayed credit disbursement had on their cost of operation. They provided multiple answers to this question (Table 6.3).

Table 6.3

Frequency and percentage distribution of the firms responding to the question relating to the consequences of delayed credit disbursement

Item	f	%
Cost over-run	22	55
Delayed implementation	20	50
Accumulated debt burden	23	57

Source: Field Survey

Because of delayed disbursement of credit, 22 firms (55 percent) experienced cost over-run and 20 firms (50 percent) could not be implemented as per scheduled time. As Table 6.3 shows, 23 firms (57 percent) suffered accumulation of debt burden.

Borrowers' Comments

“If the BSB could cooperate with us, the project could be implemented much earlier”.

“The BSB officers always created snags in the way of credit disbursement”.

“Applied for loans in 1981, but the BSB sanctioned it in 1985”.

“The BSB sanctioned Taka 2.4 million in 1989 in foreign currency and the loan liability soared to Taka 5.45 million during disbursement”.

Bankers' Comments

“The borrowers could not show their evidence that they made adequate pre-disbursement equity investment”.

“ We were ready to disburse money but borrowers delayed in investing their equity money”.

“ Loan disbursement was delayed due to unavailability of foreign credit”.

6.2.2 Term and Variable Loan Ratio

Variable or working capital received wider attention from the responding firms. More than four-fifths (84 percent) of the 43 responding firms said that they got insufficient working capital from the banking sector as a whole. This reinforces findings of another study (Sobhan and Ahsan 1990) that inadequate working capital was a problem for 73.8 percent of firms they surveyed. Table 6.4 shows that the BSB provided inadequate working capital to 94 percent of the respondents (52 firms). The majority (88 percent) of these respondents did not receive working capital in time.

Table 6.4

Frequency and percentage distribution of the firms responding to the questions relating to working capital

	Yes		No	
	f	%	f	%
Insufficient working capital from all banks	36	84	7	16
Inadequate working capital from the BSB	52	94	3	6
In time availability of working capital	1	12	2	88
Inadequate working capital caused loan default	41	91	4	9

Source: Field survey

It appears from the above that 91 percent (41 firms) of the 43 responding firms answered affirmatively that inadequate working capital was responsible for loan default. Less than 10 percent of them answered negatively which meant that loan default was not solely attributed to the dearth of working capital.

Borrowers' Comments

“We have received negligible amount of working capital”.

“ Working capital shortage prevented us from running the firm”.

“The BSB should provide sufficient working capital”.

“We could repay loans much earlier if we could get working capital from the bank”.

“We had to postpone production for three years after machinery was installed because of unavailability of working capital from the BSB”.

“We got working capital after nine years, but no firm can operate with such a small amount”.

Bankers' Comment

“ The BSB should provide more working capital to the firms”.

“ Many of our firms suffered from working capital shortage”.

6.2.3 Loan Repayment Period

Respondents were asked to select their options regarding the loan repayment period. Responses were received from 56 firms and 92 percent (51 firms) of them favoured the extension of the loan repayment period (Table 6.5).

Table 6.5

Frequency and percentage distribution of the firms supporting longer loan repayment period than those fixed by the BSB

Response	f	%
Yes	51	92
No	5	8

Source: Field Survey

Less than one-tenth (5 firms) of the responding firms opposed such extension of loan repayment period.

6.3 Developmental Role Variables

In order to understand the extent of the involvement of the BSB in the entrepreneurial development activities, questions relating to choice of firm, excess capacity, project implementation, project supervision and follow-up, monitoring and project management were included in the questionnaires. Responses obtained are provided under the heading of each variable.

6.3.1 Choice of Firm

The respondents were asked to identify the factors which motivated them to apply for loans to the BSB. Multiple answers received from the 56 borrowers which are reproduced in Table 6.6.

Table 6.6
Frequency and percentage distribution of the respondents identifying reasons for choosing firms financed by the BSB

Reasons	f	%
Industry experience	26	46
Product's market prospect	38	68
BSB's loan offer	22	39
Motivation by friends	9	16

Source: Field survey

Table 6.6 shows that about half (46 percent) of the 56 respondents have industry experience which suggests that 54 percent of the BSB-borrowers have no previous industry experience. But Sobhan and Sen (1991) found that 65 percent of the

borrowers had no industrial experience. However, more than one-third (39 percent) of them applied for loans after they heard that term loans were available from the BSB. Though 38 borrowers (68 percent) identified marketing opportunity for their products as one the reasons for taking loans from the BSB, 9 borrowers admitted that they were motivated by their friend to apply for loans.

6.3.2 Excess Capacity

When asked about the existence of unused productive capacity, two-thirds (36 firms) of the 54 responding firms answered affirmatively (Table 6.7).

Table 6.7

Frequency and percentage distribution of the firms responding to the questions relating to the existence of unused productive capacity

Response	f	%
Yes	36	67
No	18	33

Source: Field Survey

However, one-third (33 percent or 18 firms) of the respondents denied the existence of unused productive capacity in their firms. When asked to identify the reasons for under-utilisation of productive capacity, multiple responses came from the 36 firms which confirmed the existence of unutilised capacity.

Table 6.8

Frequency and percentage distribution of the respondents answering questions relating to the reasons for un-utilised productive capacity

Item	f	%
Excess capacity in the industry	13	36
High costs of raw materials	22	61
Loss of market	16	44
Unavailability of skilled personnel	10	28

Source: Field Survey

It appears from Table 6.8 that excess capacity (13 firms or 36 percent), high costs of raw materials (22 firms or 61 percent), loss of market (16 firms or 44 percent) and unavailability of skilled persons (10 firms or 28 percent) were identified as the reasons for under-utilisation of productive capacity. The corresponding percentages found by another survey (Sobhan and Ahsan 1990) were 88.1 percent for high cost of raw materials, 78.6 percent for loss of market and 15 percent for excess capacity. This shows that there is substantial difference between the results of the previous survey on Bangladeshi industrial borrowers and the current survey in respect of cost of raw materials, loss of market and excess capacity. These difference may be attributed to the availability of relatively cheap raw materials from domestic sources, increased level of protection provided by the public policies and the indiscriminate sanction of industrial capacity after 1990 when nationalised commercial banks led the industrial credit market. Sobhan and Ahsan (1990) completed their survey in 1986 when industrial firms were relatively more dependent on imported raw materials and commercial banks supplied an insignificant amount of industrial credit. This suggests that the changes in the credit regimes and public policies in the post-1986 period were reflected in the above findings of the current study.

Borrowers' Comment

“ We could not utilise our productive capacity due to unavailability of sufficient working capital”.

“ The BSB and other banks are responsible for creating excess capacity by indiscriminate sanctioning of industrial loans”.

“ We could not operate our mills due to lack of raw materials”.

Bankers' Comment

“ Lack of coordination among various loan giving agencies and banks is responsible for excess capacity”.

“ Of course, cost of raw-materials have gone up. But at the same time, price of output has gone up”.

6.3.3 Project Implementation

The entrepreneurs of 304 industrial firms were asked to state their experiences regarding delayed implementation. Responses received from the 52 firms are presented in Table 6.9.

Table 6.9

Frequency and percentage distribution of the respondents answering questions relating to delayed implementation of project and delayed loan repayment

Item	Yes		No	
	f	%	f	%
Project implementation delayed	37	71	15	29
Repayment delayed	36	88	5	12

Source: Field Survey

Table 6.9 reveals that project implementation was delayed for 71 percent (37 firms) of 52 responding firms and this delay contributed to delayed loan repayment for 88

percent (36 firms) of the 41 responding firms. The firms (37 firms) experiencing delayed implementation were subsequently asked to identify the reasons for such delay in the implementation of the firms. All of them resorted to multiple answers which are presented in Table 6.10.

Table 6.10

Frequency and percentage distribution of the firms identifying reasons for delayed implementation of the firm

Item	f	%
Delay in foreign currency allocation	21	56
Delay in building construction	10	27
Delay in machinery selection	18	48
Delay in machinery arrival	12	32
Delay in machinery installation	13	36

Source: Field Survey

Table 6.10 shows that more than half (56 percent) of the 37 responding firms experienced delay in foreign currency allocation which was related to delayed availability of fund from the international finance institutions such as the World Bank, Asian Development Bank, etc. Other factors responsible for delayed implementation were delayed arrival of machinery (12 firms or 32 percent), delayed construction (10 firms or 27 percent), delayed machinery selection (18 firms or 48 percent) and delayed machinery installation (13 firms or 36 percent).

When asked about their involvement in the process of machinery selection, 47 firms answered the question which is reproduced in Table 6.11.

Table 6.11
Frequency and percentage distribution of the firms
responding to the questions relating to machinery selection

Item	f	%
Machinery selected by the BSB	7	15
Machinery selected by the BSB and sponsors	37	79
Machinery selected by the owner/consultants	3	6

Source: Field Survey

It appears from Table 6.11 that the machinery of more than three-quarters (79 percent) of responding firms was selected by both the BSB and the entrepreneurs. Private consultants or borrowers' involved in the selection of machinery for 6 percent (3 firms) firms.

There were 52 firms which responded to the question relating to involvement of the BSB in project implementation in terms of providing professional advice for machinery installation and building construction. Of them, nearly half (25 firms) of them confirmed that they did not receive any assistance from the BSB regarding either building construction or machinery installation. However, 15 firms (29 percent) and 12 firms (23 percent) received assistance in respect of machinery installation or building construction respectively (Table 6.12).

Table 6.12

Frequency and percentage distribution of the firms responding to the questions relating to BSB's assistance regarding machinery installation and construction work

Item	f	%
Building construction	12	23
Machinery installation	15	29
Neither of these	25	48

Source: Field Survey

Borrowers' Comments

“ Documents relating to the import of machinery was faulty which delayed release of machinery from the port authority”.

“ We have not got sufficient assistance from the BSB regarding building construction”.

Bankers' Comments

“ The BSB has manpower limitations to attend each and every work of the project”.

“ I agree that Bank's participation in the implementation would have brought the project more quickly into the production”.

6.3.4 Supervision and Follow-up.

The involvement of the BSB in the supervision and follow-up of the implementation work can be understood from the frequency of visits or inspections it undertook to the firms. Table 6.13 shows that over three-quarters (43 firms) of the 56 responding firms were visited by BSB officials to carry out pre-disbursement inspection.

Table 6.13

Frequency and percentage distribution of the firms responding to the questions relating to project supervision, follow-up and monitoring

Item	f	%
Pre-disbursement inspection	43	77
Attend board meeting	5	8
Follow-up inspection	28	50
Fill-out forms	17	30
Loan recovery	33	59
Advice regarding implementation	6	16

Source: Field Survey

It is to be mentioned here that pre-disbursement inspection involves detailed assessment or thorough examination of the building construction and machinery installation and these two types of works are suited for civil engineers and mechanical engineers, respectively. Investigations into the files of the loan-cases revealed that in most of the cases, professionals unsuited for the work were sent to the firm to prepare inspection reports. Several instances were found where mechanical engineers were deputed to carry out inspection related to building construction and civil engineers were sent to report about machinery installation. Consequently, project inspection ended up as form-filling exercises in 17 firms (Table 6.13).

However, 6 firms (16 percent) received some form of professional advice from the BSB in respect of implementation, although 33 firms (59 percent) were visited by the BSB officials in connection with loan recovery. The poor follow-up activities of the BSB are reflected in its presence at the management meetings of 5 firms (8 percent). However, follow-up visit after pre-investment visits were undertaken to 28 (50 percent) firms.

The extremely low level of attendance to the operational problems was the result of few requests from firms for such assistance from the BSB. Table 6.14 shows that 24 firms

(43 percent) sought advice regarding construction works and 14 firms (37 percent) requested the BSB to provide advice regarding machinery installation.

Table 6.14

Frequency and percentage distribution of the firms identifying reasons for requesting the BSB to carry out inspection.

Item	f	%
Equity investment verification	48	86
Advice regarding construction	24	43
Advice regarding machinery installation	14	37

Source: Field Survey

It appears that the advice for project implementation were outcomes of the initiatives of the BSB rather than of requests from the entrepreneurs for such service. Almost all (86 percent) of the requests were related to equity investment verification (Table 6.14). When asked about the satisfaction drawn from the response of the BSB to the requests to carry out inspection, over a half (27 firms) of the 48 responding firms answered negatively. Two-thirds (29 firms) of the 45 responding firms were dissatisfied with the inspection carried out by the BSB officials (Table 6.15).

Table 6.15

Frequency and percentage distribution of the firms responding to the question relating to the satisfaction drawn from the BSB's response to inspection request

Response	Satisfied with response		Satisfied with inspection	
	f	%	f	%
Yes	21	44	16	35
No	27	56	29	65

Source: Field Survey

As regards frequency of visits, data were procured from files of 126 loan cases and the findings were recorded in the Table 6.16.

Table 6.16
Frequency and percentage distribution of the firms visited by the BSB

Item	f	%
Less than four times	37	29
Between four & and six times	51	41
Between six & eight times	22	17
Between eight & ten times	11	9
Above ten times	5	4

Source: Loan Files, BSB

It appears from Table 6.16 that less than half (41 percent or 51 firms) of the firms were visited between four and six times and more than one third of them were visited less than four times. While 22 firms (17 percent) got between six and eight visits, 11 firms were visited between eight and ten times. There were 5 firms (4 percent) which were visited more than ten times.

As regards the duration of the visit, it was found that most (89 percent or 112 firms) visits to the firms lasted for less than 12 working hours. The visiting officers spent more than two days in 13 firms (10 percent) and 3 days in one firm. This reinforces the responses of the entrepreneurs that most visits were related to pre-disbursement inspection and the loan recovery drive.

6.3.5 Monitoring

As per loan agreement, borrowers were required to comply with a number of conditions and the objectives of some of these were to monitor operational performances of the firms financed by the BSB. Information elicited from the files of 89 loan-cases were recorded in Table 6.17.

Table 6.17

Frequency and percentage distribution of firms responding to the questions relating to monitoring of operational performances

Response	Operational Data		Quarterly Report		Balance Sheet	
	f	%	f	%	f	%
Yes	5	6	9	10	18	20
No	84	94	80	90	71	80

Source: Loan files of the BSB

A fifth (20 percent) of the firms investigated sent audited balance sheet, while only 5 firms (6 percent) sent monthly operational data to the BSB. However, the BSB did not receive quarterly reports from the 80 firms (90 percent) investigated (Table 6.17).

About 58 percent (25 firms) of the 43 responding firm considered these reports as unnecessary. Less than half (42 percent or 18 firms) of the respondents thought that sending reports to the BSB was wastage of time (Table 6.18).

Table 6.18

Frequency and percentage distribution of firms showing reasons for not sending regular reports to the BSB

	f	%
Unnecessary	25	58
Wastage of time	18	42

Source: Field survey

But there were about two-thirds (65 percent or 24 firms) of the 37 responding firms (Table 6.19) which would send reports to the BSB if there was a penalty for not complying with the loan conditions.

Table 6.19

Number and frequency of firms responding to the question relating to the lodgement of reports if there is penalty for non-compliance

Response	f	%
Yes	24	65
No	13	35

Source: Field Survey

However, 35 percent (13 firms) of the responding firms would not send reports to the BSB even if there is penalty for non-compliance.

Comment from the Bankers

“ The response from the borrowers is very poor”.

“ The bank should rigorously follow loan conditions and should obtain all operational data from them”.

“ We could monitor loan default problem if we could have those reports from the borrowers”.

6.3.6 Project Management

Respondents were asked about the frequency of the meeting of the board of directors of the firms. About a half (46 percent or 26 firms) of the 56 responding firms held one board meetings in every quarter, 20 percent (11 firms) held half-yearly meetings, and 21 percent (12 firms) held one meeting in a year (Table 6.20). There were 7 firms which did not hold a board meeting within a year.

Table 6.20

Frequency and percentage distribution of firms responding to the question relating to Board of Directors' meetings

Item	f	%
Meeting in a quarter	26	46
Half-yearly meeting	11	20
Meeting in a year	12	21
Meeting in more than a year	7	13

Source: Field Survey

When asked about the presence of a BSB representative in the board meeting, a quarter (14 firms) of the 56 responding firms opposed it (Table 6.21). But 42 firms (75 percent) supported the presence of the BSB's representative in the board meeting.

Table 6.21

Frequency and percentage distribution of firms responding to the question relating to BSB's presence in the Board and BSB training

Response	Board Presence		BSB Training	
	f	%	f	%
Yes	42	75	45	85
No	14	25	7	15

Source : Field Survey

The majority (85 percent or 45 firms) of the 52 responding firms supported that the BSB should provide management training, although 15 percent (7 firms) of the respondents opposed such training.

6.4 Public Policy Variables

In order to test the effect of public policy regimes on the loan repayment performance, respondent were asked questions relating to interest rates, Taka devaluation, protecting firms from imports and high taxes on the imported raw materials. The responses were multiple (Table 6.22)

Table 6.22

Frequency and percentage distribution of firms responding to the question relating to policy factors affecting loan repayment performance

Item	f	%
High interest rate	52	93
Taka value devaluation	32	57
Less tariff protection	29	52
High taxes on imports	32	57

Source: Field Survey

It appears that high interest rates were considered by most (93 percent or 52 firms) of the 56 responding firms (Table 6.22) as one of the significant policy factors that adversely affected their loan repayment performance. The Taka devaluation was a problem to 57 percent (32 firms) of the firms which responded and less protection from imports was considered important by 52 percent or 29 firms. High taxes on imported raw materials were pointed out by more than half (32 firms) of the 56 responding firms. The data in Table 6.22 suggest that public policies had adverse effects on the operations and loan repayment performances of the responding firms.

Borrowers' Comment

“ The interest rates have killed us”.

“ The government should protect us from cheap imports”.

“ Profitability of firms decreased due to changes in tariff structures”.

Bankers’ Comment

“ We do not agree that devaluation has increased loan burden. If they could pay us regularly, devaluation would have not affected them”.

“ Interest rates are fixed by the government and bank has little autonomy in it. We do recommend that interest rate should go down”.

6.5 Summary

This Chapter contains the results obtained through a field survey of borrowers and an investigations into loan files. The comments received from the borrowers and bank officials are also provided in this Chapter. These results and comments are related to credit disbursement, choice of project, term and variable loan ratio, debt-equity ratio, excess capacity, project implementation, supervision and follow up, monitoring, project management, loan repayment period and public policies.

The results show that the majority of respondents experienced delayed disbursement of credit, secured inadequate working capital, suffered from huge unutilised productive capacity and could not generate enough income to service debt obligations due to delay in firm set-up. A large segment of respondents registered their indignation over the inadequate supervision of the BSB over implementational work of their firms. Poor monitoring of the operating conditions of the firms and holding of infrequent management meetings were the predominant opinion of the majority of respondents. Most respondents favoured extended loan repayment periods, training by the BSB and opposed any public policy that adversely affect profitable operations of firms.

The loan officials interviewed expressed concerns about borrowers' inability and delay in equity investment, low level of response regarding lodgement of operational reports and data regularly and lack of coordination among lenders. They also agreed that borrowers should get adequate working capital, loans at low rates of interest and admitted lack of adequate manpower in the BSB which constrained sufficient entrepreneurial guidance. The comments made by the borrowers on several aspects were also supported by the results. These findings, gathered from the opinions and concerns of the borrowers and bankers, are used in Chapters 7-10 to test hypotheses relating industrial loan defaults in Bangladesh.

CHAPTER SEVEN

TESTING THE MODEL – PART I:

FLAWED FINANCIAL ROLE AND INDUSTRIAL LOAN DEFAULT

7.1 Introduction

The validity of the industrial loan default model which was developed in Chapter 4 is examined in the light of the situation that the Bangladesh Shilpa Bank (BSB) has been going through for more than twenty-seven years. The aim of such examination is to determine the extent of the relationship between industrial loan default and three principal explanatory variables, i.e., flawed financial role, flawed developmental role and flawed public policies. These flaws contribute to borrowers' inability and unwillingness to repay industrial loans which are responsible for industrial loan defaults.

A detail examination of the relationships between industrial loan defaults and principal variables is provided in Chapters 7-10. While Chapter 7 deals with the relationship between industrial loan default and flawed financial role, Chapter 8 focuses on the analysis of how flawed developmental role contributed to industrial loan default. Lastly, in Chapters 9 and 10 the contributions of flawed public policy towards industrial loan defaults in Bangladesh are examined. The testing of the hypotheses in these Chapters was carried out on the basis of processed secondary data obtained from the BSB and results of borrowers' survey and loan file investigation presented in Chapter 6. Apart from data, documentary evidence and qualitative statements were also used to examine the relationship between industrial loan defaults and identified variables.

Beginning with Chapter 7 first, it deals with testing of Part I of the of the theoretical model (Figure 4.3) elaborated in Chapter 4 which states that industrial loan default is

the outcome of the flawed financial role. The financial role of a development bank is manifested in the 'operational efficiency in terms of the profitability of its investment operations' (Jain 1989, p.100). This profitability, again, rests on financial management of investible resources that lie under the disposal of a development bank. Whether or not financial role played by the BSB - an industrial development finance institution (IDFI) - was flawed which contributed to industrial loan default is determined through the testing of the following principal hypothesis (PH1).

PH1: Financial role played by the BSB was flawed which contributed to industrial loan default.

This principal hypothesis is examined by testing the following 8 hypotheses (H).

- H1** High officer-application ratio tends to reduce efficiency in credit assessment which increases risks of loan default.
- H2** Borrowers screening mechanism employed by the BSB was defective and inefficient.
- H3.** Credit need assessment carried out by the BSB was flawed which increased the risk of default.
- H4** Government policy intervention in the industrial credit market tends to distort the efficiency and quality of term lending activities.
- H5** Delays in credit disbursement tend to increase debt burden.
- H6** Firms with high debt-equity ratio tend to repay less than firms with relatively low debt-equity ratio.
- H7** High term and variable loan ratio tends to increase debt burden.
- H8** Loan repayment period and instalments determined by the BSB compound loan default problem.

The testing of these hypotheses is carried out in several sections. Section 7.2 deals with hypotheses relating to credit control mechanism, while Section 7.3 and Section 7.4 focus on the hypotheses relating to credit disbursement and debt-equity ratio respectively. The hypothesis relating to term and variable loan ratio is tested in section 7.5. Section 7.6 tests the hypothesis relating to loan repayment period. The summary is provided in Section 7.7.

7.2 Credit Control Mechanism(CCM)

Credit control mechanism (CCM) has various parts. Prominent among these are: the borrower screening mechanism and the credit need assessment mechanism such as testing the project's viability from economical, technical and financial view points. Flaws in any of these mechanisms will make CCM faulty and if industrial credit is provided on flawed mechanism, industrial loan default is more likely to happen. To confirm or reject the presence of flaws in CCM, hypotheses relating to officer-application ratio, borrower credit worthiness, credit need assessment and government intervention are tested.

7.2.1 Officer-Application Ratio

H1 High officer-application ratio tends to reduce efficiency in credit assessment which increases risks of loan default.

The credit needs of an industrial enterprise (which is called a project in BSB) are assessed by loan officers and professionals such as economists, engineers and financial analysts. While the assessment of borrowers' credit worthiness is done by the loan officers, assessment of the economic, technical and financial viability of the enterprise is carried out by the economists, engineers and financial analysts, respectively. The quality of the assessment of credit worthiness of the borrowers and the project feasibility

reports on the enterprise is likely to deteriorate if the growth of the number of loan applications is not matched by the increased number of loan officers and professionals. This creates scope for the would-be defaulters to obtain industrial credit.

Table 7.1
Officer-Application Ratio in BSB

Period⁴⁴	No. of Loan Application Received	No. of Loan Application Processed	No. of Loan Application Pending
1. July 1972- June 1975	255 (85)*	121 (40)	206 (69)
2. July 1975- June 1982	2069 (296)	1070 (153)	1880 (268)
3. July 1982- June 1990	960 (120)	567 (71)	1048 (131)
4. July 1990- June 1995	4 479 (96)	285 (57)	223 ⁴⁵ (56)

Note: * Indicates yearly average.

Source: BSB, MIS Department. Data were compiled by the author.

Table 7.1 shows that loan applications received by the BSB jumped to 2069 between July 1975 and June 1982 from 255 between July 1972 and June 1975. Such a phenomenal growth in loan applications was unmatched by the number of loan officers which remained almost static. For example, the number of loan officers engaged in assessing credit worthiness hovered between 5-7 and that of project economists,

⁴⁴ The periods are linked to the Mujib Regime (1972-1975), Zia regime (1975-1982), Ershad regime (1982-1990), and Khaleda regime (1990-1996) to assess the effects of government policies on the industrial borrowers.

⁴⁵ Excluding data of 1994-95.

engineers and financial analysts between 25-30. With such under-resourced manpower (Hassan 1995) BSB had to deal with a large number of applicants. Under the surge of loan applications from the borrowers until June 1982, the officer-application ratios, particularly, project-economist and loan-case ratio, project-engineer and loan-case ratio, and financial analyst and loan-case ratio have decreased manifold. This also supports Hassan's (1995) findings that trained banker and loan-case ratio is very low in Bangladesh.

Though the average number of loan applications continuously declined from 296 per annum in period 2 to 120 per annum in period 3 due to the drying up of loanable funds, the number of loan officers engaged in loan processing was also reduced and they were relocated to other departments of the BSB with the tasks of recovering loans. As the number of loan officers was reduced from 1982 onwards, the officer-application ratio remained always low, irrespective of the fact that the number of loan applications declined from the early 1980s.

The presence of a low officer-application ratio may also be indicated by the existence of loan cases awaiting processing or pending cases and delays in loan processing. It is evident from Table 7.1 that the average annual number of pending loan cases soared to 268 in period 2 from 69 in period 1.

Delay in loan-case processing is also another indication that loan officers suffered from a log-jam of applications, though the inability and/or unwillingness of borrowers to provide necessary information and documents in time may have contributed to such delay. Price Waterhouse (1984) found that BSB took about four years from the date a borrower first approaches it to the establishment of a letter of credit for importing project machinery. Wasow (1984) reported that IDFI's in Bangladesh spent 50 months between loan application and commencement of commercial production by their approved projects. It indicates that serious bottlenecks existed in the BSB's approval process for long-term credit (World Bank 1986).

Under these circumstances of loan-rush, it was highly unlikely that BSB was able to maintain a high standard and efficiency of credit control, regardless of the honesty and job commitment of its employees. Since loan officers, professionals and credit approval authorities, were required to make haste to unload their loan case-processing work, they had to compromise with their standards relating to the enterprise as well as borrowers' selection conditions and accept an inefficient CCM to cope with the growing number of loan applications. The huge pile-up of loan applications together with the pressure from the State and the donors to provide funds without too careful a scrutiny of the borrowers or of the projects (Sobhan 1993) have contributed towards the financing of projects with dubious commercial viability (Alam 1996, p.144).

All these are indicative of the fact that the loan officers, over-stressed by the surge in loan applications, were more likely to compromise with quality and efficiency of the loan screening mechanism which allowed the unworthy borrowers to receive loans they did not deserve thus increasing the risks of default. This supports hypothesis H1.

7.2.2 Borrowers' Creditworthiness

H2 Borrower screening mechanism employed by the BSB was defective and inefficient

Unworthy borrowers may have access to the credit regime if the screening mechanism is defective. Whether the screening mechanism employed by the BSB was defective can be tested with the help of some proxy variables: the presence of stuck-up cases; the time taken to get disbursement of funds, and repeat lending to defaulters. A detail discussion of these proxy variables is presented below.

Stuck-Up Loan Cases

An industrial project becomes stuck-up when its sponsors cannot either implement it or put it into commercial operations due to their insolvent or weak financial position. The existence of stuck-up loan cases in the BSB's loan portfolio means that uncreditworthy borrowers were able to get access to term loan facilities.

Borrowers face the test of financial soundness when they are required to mobilise their equity before any instalment of the loan is disbursed to them. The BSB disburses term loans to borrowers in four instalments and disbursement of each loan instalment is preceded by substantial equity investment by the borrower. A financially unsound borrower obtains only part disbursement of the loans by meeting pre-disbursement (equity investment) conditions. Consequently, the industrial enterprise remains partly-implemented or in a condition which does not allow its commercial operation. BSB describes such firms as stuck-up cases. That is, stuck-up cases are the indicators of the existence of a defective screening mechanism. The higher the number of stuck-up cases, the stronger is the indication that the screening mechanism is defective.

There are a large number of stuck-up cases in BSB's loan portfolio. Of the 627 industrial projects in BSB's loan portfolio as at September 1996, there were 201 enterprises which were stuck-up at various stages of implementation (Table 3.7 p. 63). These stuck-up loan cases remained partly implemented due to the fact that the owners of these cases were not able to mobilise their equity money due to their financial insolvency. There are a number of stuck-up cases which, although between 15 to 20 years have passed since loans were sanctioned by the BSB, could not fully be implemented. The names of some of these cases are presented in Table 7.2.

Table 7.2

**Position of Selected Stuck-up Loan Cases As at
September 1996**

(Taka in Thousand)

Name of the Project	Date of Sanction	Amount of Loan Disbursed
Jem Rice Mills	Sept. 1976	4,446
Ajmirgonj Food & Allied Products	Nov. 1976	451
Altaf Rice Mills	Feb. 1978	3,725
Noor Rice Mills	April 1978	1,457
Raj Garments Industries	May 1979	2,997
Kalpna Hosiery	July 1975	1,117
Specialised Jute Yarn & Twin	April 1977	13,188
Progressive Paper Products	July 1975	3,492
Sea Trade	May 1978	1,100
Khan & Khondoker Industries	June 1977	2,716

Source: BSB, MIS Department. Data were processed by the author.

These stuck-up cases accumulated huge loan repayment burdens and, since they could not go into commercial operation, BSB could not recover its credit by executing the normal loan repayment schedule. As such, it had to file cases against about two-thirds (130 projects) of the total stuck-up cases to recover its loans. The presence of such a large number of stuck-up cases indicates that the borrower screening mechanism employed by the BSB was highly inefficient and flawed. This supports hypothesis H2.

Time Taken for Loan Disbursement

The disbursement of credit by the BSB is preceded by fulfilment of certain conditions by the borrowers. For example, to get disbursement of the first instalment of loans, borrowers are required to construct a substantial portion of the project buildings by

mobilising their equity money. When BSB is satisfied with the level of equity investment, it disburses a part of the loans. While credit worthy borrowers take a reasonable time to meet these conditions prior to the disbursement of credit, unworthy borrowers find it difficult to fulfil pre-disbursement conditions and take excessive time. When borrowers take excessive time to qualify, for instance, for the first disbursement, the defect of the screening mechanism is exposed. That is, the more time borrowers take to get the first disbursement, the clearer is the exposure of the flaws in the borrower screening mechanism.

The data in Table 7.3 show that 38 percent (48 firms) of the 126 firms investigated took less than ten months to complete their equity investment before the first disbursement of credit was obtained from the BSB.

Table 7.3

Distribution of Enterprises by the Months Taken to Invest Equity Before Disbursement of First Instalment of Loans

Months Taken	No. of Firms	% of Firms
0 - 10	48	38
11 - 20	28	22
21 - 30	16	13
31 - 40	14	10
41 - 50	11	9
51 - 60	5	4
61 & Above	4	3
Total	126	100

Source: BSB. Data were compiled and computed by the author.

Nearly one-quarter (29 firms) of them took less than six months to mobilise their equity and the borrowers of these enterprises can be termed credit worthy borrowers

who seem to be financially strong and solvent. There were 20 firms (about 16 percent) which took more than 40 months⁴⁶ to arrange equity investment in their projects before they were qualified to get the first disbursement of credit from the BSB. These borrowers seem to be financially weak and less capable than the borrowers of 28 firms who took between 11 and 20 months to get the first disbursement. The presence of these long-time takers among the borrowers reinforces earlier findings that the borrower screening mechanism in the BSB was flawed thus giving further support to hypothesis H2.

Lending to Repeat Defaulters

The flawed screening mechanism may allow defaulting borrowers of one lending institution to receive a loan from another lending institution. In other words, the existence of the repeat defaulters in the loan portfolio indicates defects in the borrower screening mechanism. The following four case studies suggest that repeat defaulters were able to obtain industrial credit by outsmarting the borrower screening mechanism employed by the BSB, despite GOB's 1986 directives to the IDFI's not to provide new loans to repeat defaulters (The Dainik Bangla, 9 July 1986).

Case Study One : Quashem Textile Mills Ltd

Quashem Textile Mills was sanctioned term credit amounting to Taka 31.184 million on 1 September 1976 by the BSB. This project, owned by Mr. Maidul Islam⁴⁷ and his brothers, failed to repay Taka 23.7 million to the BSB in 1982 (The Bangladesh Observer, 4 January 1982). Not only that, these borrowers owed Taka 30 million to Investment Corporation of Bangladesh (ICB) and three Nationalised Commercial Banks-NCBs (The Ekota, 4 August 1984). The

⁴⁶ There are four cases (Table 7.3) where entrepreneurs took over five years to arrange and invest their equity.

⁴⁷ Mr. Maidul Islam was jailed by the government in 1982 for misappropriation of public money (Alam 1991, p.472).

accumulated outstanding dues from Quashem Textile Ltd. stood at Taka 133.613 million as at September 1996 even though the BSB tried for 20 years to recover loans from these defaulting borrowers.

Despite these huge amounts of overdues to the BSB and NCBs, these repeat defaulters were, again, able to receive Taka 21.306 million from the BSB for another project, namely, Quashem Dry Cell Ltd. BSB has been struggling to recover Taka 33.61 million from this project.

Case Study Two: Bengal Carpets Ltd

The BSB sanctioned term credit to this project on 27 February 1978 and it disbursed Taka 76.33 million by June 1980 (BSB, Operational Statistics 1996, p.67). Mr. A.K. Litu is the managing director of this project who owed Taka 138 million to ICB, NCBs and Bangladesh Krishi Bank (The Ekota, 6 June 1984). The Martial Law Investigation Committee commissioned by the Military Government of Ershad in 1982 found that Mr. Litu repaid only Taka 0.40 million against overdues of Taka 165.40 million (Hoque 1991, p.299). The IDFI, including the BSB, provided loans without scrutinising the necessary papers (Alam 1991, p.475). The BSB sued Mr. Litu and other directors to recover Taka 479.32 million accrued at September 1996 (BSB, MIS Department 1996.)

Case Study Three : Beximco Textiles Ltd

The sponsors of this project were able to receive Taka 180.00 million from the BSB as at September 1996 despite the fact that they were repeat defaulters for two previous projects, namely, Sonali Aansh Ltd and Shinepukur Jute Spinners Ltd. Previously, the BSB sanctioned Taka 54.95 million to these two projects within 19 months (BSB, Operational Statistics 1996, pp. 68-69) despite the fact that Mr. S. Rahman, Managing Director of these two projects, fled to England in 1972 after he was sued in the court by the GOB (Alam, 1991, p.479). Mr. Rahman's group borrowed Taka 271.00 million (The Ekota, 5 February 1985) from the IDFI including the BSB. After the imposition of Martial Law, the GOB seized

his passport so that 'he could not flee from the country' (Alam 1991, p.481). In December 1984, his group defaulted to BSB for Taka 70 million and to Sonali Bank, BSRS and ICB for Taka 201 million (The Ekota, 5 February 1985).

