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Credit Information in the Bangladesh Financial System

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This report covers the condition of the credit information industry in Bangladesh and proposes a direction for future growth. The credit information industry is an essential component of the financial system. Its evolution in Bangladesh over the past decade has been very successful, but also with unexpected side effects. These side effects now seriously impede the further development of the industry. It is now imperative, for the health of the financial industry, that the provision of credit information and ratings be expanded, deepened, and the negative side effects be remedied. This agenda calls for a serious and sustained effort to stimulate the emergence of new credit information companies able to provide relevant data to the financial sector.

The credit information industry collects information and provides analyzed data to financial institutions to assist in the allocation of funds to particular users. This industry brings together data management, capacity to discover facts, and analytical ability to assess the probability of payment whether it is a borrower, an issuer of debt instruments for sale to the public, the soundness of equity issues, or likelihood of an insurance company making a payment. Every organization that takes money from a saver represents some risk to the saver that an expected payment will not take place. The credit rating estimates the probability of default by the person or organization that took the saver's funds.

Credit information facilitates the operation of financial markets by creating specialists in the assessment of risk, lowering the cost of data acquisition, and providing information to all forms of financial inter-mediation.

The Credit Process

Improving access to finance for the SMEs is perhaps the single most important limiting factor to the growth of small enterprises in Bangladesh.[1] The centrality of the availability of credit as a constraint to SME development has emerged from numerous studies and surveys. The enhancement of the flow of credit to the SME sector is one of the key objectives of the JOBs program. There have been many programs attempting to increase the flow of credit of these firms over the past 25 years. These have been of limited success. Credit access to banks by small enterprises is very limited: For term loans almost impossible; for working capital somewhat better. We estimate 20-25% of small enterprises have working capital relationships and probably 50% of medium size firms. On the other hand only 3-7% of the small enterprises have term loans compared to 20% for medium size establishment. Trade credit is key for small enterprises. However, while on balance small enterprises are net providers of credit, the availability of trade credit essentially provides the financing for such

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1 Definitions are a problem when discussing SMEs. Two definitions suggest themselves, one based on employment and one based on assets.

	Employment	Assets
Small	2-9	0-2 million
Medium	10-100	2-30 million
Large	100+	30+ million

In this paper we prefer the employment based definition. The asset based definition is set so as to match the SME definition with the Bangladesh Bank's definition of "small". However, Taka 30 million up limit is really very high. Annex 2 describes the manufacturing sector according to the above employment defined categories.

enterprises. Annex 1 provides a summary of the only comprehensive information on financing of manufacturing with 10+ employees.

The flow of credit is conditioned upon availability of resources from financial institutions, ability of such institutions to recover costs of making and administering credit programs, and technically sound procedures for administration of credit. The first of these three conditioning factors is dependent on the overall position of the financial system. The second on the interest rate structure and limitations thereon imposed by the monetary authorities or by usury laws. The third of the three conditioning factors is the target of much of the JOBs credit related activities. The focus on improved credit information follows from the conclusion that improvement in the credit process will increase the volume of credit. The rationing of credit for small enterprise is evident in the Bangladesh financial system. the evidence for this is best summarized in three propositions.

1. The financial system is rarely able to effectively collect collateral associated with a loan.
2. Recovery rates for small loans are higher than for larger loans.
3. The return on capital is of the order of 30%.

From these three propositions it is obvious that the profit maximizing position for a financial institution is to lend to small borrowers at high interest rates without collateral. The most successful financial institution in Bangladesh is Grameen Bank which has followed these principles. These principles, applied to small and medium enterprises, would result in a much greater flow of credit to these enterprises. The impact of the central bank's and Ministry of Finance's intervention in interest rates and insistence on collateral is to ration available saving heavily to large enterprises which provide low return and high default rates. The overall impact of the rationing of credit leads to a misallocation of capital and insolvency in the financial system. Even the credit information system supports concentration on large size loans. Ironically, rather than try to encourage lending to small enterprises the action of the regulatory authorities supports continued rationing against small enterprises. If the regulatory authorities were to enforce provisioning requirements and require maintenance of capital adequacy the banks would be driven towards profit maximization which would direct much more resources to the smaller enterprises.