However, the debt owed to the BSB on account of the above two cases was liquidated after the GOB announced a loan amnesty in 1988. Using this as a proof of credit worthiness, this group was, again, able to obtain a further Taka 180 million from the BSB for Beximco Textile Mills Ltd. Mr. Rahman and other directors have paid nothing against overdues amounting to Taka 8.564 million as at September 1996. In addition, they owed Taka 10.5 billion to 16 banks and financial institutions as at August 1997 (Jai Jai Din, 5 August 1997). Not only this, these repeat defaulters obtained Taka 200 million from IFIC Bank by defying Banking Company Act 1997, section 17 of which has clearly forbidden loans to the defaulters (Jai Jai Din, 19 August 1997).

Case Study Four: High Speed Ship-Building and Heavy Engineering Co. Ltd

The BSB sanctioned Taka 50.67 million to this project on 30 April 1979 and after 17 months it sanctioned Taka 3 million for another project, namely, Express Shipping Lines Ltd, owned by Mr. Mahmudur Rahman and his family members. Mr. Rahman, skilfully outsmarted the borrowers' screening mechanism employed by the BSB which gave his group another Taka 5 million, two and a half months (i.e., 16 June 1979) after sanctioning the first project, for Express Coastal Service Ltd. The Martial Law Government identified him as a culpable defaulter and issued an arrest warrant against him and he fled to Singapore in 1983 (The Saptahik Bichinta, 17 January 1988). The BSB had been pursuing the group to recover outstanding dues amounting to Taka 91.53 million against these three projects (BSB, MIS Department 1996). It filed a case in the court against Mr. Rahman and other directors to recover Taka 5.58 million on account of Express Coastal Services Ltd.

These repeat defaulters belong to the list of 233 defaulters⁴⁸ published by the central bank of Bangladesh (The Saptahik Bichitra, 22 September 1995) who defaulted, previously, to other financial institutions, including the BSB and they were able to take advantage of the flawed or inefficient borrower screening mechanism to obtain huge loans. Although the character and integrity of borrowers are important (Rouse 1993) for corporate lending, these borrowers - whose character and integrity regarding loan repayment were previously exposed by the government and the press - were able to evade the borrower screening mechanism in the BSB.

It should be pointed out here that concentration of huge amounts of term loans in few business houses was found by GOB's own investigation (GOB, Report of the Task Force 1991 Vol.1, p.234). Alam and Rahman (1992, p.24) identified these influential borrowers as the 87 richest families in Bangladesh. Sobhan (1993, p.172) pointed out that between 1980 and 1985, over half (55.1 percent) of the total term loans disbursed by the BSB went to seven business groups.

There are hundreds of instances where borrowers decamped with large amounts of loans (Taslim 1995; and Abedin 1988;) by providing false papers and there is no trace of the project (Janakantha, 4 January 1999) for which financial institutions sanctioned and disbursed the term loans (Hashem 1982, p. 91). The Saptahik Bichitra (22 September 1995) reported that 4,422 industrial projects which obtained loans from the banks and financial institutions have left no trace at all. The GOB also found a number of cases where fake entrepreneurs acquired term loans from the financial institutions (GOB, Report of the Task Force Vol.2, 1991).

⁴⁸ Mr. Salman Rahman and Sohel Rahman, the managing director and director, respectively, of Beximco Textile Mills (see case study three) threatened Mr. Lutfur Rahman, Governor of Bangladesh Bank with dire consequences if their names were not dropped from the defaulter list (Jai Jai Din 19 August 1997). Eventually, Mr. Rahman lost his job in 1998.

The BSB has also one non-existent project, namely, R.R.Ducks Firm Ltd. The borrowers of this project were able to receive term loans amounting to Taka 733 thousand by showing false documents and papers. This vividly shows that the borrower screening mechanism employed by the BSB was flawed. It was because of such inefficient borrower screening mechanism that credit unworthy borrowers were able to have access to industrial term loans (World Bank 1995b, p.138; and Abedin 1998, p.61). Sobhan (1993, p.208) and Ahmed and Kabir (1996) also confirmed the existence of inefficient borrower screening mechanism in Bangladesh which facilitated the flow of term credit to high risk borrowers who defaulted in repaying loans. These support hypothesis H2.

7.2.3 Credit Need Assessment

H3. Credit need assessment carried out by the BSB was flawed which increased the risk of default

The assessment of credit need is carried out in the form of economic, technical and financial feasibility studies of the project after the loan case has passed through the borrowers' credit worthiness test. The BSB conducts, as a part of credit need assessment, economic and market feasibility studies. The project appraisal reports prepared by the project-economists, show demand, supply and supply gap for the particular products the project proposes to produce and if a supply gap is established, the project is declared feasible from the market point of view. Economic analysis focuses on costs and benefits and quantifies the effect of the project on the general economy.

The technical appraisal report concentrates on production capacity, manufacturing processes, building and civil works, selection of local and imported machinery, technical service and all other technical aspects. After the project is found feasible from economic

and technical view points, it is sent to the financial analyst who quantifies the costs and return of the project on the basis of market, economic and technical appraisal reports. So the market and economic appraisal reports of the project are crucial because other appraisal reports follow them.

Though the project-economists of the BSB follow a World Bank Manual for preparing the market and economic appraisal reports of the proposed projects, the competence and skills of the recent graduates, who comprise the majority of appraisal-officers, are highly questionable. As the BSB has a very high officer turn-over ratio, experienced economists⁴⁹ tend to leave the BSB after a few years' service because of unattractive remuneration. As such, the task of preparing economic and market appraisals reports is mostly left to the fresh graduates. This results in inadequate ex-ante economic and markets appraisals of the projects (Hussain 1996, p.13).

However, the availability of highly skilled and competent economists does not provide a guarantee that the viable project will be chosen by the BSB, since findings of a genuine study are, sometimes, tempered by outside interference. The author interviewed three such loan officers who were informally asked by the top management on several occasions to manipulate data until the 'projects are made viable'. An identical type of interference was also reported to the author by a project-engineer and a financial-analyst. The GOB (Report of the Task Force Vol.2, 1991) and Sobhan 1991b and 1991c) mentioned that borrowers brought outside pressure and interference to override doubts of the viability of the project to get loans. In the course of an interview, the Managing Director of the BSB told the author that about 80 percent of the decision taken relating to loan sanction was the product of outside intervention in the loan intermediation process. The intervention by the top civil and political executives in the loan approval process has compounded the loan default problem in

⁴⁹ The author encountered a number of project-economists, project-engineers and financial analysts who expressed high disenchantment over existing salary and all other allowances.

Bangladesh (Sobhan 1991b). These contentions and findings are corroborated by the two case studies presented here.

Case Study Five: TMT Rice Mills Ltd, Dinajpur

This project was sanctioned Taka 3.65 million on 24 April 1979 when the late President Zia was in power. The Managing Director of the this project was connected with the father-in-law of the late President who was a resident of the same place. Despite the fact that there was over-supply of rice milling capacity and that there was no scope for development of further capacity in Dinajpur due to the largest concentration of rice mills there, the Managing Director of the project exerted informal pressure on the BSB management⁵⁰ to make the project economically viable. Eventually, it got access to the above amount of credit, but remained unimplemented for the past 19 years. The BSB is pursuing the borrowers to recover Taka 28.84 million which accrued as outstanding dues as at September 1996.

Case Study Six: Synthetic Textile Weaving Mills

Synthetic textile weaving mills produce a variety of fabrics ranging from shirting to suiting. According to an expert textile engineer⁵¹ of the BSB, any synthetic textile mill having less than 50 looms is not viable from the economic, financial and technical points of view. But ignoring this benchmark for technical feasibility, the BSB has financed 48 such textile mills, some having as low as 10 looms. Table 7.4 shows that the BSB sanctioned term loans to 29 textile units having 20 looms, to nine mills with 18 looms and to 3 mills with 10 looms which failed to meet the

⁵⁰ The economist informally admitted to the author.

⁵¹ The author interviewed Mr. Syed Anwar Hossain, a retired Assistant General Manager and Textile Engineer of the BSB.

Table 7.4**Number of Synthetic Weaving Textile Mills Financed by the BSB**

Year	30 Looms	20 looms	18 Looms	10 Looms
1981	3	2	9	3
1983	0	8	0	0
1984	0	12	0	0
1985	0	4	0	0
1986	4	3	0	0
Total	7	29	9	3

Source: BSB, MIS Department. Data were computed by the author.

threshold loom number (50) for viable synthetic textile mills. The GOB's own investigation found that the loom-size of these textile mills was highly uneconomic (GOB, Report of the Task Force Vol.2, 1991) Out of these 48 textile mills, borrowers of 14 mills withdrew their loan applications and among the remaining 34 mills which received loans, 32 mills defaulted in repaying the loan. The BSB filed cases against 12 such textile mills for not repaying loans. Only two mills were successful in repaying their loan obligations. Such a staggering rate of default incidence in the synthetic textile industry supports the findings of the GOB that the funding organisations such as the BSB had grossly deficient arrangements for project appraisal (GOB, Report of the Task Force Vol.2, 1991) from the economic, technical and financial view points.

The feasibility study of industrial projects is also constrained by the lack of reliable and adequate data in Bangladesh (World Bank 1996). As such, the level of accuracy in the projections and various estimations such as projected demand for the product, cash-flow, debt-service coverage ratio, and costs and benefits calculation (e.g., net present value and internal rate of return) have wide variations from the actual results. In an

examination of some project reports⁵², the author found that appraisal-officers across the board followed some stereo-type style of analysis by disregarding variability in the nature and type of products of diverse industrial firms.

In fact, the author has not found any significant improvement in the project appraisal reports even though Price Waterhouse (1984) registered the following points fourteen years ago.

"Individual appraisals often seem superficial also, with inadequate analysis of the inherent interrelationships of the different aspects - technical, economic, financial, commercial, management - that will determine project viability and repayment capacity. Sometimes, indeed, successive appraisals in a given subsector (sic) could be carbon copies, with different sponsors' names and plant locations inserted in the proper blanks" (p.136).

A number of studies (Nafziger 1984; Sen 1988; World Bank 1995b; Ali et al 1987; Chowdhury et al 1996 and GOB, Report of the Task Force Vol.2, 1991) confirmed that the project appraisal reports prepared by the financial institutions in Bangladesh were incomplete, inadequate and very poor in quality. Alam (1996), Hassan (1995), Sobhan (1983 and 1991b) and, Sobhan and Sen (1989) reported that most project feasibility studies carried out by the BSB-type IDFI's remained pro-forma exercises and full of inconsistencies and these were designed to provide a cosmetic justification for sanction of term loans to the industrial entrepreneurs. This has caused the quality of the loans to deteriorate which contributed to loan defaults. Historically, 'the deterioration in the quality of loans in the 1920s prompted the bank failures' (White 1984, p.120).

These findings are consistent with the above case studies and suggest that a substantial number of project appraisal reports used by the BSB to assess credit need of various

⁵² The author examined project reports of T.M.T Rice Mills, Aegis Cotton Mills, Shams Metal Industries, High Speed Ship Building and Heavy Engineering Co, Baximco Textile Mills, Bengal Carpets Ltd. and Quashem Dry Cell Ltd.

projects were flawed which wrongfully allowed would-be defaulters access to a large amount of industrial credit. This supports hypothesis H3.

7.2.4 Government Intervention

H4 Government policy intervention in the industrial credit market tends to distort the efficiency and quality of term lending activities.

The government policy directions regarding project selection may have affected the efficiency of the borrowers' credit needs assessment mechanism employed by the BSB. Since the BSB is owned by the State, the GOB directed BSB, through industrial policies from time to time, to allocate credit to projects in priority sectors such as export-orientated or import-substituting enterprises.

Hassan (1995) found that NCBs were to act under GOB directed credit programs which evaded prudent lending criteria. He also reported that the credit programs of the GOB 'have undermined the autonomy and efforts of these banks to maintain good credit approval practices' (p.132). Like NCBs, DFIs were also under pressure from the GOB as well as from the donor countries to finance particular types of project which, essentially, put intense pressure to avoid careful scrutiny of borrowers (Sobhan 1993). Chowdhury et al (1996, p.7) reported that 'financial institutions pursued a policy of rapid credit expansion (during 1972-82) to priority areas in response to government directives with little regard to loan quality. Sound credit analysis was replaced with socioeconomic considerations'. The prevalence of such a condition in the term loan markets led Battacharya (1993, p.10) to recommend the GOB to refrain from directing credit to any preferential industrial sector.

Between 1972 and 1985, the Department of Industries, GOB, used to publish an Industrial Investment Schedule (IIS) which included provision for creating further

capacity in a particular industrial sector. The BSB had to sanction loans to those projects which were permitted by the IIS. As BSB was required, in compliance with IIS, to sanction and disburse loans to specific industrial sectors, the quality of credit assessment might have been compromised to attain the target number of industrial enterprises. The IIS served as a foothold to evade responsibility (World Bank 1978) for conducting authentic feasibility studies of the projects which applied for term loans.

In the light of these findings (Sobhan 1993; Hassan 1995; Chowdhury et al 1996; World Bank 1978; Battacharya 1993) it appears that BSB's efforts to conduct efficient lending activities were undermined by GOB's policy intervention. This supports hypothesis H4.

7.3 Credit Disbursement

H5 Delays in credit disbursement tend to increase debt Burden.

BSB disburses foreign and local currency loans in four, sometimes more, instalments subject to the prior fulfilment of specified conditions. These conditions take different forms depending on whether borrowers are seeking local or foreign currency loans. Usually, BSB prepares a loan disbursement schedule incorporating the following conditions.

Conditions for Disbursement of Foreign Currency Loans

BSB disburses foreign currency loan money directly to the foreign sellers of machinery and equipment after fulfilment of the following conditions by the borrowers.

1. Opening of confirmed and irrevocable Letter of Credit (L/C) for plant and machinery;

2. Depositing with the BSB a sum of local currency as L/C margin;
3. Purchasing land and developing access facilities ;
4. Completion of the construction of a part of project building;
5. Payment of legal, documentation and consultation fees;
6. Arranging pre-shipment inspection of imported machinery by international surveyors;
7. Raising the paid-up capital of the company to the amount invested and producing an auditors' certificate to that effect; and
8. Depositing with the BSB fully paid share certificates⁵³ of the concern as collateral security.

Conditions for Disbursement of Local Currency Loans

Local currency loans are disbursed by the BSB either to the supplier of locally procured machinery and equipment and/or to the borrowers for completion of construction of project buildings after it (BSB) is satisfied that borrowers fulfilled the following conditions.

1. Opening of L/C for imported machinery and equipment;
2. Completion of the construction of a part of project building;
3. Making advance payment to the supplier of local machinery, if needed;
4. Raising the paid-up capital to the amount spent and producing auditor's certificate to that effect;
5. Depositing with the BSB fully paid share certificates of the concern as collateral security;
6. Completing all formalities and auxiliary works for putting the concern into trial production.

⁵³ Share certificates are used by the BSB as collateral against term loans. BSB does not take any other collateral except these certificates. It recovers part of its loan overdue by selling/transferring those to the interested buyer should it become necessary in the event of loan default.

Loan disbursement takes place as soon as these conditions are fulfilled to the satisfaction of the BSB. However, fulfilment of such conditions takes a considerable period of time due to the borrowers' failure to mobilise equity capital on the one hand and to BSB's delay in carrying out pre-disbursement inspections to verify compliance of these conditions on the other hand. Most of the borrowers do not have readily investible liquid assets. They mobilise their equity money either by selling fixed assets or by borrowing from the formal and informal credit markets and, in both cases, this takes considerable time.

Delay in the disbursement of loans of either type is a regular phenomenon in BSB. It is evident from Table 7.5 that sponsors of nearly half (55 firms) of the 126 enterprises investigated waited up to 10 months after the first disbursement to get final disbursement of loans.

Table 7.5

Months Spent Between First and Last Disbursement of Loans

Months Spent	No. of firms	% of Firms
0 - 10	55	43
10 - 20	36	29
20 & Above	35	28
Total	126	100

Source: BSB, MIS Department. Data were computed by the author.

Sponsors of more than a quarter (28 percent or 35 firms) of these enterprises had to wait beyond twenty 20 months to obtain the final disbursement after they received the first disbursement of loans. Among these 35 firms, there were 14 firms which waited more than 31 months after they took first disbursement. This may be due to the problems associated with the delayed equity investment or with delayed loan processing

by the BSB. At least 14 percent of the borrowers surveyed by the author admitted that they had problems with pre-disbursement equity investment (Table 6.2).

Among these 126 firms, there were 34 firms (27 percent) which got disbursement within five months after first disbursement of loans and it may be that these were credit worthy firms. Sobhan (1993) has doubts on this contention. He reported that BSB-type IDFI's were under severe pressure from the international financiers, GOB and borrowers to disburse loans quickly. It may be that those who were politically influential or connected with the government⁵⁴ had been able to skip several preconditions and receive relatively early disbursement of credit.

The above findings are also corroborated by the results of the borrowers' survey. The survey showed that 74 percent of the 54 responding firms did not receive loan disbursement in time (Table 6.1). Delay in loan disbursements may not be entirely due to the failure of the borrowers to satisfy pre-disbursement conditions. About two-thirds (62 percent or 25 firms) of the 40 responding firms blamed delayed loan processing for delays in disbursement (Table 6.2). One-quarter (25 percent or 10 firms) of these respondents alleged that credit disbursement was delayed due to delayed inspection by the BSB (Table 6.2). When interviewed, the officials of the BSB admitted that shortage of personnel was responsible for delayed pre-disbursement inspection. But Cookson (1997) and Price Waterhouse (1994) found that bank staff in Bangladesh were too bossy, hostile or arrogant and saw the borrowers at their mercy. Saha (1997) also found that the BSB made unusual delay in the disbursement of loans.

Price Waterhouse (1984) specifically mentioned that IDFI staff make little effort to help clients complete the necessary documentation against disbursement of loans and

⁵⁴ See Case Study Ten in Chapter 10.

that some of them demanded bribes, commissions and other forms of kickbacks⁵⁵. While examining the loan file of Shahnawaz Superior Textile Mills, the author came across an official note mentioning the bribery case of a project-engineer who took a side payment from the sponsor of the project to recommend disbursement of the loan. All these indicate that the delay in loan disbursement may be partly attributed to the borrower's failure to make pre-disbursement equity investment in the project and partly due to delays in loan processing and corruption of loan-officers and managers.

Such delays in loan disbursement resulted in cost overrun (Ali et al 1987), high cost of borrowing (Cookson 1977; Sobhan 1993; and Uddin et al 1985) and increased transaction costs (Ahmed 1989). The borrowers surveyed by the author also expressed identical views. Of the 40 borrowers asked to report on the consequences of the delayed credit disbursement, 22 borrowers (55 percent) said that they experienced cost-overrun and 20 borrowers (50 percent) acknowledged delayed implementation of the firm (Table 6.3). Saha (1997) reported that about 77 percent of the entrepreneurs experienced cost-overrun up by 55 percent.

It is to be mentioned here that delayed credit disbursement increases debt burden. When borrowers get part disbursement of credit and wait too long for disbursement of another part of credit, they are to count interest on the past loans disbursed. This means that the more delays that occur in getting any subsequent disbursement of credit after the first disbursement, the higher is the interest repayment liability that borrowers are to bear. Table 7.5 shows that 35 firms spent more than 20 months between first and last disbursement of credit and these firms will to bear more interest burden than 55 firms which waited less than 10 months. In the borrower survey, more than half (57 percent or 23 firms) of the 40 responding borrowers said that delayed disbursement contributed to accumulated debt burden (Table 6.3). This supports hypothesis H5.

⁵⁵ According to Reza (1989), bribery, illegal commissions and other forms of kickbacks generate bulk of black income in Bangladesh.

7.4 Debt-Equity Ratio

H6 Firms with high debt-equity ratio tend to repay less than firms with relatively low debt-equity ratio.

Industrial investment in Bangladesh comes from two sources: bank loan and borrowers' equity. The IDFI's demand that the borrowers must be willing to invest their equity in an industrial enterprise along with the funds they would like to receive from the bank. Borrowers in developing countries are resource-poor and are not in a position to provide adequate equity and they depend mostly on bank credit to finance their industrial enterprises.

It should be mentioned here that Bangladeshi entrepreneurs mobilise equity money from four known⁵⁶ sources: accumulated personal fund or assets, commercial banks, venture capital provider and over-invoicing⁵⁷. There were borrowers who mobilised equity money from personal savings, trading business and/or from sales proceeds of their real estates or farming land⁵⁸. Sobhan (1974) found many entrepreneurs who borrowed from the commercial banks by pledging fictitious or overvalued assets. The most popular and open secret method of finding equity money is over-invoicing of imported plant and machinery.

Following the practice of money laundering through over-invoicing established by the Pakistani entrepreneurs (Amjad 1982; and Winston 1972), most of the Bangladeshi entrepreneurs resorted to over-invoicing to launder money and mobilise part or all of

⁵⁶ Unknown sources are kickbacks, bribes and various forms of money laundering. Sobhan (1993, p.173) believed that black money was also used as equity money.

⁵⁷ Farouq (1982, p.72) and the GOB (Report of the Task Force Vol.1 1991, p. 232) found that black income through over-invoicing varied between 15 and 25 percent.

⁵⁸ Sobhan (1993, p.176) reported that borrowers used overstated value of their real estate or farming land to justify their credit worthiness at the time of loan processing.

them to support equity investment in the project financed by the bank (Alamgir and Razzaque 1989; Sobhan 1974; and GOB, Report of the Task Force Vol. 1, 1991). Thus, a project sanctioned with 20 percent equity contribution by the borrowers was funded out of the over-invoiced amount of the loan component given by the BSB. This was equivalent to frying a fish with its own oil and, even, keeping some for future use. This practice resulted in the ownership of the industrial firm without any real equity investment (Alam 1996; and Sobhan and Sen 1989).

In addition, the availability of bridge finance⁵⁹ from the state-owned ICB - a venture capital company - results in debt equity ratio as low as 90:10 in the initial years of a project. Some entrepreneurs tend to borrow directly from the commercial banks to make equity contribution which further raises the debt level of the project. Two studies (World Bank 1978; and Battacharya 1995) found private companies with high debt and low equity ratio experienced difficulty in servicing their debts. The GOB (Report of the Task Force Vol.1, 1991) found that the low level of 'entrepreneurs' own capital staked in a venture sometimes resulted in inappropriate project choice, improper choice of technology and machinery, overcapitalisation, poor management and inefficient operation' (p.3).

Of course, there are borrowers who provide equity as high as 91 percent of the total investment in an industrial concern. Those who provide proportionately more equity than receiving debt may feel a stronger sense of belongingness to the firms than those who receive proportionately more debt than equity. Borrowers with high equity and low debt ratio are expected to be very careful and concerned about the choice of investment project since the brunt of any operational loss will be borne by them rather than by the BSB. More equity means more collateral and low debt level means low risk

⁵⁹ In Bangladesh, companies can make public issues after production and profitability have been established which in some cases can be five years after company flotation. In the interim period, bridge finance is made against the underwriting commitment. The ICB provides such bridge finance to the firms financed by the BSB.

of default. Gupta (1983) found that companies with weak equity was more prone to sickness which ended up in loan default.

Given this understanding, let us examine whether or not the industrial loan default rate in the BSB is less with a low debt-equity ratio than with a high debt-equity ratio.

Table 7.6
Debt-Equity Ratio and Percentage of Dues Repaid⁶⁰
By the firms

Debt-Equity Ratio	No. of Firms	Average % of Dues Paid
Less than 50:50	36	33
51:49 - 70:30	77	25
71:29 & Above	13	49

Source: BSB, MIS Department. Data processed by the author.

It is evident from Table 7.6 that out of 126 enterprises investigated, about two-thirds (77 firms) of them provided equity which was more than 30 percent but less 49 percent of total investment. These firms on average repaid only one-quarter (25 percent) of what they owed to the BSB. On the other hand, about one-third (28 percent or 36 firms) of them having 50:50 debt-equity ratio repaid 33 percent of their loans due to be repaid. This suggests that firms taking less debt and investing more equity repaid more than their counterparts taking more debt and providing less equity. In other words, firms having higher debt-equity ratio defaulted at a higher rate than firms having relatively lower debt-equity ratio. This supports the hypothesis H6.

These findings are apparently contradicted by the repayment performances of 13 enterprises having 71:29 and above debt-equity ratio. These enterprises, comprising

⁶⁰ Percentage of dues paid indicates percentage of loans recovered against loans which were due for collection. This percentage will be lower if loan amount repaid is compared against outstanding loans which includes both due loans and non-matured loans. This note applies throughout this study.

10.32 percent of total enterprises investigated repaid, on average, about half (49 percent) of the loan money they owed to the BSB. This average performance figure does not represent the true repayment behaviour of the majority (90 percent) of these enterprises. Among these 13 enterprises, 5 enterprises have repaid over 80 percent and 5 enterprises repaid less than 14 percent of the repayable amount. If the loan repayment behaviour of only 5 enterprises is not considered, then the above hypothesis (H6) is supported. This finding is reinforced by the reports of the World Bank (1995b) and the Saptahik Bichitra (1995) that a high debt-equity ratio, which indicates high dependence on borrowed funds (Hussain 1996, p.13) was one of the causes of industrial loan default in Bangladesh.

7.5 Term and Variable Loan Ratio

H7 High term variable loan ratio tends to increase debt burden.

The variable capital has been popularly known as working capital which is the difference between current assets and current liabilities. Most firms operate with some amount of net working capital (Haque 1988a) and BSB-financed firms are not an exception. The GOB recognised that most of the industries had been suffering from the dearth of working capital (GOB, Fourth Five Year Plan 1995). Chowdhury (1977) and Saha (1997) found that industries in Bangladesh were perennially starved of adequate working capital. Although there were government directives for working capital financing, these were not being fully adhered to (GOB, Report of the Task Force Vol. 2, 1991). Battacharya (1995) reported that fixed assets such as plant and machinery accounted for 66 percent of total fixed assets in the industrial sector which meant that bigger stake of investment took place through term loans rather than working capital loans.

Credit policy of the BSB, since its inception, has been heavily weighted towards term loans for procuring fixed assets such as land, building, machinery and equipment rather

than working capital loans for building inventories. This is evidenced by the BSB's sanctioning of Taka 648.25 million as working capital against disbursement of term loans amounting Taka 8.375 billion between December 1971 and June 1996 (BSB, MIS Department 1996). This shows that variable loans comprised 7.74 percent of total term loans sanctioned during that period. This finding is also corroborated by Hussain (1996) who found that term loans claimed 94 percent of the total funds lent by the BSB to the private sector. The supply of such a low proportion of working capital provided by the BSB contrasts with the practice of its counterparts in Great Britain, Germany and Japan where term loans and working capital loans are given almost equal importance⁶¹.

In every loan agreement sponsors of the project are required to provide an undertaking that they will arrange working capital from the banking sector which is dominated by the conventional commercial or trading banks. Although there were government policy directions to the NCBs to provide up to 90 percent of the total working capital needed by the firms (Alamgir and Razzaque 1989), industrial firms received very little amounts of such short-term loans. For example, working capital provided by the NCBs comprised only 8.32 percent of their total outstanding advances between 1989 and 1994 (Battacharya 1995).

It would not be out of place to mention here that commercial banks in Bangladesh suffer from a liquidity crunch due to GOB's borrowing⁶² from the banking sector

⁶¹ In the early stage of industrialisation in Great Britain and Germany which is now the present condition in Bangladesh, variable capital was more important than fixed investment (Pollard 1964, p.111). Contrarily, lending institutions such as BSB in Bangladesh weighted fixed capital much more than working capital. Adam Smith's pure model of growth was consistently carried though on the assumptions that the only form of capital that matters was circulating or working capital, although Cameron (1972, p.12) contested such argument on the ground that both fixed and working capital were given much importance. But not a single instance was found where working capital was so much under-weighted as found in Bangladesh.

⁶² The GOB regularly borrows from the banks to pay import bills and finance deficit of the public sector corporations. The World Bank (1983, p. 4) reported that the flow of working capital from the NCBs to the private enterprises declined due to GOB's policy of financing the excessive financial losses of the public sector corporations.

(World Bank 1996). Moreover, whatever working capital was provided by the banks large chunks (86 percent) were claimed by the large firm sector. This suggests that the BSB's direction of its financed-firms to the cash-starved commercial banks for working capital loans was flawed. Since borrowers were to compete with the GOB in respect of borrowing from the commercial banks, the prospect for the BSB-borrowers in getting working capital from commercial or trading banks was bleak. Additionally, the BSB has instituted some impediments to the availability of working capital from the commercial or trading banks.

Usually, commercial banks demand a no objection certificate (NOC) from the BSB before they consider borrower's applications for working capital. This NOC is required in order to create a second charge⁶³ on the fixed assets of the project financed by the BSB as a collateral against working capital. However, current assets financed by any bank are hypothecated as collateral and the lender can create a first charge on the current assets without any objection from the BSB. But the BSB does not allow any financial institution to create a second charge on the current assets already pledged or hypothecated to it.

The BSB issues NOCs for creating a second charge on the fixed assets only after it is satisfied with the repayment performance of the borrowers or with the future repayment commitment provided by the borrowers. Since borrowers either default in keeping loan repayment commitments or are unable to make satisfactory loan repayment arrangement due to low cash-flow caused by the shortage of working capital, BSB refuses to provide NOC which makes working capital loans unavailable from the commercial banks.

⁶³ The second charge implies that in the event of continuous defaults, the working capital provider will have a claim on the collateralised property after the liability of the first charge (created by the first lender on the property concerned) is fully liquidated.

It looks like Catch-22 where borrowers, being unable to operate the firm at full capacity because of unavailability of working capital, suffer from inadequate cash-flow and fail to service debt obligations to the BSB which makes NOC unavailable for working capital. It is because of the existence of such impediments to availability of working capital from the commercial or trading banks together with the meagre supply of short-term capital from the BSB, the proportion of term loans far exceeds that of working capital loan. Battacharya (1995) also found that 'the volume of the flow of the working capital finance to industry did not match the growth in the finance of fixed investment'(p.207).

Data collected from 304 firms revealed that only 24 percent (73 firms) of them were able to receive working capital more than once from the BSB. The volume of working capital loans supplied by the BSB has never matched the surge in its term lending which indicates that working capital fell well below the level of capital required to utilise the plant and machinery it financed under term loans. This contrasts with the practice of the Industrial Development Corporation of South Africa and Nacional Financiera of Mexico which provide permanent working capital along with fixed asset loans.

These flaws in BSB's term loan versus working capital loan policy are confirmed by the borrower survey results provided in Chapter 6. Almost all (94 percent) of the 43 respondents said that they received inadequate working capital from the BSB (Table 6.4). More than four-fifths (88 percent) of the responding borrowers said that they did not receive working capital in due time.

This not only shows that the term and variable loan ratio in the BSB was very high but also indicates existence of potential risks of low level cash generation caused by unavailability of sufficient amount of working capital loans either from the BSB or from the commercial banks.

The extent of the problem of working capital shortage is far deeper than it appears. The case study seven presents a snap-shot of the extent of working capital shortage which has been crippling the industrial sector in Bangladesh.

Case Study Seven: Working Capital Needs in Leather Industry

The leather industry is highly dependent on working capital. Stone (1992) found that working capital needs in the leather industry in Bangladesh are at least four times the size of the initial capital investment. It is due to the unavailability of working capital that as many as 60 percent of the existing tanneries and other leather enterprises were in considerable financial distress (World Bank 1995b, p.84).

The same is true for leather enterprises financed by the BSB. As at September 1996, BSB has 15 leather enterprises including 5 shoe-making units in its loan portfolio. Of them, only 5 firms received working capital loans from the BSB which are detailed in Table 7.7

Table 7.7

**Leather Enterprises Which Received Working Capital Loans
From the BSB as at September 1996**

(Taka in Million)

Name of the Firm	Term Loan Disbursed	Variable Loan Disbursed (%)**	Amount Overdue*	Amount Outstanding*
Dhaka Belting & Co	8.65	2.00 (18.77)	31.32	33.36
Excelsior Shoes	111.14	40.00 (26.46)	50.99	148.86
Noor Trading Corp.	19.78	17.38 (46.77)	38.06	48.00
Orient Leather	29.24	7.13 (19.60)	6.62	40.15
Rita Footwear	6.92	1.00 (12.63)	13.30	16.21
Total	175.73	67.51 (27.75)	140.29	286.58

Note: * Overdues and loan outstanding do not include working capital loan.

** Figure in parenthesis indicate percentage of total loan as working capital.

Source: BSB, Loan Accounting Department. Data were computed by the author.

It appears that the term and variable loan ratio for the above five firms was about 78:28 which means that well over two-thirds of the total loans (Taka 243.24 million) was provided in the form of fixed capital. Thus, variable capital provided (Taka 67.51 million) by the BSB was hugely unmatched by the fixed capital loans which meant that productive capacity developed though term lending remained unutilised to a large extent. This has created a cash flow shortage in the leather industry which increased the chance of loan default.

Data obtained from the BSB showed that these five leather firms owed Taka 160.91 million to the BSB and that they repaid only Taka 20.62 million which meant that 87.19 percent of loans due remained unrealised as at September 1996. This indicates that the high term and variable loan ratio that existed in the leather industry contributed to the building of overdues and outstanding dues amounting to Taka 140.29 million and Taka 286.58 million respectively as at September 1996 when 6 firms in the leather industry were also sued in the court for non-repayment of loans to the BSB.

Like the leather industry, the term and variable loan ratio for all other industrial sectors was also disproportionately high. The World Bank (1983, p.41) found that private sector firms were affected by the dearth of working capital. Bangladeshi industrialists⁶⁴ also complained that only 20 percent of their working capital needs were fulfilled by the banks and IDFI's (The Bangladesh Observer, 13 May 1985). As 'high fixed and variable loan ratio is indicative of the low rate of the utilisation of productive capacity' (Battacharya 1995, p.210), it is highly possible that productive capacity developed through term lending from the BSB remained unutilised or under-utilised to a large extent⁶⁵. The GOB's own investigation found that working capital shortage stood in the way of timely and economic procurement of raw materials which resulted in the under utilisation of productive capacity in the private firms (GOB, Report of Task Force Vol. 2 1991).