One may wish to add that what credit information will enable is an increase of "effective" credit; by which we mean that the credit facility is repaid and the resources used for this repayment arise from the surpluses generated from the activities financed with the facility. Provision of credit is "ineffective" when the underlying economic activity does not generate a surplus or when the borrower refuses to repay. If recovery takes place due to the foreclosure on security provided, then the financial institution has protected its resources but the credit is considered "ineffective". Thus the volume of effective credits to SMEs will increase if there is an improved flow of credit information permitting a better choice of borrowers, reducing the rationing effects.

The recovery process of credit facilities is also strongly affected by the ability of the borrower to realize the value of the goods and services that are sold. In Bangladesh this is a far greater problem than it is in many countries and the difficulties in obtaining payment for goods and services sold on credit is a considerable factor for small enterprises in meeting repayment obligations. In our terminology such repayment failures do not render the credit facility ineffective. The failure is a systematic one and cannot be resolved at the level of the individual credit transaction. Unfortunately the Government is one of the major causes of the poor flow of payments. It is widely claimed in the business community that to obtain payment from Government is an uncertain, lengthy process often with substantial associated transactions costs. A substantial volume of bad loans arise from the inadequate payment procedures of Government.

Credit extension is based on the evaluation of five aspects of the applicant's proposal:

1. The analysis of the uses for which the credit is to be put. This is the most important consideration and requires the greatest skill by the financial institution or the provider of trade credit.

2. The past repayment record of the company. This information relates both to the underlying strength of the company, the other claims on the surpluses generated from the proposed economic activity, and the character and will of the owners and management of the company.

3. The assets available for collateral. Assessment requires market valuation, determination of prior claims on such assets, and finally assessment of the likelihood and time delays involved in foreclosure.

4. The character of the persons involved. This is a critical central judgment, ultimately the responsibility of the loan officer to determine.

5. The likelihood of collecting for sales made. This is rarely assessed by the lending institution, but in Bangladesh is a key factor. It emerges of considerable importance for small enterprises that make substantial credit sales. Unpaid accounts receivable cause chains of defaults in the economy.

The flow of credit information is concerned with the first, second and last of these factors. Assessment of credit risk requires both analysis of the company's repayment record and analysis of the expected cash flow compared to repayments required. The difficulties the firm faces in collecting its accounts receivable are directly relevant to the repayment capacity of the borrower. To provide effective credit, it is necessary to develop access to all three types of information.

CREDIT INFORMATION ORGANIZATIONS

Most credit information in Bangladesh is secret. Knowledge of which companies and persons are good borrowers or reliable in meeting their obligations is valuable information and held closely within trade circles.

At present there are only two formal organizations providing credit information. One organization CRISL is a private company that makes ratings of companies and has been in operation for more than a year. The second is the central

bank's credit
information bureau (CIB).

CRISL

The Credit Rating Information and Services Ltd. is a private rating company established as a joint venture with three foreign rating agencies[2], two domestic financial institutions[3] and several individuals. CRISL was established particularly to rate traded financial instruments, both debt and equity. It will also prepare "entity" ratings for loans, prepare ratings of banks and of the claim paying capacity of insurance companies. With its primary business to prepare ratings related to the capital markets, CRISL has applied to the Securities and Exchange Commission for a license for IPOs, Rights Issue, Mutual funds, and debentures. The SEC has this application under review. CRISL is aimed at the high end of the debt and equity market, not SMEs. It has an established corporate structure, training programs for rating analysts, and a rating methodology based on internationally accepted principles.

CRISL has a close relationship with Duff and Philps Credit Rating Cop. (DCR) one of the largest U.S. rating organizations. We understand DCR is committed to providing training and quality assurance of CRISL's ratings. CRISL collects information from banks, audited annual reports, other material available to the public through the SEC. CRISL uses its network of contacts to collect information related to companies on which it is preparing ratings.

CRISL is really waiting to get started and once its license is granted by the SEC it will be able to work in the offer end of the market of financial instruments. It has no defined relationship with the CIB.

As CRISL gets started the key question will arise when companies do not like the credit ratings that they receive. When the credit rating is poor then there will be a threat of pressure of various sorts brought against CRISL to try to obtain a better credit rating with respect to a loan. The same may arise in the case of ratings for companies involved in IPOs or Rights Issues. Any private credit rating organization will be threatened with these kinds of pressures that historically arise both from the economic side but also the political. Will these private organizations be able to withstand the pressures? It is more serious since the appearance of fairness is very important for the acceptance of the ratings.