A number of authors (Begum 1990; Rahman 1992; Nabi 1991 and Saha 1997) found that low capacity utilisation in the manufacturing industry was the outcome of the unavailability of adequate working capital. Sobhan and Ahsan (1990) reported that better loan repayment performance of BSB-borrowers was associated with better

⁶⁴ President, Rangpur Chamber of Commerce and Industry complained that industrial entrepreneurs received only 20 percent of their working capital requirements (The Bangladesh Observer, 13 may 1985)

⁶⁵ Other reasons for under-utilisation of productive capacity are unavaialbility of raw materials (which is, again, due to lack of working capital), obsolete technology, labour disputes, power disruption and borrowers' engagement more in trading than manufacturing since the former is more profitable than the latter (GOB, Fourth Five Year Plan 1995, p. 1-11).

capacity utilisation of the productive capacity of their firms. This suggests that firms suffering from working capital shortage were not able to utilise productive capacity and borrowers' incomes were far below the level of earnings projected⁶⁶ by the BSB at the time of financial appraisal. Thus, borrowers were unable to repay loans as per repayment schedule and so experienced loan default. The results of the borrower survey show that 91 percent (41 firms) of the 43 responding firms (Table 6.4) blamed inadequate working capital for loan default. These findings support hypothesis H7

7.6 Loan Repayment Period

H8 Loan repayment period and instalments determined by the BSB compound loan default problems.

The BSB provides term loans for a maximum period of 15 years. It fixes loan repayment period and instalments according to the types of industrial projects. For example, the loan repayment period for the transport sector (i.e., bus and truck) and service sector (i.e., cinema hall) varies between 12 and 15 years while it is 12 years for the textile mills sector. Again, firms falling into metal industries have a 10-year repayment period.

Except in the transport sector, repayment of loan starts 18 to 42 months after from the opening of L/C for imported machinery or twenty four months after the project goes into operations whichever is earlier. However, repayment for the transport sector starts 6 months after the commissioning of the project. Loan instalments are at 6 monthly intervals.

⁶⁶ The BSB estimates the project's future earning on the basis of 70 percent capacity utilisation in the first year of its operations (Project Report of Aegis Cotton Textile Mills Ltd.). Given the unavailability of working capital, it seems that such an earning forecast is not realistic.

The BSB provides a moratorium on repayment of interest that is accrued during the period when the project remains under implementation or construction. This period of construction of project varies between 20 to 40 months due to cost over-run and other factors which are beyond the control of the borrowers. However, BSB's decision regarding length of the construction period of the project is final and conclusive and is binding on the borrowers. It is the policy of the BSB to realise this accrued interest in four equal half-yearly instalments and borrowers are required to repay interest instalments even though construction work remains incomplete. This puts the borrowers in a financially distressful condition since they are not in position to repay loans. How such interest repayment policy created extra burden on the borrowers can be grasped from the case study presented here.

Case Study Eight: Aegis Textile Mills

This case study shows BSB's calculation of the repayment schedule on account of the above project for a term loan amounting to Taka 265.247 million which was to be repaid in 9 years excluding 2 years required for implementation.

Table 7.8
Repayment Schedule for Borrowers
(Taka in Million)

Item	First Year	Second Year	Third Year	Fourth Year
Principal Loan	265.247	265.247	265.247	235.78
Instalment	-	-	29.47	29.47
Balance	265.247	265.247	235.78	206.31
Interest (IDCP)**	34.01 (3.31)	33.31 (2.81)	30.91 (2.11)	26.82 (1.4)
Repayable Loan	34.01	33.31	60.38	56.29

Notes: * The repayment of principal loan instalment starts from the 3rd year.

** Figure in parenthesis indicates interest on interest accrued during construction period, given that interest rate is 11.5 percent.

Source: BSB, Project Appraisal Report of Aegis Textile Mills, 1995, p.78.

It is clear from Table 7.8 that the borrower was required to repay interest amounting to Taka 67.32 million within two years of when the project was under implementation and before the project generated any cash flow or income. Moreover, a loan repayment burden of Taka 60.38 million which included both principal and interest for the third year, when the project just starts commercial operation, adds another financial burden on the borrowers.

It is highly unlikely that borrowers will be able to repay Taka 60.38 million within three years of the project being implemented, and as such, there is a strong possibility that borrowers would default. The consequence of default will result in the capitalisation of Taka 60.38 million and imposition of interest at the rate of 11.5 percent plus penal interest at the rate of 4 percent, in addition to 11.5 interest rate which was charged previously. This means that loan repayment instalments do not commensurate with the cash-flow situation of the project and this may trigger loan default.

Also it appears from Table 7.8 that yearly debt burden (which includes both principal and interest instalments) goes down to Taka 56.29 million from the fourth year as the principal loan drops to Taka 235.78 million in fourth year from Taka 265.25 million in the third year. This shows that the loan repayment instalment is relatively higher in the initial period than the instalment in the subsequent period. This does not match with the cash flow position of the firm which is relatively low at the initial period and higher at the later period. It means that the cash flow position of the firm fits well with repayment instalments which is lower in the initial stage and higher in the later stage.

This suggests that loan repayment schedules, which fail to recognise the strength of firm's financial ability to repay loans, increase the chances of loan default. This is corroborated by the findings of other studies (GOB, Report of the Task Force Vol. 1, 1991 ; Hassan 1995; and Price Waterhouse 1984) that loan repayment instalment set by the BSB-type IDFI's were unrealistic and inconsistent with the borrowers' earning from the project.

Basu (1965) reported that with short period of repayment the firm may not be able to earn sufficient income to service the loan which suggests that loan default is associated with shorter loan repayment period. The loan repayment burden can be eased by working out a loan repayment schedule commensurate with the prospective cash flow position of the firm. As cash generation varies from firm to firm⁶⁷, an uniform loan repayment schedule should not be applied to all types of firms. Basu (1965) recommended that 'the fixing of the amount and number of instalments of loan repayments has to be tuned to the prospect of an early return on the enterprises' investment' (p.67).

It is generally believed that as the loan repayment period increases, loan repayment instalment decreases which reduces the risks of loan default (Price Waterhouse 1984). Take the case of Aegis Textile Mills Ltd. If the loan repayment period is increased for more years than nine years, the repayment instalment will be relatively smaller. Since small loan repayment instalment may match low cash flow position of the firm, there is strong possibility that the default risk will be relatively much lower with long repayment period than short repayment period.

This is also evidenced by Table 7.9 which mirrors the repayment position of 300 firms financed by the BSB.

⁶⁷ Application of a loan repayment schedule incorporating six-monthly instalment is not suitable for business where cash generation occurs daily or weekly such as hotels, cinema hall and small engineering firms.

Table 7.9
Loan Repayment Period and Loan Recovery as at
September 1996

Loan Repayment Period	No. of Firms	Loan Recovered (%)
Below 20 Instalments	123	32.65
21 - 24 Instalments	142	47.70
25 - 30 Instalments	35	39.40

Source: BSB, MIS Department. Data were computed and compiled by the author.

Data collected on 300 firms show that most (88 percent) of the projects have repayment period which ranges between 10 and 12 years. It has been found that more than one third (41 percent or 123 firms) of the firms investigated having 10 years' (i.e., 20 instalments) repayment period repaid 32.65 percent of their dues while nearly half (47 percent or 142 firms) of these projects having 12 years (i.e. 24 instalments) repayment period serviced 47.70 percent of their debt obligations. However, 35 firms having over twelve years' (25 to 30 instalments) repayment period repaid 39.40 percent of their dues. Though this repayment rate was lower than 47.70 percent of the total due loans repaid by the 142 firms, it was larger than the repayment rate of 123 firms having less than 10 years repayment period. Moreover, the loan repayment performance of these 35 firms do not reflect the loan repayment performance of all firms in general, since they constitute only about 12 percent of the firms investigated. This suggests that longer loan repayment period is related to better loan repayment performance. In fact, it is evidenced by the loan repayment performance of the firms taking loan rephasing facility⁶⁸ from the BSB. Data collected from the BSB (MIS Department 1998) show that of the 88 firms having rephased/rescheduled loan instalment between 1991 and 1997, 38 firms (43 percent) had satisfactory loan repayment performances than those firms which did not rephase/reschedule their loan repayment obligations. It has been found in the borrower survey that 92 percent (51 firms) of the 56 responding firms

⁶⁸ Loan rephasing indicates the extension of the loan repayment period.

(Table 6.5) favoured extension of loan repayment period by the BSB. These findings support hypothesis H8.

7.7 Summary

The summary of this Chapter is provided as under:

1. The BSB had a credit control mechanism in place but available evidence showed that it was highly inefficient. The laxity in the CCM was supported by the high officer-application ratio, large number of stuck-up cases, lending to repeat defaulters in contravention of the bank's credit policy and defective project appraisal reports. Even there was a ghost firm in the BSB's loan portfolio. These suggest that borrower screening mechanism employed by the BSB was defective which allowed the unworthy borrowers to receive huge term loans.
2. The assessment of firm's credit need was flawed since loan appraisal reports were incomplete and full of inconsistencies. These feasibility studies provided cosmetic justification for sanction of term loans to the would-be defaulters.
3. Rampant political interference and frequent government policy intervention in loan intermediation process reduced the efficiency and quality of term lending activities.
4. It transpired that credit disbursement delayed due, partly, to the inability of borrowers to mobilise the necessary equity and, partly, to the slackness in the BSB's loan processing work. Such delay, which increased costs of borrowing, was found to be an important factor which contributed to industrial loan default.
5. It was found that a higher rate of loan default was associated with the lower level of borrowers' equity investment in the project and vice versa. An identical experience

was reported for the term and variable loan ratio; firms struck by the shortage of working capital loans were not able to utilise their productive capacity. This caused them to suffer low cash flow which reduced their ability to repay loans.

6. The loan default problem was compounded by the stringent loan conditions requiring the firms to repay loans even when they were under implementation. Loan burden escalated due to failure of the BSB to match the borrower's ability to repay loans or firms' cash flow sequence with the repayment instalment.

These indicate that the financial role played by the BSB was flawed since all hypotheses, from H1 to H8, supported the principal hypothesis PH1. These findings validate the Part I of the theoretical model developed in Chapter 4.

The flaws in the financial role of the BSB is also evidenced by the fact that it has been experiencing no net profit since 1994-95 (BSB, Annual Report 1996-97). Cookson (1997) found it technically insolvent and undercapitalised. Since mid-80s, the BSB has been surviving under bail-out programs or continuous fund injections by the GOB. From these, it can be concluded flawed financial role was responsible for financial insolvency of the BSB.

CHAPTER EIGHT

TESTING THE MODEL – PART II :

FLAWED DEVELOPMENTAL ROLE AND INDUSTRIAL LOAN DEFAULT

8.1 Introduction

It is premised in the second part of the theoretical model developed in Chapter 4 that industrial loan default is associated with flawed developmental role of an industrial development finance institution (IDFI). In a society where the availability and quality of entrepreneurship are quite scant, it is imperative that an IDFI should become instrumental in industrial/entrepreneurial development activities. Instead of taking a passive position of waiting for entrepreneurs to approach it, it should go out, identify and pick up prospective entrepreneurs and cultivate an entrepreneurial talent (Hu 1981; and Bhatt 1993). If credit delivery is not accompanied by entrepreneurial guidance by the IDFI from the set-up stage of the firm to the liquidation of loans, it is highly likely that unskilled and inexperienced entrepreneurs would not be able to implement, operate and manage industrial enterprise efficiently to generate sufficient income to service the debt. Thus, entrepreneurial disability may cause borrowers to default in repaying industrial loans, given that they are willing to repay loans.

A number of authors (Siddiqui 1990; Sobhan 1988; Haque 1988b; Sobhan and Sen 1991; Rahman 1977; and Hashem 1982), found that majority (i.e., over-two-thirds) of borrowers in Bangladesh lacked experience in industrial entrepreneurs and they were mostly trader-turned-industrialists. The borrower survey conducted by the author also found that more than half (54 percent) of the respondents were inexperienced entrepreneurs (Table 6.6). Many potential entrepreneurs were not clear about which

industrial activities should be sponsored and which investment project would be profitable (World Bank 1978).

In fact, Bangladeshi entrepreneurs require industrial promotional assistance regarding 'planning and development, policy formulation, internal staff training, management training and expansion service, technical training liaison, procurement of machinery, materials, spares, provision of working capital, premises and sites and marketing of products' (Rahman 1977, p.564).

Given the acute dearth of industrial entrepreneurship in Bangladesh⁶⁹, the BSB - being an IDFI - is expected to play an active role in entrepreneurial development like its counterparts in Germany and Japan⁷⁰ by getting involved throughout all the stages of the industrial project's life cycle. It is not unreasonable to expect that the BSB - as a catalyst for entrepreneurial development - should take the initiative and shoulder a greater part of the responsibility to select borrowers with potential entrepreneurial skills, groom them as successful entrepreneurs and guide them at various stages of project identification, project implementation, operations and management. This Chapter examines whether entrepreneurial development role played the BSB was flawed and whether such flawed role contributed to industrial loan default. The extent of the BSB's involvement in the developmental role and the level of flaws that contributed to industrial loan default can be gauged by testing the following principal hypothesis (PH2).

⁶⁹ Entrepreneurial activity in Bangladesh prior to independence was dominated by the Pakistani monopoly house (Amjad 1982) who controlled all but few large manufacturing industries, 70 percent of bank deposits and principal retail establishments (Sobhan 1993, p.157). Prior to partition of India in 1947, productive activities in the area now called Bangladesh included a variety of small and cottage industries (Ahmad 1978, p.386). There was no single case of modern industrial enterprise at that time which was owned and operated by any resident Bangladeshi. The entire class of Bangladeshi industrialists was made up of first generation industrialists or traders when Bangladesh emerged as an independent state (Sobhan, 1993, pp.157-163).

⁷⁰ Industrial Bank of Japan gets involved in the entrepreneurial development and guidance throughout the life of an industrial project. During the early years of industrial development, universal banks in Germany played the same role.

PH2 : The Developmental role played by the BSB was highly inadequate and it weighted the financial role more than the developmental role which contributed to industrial loan default.

The validity of this principal hypothesis is examined through testing the following eight hypotheses relating to project selection, project implementation and follow-up, monitoring and project management.

- H9 The selection of the Export-Orientated Industry (EOI) for term loans was efficient since loan repayment performance of this industry was relatively better than that of other types of industries.
- H10 BSB's selection of Import-Substituting Industry (ISI) for term loans was not prudent since this industry repaid less loans than that of other industries.
- H11 BSB provided term loans to the industries which suffered from the problems of excess productive capacity, thereby contributing to the increased risks of loan default.
- H12 BSB's selection of small firms for term loans was not flawed since their repayment performance was relatively better than that of large firms.
- H13 BSB's involvement in project implementation was highly inadequate which increased the risks of loan default.
- H14 BSB's involvement in project supervision and follow-up was highly inadequate.
- H15 BSB paid little attention to the monitoring of the project performance which contributed towards build up of debt burden.

H16 Financed projects suffered from the BSB's failure to police its own regulations about efficiency of their management.

These hypotheses are tested on the basis of processed secondary data, published materials, and results of field survey and loan file investigation presented in Chapter 6. While four hypotheses relating to project selection are tested in Section 8.2, one hypothesis relating to project implementation is tested in Section 8.3. The hypotheses relating to supervision and follow-up, and monitoring are tested in Section 8.4 and Section 8.5 respectively. Section 8.6 is devoted for testing hypothesis relating to the management of project. The summary of research findings is presented in Section 8.7.

8.2 Project Selection

BSB selects industrial projects for term lending in compliance with the strategies set out in the industrial policy (IP) which is announced by the Government of Bangladesh (GOB) from time to time. The following types of industries were given priority in the past and present industrial policies (IPs)⁷¹:

- (i) Export-Orientated Industry (EOI) where the industrial concern must export at least 70 percent of its products;
- (ii) Import-Substituting Industry (ISI) where the industrial concern is required to produce products which are close substitutes for imported products;
- (iii) Industries based on indigenous raw materials;
- (iv) Industries based on agro-inputs and labour-intensive technology;
- (v) Industries devoted to manufacturing capital goods; and
- (vi) Industries located in less developed or least developed areas.

⁷¹ A brief discussion on industrial policies is provided in Chapter 10.

Loan applications satisfying the above criteria do not automatically qualify for industrial loans though they get priority over other types of industry such as those in the transport and service sectors. Apart from satisfying the above criteria, a loan for an industrial project is considered on the basis of its market, economic, financial and technical viabilities. Whether the work of project selection carried out by the BSB was flawed is determined by examining loan repayment performance of EOI, ISI, firms having excess capacity and, small and large firms.

8.2.1 Export-Orientated Industry

H9: The selection of Export-Orientated Industry (EOI) for term loans was efficient since loan repayment performance of this industry was relatively better than that of other types of industries.

Export-orientated industrialisation has always been one of the major objectives of IPs pursued by the GOB. The GOB has defined EOI as 'any industry directly exporting or indirectly assisting using indigenous raw materials, in exporting 70 percent or more of its manufactured goods or services on value/income basis' (GOB, Ministry of Industries 1992, p.16).

EOI has received top priority in all IPs and, in compliance with the GOB's direction, the BSB has also financed a substantial number of EOIs. Table 8.1 shows that there were 27 export orientated firms in the loan portfolio of the BSB as at September 1996 and that they repaid a little over one quarter (26.64 percent) of their total dues against 20.95 percent dues repaid by all other industries.

Table 8.1

**Loan Repayment Performance of EOIs
as at September 1996**

(Taka in Million)

Industry (1)	No. of Firms (2)	Amount Due (3)	Amount Recovered (4)	% of Dues Recovered* (5)
RMG ⁷²	6	17.4	8.9	46.17
Fish	5	11358	77.31	68.07
Leather	5	122.39	9.14	7.42
Jute ⁷³	5	677.00	132.82	19.62
Other ⁷⁴	6	179.61	68.29	38.02
Sub-Total	27	1110.32	295.75	26.64
All Other Industries	194	10900.18	2283.87	20.95

* Note: Loan recovered is obtained by (4)/(3)*100

Source: BSB, MIS Department. Data were processed by the author.

Among the EOIs, the RMG and the Fish sectors, which repaid 46.17 and 68.07 percent of their dues, respectively, performed very well compared to all other EOIs. This indicates that BSB's selection of RMG and fish processing for term finance was more rewarding than other EOIs. For example, selecting firms in the leather sector for term finance appears to be faulty since they repaid only 7.42 percent of their dues. All other EOIs, which include textile yarns and textile fabrics, and ceramic products, have also outperformed the jute and leather industries in terms of loan repayment performance. It transpires that some EOIs rather than all deserve term loans and indiscriminate selection of EOIs for term finance was not justified from the view point of loan repayment performance. This does not support hypothesis H9.

⁷² Ready Made Garment (RMG) industries include industrial firms which are engaged in the production of shirting, suiting, jumpers, towels, knitwear, embroidery, etc.

⁷³ Jute industry includes industrial firms engaged in the production of jute yarn, jute carpet, jute cloths such as hessian and sacking.

⁷⁴ Other industries include textile yarn, textile fabrics, ceramic products, etc.

8.2.2 Import-Substituting Industry

H10: BSB's selection of Import-Substituting Industry (ISI) for term loans was not prudent since this industry repaid less loans than that of other industries.

Bangladesh, in general, pursued a strongly inward orientated strategy (Love 1995, p.16), which was reflected in its stress in the IPs. In compliance with the IPs, the BSB has provided term loans to industrial firms which belong to the Import - Substituting Industry (ISI). Table 8.2 shows the loan repayment performance of 63 import-substituting firms which were in operation in 1996.

Table 8.2
Loan Repayment Performances of ISI as at
September 1996
(Taka in Million)

Industrial Sector	No. of Firms	Amount Due	Amount Recovered	% of Dues Recovered *
Chemicals	13	736.53	277.40	37.66
Machinery Parts	8	60.49	4.55	7.52
Rubber Products	4	35.78	3.14	8.78
Textiles	14	675.96	309.78	45.83
Other Industries ⁷⁵	24	454.29	87.05	19.16
Total	63	1963.05	681.92	34.74

Source: BSB, MIS Department. Data were organised and computed by the author.

⁷⁵ Industrial units engaged in the production of various items such as magnetic wires, tapes, toys, grease, copper wire, mosquito coil, salt etc. fall into the category of other ISIs.

It appears that firms belonging to ISI repaid 34.74% of their dues against 26.64% of dues (Table 8.1) repaid by their counterparts in EOI and in this sense, the above hypothesis appears to be rejected. However, like EOI, ISI has also some better performing sectors and some worse performing sectors. For example, the textile and chemical sectors repaid 45.83 percent and 37.66 percent, respectively, while firms engaged in the production of rubber and machinery parts repaid 8.78 percent and 7.52 percent of their dues, respectively. This suggests that ISI outperformed EOI in terms of loan repayment and the hypothesis H10 is not supported.

8.2.3 Excess Capacity

H11: BSB provided term loans to the industries which suffered from the problems of excess productive capacity, thereby contributing to the increased risk of loan default.

Industrial capacity utilisation in Bangladesh has always been a much publicised issue. The White Paper for 1974-75 released by the GOB showed that industrial capacity utilisation at that time varied from 60 percent in the jute industry to 17 percent in the leather industries (Ahmed 1977). Between 1971 and 1995, the BSB has provided term loans to some sectors such as cold storage and oil mills (Battacharya 1993) which were already saturated in terms of development of productive capacity⁷⁶ (Sahota 1991 ; and Sobhan 1991c). An investigation carried out by the GOB found that overcrowding of investors/firms in a particular type of industry was one of the reasons for industrial sickness in Bangladesh (GOB, Report of the Task Force Vol.1 1991, p.234).

Further capacity creation in an already overcrowded industry leads to the under-utilisation of the productive capacity of both the existing as well as the new industrial units. According to a national newspaper (The Dainik Sangbad 2 August 1987), 40

⁷⁶ Deputy Prime Minister Moudud Ahmed informed the National Parliament of Bangladesh that the different sponsoring organisations sanctioned 16,000 industrial firms between 1981 and 1986 (The New Nation 13 March 1987).

percent of industrial productive capacity remained unutilised. In its Fourth Five Year Plan (1990-95) document, the GOB also recognised low utilisation of productive capacity as an economic problem in Bangladesh. This suggests that firms operating at 60 percent capacity or at a level lower than full capacity could not generate enough income to service the debt. This contributed to industrial loan default.

Between December 1971 and September 1996, the BSB supplied term finance to 1490 industrial firms and a little over half (763 firms) of them belonged to three industrial sectors, namely, food and allied, textile and transport. It is evident from Table 8.3 that the BSB has sanctioned loans to a large number of particular types of industrial firm within a short period and this has not been supported by a matching surge in demand for the products or services of those firms. Not only might this have compounded the problems of excess productive capacity, but might also have created a false impression among the would-be borrowers that particular types of industrial firms were profitable and this caused the loan rush.

This contention has also been supported in the borrowers' survey carried out by the author. More than a third (39 percent) of the borrowers surveyed (Table 6.6) admitted that they became interested in a particular type of industry after they heard that the BSB had been sanctioning loans to that industry. Moreover, it transpired from the survey that more than half (54 percent) of the responding borrowers were not experienced industrial entrepreneurs. It turned out that instead of viable projects chasing credit, credit was chasing unviable projects. This craze in the term loan market has created excess capacity in various industries which has forced the borrowers to operate their industrial firms at a lower capacity. Sensing the existence of excess capacity, the *Dainik Sangbad* (2 August 1987) suggested that full utilisation of productive capacity was more important than developing new capacity through sanctioning term loans to new firms.

But the BSB, along with other banks and financial institutions such as NCBs, continued to sanction credit, regardless of the existence of the excess capacity. Such

indiscriminate sanctioning of term credit by the BSB has created, as Table 8.3 shows, over-supply of productive capacity and concentration of some types of industrial firms such as rice mills, cold storage, textile (weaving) mills and cargo and passenger vessels within a short period which compounded the problems of excess capacity.

Table 8.3
Concentration of Industrial Projects

Industrial Sector	Total No. of Firms Sanctioned Between 1972-90	No. of Firms Sanctioned in Particular Period		Year and No. of Firms Sanctioned in a Year	
		Period	No. of Firm	Year	No. of Firm
Rice Mills	61	1978-82	43	1979	15
Cold Storage	45	1979-81	38	1980	21
Cargo Vessel	89	1979-81	59	1980	33
Passenger Vessel	45	1978-80	45	1979	39
Synthetic Textile	42	1981-84	35	1984	13

Source: BSB, MIS Department. Data were compiled by the author.

The sanctioning of loans to a large number of industrial projects within a year or within three to four years gives rise to this speculation that project selection was not driven by market prospect. Industry-wise analysis of loan repayment performances in the following paragraphs presents ample evidence of this contention.

Automatic Rice Milling

Automatic Rice Mills (ARMs) are required to process paddy collected by traders and the Food Department of the GOB. The demand for ARMs depends on the increase in paddy production as well as increased volume of paddy collected by the rice-traders and by the GOB. It would appear from the Table 8.3 that the BSB sanctioned loans to 61

ARMs between 1972 and 1990 which meant that it sanctioned loans to three ARMs per annum on average during that period.

But term loans to the ARMs sector jumped suddenly from the yearly average of 3 ARMs to 15 ARMs in one year (i.e., 1979) or 43 ARMs within 1978-82. The decision to finance such a large number of ARMs within a short time was not matched by the growth of demand for services of ARMs or by the policy shift of the GOB to divert the work of rice processing activities from the cottage-based hauler rice milling sector⁷⁷ to automatic rice milling or by the abnormal growth of production and collection of paddy by the GOB or by the traders in the private sector.

Data collected from the Bangladesh Bureau of Statistics (BBS) and reproduced in Table 8.4 show that rice production was up by only 14.82 percent between 1977-78 and 1984-85. On the other hand, rice processing capacity created by the BSB jumped by 400 percent between 1977-78 and 1981-82 when rice production grew by 7 percent. It indicates that BSB's selection of ARMs for term loans was not justified, given the low growth of rice production and existence of excess capacity in the ARMs sector due to indiscriminate sanctioning of terms loans by other DFIs such as Bangladesh Krishi Bank (BKB) and Bangladesh Shilpa Rin Sangstha (BSRS).

⁷⁷ Hauler rice mills, though they do not process rice as automatically as ARMs, are competitors of ARMs. Also there are other rice processing techniques such as Dheki - a wooden mortar which husks rice by using manual labour.

Table 8.4

**Rice Production in Bangladesh
(Quantity in 000 Metric Tons)**

Year	Rice Produced
1977-78	12,736
1978-79	12,647
1979-80	12,539
1980-81	13,882
1981-82	13,630
1982-83	14,216
1983-84	14,509
1984-85	14,623

Source: GOB, Statistical Year Book of Bangladesh 1995,
Bangladesh Bureau of Statistics, p.147.

One Deputy General Manager of the BSB informally admitted to the author that the discontinuation of lending to rice mills from 1983 was linked to the realisation that excess rice milling capacity existed in the industry. Also, the GOB discouraged further capacity creation in this sector in 1987 (GOB, Guide to Investment 1987) due to the same reason.

The existence of excess capacity in the rice milling industry might have convinced sponsors of nearly half (27 units) of the 61 rice mills sanctioned by the BSB not to accept the loans and, hence, withdraw loan applications. Though the remaining 34 rice mills received loans, investigation into their loan repayment performance revealed that every ARM borrower defaulted in repaying loans to the BSB. As at September 1996, there were 22 rice mills in the BSB's loan portfolio and only half (11 firms) of them were in operation. As at September 1996, total loans due from these 11 performing rice mills was Taka 163 million and the BSB recovered only 10.75 percent of recoverable dues. The existence of a persistently high rate of loan default in the rice milling industry indicates that these defaulting rice mill units could not operate at their full capacity

since there was excess capacity in the rice milling sector. Thus, hypothesis H11 is supported.

Cold Storage

Like rice mills, the problem of excess capacity has also existed in the cold storage firms which were required to store and preserve potatoes. Table 8.3 shows that the BSB sanctioned term loans to 45 cold storage plants between 1972 and 1990. Of them, 38 plants were sanctioned within three years (i.e., 1979-81) and 21 units were sanctioned in one year, i.e., in 1980.

The rate at which cold storage capacity was created by the BSB was far in excess of potato production at that time. BBS data show that potato production rose to 983,000 metric tons in 1980-81 from 849,000 tons in 1977-78, showing a growth rate of 5.26 percent (GOB, Statistical Year Book of Bangladesh 1995). Total potato production in Bangladesh grew at a lower rate in the later years⁷⁸. BSB's selection of cold storage for term finance was not matched by the growth of potato production. The creation of storage capacity to the tune of 42, 000 metric tons within a year (e.g., 1980) was not reflective of the real situation.

It is to be pointed out here that other financial institutions such as BKB and BSRS have also sanctioned term loans to the cold storage sector. Like rice mills, this has compounded the problem of excess capacity in this sector since there was no coordination or monitoring of the sanctioning activities of lending institutions. The GOB recognised that excess capacity persisted in the cold storage sector and that is why it formally discouraged further capacity development in this sector in 1987 (GOB, Guide to Investment 1987).

⁷⁸ Total potato production was 1,095 thousand metric tons in 1981-82 which grew to 1,159 thousand metric tons in 1984-85 (GOB, Statistical Year Book of Bangladesh 1995, p.146) which means that average annual growth rate was 1.95 percent.

The existence of excess capacity in the cold storage industry has adversely affected the repayment capacity of the borrowers. This is evidenced by BSB's 12 performing cold storage plants which repaid a little over one-fifth (22.93 percent) of their overdue loan amounts as at September 1996. That is, by selecting cold storage firms for term loans, the BSB has increased the chance of loan default. This supports hypothesis H11.

Water Transport

BSB's apparent obsession with term lending to a large number of the same types of firms within a very short period is also evident in the case of passenger and cargo vessels which are used to ferry passengers, goods and materials respectively. Table 8.3 shows that between 1979 and 1981, the BSB sanctioned term loans to 59 cargo vessels and among them, 33 units were sanctioned within a period of one year (i.e., 1980). Table 8.3 further shows that among the total 45 passenger vessels sanctioned between 1978-1980, 39 passenger vessels were sanctioned in 1979. Such indiscriminate sanctioning of loans for passenger vessels and cargo vessels within a year has increased the risks of loan default. This is evidenced by the loan repayment performances of these firms.

The BSB had 21 performing cargo and passenger vessel firms as at September 1996. These firms were able to repay only 31.02 percent of overdue loans amounting to Taka 128 million by that time (BSB, MIS Department 1996). In other words, these firms defaulted on repayment of more than two-thirds of their dues and the existence of excess capacity is reckoned as a contributory factor for such unsatisfactory loan repayment performance. This supports hypothesis H11.

Textile Mills

As regards textile weaving mills which produce fabrics, the BSB followed the same policy: selecting a large number of a particular type of firms within a short time. It is

shown in Table 8.3 that it sanctioned term loans to a total of 42 textile weaving mills between 1972 and 1990 and 35 of them were sanctioned between 1981-84, the highest number was 13 firms in 1984. At the same time, other lending institutions such as, Sonali Bank, were also lending to the textile weaving industry. The sudden sanctioning of term loans to a large number of textile weaving mills within a year contributed towards creation of excess capacity in the already ailing textile industry. This is supported by the low loan recovery rate in this sector.

As at September 1996, the BSB had only 19 performing textile weaving mills in its loan portfolio. By that time, about Taka 273 million were due to be recovered from these textile mills and the BSB was able to recover only Taka 34 million which constitutes 12.45 percent of the recoverable amount. Such low repayment performance in the textile weaving sector was reflective of the lower capacity utilisation.

These findings regarding excess capacity in ARMs, cold storage, water transport and textile industries suggest that the BSB had selected firms for term finance on the basis of the wrong premise that there was scope for further capacity development in these industrial sectors. Even after the confirmation of the existence of over-congestion of firms in a particular industrial sector by a study (Ali et al 1987), the BSB continued to finance firms in that overcrowded sector. This was confirmed by the borrower survey conducted by the author. More than two-thirds (67 percent) of the 54 respondents agreed that their firms had unused capacity (Table 6.7). This was, according to them, due to the excess capacity in the whole industry (Table 6.8), which has forced them to run their industrial concerns at below installed capacity which made them unable to repay their dues to the BSB.

Several studies (Ahmed 1977; Afroz and Roy 1977; Battacharya 1993; Sahota 1991; World Bank 1995b; GOB, Report of the Task Force Vol. 1&2 1991; and Sobhan and Sen 1989) also found that the problem of excess capacity in various industrial sectors of the economy was widespread in Bangladesh and this reduced borrowers' ability to

repay loans which contributed to loan default. All these indicate support for hypothesis H11.

8.2.4 Firm Size

H12: BSB's selection of small firms for term loans was not flawed since their repayment performance was relatively better than that of large firms.

Over the last two decades, the BSB has supplied a large amount of term loans to small firms, the definition of which varies from country to country⁷⁹. The GOB has defined small firms as those firms which invested up to Taka 15 million or spent not more than Taka 10 million excluding taxes and duties on machinery and equipment (Bangladesh Bank, BCD Circular No.20, 7 July 1986).

Khan (1972, p.60) argued that 'small firms in Bangladesh were more efficient users of capital than large firms', although private profits in large firms were higher than small firms. Being directed by the GOB, the BSB provided term loans to small firms which constituted two-thirds (72 percent) of its total investment portfolio. But large firms claimed the largest chunk of total term loans since big industrialists had easy access to the industrial finance market in Bangladesh (Khan 1972). Table 8.5 provides loan repayment performance of 304 operating firms funded by the BSB.

⁷⁹ In Australia, a firm employing less than 100 persons is called a small firm.

Table 8.5**Loan Repayment Performance of Small and Large Firms
as at September 1996****(Taka in Million)**

Item	Small Firm	Large Firm
No. of firms	219 (71)	85 (29)
Amount of loan disbursed	737 (17)	3,686 (83)
Total outstanding dues	1,801 (21)	6,677 (79)
Total loan recovered	288	1,869
Recovery rate (%)	15.99	27.99

Note: Figure in parenthesis indicates percentage.

Source: BSB, MIS Department. Data were processed by the author.

Table 8.5 shows that small firms constitute 71 percent of the total performing firms as at September 1996. They received 17 percent (Taka 737 million) of the total term loans provided by the BSB. On the other hand, 85 large firms which constitute 29 percent of the total performing firms received 83 percent (Taka 3.686 billion) of total term loans.

Small firms repaid only 15.99 percent (Taka 288 million) of the outstanding dues (Taka 1,801 million) while large firms repaid 27.99 percent (Taka 1,869 million) of their outstanding dues (Taka 6,677 million) by September 1996. It indicates that large firms performed relatively better than small firms in respect of loan repayment which is quite contrary to the hypothesis H12. Lawrence et al (1992) also found that higher probability of loan default was associated with small loans. In view of the above, hypothesis H12 is not supported which means that BSB's selection of large firms for term finance was not flawed.

8.3 Project Implementation

H13: BSB's involvement in project implementation was highly inadequate which increased the risks of loan default.

The commencement of commercial operations by an industrial enterprise depends on its implementation after the loan is sanctioned by the BSB. For the sake of a detailed analysis, the industrial project implementation work is divided into two types: Type A work and Type B work. While Type A work included all implementation activities carried out between the date of sanction of loans to the project and opening of letter of credit (L/C) for its plant and machinery, Type B work included activities between opening of L/C and commencement of production. BSB gets involved in both types of works. As regards Type A work, it allocates foreign currency, selects package and price of machinery on the basis of the papers supplied by the borrowers and realises down payment from the borrowers before opening L/C, processes papers and makes first disbursement of loans.

Considerable delays occur in this stage of implementation work. Data collected from 215 projects and reproduced in Table 8.6 show that though 98 firms (45.58 percent) spent less than twelve months, more than half (54.42 percent or 117 firms) of them waited more than twelve months to get the first disbursement of loans from the BSB.

Table 8.6

Months Taken for Disbursement of First Instalment of Loans

Months Taken	No & Percentage of Firms	
	No.	Percent
Less than 12	98	45.58
13 - 24	54	25.12
25 - 36	30	13.95
37 and over	33	15.35
Total	215	100

Source: BSB, Loan Accounting Department. Data was collected and compiled by the author.

Again, a little over one quarter (25.12 percent or 54 firms) of them took between 13 and 24 months to receive disbursement of the first instalment of loans. But there were 33 firms (15.35 percent) which waited for more than three years to receive first instalment of loans. It was found in the borrower survey that about three-fourths (71 percent) of the 52 responding firms (Table 6.9) experienced delays in project implementation. These delays were due to (Table 6.10) delay in foreign currency allocation (56 percent), delay in building construction (27 percent) and delay in machinery selection (48 percent).

Such inordinate delays reflect inefficiencies in the implementation of Type A work. These delays may be due to delays in procuring and submitting papers relating to the selection of plant and machinery and in mobilising equity and/or to delays by the BSB in committing funds, processing papers and making disbursement of loans. The GOB (Report of the Task Force Vol.2 1991) and Sobhan (1991b) reported that there were borrowers who used the occasion for selection of plant and machinery to siphon off capital from the industrial loans for retention abroad by way of over-invoicing.

Over-invoicing works like this : an industrialist whose new firm has been sanctioned a foreign currency loan will arrange with a foreign supplier to sell him equipment at a fictitious invoice price, higher than the price he actually pays (Winston 1972). Presentation of the partly fictitious invoice to the BSB entitles the supplier to get the full invoice amount of foreign exchange. He is to convince, by subterfuge or inducement, the BSB officials that the equipment he is ordering is really worth its over-invoiced value (Sobhan and Sen 1989). The portion of the invoiced amount that represents overpayment is then deposited by the supplier to the industrialist's account in a foreign bank. The deception of BSB by this process allows the borrowers to support equity investment in the project or to support lavish spending overseas.

Borrowers engaged in this type of transaction spent a considerable amount of time by way of negotiation and travel with the equipment supplier and, consequently, the

selection of machinery and equipment and opening of L/C was delayed. Moreover, equipment selected under such transactions by the inexperienced borrowers was found to be defective (Sobhan and Ahsan 1986; and Sobhan and Sen 1989). Borrowers who have distaste for such deceptive transactions are also caught by the delays in getting fund commitment from the BSB which depends on international funding organisations and/or GOB for supply of loanable funds.

As regards Type B implementation work, many irregularities, inefficiencies and delays have also been observed. Sobhan and Ahsan (1986) believed that Type B work, starting from the opening of L/C to the installation of machinery and commissioning of the project, should take 6 months. Against this expectation, they found that each project financed by IDFI's like the BSB spent 9 months on average for arrival of machinery after the opening of L/C. On average, each firm took 14 months to get a trial run after the machinery arrived. The borrower survey conducted by the author revealed that 32 percent of the total respondents experienced delayed arrival of machinery to the project site. Moreover, machinery installation was delayed for 36 percent firms (Table 6.10).

Such delay in project implementation is also evidenced by Table 8.7. It shows that only 60 firms which constitutes just over one-quarter (27.91) of 215 firms investigated by the author started production within two years after BSB sanctioned loans to them.

Table 8.7
Months Taken to Commence Commercial Operations

Months Taken for Commencing Production	No. & Percentage of Firms	
	No	Percent
Less than 24	60	27.91
23 - 36	62	28.84
37 - 48	32	14.88
49 - 60	20	9.30
More than 61	41	19.07
Total	215	100

Source: BSB, Loan Accounting Department and MIS Department. Data were computed by the author.

It also indicates that the remaining 155 firms (72.09 percent) commenced production after twenty four months. Among these 155 firms, there were 20 firms which took between 49 and 60 months to start production. There are even 41 firms which took more than 61 months; seven of which took more than ten years to start production. Sobhan and Sen (1989, p.61) also found that delays in the implementation of the projects funded by the IDFI were a regular phenomenon.

This unusually long delay in commencement of commercial production is reflective of the absence of BSB's adequate involvement in project implementation work. It has been found in the borrower survey that though machinery is selected by the borrower and the BSB in 79 percent of the cases (Table 6.11), about half of the borrowers (48 percent) did not receive any help⁸⁰ regarding machinery⁸¹ assembly and installation, and building construction (Table 6.12).

Construction of project building is supposed to be completed before the arrival of machinery but the author found several projects⁸² where machinery arrived well ahead of construction of the project building and valuable machinery remained dumped under the open sky which affected its operating life. The UNDP (1991)) also found that there was a perceived gap between project concept and project design and the BSB was least engaged in maintaining continuity and allowing timely access to experts and other inputs needed to keep the momentum of the project's implementation.

⁸⁰ But 29 percent and 23 percent of the firms surveyed received help in machinery installation and building construction respectively (Table 6.12).

⁸¹ Sobhan (1991a, p.19) reported that over 75 percent of the project machinery financed by the BSB was imported. This machinery required technical assistance for assembling and installation.

⁸² The names of the projects are: M.Rahman Textile Mills Ltd., N.N. Super Textile Mills Ltd., Shahnewaz Superior Textile Mills Ltd. and Quaderia Reza Textile Mills Ltd.

All these suggest that had the industrial firms under the guidance and involvement of the BSB been able to construct project buildings as per work schedule, select appropriate plant and equipment containing no scope for over-invoicing, and erect and install machinery within the planned time, the delays in commencing production and consequential debt burden could have been reduced to a great extent. Especially, in a country where the majority of entrepreneurs have no industrial experience (Table 6.6; and Sobhan and Sen 1991), inadequate involvement by the BSB in the implementation of the project was certainly not helpful in increasing the entrepreneur's ability to repay loans. Over four-fifths (88 percent) of the 52 borrowers (Table 6.9), who responded to the survey conducted by the author, blamed delayed implementation of their firms for loan default. These findings support hypothesis H13.

8.4 Supervision and Follow-up

H14: BSB's involvement in project supervision and follow-up was highly inadequate.

BSB has the mechanism in place for project supervision and follow-up. The responsibility of project supervision and follow-up at various stages of project-buildings construction and machinery installation is given to its Inspection and Evaluation Department. The author carried out a field investigation in this regard and found that deficiencies in project supervision and follow-up were widespread. Supervision and follow-up visits to project sites were highly infrequent, unsystematic and unorganised. Investigation of 126 firms revealed that between four and six inspections were carried out for most of the firms (Table 6.16) before they went into commercial operations. Moreover, most (89%) of these inspections were carried out in

less than 12 hours against the requirement of about 40 hours⁸³.

The futility of such short visits to the project by the BSB officials also caused disenchantment among the borrowers, not to mention the quality of supervisory work. About one-third (30 percent) of the borrowers who responded to the survey conducted by the author complained that prescribed inspections forms were quickly filled out by the inspecting officers (Table 6.13) without going deeply into proper investigation. About two-thirds (65 percent) of them were dissatisfied with the inspection carried out by the BSB officers (Table 6.15). Supervision of projects did not continue beyond the construction period of the project which is usually twenty-four months.

More than half (56 percent) of the responding borrowers expressed their dissatisfaction (Table 6.15) over the way the inspecting officers from the BSB were brought to the project to carry out the inspection. According to them, 86 percent inspections (Table 6.14) were carried out at their request so that they could receive disbursement of loans. More than half (59 percent) of the inspections were carried out to recover loans (Table 6.13) though 50 percent of inspection were follow-up inspections. Also much time, varying from two to four months, was lost in getting inspectors from the Head Office⁸⁴ of the BSB after borrowers requested them to carry out inspections of their industrial concerns.

The delay in project inspection may be confirmed by the relative shortage of staff-engineers in the BSB. Between December 1971 and June 1995, BSB processed 2043 loan applications (Table 7.1) which means that about 85 new projects on average were to be inspected each year, in addition to carrying out inspections on old projects.

⁸³ This time requirement for a fruitful inspection of a project under implementation was quoted to the author by a project-engineer of the BSB. He believes that effective inspection is a time consuming affair and that a thorough inspection of how implementation work is carried out requires at least five working days.

⁸⁴ Although BSB deputs an engineer for each of its 13 branch offices, officers from head office are brought in to help the overstressed branch office engineer.

According to Price Waterhouse (1984, p.144), a project requires at least one inspection each quarter to ensure the timely and quality implementation of the project. This means that a high volume of inspection work deserved the engagement of a number of staff-engineers. As the BSB had few engineers, it was highly likely that implementation of the project was inordinately delayed.

The low level engagement of the BSB officials is supported by the borrower survey. It showed that 37 percent (14 firms) firms received advice during machinery installation and 43 percent firms received some form of advice during building construction (Table 6.14). Field investigation carried out by the author into several projects revealed that the BSB has also failed to depute the right person for the work. For example, instead of a civil engineer, a mechanical engineer was deputed in May 1988 to carry out inspection of building construction of Naya Progoti Textile Mills Ltd., M. Rahman Textile Mills Ltd., N.N. Super Textile Mills Ltd., Shanawaz Superior Textile Mills Ltd. and Quaderia Textile Mills Ltd. Investigating several loan files, the author found that civil engineers were sent to inspect and report on machinery installation - a job suitable for mechanical engineers. Such mismatches in staff engagement resulted in compromise of the quality of inspection and the project was deprived of adequate supervision and follow-up.

From this analysis it is evident that the BSB's engagement in terms of project supervision and follow-up of the projects it financed was far from adequate. This finding was corroborated by Sobhan's (1991c) findings that weak loan supervision compounded the problems of loan default. This has lead the UNDP (1991, p.11) to recommend improved supervision of projects funded by the BSB. This supports hypothesis H14.

8.5 Monitoring

H15 BSB paid inadequate attention to the monitoring of project performance which contributed towards build up of debt burden.

Monitoring of the project's overall performance is required to reduce loan loss. Murinde (1996) thought that a development bank should 'set up a system which would give early warning signals if a project is getting into trouble; so that it can come to its aid as soon as possible to make sure that the projects stays on course' (p.223).

The system of monitoring includes some important aids such as internal records, visits and interviews, audited accounts and management accounts (Shanmugam and Turton 1992; and Rouse 1993). These instruments of monitoring enable the lender to ensure that the credit is used only for the purpose for which it was granted, to identify main risk areas for a particular business or project and to take action for maintaining the good financial health of the business so that the borrower can service the debt.

The BSB also has a system in place to monitor the progress and performance of a particular industrial project. In order to monitor the operational performance of the project, BSB adds some provisions to the loan conditions, according to which borrowers are required:

- a. to submit monthly operational results and cash flow statements of the company;
- b. to maintain all books of accounts which may be inspected by the BSB;
- c. to submit quarterly progress reports, as per prescribed pro-forma, on the project;
and
- d. to submit to the BSB the audited balance sheet, together with the profit and loss account of the company for every financial year within four months of the close of the company's financial year.

These requirements, though far from being sufficient for adequate monitoring of project performance, could assist the BSB in identifying the default risks faced by the client-project. Of the loan files of 89 project investigated, 6 percent sent operational data, 10 percent sent quarterly reports and 71 percent did not send annual balance sheet to the BSB (Table 6.17).

In the course of an interview, the Head of the Inspection and Evaluation Department of the BSB mentioned to the author that borrowers' level of compliance with (a), (c) and (d) is extremely poor and the bank had to undertake visits to the projects to prepare quarterly inspection reports. As regards inspection of books of account, he admitted that the bank carried out very few visits due to shortage of human resources.

Apart from the above, no instance was found where any of the firms investigated was penalised or officially censured for non-compliance with the above loan conditions. Moreover, no instance of consistent and annual review of BSB's loan portfolio was found. Rouse (1993) pointed out that for those companies which provide little or no management information, internal records are the only way in which effective monitoring can be carried out. It was because of the unavailability of firm's internal records, such as monthly sales and accounts data, that the BSB could not effectively monitor the true financial position and liquidity condition of the firm.

A major benefit of management accounts is that they offer opportunity to the lender to see how the assumptions made in the budget are working in reality (Rouse 1993, p.81) and how the capacity to repay debt is going to be impaired by such things as lower levels of sales or tighter margins. Being unable to get access to the management accounts of the non-complying projects, the BSB was not able to understand what was really going on inside the company it financed and how it was going to repay debt, etc. Because of non-compliance of borrowers with the requirement to provide information or data or of BSB's inability to procure them, the true financial and operational position of firms could not be adequately monitored which compounded the problems of loan default.

Such a high degree of non-compliance may be attributed to the evasive mentality of the borrowers. More than half (58 percent) of the 43 borrowers, who responded to the survey conducted by the author, believed that such reports were unnecessary and 42 percent of them considered such exercise as wastage of time (Table 6.18). However, 65 percent of the 37 responding borrowers (Table 6.19) agreed that they would have complied with these loan conditions had BSB imposed penalties on them.

As regards the visits to the project site, data collected from the Final Construction Reports (FCR) on 126 defaulting projects showed that 29 percent (37 firms) of them were visited by the BSB less than four times on average (Table 6.16) during the course of project implementation, such as building construction work. Nearly half (51 firms) of them were visited between four and six times. However, there were 22 firms (17 percent) which were visited six to eight times and these projects repaid 21 percent of their loan overdues in contrast to 17 percent of loan overdues repaid by the 88 projects being visited less than six times by the BSB. It shows that the higher frequency of project visits for the purpose of monitoring project implementation has influence on the relatively higher loan repayment performance.

This suggests that loan defaults in the BSB were partly caused by the lower level of project monitoring activities. From an investigation into 126 loan files, it was also found that better loan repayers received more written correspondence than poor loan repayers. If such correspondence is taken as a proxy for monitoring, it strengthens the claim that loan default was associated with poor monitoring of the overall performance of the project. Haque (1988b, p.32) also found that post-investment monitoring was very poor in BSB-type IDFI in Bangladesh which suffered massive debt defaults. This supports the hypothesis H15.

8.6 Project Management.

H16 Financed projects suffered from the BSB's failure to police its own regulations about efficiency of their management which contributed to loan default.

Management of projects involves continuous supervision, control and coordination of all aspects relating to production, marketing, sales, finance, human resources and responses to competition. The project management problem has always been a subject of intense academic discussion in Bangladesh. In an address to the second annual conference of the Bangladesh Economic Association (15 March 1976), the late President Ziaur Rahman pointed out that endless mismanagement was one of the negative factors crippling the productive sector (Rahman 1976, p.599). Bangladesh did not have an established class of experienced managers (Islam and Quddus 1996, p.190) and this was evidenced by the fact that only 2 percent of mill managers had relevant professional qualifications (World Bank 1978, p.49). Several studies (Ahmed 1977; Sobhan and Sen 1989; GOB, Report of the Task Force Vol.1 1991; Hassan 1995; Afroz and Roy 1977; Sobhan and Ahsan 1990; and Siddiqui 1990) reiterated that lack of efficient management adversely affected the financial health of industrial enterprises and has been responsible for industrial sickness⁸⁵ which varied from 50 percent (e.g, food industry) to 100 percent (e.g., jute industry).

Industrial projects financed by the BSB are mostly "family enterprises" which are owned and managed by the adult members of the family. Sobhan and Sen (1991) found that family members and relatives of the Managing Director comprised 65 percent of the members of the Board of Directors (BODs) of the firms financed by the BSB. Not only that, 98 percent of the board was occupied by 3 family members (Saha 1997) who were involved in the day-to-day management of the enterprises. Rarely were their

⁸⁵ Industrial sickness is defined as the inability of the firm to generate, after meeting the costs of goods, operating surplus to keep it running (Siddiqui 1990, p.125).

wives and children, who were also so-called members of the BODs, involved in the decision making or management of the enterprise (Bakht, 1984, p.26).

In terms of numbers, the loan portfolio of the BSB is dominated by small firms which comprise about two-thirds (71 percent) of the firms financed (Table 8.5). Performance of entrepreneurial functions in these firms is the prerogative of the head of the family who becomes the Managing Director. Although industrial firms require managerial skills of a high order and very frequently make heavy demand on special skills (Faaland and Parkinson 1976), Sobhan and Sen (1991) found that the majority of (60 percent) the owners of the projects had no connection with the previous occupations, such as trading or farming.

This suggests that the majority of the borrowers had no experience in industrial firm management and industrial enterprises suffered from the lack of proper management skills (Far Eastern Economic Review, Asia 1990 Yearbook, p.85). Sobhan and Ahsan (1990, p.22) found that it was because of the dearth of management skills, two-thirds (66.6 percent) of the firms financed by the BSB suffered from management problems, such as product marketing in 79 percent firms and raw material shortage in 81 percent firms. Hussain (1996, p.13) also identified poor management capacity of the borrowers of the BSB-financed firms as a pertinent reason for lacklustre repayment performance.

The BSB sensed the existence of management problems in its financed firms, so it incorporated a number of loan conditions to deal with such problems. Table 8.8 contains salient features of these conditions together with their compliance level by the borrowers.

Table 8.8**Loan Conditions and the Level of Compliance by the Borrowers**

Loan Conditions	Level of Compliance
Appointed Experienced Professionals	Very Poor
Allowed BSB to Appoint Auditors for Firm	Very poor
Hold Quarterly Board Meeting	Very Poor
Send Minutes of Board Meeting	Very poor
Allow BSB to Appoint Nominee Director	Good

Source: BSB, Inspection and Evaluation Department and Loan Files in the Head Office of the BSB as at January 1997.

Table 8.8 suggests that there was very poor compliance with loan conditions in all but one case. The BSB deputed 115 officers (BSB, Central Recovery Department 1998) as nominated directors in the Board of Directors (BODs) of the 185 industrial firms. This shows that the BSB had no nominated director in about 70 percent of the 627 firms which were included in its loan portfolio as at September 1996. Moreover, of these officers, 6 general managers were deputed for 15 firms, 15 deputy general managers were for 33 firms and 94 other officers were for 137 firms. However, the dearth of experienced managers constrained BSB's effective presence in the board of the firms.

The borrower survey showed that out of the 56 responding firms, 26 firms (46 percent) held BODs meeting in every quarter. One-fifth (11 firms) of them held up to two BODs meetings a year while 12 firms (21 percent) held only one such meeting in a year on average (Table 6.20). A little over one-tenth (13 percent) of firms did not hold any BODs meeting within a year. Such findings show non-compliance by the borrowers with contractual obligations to hold at least four BODs meeting in every year. Moreover, only 8 percent of the firms (Table 6.13) held BODs meetings in the presence of BSB representatives and very few firms sent minutes of their BODs meetings to the BSB which, again, breached their loan contract.

The main reason for BSB's low representation in the BODs meetings is that borrowers are reluctant to invite them to meetings of the management. Price Waterhouse (1984) found that borrowers were resentful of the BSB's advisory role in the management of the enterprise as they thought it was an attempt to interfere with their management prerogative. But such contention was contradicted by the survey results which showed that only 25 percent of the 56 firms which responded (Table 6.21) opposed the participation of the BSB in the management.

Interestingly, there is no single firm which was reprimanded by the BSB on the ground of non-compliance with contractual obligations to hold company board meetings though BSB issued couple of reminders to few firms to hold such meetings. Equally, it did not punish any firm for not providing minutes of the BOD meetings or annual accounts to the bank as per loan contract. This indicates that BSB's involvement in the management of firms was far from adequate and firms were left unsupervised and uncontrolled for matters of operational and financial management which has increased the risks of loan default.

This is evidenced by the loan repayment performance of small and large firms financed by the BSB. While small firms tend to hire few trained managers or professionals (since they are mostly managed by the owners themselves, family members and relatives), large firms hire relatively larger numbers of managers and professionals. Bakht (1984) surveyed 1205 firms in Bangladesh and found that those enterprises which hired managers were of relatively large size.

As the large firms are relatively better managed than the small firms, their loan repayment performance is expected to be relatively better than small firms. This is found to be true in case of BSB. Small firms, which constitute about two-thirds (71 percent) of 304 firms surveyed, repaid 15.99 percent of their total outstanding dues compared to 27.99 percent of total outstanding dues repaid by the large firms (Table 8.5). It turns out that by participating in the management of the firms or compelling the

firms to comply with the loans conditions spelt out in Table 8.8, the BSB could make a difference in terms of improved loan repayment performance by its financed-firms. The BSB could improve firm management skills of the borrowers by organising and conducting management training programs. The majority (85 percent) of the 52 responding borrowers expressed interest for such training (Table 6.21). As the borrowers did not receive any training regarding firm management from the BSB, they were not able to run and manage the firm efficiently which constrained them to earn sufficient income to service the debt. Thus, insufficient management of the firms together with BSB's inadequate participation in it constitutes one of the reasons for increasing loan default risks which supports hypothesis H16.

8.7 Summary

The primary objective of this chapter was to examine the relationship between the flawed developmental role and industrial loan default. For this purpose, eight hypotheses involving eight explanatory variables were tested. Several conclusions can be drawn from their results.

1. There is no guarantee that an export-orientated industry (EOI) will repay loans more than an industry not engaged in export business. While providing term finance, the BSB preferred EOIs to other industries; but some firms in the EOI repaid less than non-exporting firms. This suggests that BSB's selection of some export-orientated firms for term loans was flawed.
2. Firms belonging to import-substituting industry (ISI) repaid relatively more than EOIs. It indicates that the loan direction to ISI was justified. However, there were some import-substituting firms which showed very poor repayment performance.
3. The BSB provided term loans to some industries, such as ARMs, cold storage, textile mills and water transport which experienced problems of excess productive

capacity. Loans allocation to such industries exacerbated the problems of capacity utilisation since financed projects had to operate at below capacity and, as such, had to experience low cash-flow problems which reduced borrowers' debt servicing capacity.

4. Better loan repayment performance was not associated with smaller loan amount or smaller size of the firm. BSB's decision to supply term finance to large firms was not faulty since loan repayment performance by them was better than that by small firms.
5. BSB's involvement in the work of project implementation was highly inadequate which delayed commencement of commercial production. In the absence of adequate entrepreneurial guidance from the BSB, the inexperienced entrepreneurs had to rely on their limited knowledge and experience to bring the project into fruition which inordinately delayed and faltered the commencement of production. As the borrowers could not generate income in time, they defaulted in repaying loans.
6. BSB's supervision and follow-up of its financed projects at the time of project implementation, such as building construction and machinery assembling, were highly infrequent, unsystematic and unorganised. This raised the costs of loans in terms of delayed commencement of production and of a growing level of interest burden. Being deprived of BSB's professional supervision and follow-up, firms were found to be directionless and were unable to have best use of resources to generate sufficient income to repay loans.
7. Monitoring of the project at all stages received little attention from the BSB. Though a monitoring mechanism was in place, it was never put into satisfactory effect. BSB was very busy with loan recovery rather than understanding and addressing the problems of the financed projects. It was found that better monitored firms repaid more loans than poorly monitored firms.

8. Dearth of efficient management skills among the borrowers was exacerbated by the BSB's failure to police its own regulations regarding efficient project management. It was found that better managed firms were large firms which repaid more loans than small firms which were plagued by management problems.

It appears that out of eight hypotheses, six were supported and two were rejected. These findings suggest that the developmental role played by the BSB was flawed. The study indicated that as a development bank, the BSB was an under-performer; it did not use its available resources while working as a catalyst towards success of its financed enterprises as was done by its most successful counterparts in developed and developing countries. The industrial credit delivered by it was not accompanied by adequate and efficient entrepreneurial guidance, supervision and direction. Its developmental role was mostly passive rather than active which constructed impediments against successful implementation, operation and management of industrial firms. As its involvement were least participative in all stages of firm life and insufficiently instrumental in developing successful entrepreneurship, inexperienced borrowers were not able to generate sufficient income to service the debt they owed to the BSB. Eventually, they defaulted in repaying industrial loans, given that they were willing to repay loans. This supports principal hypothesis PH2 and validates Part II of the theoretical model developed in Chapter 4.

CHAPTER NINE

TESTING THE MODEL - PART 111A:

FLAWED PUBLIC POLICIES AND INDUSTRIAL LOAN DEFAULT

9.1 Introduction

Public policy is a crucial factor which influences borrowers' ability and willingness to repay industrial loans. It is the Government of Bangladesh (GOB) which is responsible for creating conditions and circumstances that induce and influence profitable operation of industrial concerns. This suggests that GOB's policy intervention makes impact on the pace, structure and efficiency of the industrialisation process. Adverse and inconsistent changes in public policies can make borrowers unwilling to repay loans. At the same time, they can create impediments against profitable operations of industrial firms which, no doubt, reduce borrowers' ability to repay loans. This results in industrial loan defaults.

As such, consistent and adequate public policy intervention is required to increase borrowers' ability and willingness to repay loans. As the efficiency of private sector industry depends on flawless public policies, it is highly possible that loan default may surface as a by-product of the inconsistencies and inadequacies in public policies. Flawed public policy can trigger inefficiency in the financial and developmental roles of the BSB. Consequently, industrial firms financed by the BSB may not be able to withstand adverse effects of flawed policies and they may experience loan default.

In Chapter 9 and Chapter 10, the contribution of flawed public policies to the industrial loan defaults has been examined through testing of two principal hypotheses, i.e., PH3 and PH4. While PH3 relating to flaws in monetary, import and fiscal policy regimes is tested in Chapter 9, PH4 relating to industrial policy, regulatory policy and policy

relating to the management of the BSB is tested in Chapter 10. These policy variables were included in Part III of the model developed in Chapter 4. At first, the relationship between industrial loan defaults and flaws in monetary, fiscal and import policy regimes is examined in the form of testing the following principal hypothesis (PH3).

PH3 Monetary, fiscal and import policies pursued by the Government of Bangladesh were inconsistent and inadequate which increased the chance of industrial loan default.

Again, the validity of the PH3 is examined through testing of following four hypotheses.

H17 Interest rate policy was flawed and inconsistent with the industrialisation policy objective which contributed to loan default.

H18 Foreign exchange rate fluctuation increased the risks of industrial loan default.

H19 Import policy was not consistent with and supportive of industrial policy which contributed to increased risks of loan default.

H20 Tariff policy created an increased tariff burden which reduced the debt service capacity of industrial entrepreneurs.

This Chapter is divided into several sections. While introductory aspects are presented in Section 9.1, Section 9.2 deals with testing of hypotheses relating to interest rate policy and foreign exchange rate policy. Section 9.3 focuses on hypothesis testing relating to import policy. The testing of hypothesis relating to tariff policy is presented in Section 9.4 and summary is provided in Section 9.5.

9.2. Monetary policy

Monetary policy has many constituents such as interest rates policy and foreign exchange rate policy which have direct influence on the loan repayment performance of private manufacturing firms. The institutional framework of monetary policy in Bangladesh is confined to the bureaucrats (Rahim 1977) stationed in the Ministry of Finance, GOB. There were no credit councils or advisory agencies staffed by the experienced policy makers to formulate and execute monetary policies relevant to and supportive of industrialisation efforts in Bangladesh. To what extent flawed monetary policy was responsible for industrial loan default can be sensed from the discussion about interest rate policy and foreign exchange rate policy pursued by the GOB.

9.2.1. Interest Rates Policy

H17 Interest rate policy was flawed and inconsistent with industrialisation policy objective which contributed to loan default.

Interest rates policy in Bangladesh is administered by the Bangladesh Bank (BB) - central bank - which functions as the adviser to the GOB in respect of monetary policy (Taheruddin 1977) and as an arm of the Ministry of Finance, GOB. As a policy-taker and as a state-owned IDFI, the BSB is required to follow the interest rate policy directives of the BB. In addition, the BSB has also been used to receiving interest rate policy directives from the Ministry of Industries from time to time. Based on these two sets of policy directives, the BSB sets interest rates for local and foreign currency loans as follows.

Interest rates by following BB's directives

Before 1989, the BSB used to charge borrowers two types of interest rates for local and foreign currencies on the basis of the Bank Rate (BR) fixed by the BB from time to time. Usually, it followed the following formula.

For Local Currency Loans

The interest rate was calculated at a rate 3.5⁸⁶ percent above the BR subject to a specified minimum interest rate (e.g., 14 percent) per annum payable at half-yearly instalments. This formula leaves the borrower liable to increasing debt-servicing costs over the life of the project

For Foreign Currency Loans

The interest rate was calculated at a rate 3.5 percent above BR fixed by the BB subject to a minimum interest rate as specified in the re-lending terms of the foreign credit line⁸⁷. The foreign currency loan of the project is repayable on a half-yearly basis. This formula leaves the borrowers with the risks of increased debt-burden at the time of devaluation of local currency or appreciation of foreign currency.

Interest rates by following Industrial Policy

The Ministry of Industries, GOB, also directs the Industrial Development Financial Institutions (IDFIs), such as the BSB, to charge interest rates which are entirely different from those directed by the BB. For example, the revised industrial policy (RIP) of 1986 recommended interest rates on industrial term loans as per criteria specified in Table 9.1.

⁸⁶ It varied from 3 to 4 percent depending on the economic circumstances and minimum interest rates charged varied between 12 and 18 percent.

⁸⁷ Foreign currency is supplied by the MFIs such as The World Bank, Asian Development Bank, etc. which charge different interest rates.

Table 9.1
Interest Rates Charged as per RIP 1986
(Figure in Percentage)

Debt-Equity Ratio	Developed Area	Less Developed Area	Least Developed Area
Up To 60:40	12	12	11
Above 60:40 & Up To 70:30	13	13	12
Above 70:30 & Up To 80:20	Not Applicable	13.5	12.5

Sources : GOB, Industrial Policy 1986, Ministry of Industry and Bangladesh Bank's BCD Circular No. 20. Dated July 7 1986.

It appears that the above interest rates were recommended by the RIP 1986 on the basis of the debt-equity ratio and the location of the firm. For example, projects with 70:30 debt-equity ratio located in a developed area attracted 13 percent interest which was higher than that (11 percent) paid by project's with 60:40 debt-equity ratio located in the least developed area.

In addition to these criteria, the rate of interest on term loans to service industries such as hotels, restaurants, cinema houses, hospitals and medical clinics, was fixed in the RIP 1986 at 16 percent irrespective of their size and location. Interest rates on EOIs were recommended to be 1 percent lower than other industries.

However, according to the RIP 1986, interest rates on small industries involving total investment up to Taka 15 million or investment in machinery and equipment not exceeding Taka 10 million were to be charged at 10 percent per annum irrespective of debt-equity ratios (Bangladesh Bank, BCD Circular No. 20, 7 July 1986), location and type of industry other than the service industry. The fixation of high interest rates by the GOB through IP directives was not consistent with market driven interest rates and

with the industrialisation objective of the GOB. The policy of requiring the firms to pay interest at a fixed rate has not only increased firms' debt burden but also deprived them from benefits which they could reap at the time of lower rates of interest in future.

However, among these two sets of policy directives regarding interest rates on term lending, the BSB imposed that interest rate which was the higher of the two. For instance, against 13 percent interest rate for the industrial projects located in developed areas with a debt-equity ratio between 60:40 and 70:30 recommended in the RIP 1986, BSB charged 15 to 18 percent interest for 78 projects by following the BR fixed by the BB. Table 9.2 represents a fraction of these projects financed by the BSB.

Table 9.2
Industrial Projects Paying High Rates of Interest

(Figure in Percentage)

Name of the Firm	Interest Rate to be Charged as per RIP 1986	Interest Rate Charged by the BSB
High Speed Ship Building and Heavy Engineering, Narayangonj	13	17.25
Nahid Cotton Mills, Dhaka	13	18.50
Bangladesh Chemical Industries, Dhaka	13	17.25
Nurul Huda Bhuyan and Company, Brahmanbaria	12	18.00
Jenia Textile Mills, Comilla	12	16.50
Qader Synthetic Fibre, Dhaka	13	17.00

Source: BSB, Documentation Department (Letter No. 43.02.642, 23 October 1993)

It appears that BSB charged interest at 16.5 -18.5 percent which was 4-6 percent higher than those fixed in the RIP 1986. The fixation of interest rate on term loans in such a manner continued until a new industrial policy (NIP) was announced in 1991. This meant that some of the industrial firms which received term loans between 1986 and 1991 paid interest at a rate much higher than those indicated in the RIP 1986.

Another example of policy inconsistency was the rates of interest imposed on small firms. As per directives of the BB, interest rates for small firms were supposed to be 10 percent in 1986 (Bangladesh Bank, BCD Circular No. 20, July 7 1986). But by following RIP 1986, the BSB charged small firms interest at 14 to 16 percent which was higher than that (10 percent) recommended by the BB. Table 9.3 reflects the position of some of these small firms.

Table 9.3

Interest Rates on Term Lending to Small Firms

(Figure in Percentage)

Name of the Firm	Interest Rate Recommended by BB	Interest Rate Charged by the BSB
Ellie Biscuits Ltd.	10	14
Sonali Silk Mills Ltd.	10	14.5
Protiva Printers Ltd.	10	14
Shanti Clinic Ltd.	10	16
Pulak Cinema Ltd.	10	16
Mohakhali Plaza Ltd.	10	16
Oram Ltd.	10	16

Sources: BSB, Loan Accounting Department (Letters Nos. 9/119/10079 and 09/106/4872, 21 March 1990 and 12 December 1993 respectively) and Documentation Department (Letter No. 40.02/642, 28 October 1993).

Table 9.3 shows that seven small firms were charged interest rates ranging from 14 percent to 16 percent which were higher than those prescribed by the BB. In addition to the above rates of interest on the principal term loans, the BSB charged defaulting borrowers with the same rates of interest on the amount defaulted. In other words, loan amounts not duly paid become capitalised on which interest was charged at the same rate which doubled the debt burden. On top of this, the BSB charged liquidity damages or penal interest at 2 to 4 percent on the total overdues on a monthly, quarterly or half-yearly basis in order to discourage borrowers from becoming defaulters and to punish

wilful borrowers. When the interest rate on the principal loan, interest on capitalised dues and penal interest are lumped together, the effective interest on term lending shoots up beyond 30 percent! In fact, almost all borrowers had been paying higher rates of interest than those stipulated in the loan agreements (Cookson 1997).