Credit Information Bureau

The CIB has been in operation for several years.[4] The need for such an organization had been discussed for several years and the Government included this in the Financial Sector Reform Project. The central bank established a separate unit headed by a General Manager[5] tasked to develop the CIB. The FSRP worked with the

2 Duff and Philps Credit Rating Co. USA, Rating Agency Malaysia Berhad, Malaysia, and DCR-VCR Credit Rating Company Ltd., Pakistan.

3 Investment Corporation of Bangladesh, Prime Commercial Bank of Pakistan.

4 The CIB went into operation in 1992.

5 Mr. Nur Karim was assigned this responsibility. The successful development of the CIB is largely due to the perseverance and drive of Nur Karim.

CIB to develop the reporting formats, computer programs, and hardware to support CIB's operations. The CIB is operated by the central bank, as a regular part of the bank. No separate organization was established and so the CIB does not have a separate corporate identify. It is staffed with regular employees of the central bank who work in the CIB on rotation of their assignments. There are currently over 40 persons working of the CIB. These are drawn from the statistics, computer and general cadres.[6]

The CIB collects information from banks on the condition of credit facilities to borrowers whenever the total exposure exceeds Taka 1,000,000 [10 lakh]. The facilities total is determined by the sum of all facilities available to the company on the reporting date. This includes both funded [advances, lines of credit, loans etc.] and non-funded facilities [guarantees, L/Cs]. The reports are submitted by all the scheduled banks and the non-banking financial institutions quarterly for all facilities from Taka 1-10 million and monthly for all facilities Taka 10 million and above. At present there is no coverage for the large number of small enterprises borrowing less than Taka one million.

All financial institutions submit reports to the CIB on every borrower with a total exposure of more than one million Taka. This report provides the balance on each facility as of the reporting data and information on the classification of the loan or facility if any. Originally these forms were completed in paper versions by the banks and forwarded to the CIB. This required a major data entry effort. Recently CIB has required the banks to provide the data on diskettes, which greatly eases the time that it takes to enter information in the database. [See Annex 3 for the forms used; these indicate the type of information available to the CIB]

There is currently no on-line connection between banks and the central bank. Moreover the classification condition of a loan changes only when the administrative process of classification is executed within the commercial bank. Otherwise, while total exposures may change, the criteria for bad debt only changes with the administrative process of classification.

Two databases are maintained by CIB: First the borrower database that lists all companies that have credit facilities. This enables the CIB to review the total exposure of the company with all banks. The second data base is called the owners database; it links the owners i.e. listed owners or directors as reported by the lending bank, to the businesses which they own. Consequently the credit exposures associated with a particular individual can be determined. Building up the database for the businesses was straightforward, as identification of a company is generally simple. The owner's database is more difficult as there are differences in spelling and some room for mistakes in the matching process of Mr. X with Mr. Y. CIB has now successfully built up this database and generally it works well. There is also difficulty from submitted lists of directors and owners, as there is not always an exact correspondence with CIB's records. However, there is great experience built up in resolving these problems although sometimes it takes time to do so. The data collection process is now well organized and the banks are experienced in the collection and submission of data on borrowers.

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6 Information from Bangladesh Bank.

At present the CIB database has approximately 25,000 borrowers listed and about 35,000 borrowers; the difference are businesses not now borrowing from the banking system. This is consistent with the number of loans at the end of 1997 as reported by the Scheduled Banks of 44,500 with balances of more than 1 million Taka. [Schedule Bank Statistics, December 1997]. As CIB operates on total exposure, there are multiple loans to enterprises, and some non-banking financial institutions are included in CIB's database but not included in the Schedule Bank Statistics. We consider these numbers broadly consistent.

Legal Basis of the CIB

The powers of the CIB to collect and provide data to financial institutions are stipulated in Chapter IV "Collection and Furnishing of Credit Information" of the Bangladesh Bank Order 1972, as amended. This order provides the legal basis for requiring financial institutions to provide loan data, including information on collateral and guarantees, to Bangladesh Bank but limits the information that the central bank can share. Thus although the information that there is a classified loan can be made available, the lending bank holding this classified loan cannot be identified. The order overrides all other laws on bank secrecy.

This legal power to collect and provide data is sharply defined in the law. The data that is collected is very detailed on the exposures and the amounts. This is probably more information than would be permissible for any organization except the central bank. At stake here is bank secrecy and the obligation of the financial institution to maintain confidentially of the transactions of its borrowers and depositors. Of course the central bank has the right to collect whatever data it wants from banks along with the obligation to keep this secret. It is unlikely that any private organization would be allowed to obtain the detailed data such as the CIB collects.

However, it is possible to consider voluntary participation by banks in the credit information business. That is, financial institutions agree to provide certain kinds of information on a cooperative basis to the advantage of all. By reporting exposures, the length of overdues, and irregularity of payments in ranges it is possible to obtain the needed information for assessing the past repayment record without providing the exact detail that the CIB collects. This is probably permissible within the existing laws, although the details must be determined by legal opinion.

The BB order also authorizes charging for the banks for this secrecy although this has never been envoked.

Response Times

There have always been difficulties in determining the speed of response of the CIB to requests and the timeliness of the data that is available to the Bureau. According to the CIB it takes no more than three days to search the databases and respond to the query from the bank initiating the information request. However, if there is a data mismatch--the name of the company differs slightly or there is a mismatch in the list of Directors, then this must be untangled before the reply is given. This may take some time. The central bank works by sending letters and notices rather than telephone calls, so there is a paper trail of all corrections of information. This, however, slows down responses. There is no reliable estimate of how the average response time is affected. However, typically perhaps 10% of the queries have problems and this may require two weeks to resolve. Hence 90% of the queries are answered quickly, with another 10% taking up to three weeks.

The timeliness of data is another problem that is often mentioned. That is, when was the data obtained. In theory the data contained in the report is on the average 3 weeks old for companies with more than Taka 10 million exposure outstanding. For smaller exposures the average age is about 7 weeks. This assumes the database is updated within a week of receiving the data for the new period.

More serious is the question of the timeliness of what is being reported. Since the information provided is the classification state of the loan one has to ask "how often does the bank classify loans?" This is probably every six months but it differs from bank to bank.

There are four delays. These are defined by the differences between the events in the following list (Table 1). These differences are between the events. 1 and 2, 2 and 3, 3 and 4 and finally 5 and 6.

Table 1

Events in a Credit Reference

1. Reference Time loan repayment analysis and classification as made.
2. Time classification is made by the bank.
3. Time classification status reported to CIB.
4. Time for CIB to integrate information into data base.
5. Time required to respond for request for information.
6. Time request for information is filled for CIB.

The difference between 3 and 4 is short as is the difference between 5 and 6. Together those amount to 3-5 weeks. This is the mechanical part of CIB's operation and cannot be greatly improved. For 1 and 2 the difference will average 4 months. This is the period it takes banks to do the classification work. The difference between 2 and 3 depends on the size of the loan: large loans three weeks and small loans averaging 7 weeks.

The total delay is summarized in Table 2. For small loans, on the average, the data is 6-7 months old and for the Taka 10 million + loan 5-6 months. The main factor in the delay is not the handling of the information, but the time it takes to get the loan records reviewed in the banks.[7]

Table 2

Loan Size

[7] The quickest way to reduce the age of the information is to have continuous reporting by banks. That is, records are corrected whenever a classification change is made. By speed up internal processes in the banks, classifications can be changed and reported promptly to CIB.

Time Delays in Credit Information

(weeks)

		1 million – 10 million	> 10 million
Time	1-2	16	16
differences	2-3	7	3
	3-4	2	2
	5-6	1-3	1-3
	Total	26-28	22-24

CIB's Operations

In this section CIB's operations are briefly reviewed.

We estimate the cost of the CIB operations to be quite low. If all costs are included the central bank spends approximately Taka 150 on each application.[8] The private sector would charge for the capital investment and additional analyses is required for a credit rating system. About Taka 250 report is a reasonable estimate. This is a very small part of the loan that is being studied which averages Taka 5 million. As coverage increases then the size of the loan decreases. On the other hand the systems become more complex. This is discussed under the section on expansion to SMEs.

How does CIB work? A financial institution considering a loan asks for information from the CIB. The CIB checks the loan record of the company being considered for a loan, call it AAA and also the record of other companies which have a director of AAA on their boards. Thus is Mr. XYZ is a director of AAA the CIB will search for other companies where XYZ is a director and report the record of those other companies. This reporting procedure is focussed on the idea that the owners and mangers of a company should be evaluated on the basis of their other operations.