The problem associated with high effective rates of interest has been indirectly recognised by the BSB. Since late 1980s, it has been executing the programs of interest forgiveness in order to ease debt burden on the borrowers. Between June 1991 and June 1998, it provided interest amnesty amounting to Taka 1.359 billion which were supposed to be collected from 206 firms it financed (BSB, MIS Department 1998).

Although flexible and low real rates of interests are required for the success of an economy (Goyal 1997), the interest rate policy of the GOB led the BSB to charge relatively higher interest rates on term lending throughout the loan period. Moreover, such interest rates remained fixed from the time of documentation to the time of full liquidation of the loans (BSB, Minutes⁸⁸ of the Board of Directors 1993). Industrial borrowers became casualties of this fixed interest rate policy in terms of loan-default. When BR or base lending rate went down and, consequently, interest rates declined, industrial firms were not able to enjoy the benefit of lower interest rates due to the prior loan agreement with the BSB to pay a fixed interest rate until all loan liabilities are liquidated. Rather, they had to pay, at times, higher interest rates than those prevailed in the market.

This policy of charging firms high as well as fixed interest rates in contravention of GOB's policy directives has been a contributing factor for the growth of firms' debt burden. Table 9.4 presents a snap shot of the debt burden of some firms which, despite repayment of substantial amount of the loans, were dogged by higher interest rates.

⁸⁸ This minutes was recorded on March 6 1993 (BSB, Project Implementation Department, Letter No. 44.5(35)/90, 20 April 1993).

Table 9.4
Debt Burden of Selected Projects as at September 1996
(Taka in Thousand)

Name of the Firm	Loan Received	Loan Repaid	Loan Outstanding
Sea Lord Cinema Ltd.	2,180	4,350 (99.54)*	331
S.K.M Jute Mills Ltd.	9,043	38,794 (328.99)	21,863
R.R. Cold Storage Ltd.	5,343	12,319 (130.56)	687
Quashem Dry Cell Ltd.	21,306	48,353 (126.95)	29,372
New Eastern Cold Storage Ltd.	9,644	17,668 (83.20)	6,727

Note: * Figure in parenthesis shows percentage of term loans repaid in excess of original amount of term loans.

Source : BSB, MIS Department. Data were compiled by the author.

It is evident from Table 9.4 that though the above firms repaid between 83.20 percent and 328.99 percent loans in excess of the original term loans they received from the BSB, they were required to repay huge outstanding dues as at September 1996. For example, despite repayment of about Taka 38.794 million against a loan of Taka 9,043 million, the S.K.M Jute Mills had an outstanding loan of Taka 21.863 million as at September 1996. This was mainly due to the imposition of interest at 18 percent on this project.

BSB's policy of charging budding entrepreneurs with high interest rates by taking advantage of GOB's interest rate policy inconsistencies does not fit well with its developmental role (Hoque 1998). It appears that BSB behaved more like a commercial

bank than a development bank which is functionally different from the former. The imposition of higher interest rates on term lending drew fire from the Finance Minister, Mr. Saifur Rahman, in September 1994; he issued directives to the banks to cut their lending rates within one month and threatened to cap rates if they failed to comply (EIU, Country Report, 1st Quarter 1994). But such directives had little effect as the BSB continued, along with commercial banks, to charge 10 to 17 percent interest rates on term lending (EIU, Country Report, 1st Quarter 1994).

The reasons behind BSB's charging of higher interest rate were many and prominent of them were two: one was the high cost of borrowing from the GOB and other was rising level of loan loss due to existence of a large number of non-performing firms and extremely low loan recovery rate from the performing firms. As regards the borrowing from the GOB, it is to be mentioned here that the BSB borrows from the GOB at a rate agreed by both the parties. In fact, GOB re-lends funds it receives from MFIs such as the World Bank, ADB and IDB at token interest rates⁸⁹. For example, the International Development Association (IDA) - an affiliate of the World Bank - provided term loans to the GOB at an average interest rate of 0.9 percent during the early 80s⁹⁰ (Sobhan 1990). Other examples are ADB and IDB⁹¹ which provided term loans at 1.1 percent interest rate and 0.6 percent service charge respectively.

The BSB borrowed these foreign funds from the GOB at a high interest rate. This is evidenced by its interest rate expenditures shown in Table 9.5.

⁸⁹ The GOB pays between 0 to 2.5 percent interest rates and service charge for 95 percent of its total foreign loan portfolio (Sobhan, 1990, p.90).

⁹⁰ IDA ceased supplying credit to the GOB in 1983 on the ground of extremely high default rate.

⁹¹ IDB does not charge any interest but imposes a service charge on term lending.

Table 9.5
Interest and Non-interest Expenditures of the BSB
(Taka in Million)

Year	Interest expenses	Non-interest Expenses⁹²	Total
1990-91	411 (84)	81 (16)	492 (100)
1991-92	462 (83)	94 (17)	556 (100)
1992-93	429 (80)	106 (20)	535 (100)
1993-94	401 (78)	113 (22)	514 (100)
1994-95	365 (76)	116 (24)	481 (100)
Total	20687 (80)	510 (24)	2578 (100)

Note : Figure in parentheses indicate percentage.
Source: BSB, Central Accounts Department. The author computed some of these figures.

It is evident from Table 9.5 that between 1990-91 and 1994-95, interest expenditures claimed four-fifths (80 percent) of the total expenses incurred by the BSB. It meant that the largest stake of the cost of running the operation of the BSB was claimed by the interest paid to the GOB. The benefits emanating from low interest rates or service charges paid on foreign borrowing were not passed on to the industrial borrowers via the IDFI's such as BSB. Consequently, interest rates charged by the BSB far exceeded those paid by the GOB on foreign borrowing.

It is to be mentioned here that following the recommendation of the NCMBC, the BB introduced regulations requiring the banks and IDFI's such as the BSB to classify their overdue loans and advances into sub-standard, doubtful and bad loans. The standard set for overdue loan classification is one year for sub-standard, three years for doubtful and four years for a bad loan or loan loss. Until June 1994, BSB used to keep a lump sum provision for bad and doubtful loans and the amount it earmarked against such provisions averaged Taka 100 million per annum between 1990-91 and 1993-94 (Hussian 1996). But after rigorous application of the central bank's rules relating to

⁹² Non-interest expenses include salary, rent, tax, insurance and payment for utilities.

overdue loan classification from 1 July 1994, the figure for bad and doubtful loans jumped to Taka 399 million in 1994-95 alone (BSB, Central Account Department 1996). As the volume of bad loans or loan loss grew⁹³, the BSB had to raise interest rates to cover the loss.

The World Bank (1996) mentioned that a Bangladeshi bank assuming 40 percent of loans to be non-performing required a spread of 20 percent between lending rates and the bank's costs of funds just to break-even. Owing to the existence of a large number of non-performing firms (201 firms) as well as high default rates, BSB resorts to high interest rates which, again, compounds the default rate. In this way, BSB is caught in the vicious circle of high interest rate and high loan default rate.

The other reasons for high interest rate were the high rates of return on some of the public savings instruments (World Bank 1995b, p.134) such as National Savings Certificate, liquidity crunch created by the GOB's borrowing from the banking sector and widening of spread between interest rate on deposits and interest rate on advances made by the commercial banks⁹⁴. These factors, though are not controllable by the BSB, have provided enough ground to charge high interest rates.

How high interest rates charged by the BSB worked as one of the contributing factors for lower rates of loan recovery (which is the inverse of higher loan default rate) can be grasped from Table 9.6. It shows that of the 304 firms studied, 88 firms which received term loans at 10 percent annual interest rates repaid 33.17 percent of the amount due by September 1996. On the other hand, 104 firms which received term loans at 14 percent annual interest rates repaid 23.74 percent of the amount due

⁹³ Other banks had also experienced rising level of loan loss. Cookson (1997) found that loan losses in the state-owned commercial banks and private commercial banks were Taka 18 billion and 8 billion respectively during 1997.

⁹⁴ Mahmud (1995) and Ghafur (1995) found that the spread between the interest rates on deposits and advances has increased since 1991.

during the same period. In other words, firms charged with high interest rates (i.e., 14 percent) repaid relatively less of debt than those charged with relatively lower rates (i.e., 10 percent) of interest.

Table 9.6
Debt Repayment by Industrial Firms as at September 1996
(Taka in Million)

No. of Firms	Average Annual Interest Rates	Total Loan Due	Total Loan Repaid	Average Percentage of Total Loan Due Repaid
(1)	(2)	(3)	(4)	(4)/(3)*100
88	10	504.59	167.39	33.17
12	11-12	152.87	67.36	44.06
22	13	1,106.28	408.91	37.00
104	14	3,083.49	732.16	23.74
78	15-18	1,724.77	781.18	45.29

Source : BSB, MIS Department. Data were compiled and computed by the author.

If the BSB could charge interest at 10 percent by following the BB's instruction, the level of overdues from small firms would have been smaller than those with 14 percent interest rates, provided that borrowers were willing to repay the loans.

However, 78 firms which were charged with annual interest rates between 15 percent and 18 percent repaid more than other firms charged with relatively lower interest rates. It may be mentioned here that the majority (67 percent) of these projects belong to the non-manufacturing or service sector such as hospitals, cinema halls, medical clinics, and cargo and passenger vessels which are engaged in cash business. As such, their repayment performance is not strictly comparable with that of firms in the manufacturing sector.

It is also evident that more than half of the total loans due belong to 104 firms paying interest at 14 percent in the manufacturing sector. If their loan repayment performance is compared with the other 88 firms in the manufacturing sector, the above finding that a higher interest rate is positively related to a higher incidence of loan default is reinforced. Several studies (World Bank 1995b; Bangladesh Industrialists' Association 1985; Sobhan 1991a; Hassan 1995; Cookson 1997; and EIU, Country Report, 1st Quarter 1994) found that a high interest rate was one of the contributing factors to loan default in the industrial sector, particularly in the manufacturing sector in Bangladesh.

From the foregoing analysis it appears that loan default could not solely be attributed to borrowers' unwillingness to repay loans; it was also an in-built problem of the interest rate policy. In other words, interest rate policy was both a cause and an effect of the high loan default rate in Bangladesh (Hoque 1998 and 1999c). As high interest rates increase costs of borrowing, debt burden grows which leads borrowers to default and, as loan default becomes persistent, the BSB loses income and becomes undercapitalised. In order to recover its financial position, it resorts to high interest rates and the cycle is complete.

The borrowers are to bear the brunt of this inconsistent interest rate policy. In the borrower survey, almost all (93 percent) of the 56 responding firms identified high interest rates as one of the causes for increased level of debt burden (Table 6.22). All these indicate that interest policy inconsistencies and anomalies worked as one of the contributing factors for industrial loan default which supports hypothesis H17.

9.2.2 Exchange Rate Policy

H18 Foreign exchange rate fluctuation increased the risks of industrial loan default.

The management of foreign exchange rate (FER) remains an important monetary policy instrument in Bangladesh. The GOB borrows foreign currency loans from the MFIs such as the World Bank and re-lends those to the BSB which disburses them to the industrial entrepreneurs for importing plant and equipment. Although the bulk of these foreign currency loans is denominated in the US dollar, some loans are also provided in terms of other foreign currencies such as Deutch Mark and Swiss Franc depending on the origin of imported capital goods. As the borrowers are required to repay foreign currency loans in terms of equivalent Taka, their debt level increases or decreases with every devaluation and appreciation of Taka respectively. This means that the fluctuation of FER influences the borrowers' financial capacity to repay loans. Sobhan and Ahsan (1987) found that borrowers' debt burden soared as a result of the depreciation in the value of the Taka. This was because of the fact that as the Taka depreciated, the borrowers had to repay more Taka for the same amount of foreign currency loan and, thus, the debt burden increased with every devaluation of the Taka.

This is explained by a simple example. Say, a male entrepreneur borrowed one thousand US dollars from the BSB to buy spares from the U.S.A in 1980 at an exchange rate of Taka 15.454 (Table 9.7). When the value of Taka depreciated to Taka 34.569/US\$ (Table 9.7) in 1990, his principal debt burden grew by 123.68 percent (i.e., to Taka 34, 569 from Taka 15, 454) at the end of ten years, assuming that he repaid nothing within this period. In fact, the loan liability would grow more and more if the normal rate of interest on both original loans, and capitalised dues and penal interest - which have a cumulative effect -are taken into account. Even if borrowers repay loans in time, the loan liability will continue to rise with the devaluation of Taka if they are required to

repay loans in foreign currency rather than local currency. This is akin to Murinde's (1996) argument that 'where loans are denominated in foreign currency, devaluation of the exchange rate makes debt service almost impossible' (p.226).

Unlike its counterparts in developed countries such as Australia, the GOB followed a fixed exchange rate policy until 1992. Under increasing pressure from the International Monetary Fund (IMF) to liberalise the foreign exchange regime, the GOB pursued managed exchange rate policy from 1993 instead of a flexible exchange rate policy. Regardless of these policies, the value of the Taka continued to depreciate due to continued trade deficits and weak macroeconomic fundamentals.

It is evident from Table 9.7 that the Bangladesh currency - Taka - has been sliding down since 1973 and there had been few instances of its appreciation since then. Over the period between 1971 and 1994, the Taka was devalued by more than 400 percent.

Table 9.7

Annual Average Value of Taka Per US\$.

Year	Rate	Year	Rate
1971	7.761	1983	24.615
1972	7.594	1984	25.354
1973	7.742	1985	27.995
1974	8.113	1986	30.405
1975	12.019	1987	30.950
1976	15.347	1988	31.733
1977	15.375	1989	32.270
1978	15.016	1990	34.569
1979	15.552	1991	36.596
1980	15.454	1992	38.951
1981	17.987	1993	39.567
1982	12.118	1994	40.212

Source: International Monetary Fund, International Financial Statistics Year Book, Various Years.

Between 1973 and 1976, the value of the Taka fell by 98.23 percent and borrowers who received loans within those three years had to repay about double the amount of the principal loan as well as the interest burden. Moreover, as the devaluation is equivalent to new taxes (Ali 1995), it increased the price of imported capital goods (Mahmud (1995) which increased the loan liability. Sobhan and Ahsan (1990) found that more than half (53 percent) of the sample industrial firms financed by the IDFI's experienced cost escalation in 1986 due to the upward trend in the value of foreign exchange.

It should be pointed out here that borrowers were disenchanted with the persistent devaluation of the Taka and its consequential effect on the rising debt burden. In a bid to resolve the default problems created by massive devaluation, the Bangladesh Industrialists' Association (1985) submitted the following memorandum to the NCMBC:

“... the DFIs have been calculating debt liabilities with devaluation effects to the extent of 600-700% inflating the principal loan amount to a frightful figure which has sickened the projects incapacitating forcibly all the more promoters in repayment of liabilities... and thus the DFIs have thrust upon the old and sick projects huge loan liabilities including the high rate of interest” (p.2).

The GOB recognised this problem and introduced the Exchange Rate Fluctuation Burden Absorption Scheme (EFAS) on 28 August 1983 which was again revised on 27 December 1984 to ‘ protect all the term foreign currency loans against the risks of exchange rate fluctuations and to provide relief to the existing borrowers of long term foreign currency loans from the burden of adverse impact of exchange rate fluctuations’ (GOB, The Bangladesh Gazette 1984, p. 1).

Under the EFAS, past and present borrowers receiving industrial loans before or after 1983 were allowed to convert their foreign currency loan liability into local currency loan liability which would protect them from exchange rate fluctuations. But there was

a catch. Borrowers were required to pay a premium of 2.5 percent per annum on the initial loan amount and, thereafter, on the outstanding loans. If the borrowers were in default after the documentation for the EFAS was complete, an additional penal interest at the rate of 2.5 percent over and above the prevailing penal interest rate (which was applied on the amount of loans not serviced on due date) was charged by the BSB until the borrower repaid all such dues. Further, defaulter-borrowers had to make a down-payment of at least 5 percent of the overdue loans before they completed the documentation for EFAS facilities. The EFAS facility was available until June 1988.

Though EFAS apparently insulated the borrowers from the devaluation of Taka, it was an ad hoc policy measure and it created distortion in the foreign exchange market and increased the market imperfection in an already inefficient financial market (Sobhan and Ahsan, 1987). Moreover, the benefits of EFAS were outweighed by the increased level of customs duty. It can be seen from Table 9.9 that the calculation of customs duty on highly over-estimated trade values (TVs) and supplementary duties of imported industrial raw materials had increased the duty burden which would wipe out much of the benefits of EFAS.

The effect of FER fluctuations on loan repayments is examined by comparing the rate of loan recovery from firms having foreign currency loans with that of firms having only local currency loans. It appears from Table 9.8 that of the 304 performing industrial firms financed by the BSB, 170 firms received loans in foreign and local currency and 114 firms received loans only in local currency. There were 20 firms which received foreign currency loans only.

Table 9.8**Loan Repayment Performance of Firms Taking Foreign and Local Currency Loans From BSB as at September 1996****(Taka in Million)**

Currency	No. of Firms	Amount To be Repaid*	Amount Paid	Loan Recovery Rate (%)
(A). L/C Only	114	2,470.29	722.95	29.26.
(B) F/C & L/C	170	4,921.23	1,153.60	23.44
(C).F/C Only	20	1,086.48	280.45	25.82
Total	304	8478.00	2157.00	25.44

Notes: L/C = Local (i.e., Taka) Currency and F/C = Foreign Currency (e.g., US\$)

* It includes outstanding amount as at September 1996.

Source: BSB, MIS Department. Data were computed and compiled by the author.

These 170 firms (Group B) repaid 23.44 percent of what (Taka 4.921 billion) they owed to the BSB as at September 1996. If the repayment performance of 20 firms (Group C) which repaid 25.82 percent of the total outstanding dues is added to Group B, the loan recovery rate of 190 firms (Group B plus Group C) receiving both local and foreign currency loans dives down to 23.87 percent.

On the other hand, 114 firms (Group A) taking only local currency loans repaid 29.26 percent of the outstanding dues as September 1996. This clearly shows that the firms receiving foreign currency loans defaulted at a relatively higher rate than firms receiving local currency loans only. In other, words, foreign currency loans increased the risks of default for 190 firms due to persistent devaluation of the Taka. Hassan (1995, p.129) believed that depreciation of Taka was one of the principal factors responsible for loan overdue in Bangladesh. More than half (57 percent) of the 56 responding firms have made the Taka devaluation responsible for growing burden of debt (Table 6.22). This shows clear support for hypothesis H18.

9.3 Import Policy

H19 Import Policy was not consistent with and supportive of industrial Policy which contributed to increased risks of loan default.

In all industrial policies including the latest one, the GOB has made provisions to make import policies supportive of and consistent with industrial policies (GOB, Ministry of Industries 1992). Government has, during the 1980s, consistently attempted to simplify and liberalise its import regimes in spite of serious foreign exchange problems. But these policy measures conflicted with industrial policy measures (Hashem 1982). The sources of this conflict were two ministries. The Commerce Ministry sets and formulates import policy which sometimes comes into direct conflict with industrial policy which is formulated by the Ministry of Industries. For example, import liberalisation of certain products allowed some importers to underprice the products of local industries established in response to the encouragement given in the industrial policy.

Prior to 1984 industrial entrepreneurs were allowed to import industrial raw materials or components under cash import licences issued by the Office of the Chief Controller of Imports and Exports (CCIE), Ministry of Commerce, GOB. To obtain an import licence, individual industrial unit needed the recommendation of the Department of Industries⁹⁵ (DI), Ministry of Industries, GOB and using the DI's recommendation, the firm applied to the CCIE. Licences for industrial raw materials were valid for six months from the date of issue or date of registration of the licence with the central bank - BB - for the purpose of shipment. But the licence for parts and accessories for industrial machinery was valid for one year.

⁹⁵ The Department of Industries is now called Board of Investment

After a licence was obtained, the firm was given a foreign exchange allocation by the BB, Ministry of Finance, to open a L/C for importing raw materials through commercial banks. Thus, three Ministries of GOB were involved in arranging foreign currency for a firm to import its raw materials. Industrial importers were required to open L/C within three months of the date of issue of the licence (EIU, Country Profile, 1986-87). The utilisation of this facility was dependent on the financial condition of the industrialists. Those who could not arrange the necessary capital either from the firm, or from personal sources or from financial institutions, missed out on this facility and could not import the necessary raw materials and components.

Industrial importers were allowed to import raw materials on the basis of sanctioned capacity which was defined as the total capacity of the firm based on a single shift operating 300 days a year. Moreover, the type and quantity of raw materials and their entitlements were determined by the GOB depending on the priority it assigned to each individual industry. Such entitlements of raw material imports were registered in the passbooks of the industrial importers and they varied from firm to firm. This facility has caused the growth of "bogus firms" which held import licences but were not in production or had closed down (World Bank 1978). The Ganokantha (12 May 1973) reported that 15, 000 false licences were in the hands of bogus firms. In order to pacify the angry owners of genuine firms, the Ministry of Commerce cancelled only 123 of these false licences (The Ganokantha, 4 May 1973). The remaining false license-holders imported products which competed with those produced by the local firms. For example, textile yarn produced by local firms lost markets to the imported yarn and yarn producing textile mills suffered from inadequate cash flow which increased their debt burden.

It is to be remembered in this connection that when import of goods becomes relatively more profitable than engaging in the production of same goods, entrepreneurs opt for import business rather than industrial investment activities. Since trading activities pay more than investment activities, Bangladeshi industrial entrepreneurs tend to divert part

of their industrial loans to the import business (Hashem 1982). Siddiqui (1990) also found that Bangladeshi industrialists behaved like traders because of persistent inconsistency between import and industrial policies.

Under various import policies, industrial firms were not equally weighted in terms of being allowed industrial raw material import. The World Bank (1986, p.115) reported that 165 industries were awarded cash licences for 100 percent of their entitlement while 88 industries received only 50 percent and had to operate at only 50 percent capacity. Even those firms which were allowed 100 percent entitlement were able to import raw materials only for a single shift of operation. Sobhan and Ahsan (1990) reported that nearly one-third (28.9 percent) of industrial firms in Bangladesh had inadequate licences for importing industrial raw materials and spares.

However, firms exhausting their single-shift entitlement could request a supplementary licence which allowed them to import through the Wage Earner's Scheme (WES) and Export Performance Licence (XPL) scheme. The WES comprised the remittances made by the Bangladeshis working abroad⁹⁶ and firms could use this fund for importing industrial inputs. But they had to buy this remitted money at the foreign exchange rate determined by market forces and, consequently, they had to spend more money on imports other than those allowed by the cash licence which were available at the official exchange rate⁹⁷. Moreover, the paucity of local currency due to non-availability of funds either from personal sources or from financial institutions in the form of working capital loans (see case study seven) made the borrowers unable to buy foreign exchange from the market and, consequently, firms were starved for industrial inputs.

⁹⁶ Remittances of Bangladeshi expatriates rose to US\$ 1.3 billion in 1995-96 from US\$ 600 million in 1982-83 (Far Eastern Economic Review, Asia Yearbook, 1996, p. 88 & 1986, p.111).

⁹⁷ Official currency exchange rate was much lower than the market rate.

The XPL scheme allowed exporters to import goods up to a certain percentage of the value of their total exports. The percentage varied according to the priority attached by the GOB to each export industry. This import entitlement was transferable to commercial importers or industrial consumers. Under the raw material replenishment scheme, export -orientated industries (EOIs) were allowed to import more than their normal entitlement of raw materials provided in the XPL scheme.

These import facilities were abused by corrupt exporters who flooded the market with imported final products at the cost of making local industrial capacity idle. For example, fabric imported to make garments for exports is duty-free. It has been reported (EIU, Country Report No.1 1991, p.18) that some firms had been selling the duty-free fabric in the open market at a much lower price than that produced by the local firms. The *Jai Jai Din* (7 Jan. 1997) reported that white writing papers were imported under the name of newsprint which carries no import duty and this has left the Bangladeshi paper producers with huge piles of unsold white paper. Battacharya (1993) also found the existence of pilferage from the bonded warehouses⁹⁸. Alam and Rahman (1992) mentioned that sanitary products imported under import liberalisation programs flooded the local markets and ceramic-ware factories faced closure.

The availability of cheap imported finished goods prematurely exposed the local firms to competition from foreign firms and this resulted in the under-utilisation of productive capacity (GOB, Fourth Five Year Plan 1995). This is equally true for imported raw materials. For example, Karnafully Rayon Mills - the largest synthetic textile yarn producing firm in Bangladesh had a massive build up of stocks in 1985 because of over-supply of imported yarn by the EOIs. This led the Bangladesh Textile Mills Owners

⁹⁸ Under the bonded warehouse system, industrial raw materials free from any duty are imported under the bond that these would be processed as final products exclusively for overseas markets. Importers who are also producers are required to record details of import of raw materials and export of finished products in a passbook. It is very difficult to monitor pilferage of both the raw materials and final products from this bonded warehouse system (Islam and Quddus 1996, p.169). EIU (Country Report No 1, 1991, p.18) found that some of these raw materials and final products ended up in local markets which adversely affected the local competing firms.

Association to call for protective action (EIU, Quarterly Economic Review of Bangladesh, 1985). This vulnerability to imported products was also the concern of the 29 firms which responded to the survey conducted by the author. According to these BSB-financed firms which constitute 52 percent of the 56 responding firms, less protection against cheap imports have contributed to unsatisfactory loan repayment performance (Table 6.22).

Between 1984 and 1986, the GOB introduced many changes to import policy: all import permits except cash licences were abolished. However, the BOI certifies industry eligibility to import raw materials and these are subject to government controls (World Bank 1995b, p.70). These changes in the import policy were the recognition of the fact that past import policies were plagued by flaws which were unhelpful for efficient operations of industrial firms.

From 1986, firms could import those raw materials which were included in the “positive list” provided in the annual Import Policy Order (IPO). The World Bank (1986) reported that such restriction ‘hampered the development and diversification of new industries and product lines because any change in import goods had to be approved by various government bodies and specifically listed in the Import Policy Order’ (p.115).

The most significant change in the IPO since 1986 was the inclusion of a “negative list⁹⁹” supplemented by a “restricted list¹⁰⁰”. While “negative lists” contain the lists of items which are not permissible for import, the “restricted list” allows import of some items only after fulfilment of conditions specified in the IPO (GOB, The Bangladesh Gazette, Extra 1986, p. 8129).

⁹⁹ “Negative Lists” include items which are not permissible for import. For example, tooth paste is not importable.

¹⁰⁰ “Restricted List” means the list of items, the import of which is subjected to some restrictions. For example, bitumen is importable with clearance of the Ministry of Petroleum and Mineral Resources.

The categorisation of items under these lists has created problems for industrial concerns. A significant proportion of industrial inputs or raw materials were included in the “restricted list” and these items could not be imported unless permission was obtained from the relevant authority before opening a L/C. For example, gas-in-cylinder is an input of many industrial firms such as re-rolling mills. It could be imported only after clearance from the Chief Inspector of Explosives was obtained (GOB, The Bangladesh Gazette, Extra, 1986, p.8167). Among the hundreds of items included under the “restrictive list” another example was carbon-dioxide which could only be imported after clearance from the Director-General of Industries, Ministry of Industries.

Obtaining permission from a large number of bureaucrat-infested departments and ministries was a time consuming exercise. In mid-February 1993, Sir William Rylie, Executive President of the International Finance Corporation - an affiliate of the World Bank - told at a news conference that he was certain that the main obstacle to private investment in Bangladesh was the lethargic and inefficient bureaucracy (EIU, Country Report, 2nd Quarter 1993, p.24). The US Ambassador to Bangladesh pointed out that bureaucratic procedures, which hamper efficiency and interfere with private enterprise, would ensure that nothing changes and the country remains poor (EIU, Country Report, 2nd Quarter 1993, p.6).

Under the dominance of bureaucratic procedures, industrialists had to spend much of their valuable time running between different departments and ministries to obtain import licences or to discover the trade value of a particular imported raw material. Say, customs authority wants to know the decision from the National Board of Revenue (NBR) regarding the trade value of a particular imported product. NBR, in turn, will seek permission from the Ministry of Finance and Ministry of Commerce which will provide an opinion only after they receive information from the embassy of the country from which the product comes. In such a process much time is lost just to know the trade value of an imported product. Moreover, prices of raw materials may

move upward during the time spent in procuring permission for the import of required raw materials.

These factors may create shortages of industrial raw materials which may cause the firm to operate below capacity. GOB (Fourth Five Year Plan 1995) and Islam (1978) found that shortage of imported raw material led to the low capacity utilisation in industrial firms in Bangladesh. This suggests that flawed import policy was one of the reasons for low capacity utilisation in the firms financed by the BSB. Because of such impediments, firms had to suffer inadequate cash-flow generation which reduced their ability to repay loans and resulted in loan default. This supports hypothesis H16.

9.4 Tariff policy

H20: Tariff policy created an increased tariff burden which reduced the debt-service capability of industrial entrepreneurs.

Since an inappropriate fiscal policy is a common cause of economic stagnation (Huyser 1988, p.201), industrial growth in a country can be adversely affected by the flawed tariff regime. The GOB recognised that an industrial incentive system should be at the centre of the process of creating an environment in which greater private participation in industry is encouraged, and that industrial development should take place in a manner which uses resources efficiently (World Bank 1983). It is the tariff policy which is supposed to create a favourable environment to provide incentives and protection in the form of tax concessions for industrial advancement in Bangladesh.

These objectives are achievable only when the tariff structure is rationalised and aligned with the industrial policy objectives. For example, during the initial period of operations of certain industries, some degree of tariff protection and tariff incentives are required. The GOB has been aware of such requirements and it has been providing market

protection to some domestic industries up to four years (GOB, Guide To Investment 1996) against the onslaught of imported products through outright bans or restrictions or rising level of tariffs on the import of certain goods¹⁰¹. But the level of protection given to certain industries was not adequate and these industries either became too costly or ceased operations (EIU, Quarterly Economic Review of Bangladesh 1985).

An investigation into the effect of past tariff policies reveals that industrial growth in Bangladesh has been inhibited by the existence of persistent serious anomalies within the tariff structure (World Bank 1986). The sources of these anomalies were diverse duty treatment for imported machinery and components, and industrial raw materials according to the geographical location of industries. Table 9.9 shows that import duty on machinery and components imported by the firms other than EOIs in least developed area was charged at a lower rate (5 percent) in 1991 than those imposed on industries located in developed areas. Again, EOIs were charged a lower rate of import duty for importing machinery and equipment than those for non-EOIs. It also varied from least developed to developed area in 1991.

¹⁰¹ For example, increased import duties and sales tax were imposed on cement, refrigerators, milk, powder, televisions, electric motors, umbrellas, ball point pens, bicycle tyres, fertilisers and some types of textile yarns with a view to protect domestic industries producing these goods (EIU, Quarterly Economic Review of Bangladesh 1985, p.7).

Table: 9.9
Rates of Import Duty on Machines and Equipment

(Figure in percentage)

Item	Area	1982	1986	1991
Machinery and components for all industries except EOI	Developed	15%	20%	7.5%
Machinery and components for all industries except EOI	Less/least Developed Area	2.5%	2.5%	5%
Machinery and Equipment for EOI*	Developed Area	2.5%	2.5%	5%
Machinery and Equipment for EOI	Least/least Developed Area	2.5%	2.5%	2.5%

Notes: * No duty on 100 percent EOI. But EOI exporting more than 70 percent of the total annual production shall be entitled to enjoy the import duty shown above.

Source: Compiled from GOB's Guide to Investment in Bangladesh, Sep. 1982, Jan 1987 and Oct 1996.

Given the above structure of duties on machinery and components imported by the EOI and non-EOI located within developed, less developed and least developed area, it was very difficult to administer (Asian Development Bank 1991) these widely dispersed rates. The World Bank (1994) reported that growth of tariffs rates on imports of capital goods such as plant and machinery was very strong.

Although the GOB introduced value added tax (VAT) - an equivalent of sales tax - in 1996 on imported machinery and equipment and allowed tariff protection for new firms for four years (GOB, Guide To Investment 1996), it did not provide any transparent guidelines for customs duty fixation on imported industrial raw materials. Tariff fixation was vested with the NBR which determined duties and taxes. In the absence of clear guidelines towards costs of raw materials, the firms were put into the business of guessing which generated uncertainty in their cost and profit structures. There was a

lack of coordination between various government departments and the NBR regarding the quantity and nature of raw materials needed by firms and the types of products warranting protection. Moreover, the absence of an institutional mechanism to pass information on industry-wide requirements for tariff incentives and protection to NBR, and to oversee the execution of these incentives at customs points, made realisation of industrial growth objectives very difficult.

Though the GOB admitted the importance of tariff rationalisation (GOB, Guide to Investment 1996; and GOB, Industrial Policy 1992) no industrial policy addressed this pertinent issue of tariff administration. The GOB has instituted the Tariff Commission - a quasi-judicial body - to recommend appropriate tariff rates on the basis of submissions by the various industry group. Since it turned into a toothless organisation because of lack of any judicial power to implement its decisions, very few industrial bodies have approached it for tariff protection (Hashem 1982).

In the absence of an objective tariff policy, all decisions about tariff rates are being taken on an ad hoc basis by different ministries such as Ministry of Commerce, Ministry of Finance and Ministry of Industries. No one knows what will be the tariff rates on the imported commodities the next time. Whatever policy measures were taken in this regard were featured by ad hocism. For example, the GOB made provision in the 1994/95 national budget¹⁰² to lower import duties within a range of 7.5 - 50 percent on 148 basic and industrial raw materials and 1024 semi-processed materials (i.e., intermediate products) to stimulate domestic industry (EIU, Country Report, 1st and 3rd Quarters 1994).

This indicates that prior to 1995, industries had to pay customs duty at a rate higher than 7.5-50 percent on the import of 1172 (i.e., 148 plus 1024) industrial raw materials. As tariff rates, prior to 1995, on intermediate and semi- processed goods were higher

¹⁰² Finance Minister Mr. Saifur Rahman, while presenting the national budget for 1994/95, announced these tariff reductions in the National Parliament (EIU, Country Report, 3rd Quarter 1994, p.18).

(World Bank 1994; and Mahmud 1995) than those after 1995, industrial firms were to experience cost-escalation which reduced their ability to repay loans.

The problem of tariff anomalies has been exacerbated by the introduction of new taxes and duties such as advance income tax (AIT), supplementary duty (SD) and licence fee, in addition to VAT at the rate of 15 percent.

Table 9.10
Tariff Burden on Importers of Caustic Soda

Item	Value and Percentage	Tax on Actual Value of Imports	Tax on TV of Imports
Average Invoice Value	US\$ 230.00		
Tariff Value (TV)	US\$ 480.00		
Custom Duty (CD)	45 %	US\$103.50	US\$ 216.00
Value Added Tax (VAT)	15%	US\$ 50.03	US\$ 104.40
Advance Income Tax	2.50%	US\$ 5.75	US\$ 12.00
Licence Fee	2.50%	US\$ 5.75	US\$ 12.00
Total Payable Duties and Taxes		US\$ 165.03	US\$ 344.40

Source: The World Bank 1994, p.62

It is shown in Table 9.10 that the amount of tariff collected in the form of custom duty (CD) has increased manifold. The principal reason for the rise in tariff rates was the application of tariff values (TVs) which were estimated at a price several times higher than actual invoice value in international market. The GOB imposes CD, VAT, AIT, SD and licence fees on these highly inflated TVs and, consequently, the industrial importers have to make excessive tax payments on the imported industrial raw materials. Table 9.10 shows that imported caustic soda, which is a basic raw material in

dyeing textile mills, attracted tariff at the rate of US\$ 344.40 per metric ton in 1994 against US\$ 165.03 estimated on actual invoice value of import.

In this example, industrial importers had to pay tariff which was 108.66 percent higher than the supposed tariff burden. The reason for such a high tariff for caustic soda was the application of the TV which was estimated at US\$ 480 per metric ton. This means that TVs are a gross exaggeration of true prices of imported products in international markets. There were 11,800 tariff lines in 1994 and the GOB imposed highly overestimated TVs on 26 percent of the product lines. When TVs are inflated, all taxes and duties are also over-estimated since their calculation follows from over-inflated TVs. The GOB's Report of the Task Force (Vol.2 1991) also acknowledged that substantial distortions existed in the structure of tariffs in Bangladesh.

Despite widespread concerns among industrial entrepreneurs about high TVs and high CDs on imported raw materials and intermediate goods, GOB could not reduce the tariff burden to a reasonable level because of persistent conflict between revenue goals and industry protection goals. The GOB is to rely very much on tariff revenue due to the fact that the direct tax base is extremely narrow in Bangladesh. This is evidenced by the lower proportion of income tax in the total tax make-up. Table 9.11 shows that in fiscal 1990/91, revenue from income tax constituted 18.27 percent of total revenues. Chowdhury (1995) found that less than one percent of the population in Bangladesh pays personal income tax. Ahsan (1995) reported that corporation tax, income tax and land tax together constituted less than 2 percent¹⁰³ of GDP in the early nineties. Owing to such small tax revenue from non-tariff sources, the GOB resorted to more tariffs, such as customs duties, excise duties and sales tax to reach the ever-increasing national revenue target set out in the annual national budget.

¹⁰³ Until 1992, corporate tax and personal income tax comprised 0.85 percent and little over a one-quarter of a percent of GDP respectively. In the early sixties, land revenue yielded in excess of one percent of GDP, but it dropped to less than one-half of a percent of GDP in early nineties (Ahsan 1995, pp. 209-214).

Table 9.11**Import Duties and Income Tax Collected by the GOB****(Taka in Billion)**

Year	Customs	Excise tax	Income Tax	Sales Tax	Total Tax
1979-80	6.25	2.09	0.98	2.63	11.95 (50.30)
1980-81	6.43	3.15	0.74	2.56	12.88 (49.92)
1981-82	8.27	4.54	3.10	3.22	19.13 (43.23)
1982-83	10.39	4.99	4.32	2.71	22.41 (46.36)
1983-84	9.54	6.03	3.18	3.56	22.31 (42.76)
1984-85	11.83	6.92	3.86	4.46	27.07 (43.70)
1985-86	13.39	7.72	4.62	4.61	30.34 (44.13)
1986-87	15.42	9.12	5.53	5.39	35.46 (43.49)
1987-88	16.54	11.72	6.64	5.43	40.33 (40.01)
1988-89	18.43	13.77	6.70	5.04	43.94 (41.94)
1989-90	21.39	16.44	7.82	6.32	51.97 (41.16)
1990-91	23.63	17.65	11.00	7.93	60.21 (39.24)
1991-92	27.15	14.30	12.35	0	53.80 (50.46)
Total	188.65	118.44	70.84	53.86	431.80(43.69)

Note: Figure in parenthesis indicates percentage of customs duty

Source : EIU, Country Profile 1989-90 and 1993-94. Total Figures and percentage were calculated by the author.

It appears from Table 9.11 that custom duty constituted 43.69 percent of the total tax revenue and it grew by about 14.94 percent per annum on average between 1985-86 and 1989-90. The World Bank (1982) also found that import duties accounted for 41 percent of the total tax revenues. The total tariff duties which include customs duty, excise tax and VAT or sales tax comprised more than four-fifths (83.60 percent) of the revenue receipts (Table 9.11). This is true reflection of Tanzi's (1987) theory that 'all the great users of taxes on imports make little use of taxes on domestic transaction and all great users of domestic taxes on goods and services make little use of import duties' (Cited from Ahsan 1995, pp.231-232)

Sobhan and Ahsan (1990, p.24) found that about a third (34.2 percent) of industrial firms in Bangladesh paid excessive tariffs on imported industrial inputs. It was highly

likely that firms paying high tariffs ended up with low capacity utilisation as they suffered shortage of raw materials and spare parts (Farouk 1982; Islam 1978; and Afroz and Roy 1977) because of excessive tariffs on them. As low capacity utilisation caused firms to suffer from low cash flow, these firms were unable to service repayment instalments even if they were willing to repay loans.

The GOB recognised the irrationality in tariff structure which culminated in the reduction of TVs of some goods in line with world prices in 1994; but the CDs have remained very high for some goods. For example, while the CD for imported machinery and equipment declined to 7.5 percent, the CD for imported components or spare parts remained at 45 percent (World bank 1994, p.63). Industrial entrepreneurs require substantial quantities of imported components or spare parts for restructuring, balancing, extension and modernisation of industry and high CDs on them increase their costs of production. Such anomalies in the tariff structure cancel the effect of tariff incentives and tariff protection in many industries. Mahmud (1995) found that the average nominal rate of protection to industries declined to 28 percent in 1993-94 from 42 percent in 1990-91.

The excessive tariff on industrial raw materials and components makes local products relatively expensive which triggers smuggling of foreign final goods in to the country. Reports (EIU, Quarterly Economic Review of Bangladesh 1985) suggest that the smuggling¹⁰⁴ of numerous industrial and consumer goods, much of which come from neighbouring India (Ali 1995), ranging from highly taxed items to more mundane items

¹⁰⁴ Smuggling is one of the largest sources of black money in Bangladesh where top men such as former President Ershad (The Sunday Times – London, 16 December 1990) down to members of the government are engaged in smuggling (The New Nation 12 June 1987). Even the Deputy Prime Minister in charge of the Ministry of Industries pinpointed smuggling as the most serious economic problem and called for waging war against it (The Inquilab, 11 June 1987). No concerted efforts has ever been made to stamp out smuggling because top operators work under administrative and political protection (GOB, Report of the Task Force Vol.2 1991, p.405). Consequently, the estimated annual flow of black money from smuggling activities grew from Taka 3 billion (EIU, Quarterly Economic Review of Bangladesh, 1985) per annum to Taka 274 billion despite arrests of one hundred thousand smugglers between 1972 and 1986 (Reza 1989, p.36).

of food and clothing (such as saree), is a common feature. As domestic firms face unfair competition from smuggled goods, they (e.g., engineering firms), experience negative protection (GOB, Report of the Task Force 1991, Vol. 2, p. 14) and their products are easily outpriced by relatively cheap smuggled goods and they are unable to sell their products¹⁰⁵. Sobhan and Ahsan (1990) found that about 79 percent firms in Bangladesh suffered from problems relating to the marketing and selling of products.

The GOB is aware of the smuggling and in order to tackle the problem, it has reduced tariff levels by 50 percent in 1994 (EIU, Country Report, 1st Quarter 1994). Even the reduction of tariff by this amount seems to be highly inadequate to thwart the adverse effects arising out of the increasing level of sophistication in smuggling activities. It appears that Bangladesh is caught in a catch-22 situation. As there is excessive tariff on imports, particularly on industrial raw materials, domestic industrial development became stagnant, growth of tax revenue from domestic industrial production stalled, reliance on imports for an excessive level of tariff revenue became inevitable. The foregoing analysis and findings suggest that sources of revenues other than tariffs were not extended and the conflict between revenue objectives and industrialisation objectives was not resolved through tariff rationalisation. Because of such policy inconsistencies, the entrepreneurs were haunted by GOB's over-reliance on tariff revenue. How excessive tariff on imported industrial raw materials and spares via cost-rise contributed towards reducing the loan repayment capacity of the borrowers can be gauged from the loan repayment performance of the firms taking foreign currency loans from the BSB.

¹⁰⁵ The Bangladesh Dairy and Poultry Federation urged the government to combat smuggling of skimmed milk powder since they are losing the market for their product (EIU, Country Report 1st Quarter 1994).

It is to be pointed out here that firms taking foreign currency loans to import machinery and equipment¹⁰⁶ are relatively more dependent on imported components and raw materials than firms needing only local currency loans. While the former group will be vulnerable to tariff increases, the latter will be least affected by such changes. It appears from Table 9.8 that the former group repaid 23.44 percent of the outstanding dues against 29.26 percent of the outstanding dues repaid by the latter group. In other words, firms taking local currency loans outperformed the firms receiving foreign currency loans in terms of loan repayment. This suggests that tariff rates contributed towards an increased level of loan default. Especially, firms which received foreign exchange loans to finance imported machinery and equipment were more prone to loan default than firms which were not dependent on imported raw materials and industrial components.

Ali et al (1987) also reported that fiscal policies imposed unnecessary tax burden on the industrial entrepreneurs. The borrower survey conducted by the author found that over half (57 percent) of the 56 responding firms (Table 6.22) identified high tariffs on imported raw materials and components as one of the contributing factors for industrial loan defaults. This indicates that there is considerable support for hypothesis H20.

9.5 Summary

The findings of this Chapter can be summarised as under:

1. Industrial loan default was both a cause and effect of inconsistent interest rate policy pursued by the GOB and BSB. The borrowers were unjustly charged with higher rates of interest than they ought have been and it increased their debt burden which supported H17.

¹⁰⁶ Bangladeshi entrepreneurs depend on imported plant and machinery because of the low level of development of capital goods sector in the country (Batacharya 1995).

2. Borrowers were vulnerable to local currency devaluation and exchange rate policy did not insulate them against foreign exchange rate fluctuation. This increased their debt burden showing support for H18.
3. Import policy was not supportive of the financed firms and it was not aligned with other policy regimes such as industrial policy. Borrowers lost markets for their products which adversely affected their ability to generate sufficient cash flow to service the debt. This supports H19.
4. Tariff policy was detrimental to the profitable operations of the financed firms. Abnormal tariff rates on imported raw materials and components made the products of the local firms uncompetitive and outpriced. Firms were also hard hit by the inconsistencies in tariff rates on imported finished products. GOB's over-reliance on tariff duties increased the cost of production which lowered firms' cash flow levels and, hence, borrowers defaulted in repaying their debt in time. This supports H20.

The above findings suggest that there is strong support for PH3 which, in turn, indicates that flawed monetary policies, import policy and tariff policy contributed to industrial loan default in Bangladesh. This shows the validity of the Part IIIA of the model of industrial loan default developed in Chapter 4.

CHAPTER TEN

TESTING THE MODEL - PART IIIB:

FLAWED PUBLIC POLICIES AND INDUSTRIAL LOAN DEFAULT

10.1 Introduction

Soon after independence in 1971, the GOB took a number of industrial policy initiatives, pursued some regulatory policy measures and executed policies relating to the management of the BSB. But the relevance and significance of these policy regimes have lost due to their inherent contradictions, inefficiencies and inadequacies which have adversely affected borrowers' ability and willingness to repay industrial loans. This points out that a great degree of the industrial loan default problem owed to the malaise created by inconsistencies and inadequacies of these policy regimes. This Chapter attempts to test the validity of the following principal hypothesis (PH4) in order to see to what extent flaws in industrial policy, regulatory policy and policy relating to the management of the BSB, which were included in Part IIIB of the model, contributed to industrial loan default.

PH4 Industrial policy regimes, regulatory policy measures and policies relating to the management of the BSB were flawed which contributed to industrial loan default.

The testing of the PH4 involves the testing of the following three hypotheses.

H21: Industrial policies were riddled with inconsistencies and inadequacies which increased the costs of borrowing and risk of loan default.

H22 : Frequent and inconsistent regulatory policy changes contributed to industrial loan default.

H23 : The loan default was an outcome of the flawed policy relating to the management of the BSB.

The introductory element of this Chapter is provided in Section 10.1 and hypothesis relating to flawed industrial policy regimes is examined in Section 10.2. Whilst hypothesis relating to regulatory policy is tested in Section 10.3, the hypothesis relating to management of the BSB is tested in Section 10.4. The summary is presented in Section 10.5.

10.2 Industrial Policy

H21: Industrial policies were riddled with inconsistencies and inadequacies which increased the cost of borrowing and risk of loan default.

Since independence and until 1992, the Government of Bangladesh (GOB) have delivered six industrial policies (IPs) to regulate size, type and location of industrial firms; to fix industrial investment limit; to determine debt-equity ratios and interest rates on directed industrial loans; to break up institutional and procedural barriers; and to align IP with other policy regimes to facilitate rapid industrialisation in the country. These policies were: Industrial Investment Policy (IIP) 1973, Revised Industrial Investment Policy (RIIP) 1974, Revised Industrial Policy (RIP) 1975, New Industrial Policy (NIP) 1982, Revised Industrial Policy (RIP) 1986 and New Industrial policy (NIP) 1991 which was revised in 1992. In fact, every government between 1971 and 1995 had its own brand of industrial policy. Except IIP and RIIP of 1973 and 1974 respectively, all subsequent IPs tended to 'confine themselves to procedural changes'

(Zohir 1996, p.44) for bringing down regulatory barriers to industrial loan approval activities.

Industrial policy frameworks - the instruments, institutions, rules and procedure - in Bangladesh were shaped and fixed under bureaucratic control which was a legacy of Pakistani rule. Entry to an industry was subject to overcoming several overlapping (Price Waterhouse 1984, p.130) procedural hurdles and control mechanisms installed by various departments, authorities and ministries. Any industrial firm wishing to have entry into a particular industrial sector must first satisfy the industrial provisioning condition provided in the Industrial Investment Schedule (IIS) published by the DI..

Prior to mid-1980s, the IIS listed the industrial projects as well as products and services which the GOB regarded as desirable and this was used to control private investment. The DI used to estimate the demand and supply for various products, set this against existing industrial capacities and compute the additional capacity which would be needed to meet projected demand. The setting up of new industrial firms or the extension of existing firms was allowed to develop production capacity up to this computed additional capacity shown in the IIS.

The accuracy of such estimated additional industrial capacity was highly doubtful, given the fact that reliable and adequate information relating to private sector industrial investment was not available in Bangladesh (World Bank 1978; and GOB, Fourth Five Year Plan 1995). The EIU (Country Report No.2 1986) registered its opinion about the accuracy of data in the following words:

"statistical aggregates changing from quarter to quarter; some of this is inevitable as provisional figures are revised, but once one delves into the sources of statistical information, it can be seen that the discrepancies run deep, often with regard to data several years old and purportedly from the same original source" (p.7).

The report mentioned, for example, the findings of the World Bank as :

"In the industrial sector, the (World) Bank tentively (sic) suggests growth of six percent or more in each of the last two years, while official data show it to have been around four percent. And, not surprisingly, both these sets of figures differ from those reported by the Bangladesh Bank " (p.7).

Even a Finance Minister¹⁰⁷ admitted that lack of proper information was one of the major problems in industrial development. As such, estimation of opportunities for further capacity development under bureaucratic control in Bangladesh is notoriously unreliable. This can be confirmed from the following report of the World Bank (1978) :

"the IIS is prepared by applying a proportionate rate of growth to the supply and demand figures and relating these to capacity sanctioned at the beginning of the period. Actual capacity and sanctioned capacity are rarely reconciled....there is so little data on actual investment that it is certain the schedule is not based on real but on estimated capacity" (p.14).

This problem was compounded by the project sanctioning power exercised by the various public banks, IDFI's and government departments. Under the RIIP 1974, the Investment Board was the highest body approving new investment in the private sector costing more than Taka 2.5 million. Under RIP 1975, state-owned BSB, BSRS, NCBs and BKB were allowed to sanction and finance industrial firms costing less than Taka 10 million which later increased to Taka 40 million under NIP 1982 and to Taka 60 million under RIP 1986.

In exercising their powers given under various IPs, the various organisations accorded sanctions to a large number of industrial firms with production capacity far in excess of

¹⁰⁷ It was Dr. Wahedul Huq, Minister for Finance for 1989-90 who admitted that lack of proper information was a major problem in industrial development (Far Eastern Economic Review, Asia 1990 Yearbook, p.85).

those provisioned in the IIS. The lack of a coordinated approach among various sanctioning authorities¹⁰⁸ to developing industrial capacity resulted in over-capacity in some sectors such as cold storage(Table 8.3) and oil mills (Battacharya 1993, p.9) and under-capacity in other sectors such as chemicals and industrial raw materials (EIU, Quarterly Economic Review of Bangladesh 1986). This is also corroborated by Wasow's (1985) findings which are reproduced in Table 10.1.

Table 10.1
Sanctioned Industrial Investment in Bangladesh

Sector	Sanctioned New Industrial Investment as Percentage of IIS
Food	230
Textile	178
Forest products	172
Paper, printing and publishing	181
Tannery, leather and rubber	91
Chemicals and pharmaceutical	155
Glass and ceramics	63
Engineering Industries	117

Source : Wasow, B. "Procedural Reform: Sanctioning," Draft TIP Paper, 1985

Table 10.1 shows that actual investments sanctioned in all sectors, except tannery, leather and rubber, and glass and ceramics have far exceeded IIS targets. It means indiscriminate and uncoordinated investment sanctioning activities have led to excess capacity in one sector such as food sector which exceeded IIS target by 130 percent and under-investment in another sector such as glass and ceramics where new manufacturing investment fell short of IIS target by 37 percent.

¹⁰⁸ The GOB recognised the existence of lack of inter-ministry and inter-agency coordination in the NIP 1991.

The problem of over-investment or under-investment in a particular industry exacerbated with the sudden and inconsistent changes in the IPs following the changes in the governments (Hashem 1982). For example, RIP 1986 provided a 'discouraged list' of industries (GOB, Guide to Investment 1987, p.89) where excess capacity has already been created and entrepreneurs were suggested not to make any investments in this sector. But NIP 1991 reversed an earlier decision and abolished the 'discouraged list' of industries. Battacharya (1993, p.40) found that ad hoc, frequent and abrupt policy modifications and changes hindered private sector investment growth in Bangladesh.

The absence of any regulatory body or policy measures to combat the problem of over-capacity continued to force the existing industrial units to operate at below capacity. For example, despite the fact that actual sanctioned capacity in the food sector exceeded the IIS target by 130 percent between July 1976 and December 1980, the BSB sanctioned and disbursed loans to 16 rice mills having a total rice milling capacity of 153,600 metric tons between 1981 and 1986. Having failed to utilise their production capacity, these rice mills could not generate enough income and service their debt to the bank. In fact, the food sector, especially rice mills, showed the worst performance in terms of loan repayment.

The problem of excess or under-capacity was also multiplied by the approval of 7068 firms by various authorities between 1980 and 1985 (GOB, Report of the Sub-Committee for Industrial Finance 1985, p.2). This situation deteriorated further with the introduction of on-the-spot sanctioning of industrial projects in open public meeting by the ministers during 1987-88¹⁰⁹ which meant commercial decisions were overtaken by political overtures. Neither policy-makers nor IDFI's nor businessmen had any

¹⁰⁹ Mr. Moudud Ahmed, Deputy Prime Minister in charge of the Minister of Industries used to provide on-the-spot sanction to anyone who approached him during his tour to country area during 1987-88. The author was present in such a meeting of so-called entrepreneurs in Dinajpur in July 1987. Such incident was also reported by Mr. Ibrahim Khaled, Deputy Governor of the Bangladesh Bank (The Dainik Janakantha, 4 January 1999).

information on what was truly going on in the private sector (World Bank 1978; and GOB, Report of IRPA 1985). Such ignorance at the highest level of policy-makers can be visualised from the Case Study Nine.

Case Study Nine : Ignorance of BOI

Sometimes, even the Board of Investment (BOI) - the second highest investment approving authority attended by the secretaries of three ministries - was ignorant of the true investment scope and/or level in a particular industry. A good example was the approval of the investment of six powdered milk canning and packaging factories by the BOI in August 1989 capable of processing nearly three times the import demand for powder milk at that time (EIU, Country Report No. 1 1990, p.10).

These plants would involve only the repackaging of imported powder milk. The GOB has also agreed to a ban on all other milk imports and discouraged further such plants. It provided the owners with the opportunity to evade huge amounts of import duties as powder milk would be considered an industrial raw material. After the matter received considerable press attention, GOB cancelled the BOI's approval before the owners of these proposed projects were able to milk the economy.

Prior to 1982, all project proposals submitted to the financial institutions including the BSB were to be referred to DI for clearance. This caused unnecessary delays in the loan sanctioning process. Realising these problems, the GOB abolished IIS in 1986 and DI was amalgamated with the BOI¹¹⁰ from 1 January 1989. Despite the fact that some degree of relaxation of control has taken place in the rules and procedures governing

¹¹⁰ The BOI supplants nine different agencies that had some control over industrial policy (Far Eastern Economic Review, Asia Year Book 1989, p.84). The aim of the BOI is to streamline procedure for obtaining permission to set up industrial units and to speed up implementation of industrial policy. Its governing body is headed by the Prime Minister, the Executive Council is headed by the Minister for Industry and the Executive Board, which performs day-to-day managerial functions, is headed by a Chairman. In 1991, BOI was restructured and shifted from the Ministry of Industries to the Prime Minister's Office to facilitate and augment industrial investment in the private sector (GOB, Fourth Five Year Plan 1995).

the private sector, centralisation of decision making process, administrative control, and procedural bottlenecks have given rise to red-tapism¹¹¹.

An investigation about the time taken by the bureaucrats to process a case revealed that as low as 112 days and as high as 1770 days were lost between opening and closing of a file in government offices in Bangladesh (Hossain and Hossain 1983). The BSB being a state-owned enterprises was also engulfed by such bureaucratic malaise. Though the RIP 1986 removed some procedural hurdles, it did not eliminate other control mechanism relating to the size of investment and requirement relating to imported raw materials. Investment in any project which used more than 50 percent of imported raw materials was to be sanctioned in the 3-monthly meeting of the BOI which was chaired by the Secretary, Ministry of Industries and attended by the Secretaries of Finance, and Commerce Ministries.

Large projects costing more than Taka 150 million¹¹² were sanctioned by the Executive Committee of the National Economic Council (ECNEC) chaired by the Prime Minister and it took much time to accord sanction to industrial investment. In 1985, a National Council for Industrial Development (NCID) was formed with the President¹¹³ as the Chairman to review fiscal and other incentives to promote industrial investment. It was formed out of the admission that industrial investment in the past had been undertaken on an unplanned basis, 'often to wider detriment to the economy, and that important industrial sectors were being neglected while others suffered from over-investment' (EIU, Country Report No. 2 1986, p.11) However, the existence of such multiple layers of investment approval authority has, in fact, complicated the industrial investment sanctioning process in Bangladesh. The procedural formalities, which were

¹¹¹ Grease money or bribes are frequently used to speed up the movement of files in government offices (Reza 1989, p.35).

¹¹² Under RIP 1975, ECNEC could sanction loans to a projects costing over Taka 100 million (GOB, Guide to Investment, 1982, p.22).

¹¹³ The President was the head of the government as well as of the state between 1983 and 1990.

to be completed before bank loans could be granted, were 'bigger bars to borrowing than the cost of the loan itself' (EIU, Country Report, 3rd Quarter 1992, p.19).

Thus, the involvement of financial institutions, DI, BOI, NCID, ECNEC in the investment approval process (which were provisioned in the IPs) together with inadequate coordination among these organisations and agencies has not only frustrated policy initiatives but also has made estimation of industrial costs in advance more difficult. This stood in the way of achieving the national objectives for industrial development. These regulatory controls enshrined in the IPs became more complex when the licensing system for imported raw materials was taken into account. Until non-cash licence¹¹⁴ system was abolished in 1989, investment in industry was largely determined by the issue of licences which were related to shift of operations. There was lack of adequate provision in the IPs to ensure the timely flow of adequate imported raw materials to facilitate the efficient use of installed productive capacity. As the productive capacity remained unutilised due to unavailability of raw materials, it adversely affected the income generation as well as loan repayment capacities of the borrowers. This hints that flawed IPs contributed to industrial loan defaults.

All but two IPs intervened in the loan intermediation process of the IDFI's in Bangladesh. For instance, the RIP 1975 directed the BSB-type IDFI's to sanction loans to industrial projects within three months from the date of lodging loan applications (The Bangladesh Observer 2 June 1981). Such policy opened the floodgate of industrial loans for credit unworthy entrepreneurs and 400 industrial units were approved within one year (1976-77) with a capital injection of Taka 800 million (Far Eastern Economic Review, Asia 1978 Yearbook, p.133). Not only that, the RIP 1986 instructed the IDFI's, such as the BSB, to disburse loans within two months after approval (The Dainik Bangla, 9 September 1986). Such policy directives to the state-owned industrial banks resulted in sanctioning and disbursing loans to non-viable industrial firms owned

¹¹⁴ Under cash licence system, importers are given a foreign exchange allocation for importing raw materials, capital goods and spares.

by the credit unworthy borrowers who later on defaulted in repaying the loans. This suggests that inappropriate IP intervention in the loan intermediation process contributed to industrial loan defaults.

All post-1975 IPs included provisions for fixed interest rates according to the location and debt-equity ratio of industrial firms. For example, RIP 1986 made provision for interest rates which varied between 13 percent (for industries with debt-equity ratio of 70:30 and located in developed areas) and 10 percent (for industries with debt-equity ratio of 60:40 and located in least developed area) which were shown in Table 9.1.

Moreover, all IPs recommended higher interest rates for service industries such as restaurants, hospitals, hotels, cinema halls and medical clinics. According to the RIP 1986, it was as high as 16 percent for these firms. However, this interest rate was applied by the IDFI's only when market interest rates were lower. On the contrary, BSB charged them market interest rates whenever IP recommended interest rates were lower than market rates. In fact, by fixing the interest rates, the IPs supplied ammunition to the lending institutions such as the BSB to charge borrowers higher interest rates even at the time of low inflation. Also fixing of interest rate for future periods though IP measures was not consistent with the objective of promoting industries in a competitive market.

Since provisions in the IPs did not allow the interest rates to move with changed market and economic conditions, they imposed an unreasonable interest rate burden on the industrial borrowers. By forcing the borrowers to pay relatively higher interest rates for a fixed period, IPs contributed to an increased level of debt burden. This means that inconsistencies between IP and interest rates policy contributed towards increasing the risks of loan default which supports hypothesis H21.

Another example of inconsistency can be observed in case of fiscal policy which constituted a significant part of IPs. All IPs provided various tariff concessions to firms depending on their nature and location. For example, firms using imported raw

materials and located in least developed areas were charged import duty at the rate of 2.5 percent against 15 percent charged to firms located in a developed area.

But industrial firms were not able to enjoy these incentives provided in the IPs. The tariff policy pursued by the GOB, such as the imposition of sales tax¹¹⁵ on duty paid value (DPV)¹¹⁶ of the imported industrial raw materials, had wiped out the benefits of tariff concession provisioned in the IPs. In addition, the level of protection promised in the IPs and given to certain infant industries was not adequate and these industries either became too costly or ceased production (EIU, Quarterly Review of Bangladesh 1985, p.12). It shows that tariff policy was not aligned with IP. Industrial firms might have ended with high costs of production and lower level of income which made them unable to repay loans. It is due to the existence of such inconsistencies, IPs became irrelevant to the actual situation in the field which led the UNDP (1991) to recommend industrial policy reform in Bangladesh.

All the IPs were built on the wrong premise that there existed a large supply of experienced entrepreneurs having adequate equity money and managerial experience waiting to be mobilised for the industrialisation provided that public policies, lubricated by industrial finance, could be delivered. In fact, there was no established class of experienced entrepreneurs engaged in large firms with the exception of a handful capitalists in jute and cotton industries (Sobhan 1974, p.184). Whatever industrial undertakings were available at the time of independence of Bangladesh was mostly (85 percent) small and cottage firms (Ahmed 1977; and Griffin and Khan 1972, p.8). Thus, the GOB's perception that these small firm owners and traders were capable of

¹¹⁵ Sales Tax was succeeded by value added tax (VAT) since 1991.

¹¹⁶ Custom duty is imposed on estimated invoice value of imported products. After adding this custom duty to the estimated value, a total value is created which is called duty paid value. Normally, estimated value is much higher than true value of the product in international market. The GOB applied this estimated value to stamp out the problems of under-invoicing.

mobilising adequate equity money for establishing modern manufacturing firms and of managing them without entrepreneurial guidance was not reflective of the real situation on the ground.

Though entrepreneurial guidance was required to increase the borrower's ability to repay loans, no industrial policy recommended any institutional arrangement for providing such assistance to the budding or first generation entrepreneurs, some of whom might have not seen such a large amount of money provided by the IDFI's in their life times. Bewildered by huge amount of credit and being left unsupervised over the use of this money, most of them remained directionless. No policy initiative was there to pick up the promising and resourceful persons, groom and graduate them for assuming the ownership and management of successful industrial undertakings financed through state-directed credit.

The failure of IPs has been recognised by the GOB. In its Fourth Five Year Plan document, the GOB (1995) admitted that

“in the past industrial policies were not considered to be helpful for the efficient development of industries in the private sector. Ad hoc, frequent and abrupt policy modifications and changes raised operation cost and affected private sector investment in industries and its growth” (p. XI-11).

The GOB's Report of the Task Force (Vol.2 1991) also mentioned that IPs did not reflect an awareness of basic malaise in the industrial sector and many of the strategies were not commensurate with fulfilment of the objectives of rapid industrialisation in the country. It reported that the ‘inconsistencies of the industrial policies with the financial, fiscal and commercial policies had contributed to a large measure, to the non-attainment of the goals set in these policies’ (p.8). Even the Minister for Industry¹¹⁷ admitted the

¹¹⁷ Mr. Shamsul Islam Khan, Minister for Industry for 1990-95, acknowledged that the industrial policies of 1982 and 1986 have failed to attract entrepreneurs (Far Eastern Economic Review, Asia 1992 Yearbook, p. 81).

failures of past industrial policies in Bangladesh to stimulate private investment. These indicate a strong support for hypothesis H21.

10.3 Regulatory Policy

H22 : *Frequent and inconsistent regulatory policy changes contributed to industrial loan default.*

The regulatory policy regimes in Bangladesh are marred by frequent and inappropriate changes which influence the will and ability of borrowers to repay loans. For example, the GOB banned the manufacture of polythene shopping bags from January 1994 (EIU, Country Report, 1st Quarter 1994, p.28) without considering the implications of such decision on the firms which had taken large loans from the banks including the BSB, not to mention owners' investment in these firms. Table 10.2 shows that BSB disbursed term loans totalling Taka 42.849 million to seven firms, of which 4 commenced commercial production of polythene shopping bags.

Table 10.2

Polythene Bag Manufacturing Firms Financed by BSB

(Taka in Thousand)

Name of the Firm	Loan Disbursed	Loan Recovered by September 1996	Loan Outstanding by September 1996
Rangpur Polythene*	500	58	4,719
S.S. Polythene *	1,892	350	6,222
L.L. Polythene*	437	10	2,614
Jesmire Polythene	2,338	48	7,828
Isamati Polythene	2,080	0	2,545
Hossain Polythene	1,542	1,614	2,091
Plast Bangla	34,060	187	67,595
Total	42,849	2,267	93,614

Note: * indicates firms not in operation

Source: BSB, MIS Department. Data were compiled and computed by the author.

These polythene bag manufacturing firms owed Taka 93.614 million to BSB as outstanding dues though they had repaid Taka 2.267 million as on September 1996. In compliance with the GOB's directives if these firms are closed, borrowers would never be able to repay the loans they received from the BSB. This is a glaring example of how regulatory policy change is responsible for industrial loan default in Bangladesh. Sahota (1991) also found industrialists who blamed policy instability as reasons for industrial stagnation Bangladesh.

From time to time, the government resorts to a loan amnesty which includes forgiving repayment of principals and interest on the belief that borrowers are burdened with too large a debt overhung¹¹⁸ (Bowe and Dean 1997, p.17). Between 1986 and 1990, the BSB waived out interests and even repayment of principals totalling Taka 1 billion (GOB, Report of the Task Forces Vol.1 1991, p.233). Data collected from the BSB (MIS Department 1998) showed that 206 firms were relieved from paying interests amounting over Taka 1 billion between June 1991 and June 1998. This loan amnesty angered those 'who had kept up with their payments' (EIU, Country Report, No.1 1992, p.13). Such policy changes not only encourage borrowers to become wilful defaulters in the hope of obtaining loan amnesty at a future date but also makes loan recovery through legal measures ineffective.

Investigations carried out about the repayment performances of borrowers revealed that BSB had a large number of wilful defaulters. In order to determine the extent of their existence in the BSB, wilful defaulters are defined as those who repaid nothing or less than Taka one thousand despite their firms being in commercial operations. Table 10.3 shows that against overdues totalling Taka 255.265 million, only 0.04 percent (Taka 96 thousand) were repaid by the 15 firms which were in operation between 2 and 14 years. Moreover, there were 10 firms which repaid nothing against overdue loans and this clearly indicates that some borrowers were deliberate-defaulters. Ghafur (1995, p.92) also found that some defaults were deliberate.

¹¹⁸ Bowe and Dean (1997, p.22) defined debt overhung as the difference between the present value of a borrower's contractual debt obligation and expected cash flow that will be made to service that debt.

Table 10.3

**Loan Repayment Performances of Selected Firms
as at September 1996**

(Taka in Thousand)

Name of the Firm	Month of commercial Operation	Over dues	Loan Repaid
1. Anamika*	January 1995	29,436	0
2. Bhawal Textile*	July 1987	4,403	0
3. Diamond Inds.	July 1991	2,500	0
4. Isamati Poly'ne	April 1990	856	0
5. Jalil Textile	April 1990	1,155	0
6. Jemia Textile	October 1988	8,358	0
7. Karmedu F'dry*	February 1993	2,284	0
8. M.G. Plaza Hotel	November 1990	1,790	0
9. Pabna Metal	June 1992	3,852	0
10. Rupsa Poutry	April 1991	354	0
11. Khaleque Textile	March 1994	189,285	1
12. Milton Bread	July 1988	932	5
13. Sarder Textile	January 1991	5,366	13
14. Shanti Clinic*	August 1989	2,329	12
15. Shilpee Bobin*	January 1982	2,365	65
Total		255,265	96

Note: * indicates that the BSB filed a case against the firm to recover loans.

Source: BSB, MIS Department. Data were extracted and computed by the author.