The CIB currently reports the funded and unfunded facilities outstanding and, within the funded facilities, (i.e. loans and advances) the total outstandings and the amounts classified substandard, doubtful, and bad/loss for each type of loan. The lending banks are not identified. This information provides a picture of the current total exposure of the company to the banking sector and the quality of the loans. This information is extended to cover other business establishments in which directors of the company applying for credit also serve as directors.

The use of this information is up to the individual commercial bank. The exception are large loans or bank director loans requiring Bangladesh Bank approved

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[8] Based on 45 employees
Average monthly compensation Taka 8,000
100% overhead
250 reports/day for 20 days/month
The development and capital costs are probably Taka 1 crore; earning 24% per year (including depreciation) would add another Taka 40 per report.

where the existence of an adverse report on the company or a Director of the company blocks the credit.

In addition to the reports to banks making loans the CIB information is used to prepare special reports used in bank inspection, eligibility for election, and special reports on loan recovery.

THE CORPORATE VEIL

The cross listing of Directors by the CIB raises a number of interesting problems with respect to limited liability companies. These issues strike at the heart of the use of CIB by the banking system. The following discussion reviews the way banks demand and use collateral, the structure of industrial ownership, and the emergence of business groups.

In brief, there has emerged in South Asia a particular structure of ownership and cross linkages adapted to the tax structures and lending practices. This structure exists in an environment of weak commercial banking practices, often resulting in substantial difficulties in loan recovery. The CIB is used now as the key instrument for discipling the lending process. The very fact that the CIB is part of the central bank provides great power to restrict lending to persons closely associated with companies with defaulting loans. The CIB has become in effect the central instrument of central bank supervision and is having a powerful macro-economic effect in limiting credit. This is an unexpected outcome of placing the CIB in the central bank, never anticipated in its conception. The ramifications of shifting the CIB, outside the central bank are therefore unexpectedly complex.

Industrial Structure

Much of the Bangladesh modern industrial sector is concentrated in 20-25 business groups. Indeed this is the common position in Asia. These groups are led by a small family group (the core) which invests over time in a number of companies, each of which effectively operates independent but under the direction of the core. The financing of industry is largely through bank borrowing, and using the earnings from one company to start another company, although capital markets have emerged to finance equity participation. Individual groups expand dependent on bank credit for leverage. In the high interest rate environment of Bangladesh and the considerable business risks this can be a dangerous approach. However, in a period of sustained rapid growth it is the most effective way to build industrial capacity.

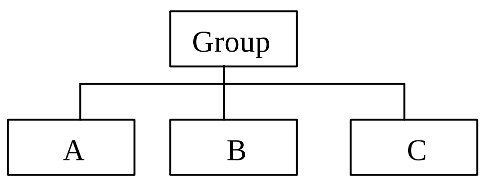
Bank Lending

Bank lending is structured on providing collateral for loans. The concept of asset based, rather than activity based, lending has dominated commercial banking in Bangladesh. For a limited company it is the practice to demand as collateral guarantees or real estate from directors in addition to the assets of the borrowing company. The belief is that this is additional security in the event of default on the loan; the assets of the defaulting company may be insufficient. The banks are extra cautious and distrust the borrowers since the legal system provides little support to the lender. Ironically, collateral has no impact in the real world of Bangladesh as few foreclosures have been made and where these have been achieved the collected collateral value was 10% of the loan balance.[9] Of course by the time of default loan balances may be two or three times the original loan due to accumulating interest. Therefore we might in practice expect collateral to cover 20-30% of the principal. Banking lending is generally only completed when there is collateral present, even through such collateral has little real value and there is no central bank requirement for such.

Nevertheless, company directors are basically forced to provide collateral in addition to the limited companies assets if they wish to obtain loans. Once this is achieved the corporate veil is torn away. The Directors, always a partial owner, find that all of their assets are exposed for collection. Limited liability as a concept is lost.

CIB and the Corporate Veil

Consider a group with three investments.



(Listed) (Listed) (Private limited)

Ownership:

Core	60	51	55
Other direct	15	10	45
Public	25	39	-

The group has three companies A, B and C. A and B are listed on the stock exchange. C is a private limited company. The core group comprising 3 persons is on the Board of all three enterprises. Other director shares are as given. Public shares are also listed, where the company is listed.

Enterprise B applies for a loan; the CIB checks all loans of company B. If also checks all loans of A and C as there are common directors (the core). If a non-core director is a director of a another firm it checks that firm also. Any classified loan held by A, B, or C may prevent B from getting the loan.

If A has a classified loan <u>regardless</u> of the reason, then B may be blocked from further credit. The underlying argument is that the core group has responsibility for the loan liabilities of A, B, and C.

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[9] This estimate is the result of BSRS's collection work in the early 1990s. BSRS has much stronger legal collection powers than commercial banks. A survey in 1992 revealed commercial banks were unsuccessful in ever foreclosing.

Obviously this approach ripes off the "corporate veil" and, by assumption, gives the creditor access to all of the assets of the directors. There is no limited liabilities for directors. The CIB has become an efficient mechanism for implementing this rule. In effect the CIB has made a substantial step towards destroying the concept of limited liability. This paper is not the place to examine the implications of this, it is taken up elsewhere. However, the fact of CIB's impact must be kept in mind in considering future developments.

The development of capitalism in Asia is structured on the emergence of the industrial group: The group makes multiple investments using its modernization and management skills combined with its ability to mobilize capital. The modest start of Bangladesh manufacturing in the private sector has followed these lines. Presumably, so long as there is cross holding of shares by companies, the corporate veil should keep these companies separate and default by one would not in itself trigger a likely refusal of credit to other group members. If the current procedure is continued it will prevent any significant industrial development.

Whatever the merits of this procedure used by CIB, there is no question that it has a strongly negative influence on the volume of domestic credit flowing to the private sector. This approach is based on the idea that default is deliberate, not really caused by economic events; further that the alleged abuse by the borrower results in assets that can be seized by the lender. These two proposition are largely false!

This remarkable vision of the realities of industry and provision of credit underlies part of CIB's purpose and objectives. There are three catastrophic impacts of this mistaken vision:

(1) Lending to the leading groups is increasingly difficult. The most experience and most skilled entrepreneurs are denied capital.

(2) It discourages reinvestment and expanding output and employment. A person with two limited companies one successful, one not successful should not be forced to hurt one company to help the other. Why should this be required.

(3) The limited liability concept is so violated that the benefits meant to flow from it are partly lost for Bangladesh.

Continuation of CIB's wide ranging linkages of companies through common directors will effectively destroy manufacturing growth. At present this is clearly having a serious dampening impact on investment by private firms.

The impact on private investment essentially shifts the demand for credit downward so that for any given interest rate the demand for investment funds is reduced. The impact of the cross reference is that to achieve a given level of investment (or output) requires a lower interest rate and a larger money supply.

If the Director linkage is suppressed and the Credit Information Industry reports only the position of the firm applying for a loan it would restore the corporate veil. It would also remove the drag from monetary policy and shift up the demand for investment by the private sector.

ASSESSMENT

The CIB was put in place as part of the Financial Sector Reform Program (1989-1996). It is now a well established, successful unit in Bangladesh Bank. In that context it falls victim to the personnel processes of the central bank. It cannot recruit high quality staff. The costs of training cannot be recovered.

The CIB provides banks a prompt source of data to assess the repayment record of potential borrowers. The data that is available reports the classification of loans outstanding. The CIB has done an excellent job of developing and maintaining the database to maintain records on loan recovery. With present rules effectively strongly discouraging new credits to any borrower whom either has a loan in default or whose directors have classified loans, the CIB plays an important, if unexpected, role in monetary policy.

The response time of the CIB is satisfactory. However, the inherent delays in using classification data arising from the process of classification, the frequency of classification, and the time it takes to get data to the CIB results in the use of information that is about six months old. That is acceptable but could be easily improved. Furthermore, with loan rescheduling lifting the firm off the classification list, the true record of loan recovery may not be available to the bank considering a loan. The present system simply suppresses past incidents of loan default if the defaulting loan is rescheduled.

At present there is no credit rating of a company made by the CIB. The significance of the loan recovery position of a company is, therefore, not easy to interpret. Present procedures are, therefore, in one sense too rigorous and in another sense, too easy. Too rigorous in that the condition of classification may be based on issues that are not really the fault of the borrower. Too easy in that a rescheduled loan may cover up a propensity to default that would signal caution to the potential lender.

The credit information industry has been a very successfully undertaking by the central bank. It now may move forward in two different ways: Expanding coverage to include small companies; second, by providing credit ratings to banks based on the repayment period and the quality of the collateral that is available. [Thus contributing to two of the five factors listed above].