Being unable to recover anything, the BSB filed law suits against five of the above defaulting firms. Until early 1990s, legal framework for recovery of loans was outmoded, expensive and time consuming (Ali et al 1987). As such, legal action against the defaulters resulted, in most of the cases, in recovery of insignificant amount of loans. For example, by resorting to legal action, BSB-type IDFI's were only able to recover 5 percent of the loans overdue (Sobhan 1991a) during late 1980s. But this loan recovery rate dropped to between 1.29 percent and 2.13 percent of total overdue loans during 1991-93 (The Saptahik Bichitra, 22 September 1995, p.30). Banks had to chase the defaulters to recover loans even after the court ordered the defaulters to pay ¹¹⁹ because, at that time, the court system was unable to enforce its decrees. In the process, five to ten years were lost while loans were recovered from the defaulters (Sobhan and Sen 1989, p.51; and Hassan 1995, p.127).

The deficiency in the legal system relating to the loan recovery is linked to the legal structure in respect of execution of court decrees. The commercial court issues decrees, while their execution remains the responsibility of civil courts. The borrowers are aware of the deficiencies in the legal system and find incentives to deliberately default on their loan instalment repayment since virtually there is no risk of asset foreclosure (Ghafur 1995, p.92). Though the GOB instituted three loan courts and two bankruptcy courts in the early 1990s (EIU, Country Report, 3rd Quarter 1998) to expedite loan cases, it did not dissuade borrowers from becoming deliberate-defaulters.

The BSB filed court cases against a number of wilful defaulters, some¹²⁰ of whom were also arrested on charges of economic sabotage (UNDP 1991, p.9), but under pressure from the lobbyists such as the Federation of Bangladesh Chamber of Commerce and

¹¹⁹ In an interview, Mr. Khurshed Alam, Governor of the central bank - Bangladesh Bank - mentioned that the lack of legal support caused banks to run after defaulters to recover loans even after the decree was obtained from the court in bank's favour (The Saptahik Bichitra, 22 September 1995).

¹²⁰ In 1987, Mr. Golam Rosul, Managing Director of Eastern Commercial Service, Dhaka, was arrested and Mr. Rafiqul Islam, Managing Director of Janata Talkies Ltd, Ghoraghat, was issued with arrest warrant for failing to repay loans they received from the BSB.

Industry (FBCCI) the GOB was to release them from jail within a short period of time. The BSB assumed ownership and control of some defaulting firms and put them on auction. 'The damper in the liquidation process was the absence of bidders at the time of auction' (UNDP 1991, p.25) and little was recovered from the assets sold.

The GOB has sometimes taken discriminatory regulatory policy measures to stop access to term loans by the defaulters. For example, it announced in 1986 that no one could stand for election if s/he had defaulted in repaying an agricultural loan (The Dainik Bangla, 12 December 1986), but it did not apply the same restrictions to borrowers who had defaulted on industrial loans. Because of this regulatory policy inconsistency, a number of defaulters were able to be elected as Members of the Parliament (MPs). Table 10.4 shows that borrowers, such as the Ministers and the MPs, owed huge amounts of money to banks and IDFI's including the BSB.

Table 10.4

Names of the Defaulters-Ministers and MPs as at August 1996
(Taka in Million)

Name	Status/Position	Political Party	Amount of Loans to be Recovered
A.S.M Feroz	MP	AL	65.25
S.M Reza	MP	AL	48.59
M. Rahmatullah	MP	AL	30.92
Tazul Islam	MP	AL	37.54
A. M. Talukder	MP & Ex-Minister	BNP	10.65
Ziaur Rahman	MP	BNP	13.70
S.F.K. Salim	MP	AL	10.07
N.A Tatukder	MP	BNP	7.36
A. M. Bhuyan	MP & Ex-Minister	BNP	9.19
A.S.M.A. Rob	MP & Minister	JSD	5.39
Abdul Mannan	MP	AL	5.35
K.M.O. Rahman	MP & Ex- Minister	BNP	3.64
N. Alam	MP	BNP	3.07
K.E. Yusuf	MP & Ex-Minister	BNP	2.90
A.L.Mirza	MP	AL	2.70
M.A Salam	MP	AL	2.49
A.H. Abdullah	MP	AL	2.02
K. Keramat Ali	MP	AL	1.42
K.M.S. Osman	MP	AL	1.35
Mijanul Hoq	MP	AL	1.09
M.G. Hakim	MP	AL	1.07
Kader Siddiqi	MP	AL	0.93
H. Monju	MP & Minister	JP	0.92
S.M. Hossain	MP	BNP	0.86
G.M. Seraj	MP	BNP	0.52
Nazmul Huda	MP & Ex-Minister	BNP	0.50
Waj.U. Khan	MP	AL	0.44
M.A. Kashem	MP	BNP	0.08
M. Hossian	MP	BNP	36.79
Total			300.85

Notes: AL = Awami League; BNP = Bangladesh Nationalist Party;
JSD = Jatiyo Samajtantrik Dal; JP = Jatiyo Party

Source: Jai Jai Din 27 August 1996.

It appears from Table 10.4 that 29 law-makers, including 7 Ministers of the present and past government defaulted in repaying over Taka 300 million to lending institutions such as the BSB. Even a former Prime Minister, Mizanur Rahman, was a defaulter who owed Taka 106.6 million to the Janata Bank against his pharmaceutical firm, Pioneer Pharmaceutical Ltd. (The Saptahik Bichitra, 22 September 1995, p.27). This shows that high level political patronage protected defaulters from the consequences of the rigorous application of loan recovery laws.

When policy-makers, law-makers and ministers including the prime minister of the country are themselves defaulters, they lose moral ground not only to make laws but also to apply existing laws or regulations rigorously for recovering loans from recalcitrant defaulters. In the presence of double standards, that is, one set of regulations for agricultural loan defaulters and another set of rules for industrial loan defaulters (e.g., qualification for getting elected to the public office of the republic), borrowers had grounds to become wilful defaulters. It is also highly likely that such regulatory policy inconsistency frustrated the efforts of the lending institutions to recover loans from the defaulters, no matter how efficiently IDFI's like the BSB played their financial role and developmental roles. Thus, there is strong support for hypothesis H22.

10.4 Management Policy of BSB

H23 : The loan default was an outcome of the flawed policy relating to the management of the BSB.

The BSB is a public IDFI which has always been dependent on the GOB for policy directives though it enjoyed autonomy in operational matters. It is a policy-taker rather than a policy-setter; it does not get involved in formulating policies such as industrial, monetary, import and tariff policies. Its lending and management activities are always subject to the imperatives of government policy and prudential regulation. State owned

enterprises (SOEs) in Bangladesh are a synonym for mismanagement and inefficiency (Alam and Khan 1995). The BSB, being a SOE, is also plagued by mismanagement which is evidenced by its persistent financial insolvency (UNDP 1991; and Cookson 1997). Sobhan (1991a) also believed that the extremely low rate of loan recovery rate and the existence of a large number of sick and non-performing firms in its loan portfolio were reflective of the inefficient management of the BSB.

The BSB is managed by a 9-member Board of Directors (BODs) headed by a Chairman. All members of the BODs, including the chairman are appointed by the GOB. The composition of its BODs and the appointment of senior bankers such as general managers are determined by the GOB. It has been managed in a bureaucratic manner since its inception and all the principles of bureaucracy were rigorously applied. Despite repeated call by experts¹²¹ to pursue and implement bureaucratic reforms to improve public sector management, bureaucratic control remains pervasive in the BSB.

The BODs had never been dominated by experienced development bankers, but by civil servants. Between 1971 and 1998, 23 Managing Directors were appointed by the GOB and of them, 11 were civil servants who were responsible for management of the BSB for 12 years (BSB, Human Resource Management Department 1998). These career civil servants, who had no experience in the management of development banks, used the BSB as a station away from their civil administration to wait for the next higher position and they endeavoured to implement ethics and rules of civil administration rather than principles of professional management of the development bank. Since the tenure of the Managing Directors stretched from a few months to three years, the BSB suffered from the problems of ad hoc managerial intervention and bureaucratic adventurism.

¹²¹ Pierre Landell-Mills, the Chief of The World Bank Mission in Dhaka urged the GOB to pursue bureaucratic reform to improve public sector management (EIU, Country Profile 1994-95, p.22).

The bank suffered from the management problems in the same manner as other public sector institutions suffered¹²², not to mention bureaucratic control. Until 1978, the BODs was chaired by a professional banker but, thereafter, all chairmen were either top bureaucrats or politicians. The members of the Board were drawn from politicians, civil servants, army officers, politically connected academics and representatives from professional bodies. An analysis of the list of the members of the BOD for the last 20 years revealed that 85 percent of the Board members had no experience in banking at all, not to speak of development banking.

The EIU (Country Report, 3rd Quarter 1998) found that key positions in the state-owned bank board were distributed among individuals with political links to the political party in power. The Board of the BSB had been subject to the same political clout. For example, during post-1975 period, the first chairman was an adviser of the Zia Government, the second chairman was a bureaucrat, the third was a member of the Ershad government and the fourth chairman was a Member of the Parliament from the Khaleda government. The present chairman, who is a former Vice-Chancellor¹²³ of the University of Dhaka, and 2 members of the BODs are staunch supporter of the Hasina government. It has become almost a rule that changes in government are succeeded by changes in the composition of the BODs. It means that the BODs has been subject to periodical political replacement, unlike the successful development banks such as Korea Long Term Credit Bank, Development Bank of Singapore and Industrial Credit and Investment Corporation of India where Chief Executive Officers (CEOs) were professional bankers with long tenures. Such instability in the BODs of the BSB sharply contrasts with the management practice of successful development banks, such as Banco Portugues de Investimento of Portugal, where stability of its BODs was one of the factors responsible for spectacular success (Diamond 1997, p.75).

¹²² Public sector corporations or SOEs made losses totalling Taka 11.28 billion (US\$ 288 million) in 1990-91 because of mismanagement. (EIU, Country Report, 1st Quarter 1993, p.15).

¹²³ In course of an interview, the current Chairman of the BSB told the author that he lacked experience in banking and the GOB dumped him into this position.

Moreover, unlike the CEOs of these successful development banks¹²⁴, who are sometimes co-opted by the government to participate in policy formulation and economic policy decisions (Diamond 1997, p. 66), the Managing Director/CEO of the BSB has never been asked by any government in Bangladesh to participate in formulation of policies that affect the management and operations of the bank.

As top management was plagued by frequent replacement of CEOs and transfer of senior managers such as general managers, the BSB suffered from lack of leadership and professional management. Two general managers and three deputy general managers informally expressed their disenchantment to the author about frequent changes in top managerial positions which created instability in the control, supervision and management of industrial loans. They also pointed out that with the appointment of each managing director, the re-organisation and re-naming¹²⁵ of departmental work has become a routine matter which affected the continuity of work.

The mismanagement of the BSB has also been noticed by the UNDP (1981). It recommended full operating autonomy for BODs of BSB to 'allow flexibilities in the hiring and firing of personnel; staff compensation policies, formulation of lending and operation policies' (p.8). It further advocated 'adequate private sector representation in the Board in making decisions on operational matters' (pp. 8-9).

The problem associated with mismanagement of the bank multiplied with political intervention in the sanctioning and disbursement of industrial loans. Managers¹²⁶ had to compromise the standard and quality of loan processing because of dominance of

¹²⁴ For example, the top executives of The Industrial Credit and Investment Corporation of India - which is one of the most successful DFIs - have participated and played an important role in many government policy-making committees, in the Finance Ministry or the Reserve Bank of India (Diamond 1997, p.71).

¹²⁵ The names of various departments of the BSB change very frequently.

¹²⁶ One manager specifically mentioned one incident of intervention by Mr. Jamaluddin Ahmed who, by using his position of Deputy Prime Minister in 1982, instructed the BSB management to sanction a flour milling unit although it was not economically viable.

political persons in the BODs and of borrowers' political influence (World Bank 1996, p. 18). Such political intervention is also evidenced by Case-Study Ten.

Case Study Ten : Political Profile of Loan Defaulters

In May 1992, the GOB published a list of those who had defaulted on repaying their loans to the banks including the BSB and many of these were either political activists or politically influential. The political background of some of these defaulters is presented in Table 10.5

Table 10.5

Political Connection of the Loan Defaulters

Name of the Defaulter	Name of the Project Financed by the BSB	Political Connection/background
Mr. Maidul Islam	Quashem Textile Mills Ltd. Quashem Dry Cell Ltd.	He was the treasurer of the Bangladesh Nationalist Party which reigned for about ten years. He was a Member of the Parliament in 1979. He served the Republic twice as a minister in 1984 and 1987. The BSB filed a case against his company on 14 January 1987 to recover overdue loans.
Mr. Sohel Rahman and Mr. Salman Rahman	Sonali Aansh Ltd Shinepukur Jute Spinner Ltd. Beximco Textile Mills Ltd.	Their father was a minister during Pakistani rule. They had close links with the industry minister in 1980-82. Mr. Salman Rahman, known as "super defaulter", is very close to the sitting Prime Minister Sheikh Hasina. He accompanied her several times as a member of the entourage. Both brothers are so powerful that they even threatened the governor of the central bank with dire consequences if their names were not dropped from the list of defaulters. Mr. Salaman Rahman was also the president of the influential FBCCI from 1994-96. Both brothers owed Taka 10 billion to seven banks including the BSB as at June 1997.

Sources: The Observer, 15 Jan 1987; Alam (1991); Jai Jai Din, 15 Oct 1996; The Ekota, 24 August 1984; EIU, Country Report, 4th Quarter 1997.

This case study shows that borrowers having strong political links with top offices of the republic received loans from the BSB. The World Bank (1995b, p.138) and the EIU

(Country Profile 1996-97) found that state-owned banks, such as the BSB, had to make high risks loans to borrowers having political influence. Rahman (1994) reported that fifty-five percent of the total industrial loans provided by the BSB went to only seven powerful individual conglomerate firms, 'all directly connected to the top echelons of state power in Bangladesh'(p.287). According to the EIU (Country Report, 4th Quarter 1997, p.28 ; Country Profile 1997-98, p.27) 33 percent of the Taka 122 billion classified at the end of June 1997 as bad debt was owed to the banks including the BSB by the prominent individuals. The same investigation also indicated that political interference contributed towards negative net worth of the BSB.

Though Abdullah (1991, p.24) mentioned about 200 families who were mainly responsible for the liquidity crisis, the EIU (Country Report, 2nd Quarter 1997, p.28) identified 137 'well-connected' individuals who owed Taka 50 billion (US\$ 1.1 billion) at the end of June 1997 to the banks including the BSB. The World Bank urged the GOB to take legal action against top 20 defaulters (EIU, Country Report, 3rd Quarter 1997, p.25); but the response from the GOB was muted since these individuals had strong foothold in the government.

It would not be out of place to mention here that BSB-type IDFI's were not equipped with adequate management cadres entrusted with proper autonomy and accountability (Battacharya 1993). There were no clear cut procedures which allowed BSB's managers and officers to exercise full freedom while applying efficient screening mechanisms to comb out credit unworthy borrowers from the pool of loan applicants; determining credit limits, and debt-equity ratios on the basis of the merit of feasibility studies, identifying viable projects independent of outside intervention and providing suggestions for efficient management of the financed projects. No instances was found where managers and officers of the BSB took part in the credit policy formulation and execution process.

It is to be pointed here that public sector bank management in Bangladesh has not been

sufficiently result-oriented (Hassan 1995). This was also true for the BSB where at the officer level, there was little relation between performance and reward. BSB managers and officers were paid according to a national pay scale and the financial reward structure was not related to performance. There is no management process in place which allows a manager to review, monitor, reward or punish lower level officers for inadequate performance or which offers incentives to managers or officers for their satisfactory performance such as very satisfactory loan collection rate. Eighty seven percent of the officers interviewed in the head office of the BSB expressed dissatisfaction with the incentive scheme and 93 percent of them expressed a desire to leave the bank if better rewards were offered elsewhere. Such dissatisfaction was also linked to the continuous fall of real income of these managerial people. Reza (1989, p.35) found that real earnings of employees in the BSB-type public sector institutions had dropped by 1985 to one-seventh of what they were in 1974.

This extremely high level of disenchantment among officers over salary and other reward schemes is responsible for a staggering rate of officer turn-over ratio in the BSB. It has been found that officers and managers tend to leave the BSB after a few years of service. However, manager turn-over ratio is not as high as that of officers. It is because of this high personnel turn-over ratio that BSB always suffers from dearth of experienced and trained personnel who can provide good advice to borrowers. Recognising the problems regarding human resource management, the UNDP (1991, p.11) recommended improvement of personnel management through staff training. Between December 1971 and March 1994, the BSB sent 188 officers overseas for mainly short-courses (BSB, Quarterly Review of BSB Activities 1994), but the experience of these officers was rarely used in the functioning of the bank.

The management of the BSB has been affected by the frequent policy changes by the GOB. Since the Ministry of Finance is the administrative ministry of the BSB, it is expected that changes of rules and regulations relating to its operations and management should not be brought about by other ministry directly. But instances were

there where Ministry of Industries initiated changes of the bank's lending directly, obtained approval by the highest authority and published the same in the government gazette dated 27th September 1988. Such gazette notification were against the principles of efficient bank management, not to mention indiscipline handed down by the GOB itself. For example, on 22 September 1988, Ministry of Industry fixed margin rate on pledge /hypothecated goods at 20 percent and 30 percent for small and big firms respectively. This margin was conceptually unsound since margin was related to nature and price of goods. Such illogical norms were ordered down 'without consulting banks or Ministry of Finance, (GOB, Report of the Task Force, Vol.1 1991, p. 233). It turns out that there were many inconsistencies in the policy framework and policy delivery mechanisms that created management problems affecting the overall efficiency of the BSB. The prevalence of overall mismanagement increased the chances of borrowers' getting away with delaying the repayment of debt. The World Bank (1995b) has also found that high loan defaults in Bangladesh occurred because state-owned 'banks have been poorly managed and have had little incentives to make good loans' (p.135). The EIU (Country Profile 1997-98, p.27) identified poor management as one of the reasons for negative net worth of the BSB which made it dependent on the GOB for continuous bail-outs. This suggests that there is strong support for the hypothesis H23.

10.5 Summary

The findings of this Chapter can be summarised as under.

1. Industrial policy was marred by persistent inconsistencies. Deficiencies in the fomulation, administration and execution of industrial policies were enormous. Industrial polices failed to provide clear direction to the industrial investment and borrowers had to bear the costs of policy contradictions and inefficiencies. It shows that there is strong support for H21.
2. Frequent regulatory policy changes such as loan amnesty and two sets of loan

repayment rules for small and large borrowers mocked all other policy regimes. The inconsistencies in regulatory policy regime created opportunity and scope to default deliberately which support H22.

3. The BSB suffered from mismanagement and inefficiencies due to GOB's flawed policies for the management of the BSB. Because of frequent government intervention in its loan intermediation process, it could not play its financial role and developmental role in an efficient manner which resulted in mismanagement of credit delivery and recovery. Borrowers were to bear the cost of such mismanagement in the sense that they were not adequately cared for. Loan default of its financed firms was linked to inefficiencies and political intervention in the loan intermediation process and credit management. These provide enough ground to support H23.

These findings show strong support for the PH4. This provides evidence that the Part IIIB of the theoretical model developed in the Chapter 4 is valid which suggests that industrial loan defaults were contributed largely by the flawed industrial policy, flawed regulatory policy and flawed public policy related to the management of the BSB.

CHAPTER ELEVEN

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

11.1 Introduction

Since the 1970s, financial institutions in developing countries have been distressed by persistent loan defaults. Despite institutional diversity, loan defaults in these countries are so pervasive that many banks have become under-capitalised and illiquid. The persistent loan defaults have not only impaired the viability of many financial institutions, but also made them dependent on government bail-outs. Yet, some banks collapsed, while others became moribund during the 1980s and 1990s. Persistent loan default was one of the pertinent reasons for global financial crises in the late 1990s.

This study deals with Bangladesh which possesses all the characteristics of underdevelopment and where the banking sector has been in malaise due to persistent loan defaults. Especially, the study focused on industrial loan default problem in Bangladesh. The Bangladesh Shipla Bank (BSB) – the largest IDFI in Bangladesh - was chosen as a case study because industrial loan providers in other developing countries experienced similar problems relating to loan defaults. The main objective of this study was to identify the reasons for industrial loan defaults which have been crippling the banking industry in developing countries, particularly in Bangladesh.

The contents of this chapter are organised into 5 Sections. Section 1 is introductory. Section 2 deals with a summary drawn from Chapters 2-10. Section 3 contains conclusions, while Section 4 discusses limitations of this study and scope for further

research. Section 5 contains specific and general recommendations and Section 6 presents concluding remarks.

11.2 Summary of the Study

The summary of the study is provided as per order of the Chapters.

11.2.1 Review of Literature on Industrial Loan Default

The literature on industrial loan default is very scarce, although a large number of studies were undertaken on agriculture and home loan defaults. Since some of the determinants of agriculture and home loan defaults are symmetrical to those for industrial loans, the review mainly concentrated on the literature relating to agriculture and home loan defaults. However, available theoretical and empirical studies on development banking as well as industrial loan defaults were also reviewed.

The literature on agriculture and home loans identified unwillingness and inability to repay loans as the major determinants of loan defaults. It is evident that loan default can occur if borrowers are willing but unable to repay or borrowers are able but unwilling to repay loans. Empirical studies (Jackson and Kaserman 1980; Gau 1978; and Lawrence et al 1992) on home loans found that higher probabilities of loan default were associated with negative equity, repeat delinquencies, borrower trait, loan age, poor payment history, smaller loans, short period loans and older borrowers. However, these studies did not take policy effects into account. While farming loans are for short periods, home loans are for long periods which has similarity with industrial loans. Both farming and home loan debtors are not subjected to policy and macroeconomic changes as forcefully as industrial borrowers. However, many of their findings would be useful, though not directly relevant, to the current study.

The review of theoretical literature on development or industrial banking indicated that unlike commercial or trading banks, development banks should have both financial and developmental roles (Bhatt 1993; Hu 1981; Kitchen 1986; Murinde 1996; Basu 1964; Schatz 1964; Ramirez 1986; Saksena 1970; Perera 1968; Diamond 1957; Kuiper 1968; and Arikawe 1986). But the explanations relating to whether deficiencies or flaws in these roles were responsible for industrial loan defaults in development banks were not given in these studies. Moreover, these authors ignored the influence of public policy regimes on the efficiency of the financial and development roles of the IDFI's. How inefficiencies or flaws in public policy trigger inefficiency in the lending and industrial development activities of the public IDFI's and how these flaws contribute towards industrial loan default were largely ignored by these authors.

The empirical research carried out by Kane (1975), Hunte (1992), Aguilera (1990), Sobhan and Ahsan (1990), Sobhan and Mahmood (1981) and Sobahn and Sen (1989) identified some factors responsible for industrial loan defaults. Each of these factors was studied separately by different authors. While some of them exclusively dealt with financial roles, others concentrated on policy factors. The development role attracted scant attention from them. But how flawed financial role, flawed developmental role and flawed public policies together contribute to industrial loan defaults were completely omitted in the above studies. As such, the current study seeks to provide a theoretical model of industrial loan defaults incorporating these three explanatory variables and to test this model on the basis of empirical findings and other evidence.

11.2.2 Overview of Industrial Finance Market and Loan Default

Problems in Bangladesh

Market imperfections, distortions, inefficiencies, dominance of control mechanism and government intervention in the credit intermediation process are the main features of the industrial finance market in Bangladesh. Since independence, the Government of Bangladesh (GOB) has endeavoured to industrialise the country through several policy

deliveries. Such intervention culminated in the re-lending of capital borrowed from the international lenders such as the World Bank to the budding and inexperienced entrepreneurs through the state-owned IDFI's such as the BSB. Along with the IDFI's, commercial or trading banks were also directed to provide term loans to these entrepreneurs since the late 1980s.

Despite wide variations in respect of roles, nature of business and operations, both the IDFI's and commercial banks were struck by persistent and staggering loan default rates. The two state-owned IDFI's bore the brunt of massive loan defaults. On average, only 5 percent of loans was repaid in cash by the IDFI-borrowers, though commercial bank-borrowers repaid a little bit more.

The GOB has taken various band-aid measures such as increased monitoring role of the central bank over industrial loan providers and borrowers, enactment of bankruptcy laws, establishment of loan courts and denial of fresh credit to repeat defaulters. These failed to arrest the rising trend of the loan default rate.

Among the two industrial DFIs, the BSB is the leading one in terms of number of industrial borrowers, firms in the investment portfolio and amount of loans provided. Between December 1971 and September 1996, it financed 1490 industrial concerns. Half of them commenced commercial operations and the rest remained either under implementation or stuck-up for year after year due to various reasons. The industrial entrepreneurs owed Taka 16.69 billion to the BSB as at September 1996. Despite a carrot and stick policy, the BSB could not recover more than about one-fifth (21.48 percent) of the outstanding loans from the industrial borrowers.

As the BSB was gripped by the extremely high default rate, it lost the ability to thrive on recycled recovered capital. This led the international financiers to freeze the credit supply to the BSB since 1985. Struck by these double blows, this once leading IDFI turned into a moribund financial institution in the early 1990s. The persistent industrial

loan default took its toll in terms not only in under-capitalisation and illiquidity of BSB-type IDFI, but also in lowering fixed investment in manufacturing industry and dashing the hope of rapid industrialisation in Bangladesh.

11.2.3 Theory of Industrial Loan Default

It appears from the writings of many authors (Perera 1968; Schatz 1964; Ramirez 1986; Saksena 1970; Bhatt 1993; Hu 1984; Kane 1975; Kitchen 1986; Murinde 1996; Diamond 1957; Kuiper 1969; Arikawe 1986, Gerschencron 1966 and 1968; and Ligeti 1985) that a development bank should play both financial and developmental roles and should not behave like a commercial or trading bank which is concerned with the financial role only. The efficiency of these roles of the IDFI is heavily influenced by the public policy regimes. The existence of unfavourable and/or flawed government policies, such as interest rate and fiscal anomalies, constrains the IDFI in conducting lending activities and in providing developmental assistance or credit guidance to stimulate industrial development. Another offshoot of the policy flaws is the inability of the entrepreneurs to operate their industrial concerns profitably and repay loans, no matter how efficiently an IDFI plays its financial and development roles.

These particles of opinions and arguments of various authors were glued together into a theoretical model of industrial loan default. The model is based on three principal explanatory variables and these are: flawed financial role; flawed developmental role; and flawed public policy. These three principal explanatory variables encompass 23 ordinary explanatory variables.

The model states that industrial loan defaults are the outcomes of flawed financial role, flawed developmental role of the IDFI and flawed public policy. In other words, the less the flaws in the financial role, developmental role of the IDFI and public policy, the less would be the rate of industrial loan defaults. Further, industrial loan default will continue to emerge if any of the variables is omitted from the model.

11.2.4 Research Methodology:

Both qualitative and quantitative research methods presented in Chapter 5 were used to test the theoretical model of industrial loan default. The objective for resorting to multiple research methods was to have convergent, valid and reliable conclusions on research findings.

Quantitative research was carried out on the basis of data collected both from primary and secondary sources. Data collection from secondary sources involved eliciting and processing pertinent information from files of 304 loan cases by spending 2640 man-hours within three months, apart from procuring and processing data from various institutions and departments in Bangladesh. The primary data were collected through an administered questionnaire as the self-administered questionnaire yielded a very poor response from the respondents.

Qualitative research was carried out on the basis, in addition to primary and secondary data, of interviews and published materials. It unfolded events which provided additional data untapped by quantitative research methods. The application of both research methods helped to discover commonalities across research findings on a number of variables and to arrive at valid and reliable convergent conclusions about the causes of industrial loan defaults in Bangladesh.

11.2.5 Results of Field Survey and Loan-file Investigation

The results presented in Chapter 6 show that the majority of respondents experienced delayed disbursement of credit, got inadequate working capital and suffered from huge unutilised productive capacity. They could not generate enough income to service debt obligation due to delay in firm set-up and delayed commencement of commercial operations. The large segment of the respondents registered their dissatisfaction over

the inadequate involvement of the BSB in the supervision of implementation work of their firms. Poor monitoring of the operating conditions of the firms and holding of infrequent management meetings were the predominant opinion of the majority of respondents. Most respondents favoured extended loan repayment period and opposed any public policy that adversely affected the profitable operations of firms. These results gathered from the opinion and concerns of the respondents were used to test a number of hypotheses relating to industrial loan defaults in Bangladesh.

11.2.6 Testing the Model - Part I : Flawed Financial Role and Industrial Loan default

The relationship between flawed financial role and industrial loan defaults was examined by testing eight hypotheses relating to: officer-application ratio; borrowers' credit worthiness; credit need assessment; government intervention; credit disbursement; debt-equity ratio; term and variable loan ratio; and loan repayment period.

The credit control mechanism employed by the BSB was flawed which was evidenced by improper and hasty processing of loan cases without careful scrutiny of the borrowers. The credit unworthy borrowers sneaked into the term credit regime by taking advantage of the laxity in the borrowers' screening mechanism and this resulted in disbursing credit to unworthy borrowers and financing projects with dubious commercial viability.

The inefficiency of the borrower's screening mechanism was evidenced by the large number of stuck-up cases in the BSB's loan portfolio, abnormal delays by the borrowers in mobilising equity capital, lending to repeat defaulters and concentration of huge amount of loans in few defaulter business houses. Rampant political interference and frequent government intervention in loan intermediation process were also

responsible for an inefficient screening mechanism which culminated in the misdirection of credit to unworthy industrial projects.

Moreover, project appraisal reports prepared mostly by inexperienced loan officers were incomplete and poor in quality. Lack of reliable data and/or information exacerbated the problems relating to quality loans. Project feasibility studies remained pro-forma exercises, full of inconsistencies and these were designed to provide cosmetic justification for the sanction of term loans to the industrial entrepreneurs, majority of whom had no industrial experience at all. This means that assessment of credit needs of various projects was flawed which wrongfully allowed would-be defaulters to grab large chunks of industrial credit from the BSB.

Disbursement of both local and foreign currency loans was delayed due, partly, to the inability of borrowers to mobilise the necessary equity and, partly, to the delayed loan processing by the BSB. Such delay increased the costs of borrowing and delayed cash generation for servicing the loans and these factors were responsible for industrial loan default.

The level of owners' equity investment in the firms was found to be very low compared to the amount of term credit provided by the BSB. It suggests that firms were highly leveraged due to high debt-equity ratio and most of these firms defaulted in repaying loans to the BSB. Given that some Bangladeshi entrepreneurs resorted to money laundering through grossly over-stating the values of imported machinery (which is known as over-invoicing), the level of genuine equity investment was extremely low.

The little or negative equity investment provided a financial incentive for the borrower to default, as the benefits of not repaying loans were greater than costs of not repaying loans. Moreover, because of little or negative equity, the entrepreneurs lost seriousness to run the concern profitably and keep loan repayment commitment to the BSB. It was found that higher loan default was associated with high debt-equity ratio which

supported the identical findings of the World Bank (1995b), Saptahik Bichitra (1995), Hussain (1996), and Jackson and Kaserman (1980).

Results obtained from both primary and secondary data showed that the term and variable loan ratio in the BSB was very high. It appeared that most of the firms suffered from the lack of adequate working capital and the bulk of the loans provided by the BSB were used to acquire fixed assets of the firms. The use of these fixed assets was not facilitated by adequate working capital loans either from the BSB or from the commercial banks. Constrained by insufficient working capital, most firms could not utilise productive capacity to the extent which allowed them to generate sufficient cash flow to service the debt in time, given that borrowers were willing to repay loans. The inevitable result of inadequate working capital was loan default.

The loan default problem was compounded by the stringent loan conditions requiring the firms to repay loans even when they were under implementation. The loan burden escalated due to failure of the BSB to match the borrower's ability to repay loans or firms' cash flow sequence with the repayment instalment.

11.2.7 Testing the Model – Part II : Flawed Developmental Role and Industrial Loan Default

The relation between the flawed development role of the BSB and loan default was examined by testing eight hypotheses involving eight ordinary explanatory variables. The summary of such examination is provided as under.

Since inception, the BSB has pursued the strategy of providing term loans to the export-orientated industry (EOI) and import-substituting industry (ISI). Such strategy was found to be rewarding in the sense that borrowers in these industries repaid relatively more than their counterparts in other industries. However, there were certain

EOIs and ISIs which showed the worst repayment performance. This suggests that indiscriminate selection of any type of enterprise for term finance was not justified.

The BSB provided term loans to certain industries, such as automatic rice mills (ARMs), cold storage, textile mills and water transport, where the scope for further development of productive capacity had already been exhausted. Even after the confirmation of the existence of over-congestion of firms in a particular industrial sector, the BSB continued to supply term finance to that over-saturated sector. This supports the findings of Ahmed (1977), Afroz and Roy (1977), Battacharya (1993) Sobhan (1991a and 1991b), Sahota (1991), World Bank (1995b), Sobhan and Sen (1989) and GOB, Report of the Task Force (Vol. 2, 1991) that the existence of excess capacity was widespread in Bangladesh which contributed towards unsatisfactory repayment performance. The majority of the borrowers surveyed also stressed that the existence of excess capacity has forced them to run their industrial concerns at below installed capacity. It made them unable to repay their loans to the BSB.

The BSB supplied term loans to both large and small firms. Despite the fact that the number of small firms constituted more than two-thirds of the BSB's investment loan portfolio, large firms claimed the largest chunk of the total loanable resources of the BSB. But the large industrial firms repaid proportionately more loans than small firms. This suggests that higher probability of loan default was associated with the smaller firms.

The BSB's involvement in all kinds of project implementation activities such as selection of project machinery, construction of building and assembling of machinery was highly inadequate. As the BSB's guidance for successful and timely implementation of the projects was far from being sufficient, the majority of firms had to wait for over two years to start commercial production. There were even several firms which took between five and seven years to implement and commence production. This shows that industrial entrepreneurs as well as firms were not adequately nursed by the BSB like its

successful counterparts in other countries. It also supported the finding of another study (Sobhan and Ahsan 1986) that delay in the implementation of the projects funded by the BSB was a regular phenomenon. This suggests that the BSB provided highly inadequate entrepreneurial guidance while implementing the project. Because of such insufficient developmental role and consequent inordinate delays in project implementation, borrowers could not commence operations of the firms as scheduled and generate income in time to service the debt.

BSB's involvement regarding the supervision and follow-up of its financed projects during the time of project implementation (such as building construction and machinery assembling) and commercial operation, was highly infrequent, unsystematic and unorganised. This resulted in cost over-runs, delayed commencement of production and a growing level of interest burden. Being deprived of BSB's professional supervision and follow-up, firms were left to be supervised by the inexperienced entrepreneurs. These unguided and directionless borrowers were unable to make best use of their resources and to generate sufficient income to repay loans.

The BSB, with a view to monitoring the real performances of the firms effectively, included a number of conditions in the loan agreement. These conditions included regular supply of data relating to operational results and cash flow situation to the BSB. Very few firms complied with these conditions and the BSB was deliberately kept in the dark about the true position of the firms. The BSB was unable to get adequate access to the data relating to the real position of the firms. Because of the borrowers' non-cooperation, the BSB could not adequately monitor the true position of the firm and take subsequent pro-active measures to pre-empt emerging loan default problems. No instance was found where the BSB reprimanded the non-responding firms for breaching the provisions included in the loan contract and this has encouraged other firms to defy loan conditions. The data show that the better loan repaying firms were visited more frequently by the BSB than the poor loan repaying firms.

Industrial projects financed by the BSB were mainly owned and managed by the family members, the majority of whom had no experience relating to industrial management. Very few firms were managed by professionals. Moreover, few firms complied with the loan conditions relating to efficient management and holding regular management meetings in the presence of the BSB representative. Even non-complying firms were not rebuked by the BSB for failing to fulfil the conditions relating to efficient management of the firm.

The problem of mismanagement of firms was exacerbated by the BSB's failure to police its own regulations regarding efficient project management. It was found that better managed firms were large firms which repaid relatively more loans than small firms which were plagued by mismanagement. This suggests that a better loan repayment rate is associated with better management of the firm.

11.2.8 Testing the Model – Part IIIA : Flawed Public Policies and Industrial Loan Default

It was found that the public policies delivered by the GOB were full of inconsistencies which created huge bottlenecks against successful operation of industrial firms and timely repayment of loans. Ad hoc policy directions and changes have strengthened some borrowers' unwillingness to repay loans even when they were able to repay loans. The adverse effects of these policies on the operations of these firms were so far-reaching that each of these policies deserved a separate study. However, the current study investigated the effects of interest rate policy, fiscal policy, import policy, industrial policy, regulatory policy and policy relating to the management of the BSB.

The BSB took advantage of GOB's policy inconsistencies regarding interest rates and charged the borrowers high interest rates in contravention of policy directives. The imposition of high interest rates on the industrial borrowers was a stark contrast to its role and objectives as a development bank. Such irrational lending behaviour cost the

borrowers in terms of accumulated debt burden. The loan repayment performance of 304 firms showed that the debt level of manufacturing firms charged with lower interest rates was relatively lower than that of firms charged with relatively higher rates of interest. This also supports the finding of other studies (World Bank 1995b; Sobhan 1991a and 1991b; and EIU, Country Report 1st and 3rd Quarters 1994) that high interest rate is one of the causes of loan default.

The application of band-aid fixes such as the imposition of a penal interest rate on the defaulted loan amount has back-fired in terms of growth of accumulated debts. The mispricing of some of the public savings instruments, the crowding out of private borrowing by the GOB's massive borrowing from the local banking sector and the GOB's policy failure to align interest rates with other policy regimes created grounds to keep interest rates always high which increased the frequency of default incidents.

The BSB was caught in the vicious circle of high interest rates and high loan default rates. The high interest rates increased the debt burden in excess of the true worth of the assets of the firm which induced the borrowers to become defaulters. This resulted in the growth of loan loss which drained BSB's lending resources. In a bid to recover these losses, the BSB had to depend on high interest rates. As such, high interest rates were both cause and effect of high loan default rate. In other words, industrial loan default was an in-built problem of the interest rate policy in Bangladesh

The persistent devaluation of the Taka had adverse effects on the loan repayment capacity of the borrowers. About two-thirds of the firms investigated received foreign currency loans from the BSB and as the borrowers were required to repay foreign currency loans in terms of equivalent Taka, every devaluation of Taka increased their debt burden. The GOB's policy of requiring firms to bear the foreign currency repayment liability was not consistent with its industrialisation policy objectives. The majority of the borrowers surveyed identified Taka devaluation as one of the reasons for their failure to repay loans to the BSB.

The GOB introduced the EFAS facility in the late 1980s in recognition of the problems associated with Taka devaluation. Though such step apparently insulated the borrowers against such devaluation in late 1980s, increased level of taxes on imported raw materials almost wiped out such benefits. Data relating to 304 firms showed that firms receiving foreign currency loans defaulted at a higher rate than the firms receiving local currency loans. This corroborated the finding of another study (Hassan 1995) that devaluation of the Taka was one of the factors responsible for loan overdues in Bangladesh.

The GOB attempted to provide import policies supportive of the financed firms, but such attempt was frustrated by the lack of coordination among various ministries and departments. The non-availability of industrial licences and sufficient foreign exchange and too much control on imports resulted in the unavailability of a sufficient quantity of industrial raw materials and components. This resulted in under-utilisation of the productive capacity of financed firms. However, GOB's liberal policy was abused by the corrupt traders who flooded the local market with foreign goods. This had not only squeezed the markets for the products of the borrowing firms but also eroded their market protection provided by the GOB.

The majority of the borrowers who participated in the survey conducted by the author blamed the GOB for inadequate protection of their industry from import of foreign goods. Being assaulted by two pronged attacks, that is, the inadequate availability of raw materials and components and take-over of the market by the imported finished goods, financed firms were forced to operate below capacity. The GOB's own Fourth Five Year Plan document recognised that the shortage of imported raw materials led to the low capacity utilisation in industrial firms. Being unable to utilise productive capacity adequately, these firms could not generate sufficient cash flow to pay off the debt, given that they were willing to repay loans.

The GOB was aware of these problems and endeavoured to provide protection to the local industry against the onslaught of imported products. But the disadvantages accrued from high tariffs rates on the imported raw materials and industrial components far outweighed the advantages flowing from this protection. This high tariff on industrial raw materials and components added extra strain to the working capital-starved entrepreneurs. Added to these problems were the complexities associated with tariff fixation and administration, and lack of coordination among various ministries and departments of the GOB. As a result, financially squeezed entrepreneurs were not able to utilise industrial capacity to generate sufficient income to pay off the debt, given that they were willing to repay loans. These suggest that interest rate policy, exchange rate policy, import policy and tariff policy were flawed which contributed to industrial loan default.

11.2.9 Testing the Model – Part IIIB : Flawed Public Policies and Industrial Loan Default

Since independence in 1971, every GOB had its own brand of industrial policy. Except for the first two industrial policies (IPs) which stressed a socialistic economy, all IPs tended to stress private sector investment. The post-1975 IPs confined themselves to procedural changes for bringing down regulatory changes to industrial loan approval activities. But the deregulatory measures recommended by the IPs were not complemented with appropriate industrial promotion measures such as creating institutional facilities and provisions for providing guidance to the budding and inexperienced entrepreneurs from the start-up of the industrial enterprise to the liquidation of loans. That is, facilities and provisions included in the IPs were not consistent with policy objectives as well as expectation for industrialisation. The GOB relied more on control mechanisms such as issuance of import licences than on policy instruments supporting the ‘nursing’ of budding industrial entrepreneurs with guided industrial credit.

Such over-reliance on control mechanisms manifested itself in the form of excessive bureaucratic controls of various ministries and departments on the instruments, institutions, rules and procedures relating to private sector industrial development in Bangladesh. Indiscriminate and uncoordinated sanctioning of industrial capacities as well as industrial loans by various public and private financial institutions led to the creation of excess capacity and over-supply of credit.

Despite some degree of relaxation of control in rules and procedures governing the private sector, centralisation of decision-making process, administrative control and procedural bottlenecks have given rise to red-tapism, duplication, delays and corruption in the industrial investment process. These hurdles delayed loan processing and loan disbursement which raised the cost of borrowing. These flaws contributed towards reducing the debt repayment capacity of the borrowers.

Most of the industrial policy was ad hoc in nature and frequent policy shifts with the changes in the government have created huge anomalies among various policy regimes, not to mention the weaknesses in each policy. Neither interest rate policy nor fiscal policy was aligned with IPs and, consequently, borrowers were forced to pay high interest at fixed rates and to pay higher prices on imported raw materials and components than what they ought to be. The policy inconsistencies created bottlenecks against profitable operations of industrial firms and these adversely affected the generation of enough income to repay loans. Such failures of the IPs were recognised by the GOB itself and some other studies (GOB, Report of the Task Force Vol.1&2 1991; and Far Eastern Economic Review, Asia 1992 Yearbook).

Apart from these contradictions and inefficiencies within IPs and between IPs and other public policies, there were not enough instruments to execute these policies. The IPs were based on the wrong premise that large numbers of experienced industrial entrepreneurs were out there to be lubricated by the industrial credit. Given the lack of experienced industrial entrepreneurs, credit guidance and instruments for guiding the

inexperienced or budding entrepreneurs were required there. No industrial policy paid attention to this pertinent aspect of credit and entrepreneurial guidance. All industrial policies stressed credit direction¹²⁷ rather than credit guidance. This suggests that the objectives set out in the IPs were incompatible with the policy instruments and mechanisms and such incompatibility contributed to industrial loan defaults.

Inadequate and contradictory regulatory regimes have not only encouraged some well-off borrowers to default deliberately but also reduced the ability of some borrowers who were willing to repay loans. Frequent loan amnesty and accumulated interest waive-out statements by the GOB mocked the loan recovery drive pursued by the BSB. Legal action against the defaulters resulted in the recovery of an insignificant portion of loans because of loopholes in the legal procedures. Political intervention and corruption in the loan recovery process were evident by the fact that top businessmen, policy-framers, law-makers, politicians and the former prime minister of the country were the prominent loan defaulters.

Industrial loan default was also in-built in the management process of the BSB itself. As a state-owned IDFI, it was managed by the state-appointed directors and very few of them had any credible experience in the management of a development bank. The BSB was administered as a public sector institution rather than a development bank. Bureaucratic and political interventions in the sanctioning and distribution of loans led the professional loan managers to compromise with the standard and quality of credit control and management. The managers had little autonomy or incentive in applying an efficient screening mechanism to comb out unworthy borrowers from the pool of loan applicants, determining credit limits and debt-equity ratio on the basis of feasibility studies, identifying viable projects and providing suggestions for efficient management of the financed firms.

¹²⁷ There is difference between credit direction and credit guidance. Credit direction is related to allocation of credit to particular sectors of industry, while credit guidance involves the use of credit. How, when and where credit should be used are dealt by guided credit.

Moreover, they were never included in the credit policy formulation and execution process. Additionally, much of the inefficiency of the BSB was due to inconsistencies in the public policy regimes affecting credit control and credit administration. Industrial loan default was the outcome of persistent flaws in these public policy regimes.

11.3 Conclusions

The drawbacks of the financial role of the BSB are evidenced by its moribund condition. Its financial unsoundness is represented by its illiquidity and negative net worth. Such financial convulsion was the inevitable outcome of inefficient borrowers' screening mechanism, delayed loan processing and credit disbursement, supply of credit to over-saturated industrial sectors, high debt-equity ratio, high term and variable loan ratio, inappropriate loan repayment schedule and frequent outside intervention in loan intermediation process.

These flaws have allowed credit unworthy borrowers to have access to long-term credit facilities. It also resulted in the credit delivery to industrial enterprises with dubious commercial viability. As the credit given by the BSB was mostly unguided, it attracted unworthy borrowers and created scope for credit leakage from the flow of industrial investment. Such leakages happened in the form of over-payment against the overstated equity investment and over-invoiced machinery and equipment. This has also increased the risks of credit which forced the BSB to impose high rates of interest on term credit which increased the debt burden. As the default burden grew more than net worth of the industrial enterprise, the borrowers found incentives to become defaulters.

These inefficiencies have not only reduced the term credit intermediation capacity of the BSB and impaired the ability of the borrowers to repay loans, but also influenced them not to repay loans even when they were able to repay loans. Like the commercial bank, lending activities of the BSB were driven by profit motive which was not compatible

with its industrial development objectives. Thus, the flawed financial role played by the BSB contributed towards persistent industrial loan defaults.

As a development bank, the BSB was an under-performer. Its departures from the developmental roles were enormous. It did not adequately use its available resources to work as a catalyst for success of its financed enterprises as was done by its most successful counterparts in developed and developing countries. It was insufficiently instrumental in developing successful entrepreneurship since picking and grooming potential borrowers as successful entrepreneurs by providing guidance from the firm's set-up stage till to the liquidation of loans did not happen. It is also evident that BSB behaved more like a commercial bank than a development bank and that its financial role was more important than its developmental role.

Whatever development role it played was not as efficient as it ought to have been. Its developmental role was mostly passive rather than active; its involvement was least participative in all stages of firm selection, implementation, operation and management. As the financed firms were in the hands of unguided but directionless and visionless borrowers who were mostly first generation entrepreneurs, most of the firms suffered from mismanagement which turned them into loss-making concerns. The inevitable result was borrowers' failure to generate sufficient cash flow and inability to repay loans. Moreover, the BSB's minimal involvement in the execution and operation of the firms in terms of policy advice created the scope for deliberate default. That is, the flawed development role of the BSB constituted one of the prominent causes of industrial loan default.

The findings of the study suggest that the policy regime was characterised by inconsistency, inadequacy, inefficiency and ad hocery which resulted in the reduction of efficiency of the financial and developmental roles of the BSB and creation of impediments against successful operations of firms. The direction of industrial credit remained inappropriate to the conception and expectation of the policy-makers.

Problems at policy execution level were more forceful than at the policy formulation stage. Inter-policy and intra-policy contradictions and inconsistencies led to the misdirection of industrial credit, high cost of industrial operations, rise of wilful defaulters, loss of market for financed industries and unhealthy environment for industrial investment. Very few firms were able to withstand these unfavourable conditions and to repay loans without being classified as defaulters.

The persistent inconsistencies in public policy regimes filtered down to the BSB's operational level and triggered inefficiencies in its financial and development roles. This meant that many of the flaws in financial and development roles of the BSB and consequential loan default were caused by the flaws in public policies. All these suggest that industrial loan default was also both a cause and effect of inconsistent public policy regimes.

Lastly, the findings of the study provide conclusive support for the theoretical model of the industrial loan defaults presented by the author. It means that industrial loan default in the BSB was the outcome of its flawed financial role and flawed developmental role and flawed public policies delivered by the GOB.

11.4 Limitations of the Study and Scope for Further Research

The study has certain limitations. Although the findings on the 23 explanatory variables supported the theoretical model of industrial loan defaults, there were other variables which were omitted from the model because of time and resource constraints. Some of these independent but controllable variables are forward and backward linkage of firms, location of firms, unavailability of social and economic infrastructural facilities, inflation, economic growth rate, industrial disputes and actions, current account deficits and various government regulations. There are also other uncontrollable explanatory

variables which influence firms' earning capacity and loan repayment performance and some of these are: natural calamities like flood and cyclone which visit Bangladesh regularly; donor's direction of aid; trade barriers; and, regulations and controls imposed by importing countries. This suggests that the current study did not exhaust the scope for further research on industrial loan defaults. Inclusion of these and other independent variables would, nonetheless, strengthen the model.

This model is tested on only one public industrial development bank. Inclusion of other industrial development finance institutions in Bangladesh and other developing countries in a future study would be useful in extending the generality of the model.

This model deals with only debt finance which comprises 99 percent of the lending activities of the BSB. There are IDFI's which prefer equity finance to debt finance. A study of the loan recovery performances of such IDFI's would be an interesting subject.

The study did not provide a comparative analysis of the reasons for industrial loan defaults differences between non-DFI's or commercial banks and development banks. Since the early 1990s, state-owned commercial banks in Bangladesh out-performed development banks in terms of loan recovery rate. It is widely believed that information asymmetry about borrowers' credit worthiness and repayment behaviour is lower with these commercial banks than with the development banks. A study of this aspect would be very interesting to test the hypothesis regarding the relationship between information asymmetry and industrial loan default.

There are industrial projects which were managed and owned by foreigners. Some of them are the clients of development banks and commercial banks. There is scope to study the loan repayment performance of these firms to examine the relationship between loan default and foreign direct industrial investment.

Other interesting research issues would include study of comparative industrial loan repayment performance between Bangladesh and other developing nations and the relationship between political regimes and industrial loan defaults. The decelerating effects of the persistent industrial loan defaults on the national economy via lost opportunity for employment creation and slowed manufacturing industry growth also deserve an in-depth study.

11.5 Recommendations

The study has resulted in the following specific and general recommendations to reduce, if not to eliminate, industrial loan defaults in Bangladesh.

11.5.1 Specific Recommendations

1. An efficient and transparent borrowers' screening mechanism should be employed as a pro-active measure to deter the entry of credit unworthy borrowers to term loan regimes. In order to increase the efficiency of borrower screening device through reducing information asymmetry between the BSB and borrowers, a provision asking the borrower to make all pre- and post-sanction transactions through the BSB should be included in the loan contract.
2. Term loans should not be provided to over-saturated industrial sectors and to repeat defaulters.
3. The loan repayment performance of the old firms should be assessed before loans are sanctioned to new firms.
4. Complete project appraisal reports should be prepared by appropriate and experienced professionals. The present practice of cosmetic justifications for sanctioning loans should be discontinued. The BSB should have a resourceful

Research Department staffed by highly experienced professionals to conduct applied research on technical, financial, commercial and economic aspects of the firms and all lending activities should be conducted as per research findings.

5. Delays in pre-disbursement inspection of the firms and loan processing should be reduced to speed up the implementation of the firms so that commercial production can be commenced in time.
6. The debt-equity ratio should not be fixed by any public policy intervention. It should be determined on the basis of the proven financial worth of the borrowers as well as the talent of the entrepreneurs. Special care should be taken so that firms do not become highly geared due to high debt obligations. It is recommended that the BSB should get involved in credit guidance to stop credit leakage and to reduce scope for loans diversion by the recalcitrant borrowers to non-industrial activities.
7. The BSB should provide adequate permanent working capital to the firms and should discontinue the practice of directing firms to other banks for such capital.
8. Loan repayment schedules should be tagged not with the hypothetical but with the real cash flow situations of the firms and be extended more than the present number of loan repayment instalment.
9. Any export-orientated or import-substituting firm should not automatically qualify for term loans. Their selection should be supported by proven market prospects.
10. As a catalyst for industrial development, the BSB should get actively involved in the selection, implementation, operation and management of the enterprise in terms of providing guidance, professional advice and technical assistance. Especially, at the time of project identification, building construction, machinery installation or assembling, appropriate and experienced professionals should be deputed to guide

the entrepreneurs and at the time of operations, professional advice should be given for the matters relating to production methods, human resource management, marketing and sales strategies, financial management etc. In order to carry out these developmental activities from the set-up stage of a firm to the liquidation of loans, a new Department within the BSB should be instituted. This Department should be staffed by experienced professionals and it should have four sections: project selection; execution; production; and financial and commercial control.

11. Loan officials should undertake frequent and unannounced visits to the projects to monitor the progress of the project implementation, operational conditions and real performance of the firms. For new firms, inspection reports should be procured for each month; for established firms, semi-annual reports may suffice. The number of visits should be more for firms having difficulties or financial distress.
12. The loan contract should include provisions giving the BSB the right to an annual independent audit and inspection of the firm, at the firm's expense, by an agency of the bank's choice. Non-responding firms should be penalised for not providing all relevant data regularly. This information should be processed immediately and appropriate measures should be taken to deal with any operational problems including financial distress.
13. The BSB should police its own regulations regarding efficient project management. It should depute, like its successful counterparts in other countries such as Japan, appropriate professionals to the board of management of the firms. The board meetings should be held frequent and regularly. It should take pre-emptive measures on the basis of minutes of such meetings to avoid emerging problems that may affect profitable operations and loan repayment performance of firms. Institutional measures should be in place to increase the cost of not complying with loan conditions regarding holding of regular and frequent board meetings in the presence of a representative from the BSB.

14. The BSB should have nominee director for all projects regardless of their operational status and such director should be nominated to the board of the firm at the start of the loan disbursement, rather than a later date.
15. For the sake of timely implementation, smooth operation and efficient management of the borrowing firms, the BSB should regularly organise and conduct various professional training programs, seminars and workshops for the client-industrial entrepreneurs as well as for their employees including managers.
16. The interest rates should be aligned with other macro-economic fundamentals such as the inflation rate. The fixation of the rates should be in conformity with the development role of the BSB. The present practice of applying fixed interest rates to the firm until loans are liquidated should be discontinued and borrowers should be given various options, such as variable interest rates, while paying interest rates.
17. The level of imperfections in the credit market should be reduced by removing distortions in interest rates currently applied on various public savings instruments. The borrowing of the GOB from the banking industry should not affect the availability of credit to the industrial borrowers.
18. The loan repayment instalment should not be denominated in foreign currency. For the sake of industrialisation, the foreign currency repayment liability should be transferred from the firm to the GOB in the form of EFAS- like facilities previously offered by the GOB. Alternative options include providing loans in local currency to the firms to buy foreign exchange from the market for making payment for imported machinery, equipment and raw materials. As the firm's repayment obligations to the bank will remain in local currency, such strategy will insulate the firm against excessive debt burden due to Taka devaluation.

19. The functions of the BSB should be diversified like its counterparts in other countries. Full blown commercial banking, lease financing, buying and selling shares and providing commercial insurances to the client-firms are some suggested activities which the BSB can endeavour.
20. The tariff rates on imported industrial raw materials and components on the one hand and on the imported finished products on the other hand should be rationalised to increase the competitiveness of the products of the domestic industry.
21. Industrial policy should be aligned with other public policies and be complemented with industrial promotion measures. The GOB should rely on policy instruments rather than on control mechanisms while directing industrial investment. Adequate regulatory measures should be there to complement credit direction by credit guidance.
22. The GOB should institute an organisation or agency with the responsibility of coordinating lending and other related organisations for matters relating to development of industrial capacity, disbursement of term and working capital loans, information of industry-wise requirement for tariff incentives and issues of tariff administration. It should also work as data bank for collecting information on investment, production, prices of imported raw materials and components, marketing, competitors and other related issues.
23. Public offices or institutions should not be used or permitted to provide contradictory regulations affecting industrial investment, credit guidance and loan recovery efforts. Legal procedures should be strengthened and all legal loopholes should be closed so that no defaulter can get away with not repaying loans.
24. In order to reduce government or bureaucratic intervention in the loan intermediation and loan recovery process, the BSB should be given full operating

autonomy to allow hiring and firing of experienced professionals and personnel, and formulation of lending and operation policies.

25. The BSB should be managed by professional development bankers and the Managing Director and General Managers should be experienced development bankers with long tenures. The members of the Board of Directors should have in-depth knowledge and experience in industrial or development banking and the Board should not be tainted by political appointment. The managers should be given autonomy and freedom in the loan intermediation and recovery process. The officials of the BSB should get involved in monetary, fiscal, import and industrial policy formulation and execution process. Effective and applied training programs for managers and officers should be organised. As good managers are always expensive, the BSB officials should be awarded with relatively high salary and perquisites to induce them to remain with the bank.

11.5.2 General Recommendations

Since the BSB is a development bank, it should not behave like a commercial or trading bank. Unlike commercial banks, it has industrial development objectives. As such, its lending activities should not be driven by profitability considerations only. This means that its profitability level from lending activities should not be expected to be as large as that of a conventional commercial or trading bank. At the same time, it cannot work like a charity or insolvent institution. As its financial profitability falls within these two spectrums, the financial role of the BSB should be reorientated and revamped to attain the goals of industrialisation in Bangladesh. The development roles of the BSB should be rejuvenated by reactivating the mechanism previously tried or applied inadequately. Under its development roles, the BSB should get more involved in entrepreneurial guidance while selecting, implementing and overseeing the firms like its successful counterparts in other countries.

Both the financial and development roles of the BSB should be supported by persistent but consistent and adequate public policy regimes. The policy makers should become aware of the consequences or costs of their policy initiatives and policy inconsistencies on the profitable operations of the industrial firms and their consequential effects on loan repayment performance.

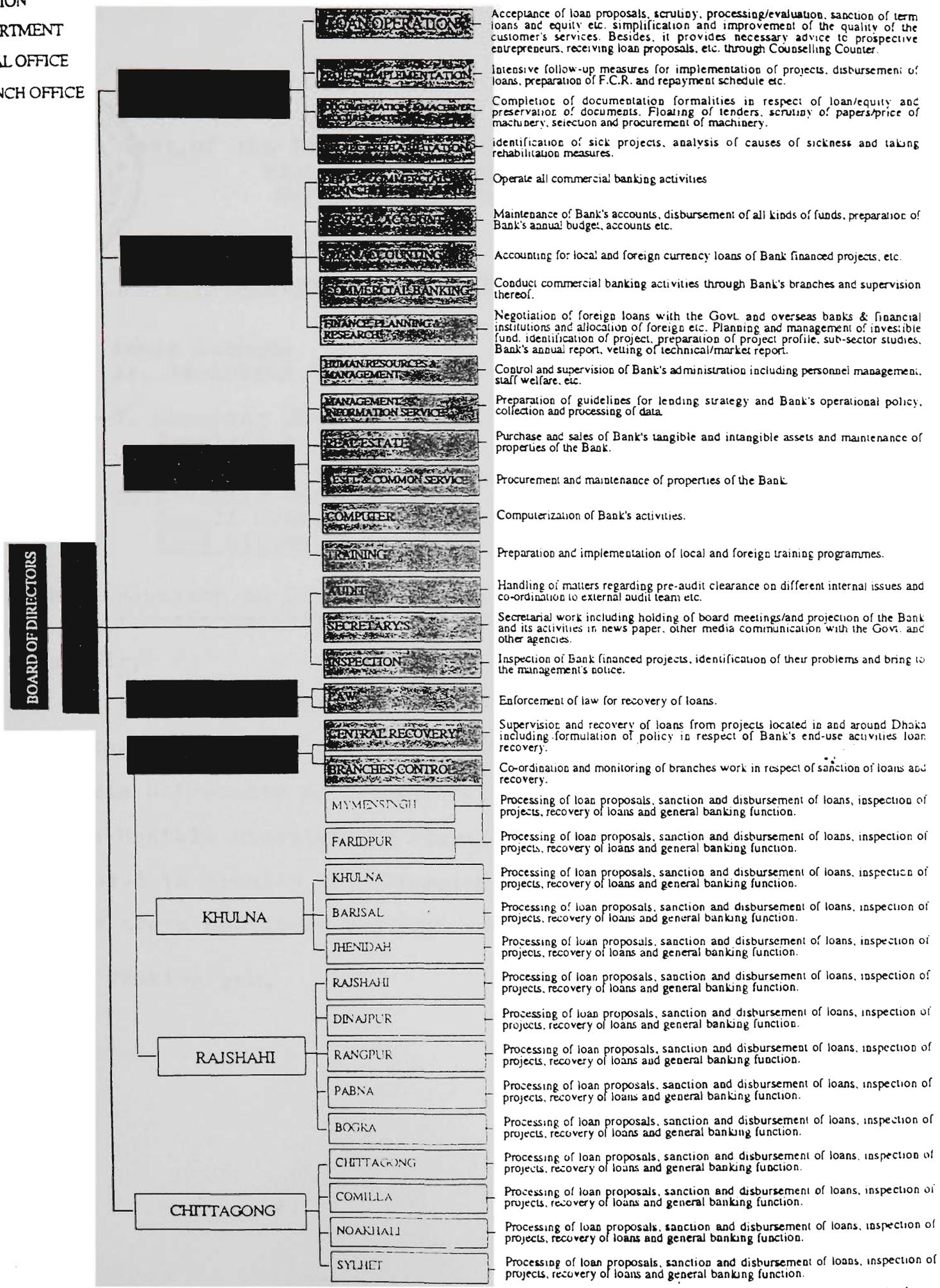
The GOB should rely more on policy instruments rather than on control mechanism for removing impediments against competitive operation of industrial firms. Institutional arrangement should be there to identify, pick up and groom talented and resourceful persons as future successful entrepreneurs. In this regard, the GOB can seek the assistance of BSB-like IDFI. Moreover, the senior development bankers should be consulted before any public policy relating to industrial loans and to operations of industrial firms is formulated and executed.

11.6 Concluding Remarks

It is the hope of the author that this study will arouse the interest for furthering the understanding of the reasons for industrial loan defaults in developing countries and advance knowledge in the subject of industrial development banking. It is ardently hoped that lenders, donors and policy makers will find this study useful in formulating and executing credit and all other policies and strategies to achieve the goals of sustained and unfettered industrial advancement in developing countries.

ORGANIZATIONAL CHART OF BANGLADESH SHILPA BANK

- DIVISION
- ▣ DEPARTMENT
- ZONAL OFFICE
- BRANCH OFFICE



APPENDIX - B

Govt. of the People's Republic of Bangladesh
 Ministry of Finance
 Banking Division
 Section-8

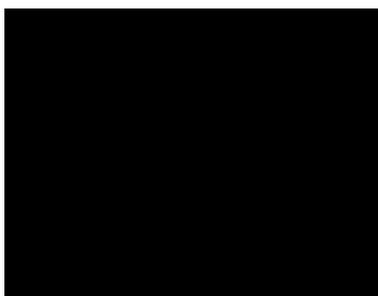
No. MF/BD/Sec.8/Loan-37/96/ 351(2)

Dated: 28-12-1996.

From: Anwar Faruque
 Sr. Assistant Secretary.

To: 1. Managing Director,
 Bangladesh Shilpa Bank,
 Head Office, Dhaka.

2. Managing Director,
 Sonali Bank,
 Head Office, Dhaka.



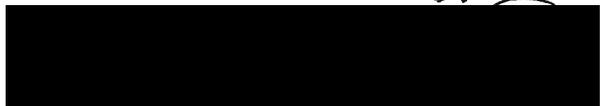
Sub: Research on Industrial Loan Default in Bangladesh.

Dear Sir,

Enclosed please find the letter of Professor Keith Lansley, Director, Research & Graduate Studies, Faculty of Business, Victoria University of Technology, Melbourne, Australia, addressed to the Hon'ble Minister for Finance on the above subject. You are requested to provide all necessary cooperation to Mr. Ziaul Hoq on the above mentioned research study.

Thanking you,

Yours faithfully,



(Anwar Faruque)
 Sr. Assistant Secretary.
 Phone: 869164 (Off).

APPENDIX - C

7 December 1996

Mohammad Ziaul Hoque
8/11 Lalamatia, Block C
Dhaka
Bangladesh

Subject: Research on Industrial Loan Default

Dear Sir,

I am writing to you regarding a research study on the industrial loan defaults in Bangladesh. This is related to my doctoral study at the Victoria University of Technology, Melbourne, Australia. Please find a set of questionnaire enclosed with this letter. Most of the questions are set with "Yes" or "No". There are questions against which multiple answers are provided. Please put tick against the question relevant to you. I have provided a stamped and self-addressed envelope. Soon after you complete the questionnaire, please send it in the envelop provided.

I also undertake to send you a brief report on the findings of my study. I am confident it will of much use to you. I would request you once gain to please complete the questionnaire and sent it to me.

Thank you very much for your time and attention.

Yours sincerely


Mohammad Ziaul Hoque

APPENDIX - D

Survey of Industrial Firms Financed By The BSB

A. Introductory

1. Name of the Firm
2. Address

B. Choice of Project

3. Why have you chosen this firm ? (Please circle one, if not told otherwise)

• You have industry experience	Yes	No
• There was market prospect for this firm	Yes	No
• You heard that BSB was entertaining such firm	Yes	No
• Others such as motivation by friends	Yes	No

C. Loan Disbursement

4. Was disbursement of loans instalment in time ? Yes No
If Yes please go to question no. 8
5. What was the reason(s) for delayed disbursement of Loans
(Please Tick)
 - Delayed pre-disbursement inspection and loan processing by the BSB-officials
 - Bank's demand for more document regarding equity investment
 - Inadequate equity capital to meet pre-disbursement conditions
 - Others such as inability to meet financial demands or bribes
6. Do you think that delayed loan disbursement was responsible for (Please Tick)
 - Cost over-run
 - Delayed implementation
 - Accumulation of debt burden
7. If there was cost over-run, was it due to increase in the price of (Please Tick)
 - Building materials

- Imported machinery

8. Has the pre-disbursement inspection occurred before you asked for it ? Yes No

9. If No, reasons for asking the BSB to inspect your firm (Please Tick)

- Loan instalment disbursement
- Seeking advice for building construction
- Looking for assistance regarding machinery installation

10. Are you satisfied with the BSB regarding

- | | | |
|---|-----|----|
| • response to your request for inspection | Yes | No |
| • inspection of the project | Yes | No |

D. Project Implementation

11. Did you experience delayed set up (implementation) of your firm ? Yes No
If no, please go question no 16.

12. If Yes, which of the followings was responsible for this (Please Tick)

- Delay in foreign currency allocation
- Delay in machinery selection
- Delay in imported machinery arrival
- Delay in building construction
- Delay in machinery installation

13. Who selected firms machinery ? (Please Tick)

- The BSB
- Private consultants and sponsors
- Both the BSB and the sponsors
- Private consultants

14. Have you received assistance from the BSB regarding:

- Machinery installation or assembly
- Building construction
- None of these

15. Do you think that delayed implementation of the project was responsible for loan default Yes No

E. Project Supervision and Monitoring

16. What were the reasons for firm visit by BSB's officials ? (Please Tick)

- Pre-disbursement inspection
- Attending Board meeting
- Attending operational problems
- Fill out inspection form
- Follow-up visit
- Loan recovery
- Advice implementation

F. Capacity Utilisation

17. Do you have production capacity unutilised ? Yes No

18. If Yes, name the reasons for un-utilisation of production capacity.(Please Tick)

- Excess capacity in the industrial sector
- High cost of raw materials
- Unavailability of spares
- Loss of market
- Unavailabilty of skilled workers and managers

19. Do you think that un-utilisation of capacity was responsible for loan default ? Yes No

G. Working capital

20. Have you got adequate working capital from the BSB ? Yes No

21. If yes, was in time ? Yes No

22. Do you think that inadequate working capital was responsible for low cash flow which caused loan default Yes No

H. Project Management

23. Do you send following reports to the BSB ?
- | | | |
|---|-----|----|
| • Monthly operational data and cash flow statement | Yes | No |
| • Quarterly progress report at the time of project implementation | Yes | No |
| • Audited annual balance sheet | Yes | No |
24. If No for any item, list the reason(s) for non-compliance (Please Tick)
- Unnecessary
 - Time consuming
25. Would you send those if there is penalty for non-compliance ?
- | | | |
|--|-----|----|
| | Yes | No |
|--|-----|----|
26. How many times you held Board of Directors' meeting (Please Tick)
- Quarterly
 - Half yearly
 - Annually
 - Over a year
27. Do you support BSB's presence in the Board meeting
- | | | |
|--|-----|----|
| | Yes | No |
|--|-----|----|
28. Do you think that training provided by the BSB to the firm would be helpful in its overall efficient management
- | | | |
|--|-----|----|
| | Yes | No |
|--|-----|----|
29. Do you think that loan repayment period should be longer than those fixed by the BSB
- | | | |
|--|-----|----|
| | Yes | No |
|--|-----|----|

I. Government Policy

30. Which of the following factors affected the firm most (Please Tick)
- High interest rate
 - Taka devaluation
 - Inadequate protection from imports
 - High tax on imported raw materials or inputs

Thank you very much for your time and cooperation

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