The present cross referencing of Directors is destroying the concept of limited liability and will hold back the development of the manufacturing sector. It also delinks the outcome of monetary policy from the instruments of control. The further development of the credit information industry should try to escape from these consequences.

OBJECTIVES

Where should the credit information industry go next? Two objectives are recommended:

- **To broaden the availability of credit information to include trade credit and small businesses.**

- **To shift the collection, processing, and provision of credit information from the central bank to the private sector.**

Before discussion the strategy for achieving these objection we review the problems of collecting information on SMEs.

Reaching SMEs

To extend the availability of credit information to smaller credits --say down to Taka 100,000 requires a major expansion [factor of ten] in the data to be managed. Furthermore, permission to initiate requests for information may be extended to sources of trade credit. This is one of the most important sources of credit for small enterprises and increasing this kind of credit requires improved, transparent methods for assessment of reliability of the borrowing organization. The current methods used by CIB will not reach the trade credit issues and would burden the Bureau with about ten times more work in maintaining data bases and increase the number of information requests to more than 1,000 per day. The administrative processes of the central bank will probably not work to support such an expansion. A new approach is needed to provide credit information for SMEs requiring Taka 100,000 – 1,000,000.

To increase the coverage to facilities of Taka 100,000 and above will increase the volume of information by a factor of 5.[10] To deal with such an increase there are significant implications for the CIB's computer systems. If we focus on the number of companies potentially covered then the increase is a factor of 10. This is a major change in the data management environemnt.

The future of the credit information system in Bangladesh

The present system works well at providing information on the current repayment performance of a company, providing information typically 5-6 moths old. The current system also "pierces the corporate veil" and reports on the loan repayments of companies linked through common directors. The lower limit of Taka one million effectively blocks out coverage of small industry.

There are seven directions where improvements in the industry may be sought:

1. Increase coverage down to one lakh Taka.
2. Provide credit ratings of companies.
3. Make the data used more timely.
4. Extend the services to support trade credit.
5. Replace the corporate veil.
6. Return all decision authority to the commercial bank.
7. Commercialize the operation to cover costs.

1. <u>Increase coverage</u>

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[10] March 1997: Number of loans 1 million up 40,000; number of loans 100,000-1,000,000 is 200,000. [Bangladesh Bank SBS March 1997].

To increase coverage down to exposures of Taka one lakh and above requires a major increase in data management. The number of records will increase by 5-10 times and one should expect further growth. To serve small industry requires such an ambitious program. This will make necessary new computer facilities and require additional software development. With expansion to potential trade credit users, the number of firms included will grow even more. Steady expansion of coverage is necessary to meet the ever changing list of companies.

In expanding credit information we need a more active approach by the credit information industry. For example, a company interested in trade credit provides a list of 500 stores. These may be checked and added to the data base. Credit information would be developed from various sources in addition to the CIBs bank reports.

2. Providing credit ratings

The provision of a credit rating is a more difficult task than simply relaying the loan balances. The rating is based on the company's credit history. To provide credit ratings requires a staff able to review data and make prompt decisions. This will add significantly to the costs. The analysts for SMEs work from available data bases to rate a company. The development of procedures and training of staff will take some time.

The sketch in Figure 2 illustrates the approach. The bank data bases at CIB continue covering the 10 lakh + loans (A in Figure 2). An SME data base is constructed for borrowers with exposures less than 10 lakh Taka but more than one lakh Taka (B). This SME data base would be similar to the CIB but for much smaller enterprises and would be built by the new credit information companies.

Other data bases may be maintained on tax numbers, VAT registration, telephone numbers etc. (C). The rating officer obtains information line from the SME data base and other data bases. If the prospective borrower is in the CIB data base, then the CIB information is processed through a filter which removes the detailed information and produces information usable for the credit rating (D).

The analyst uses the available information to complete a questionnaire which provides a credit rating (E). This information is provided to the client and also stored in the rating data base (F).

Let us assume there are 500 requests a day. (twice the current level). A rating is needed for each. The analyst can perform 10 ratings per day. Initially none will have ratings but as time passes more and more will have credit ratings that need only updating. To catch up to a data base of 50,000 establishments takes 20 analysts one year [20 persons for 250 days at 10/day] Initially the credit ratings would be made for medium and large firms with gradual inclusion of smaller firms as the data base is built. Thus about 50 analysts are required.

How can the credit rating be made?

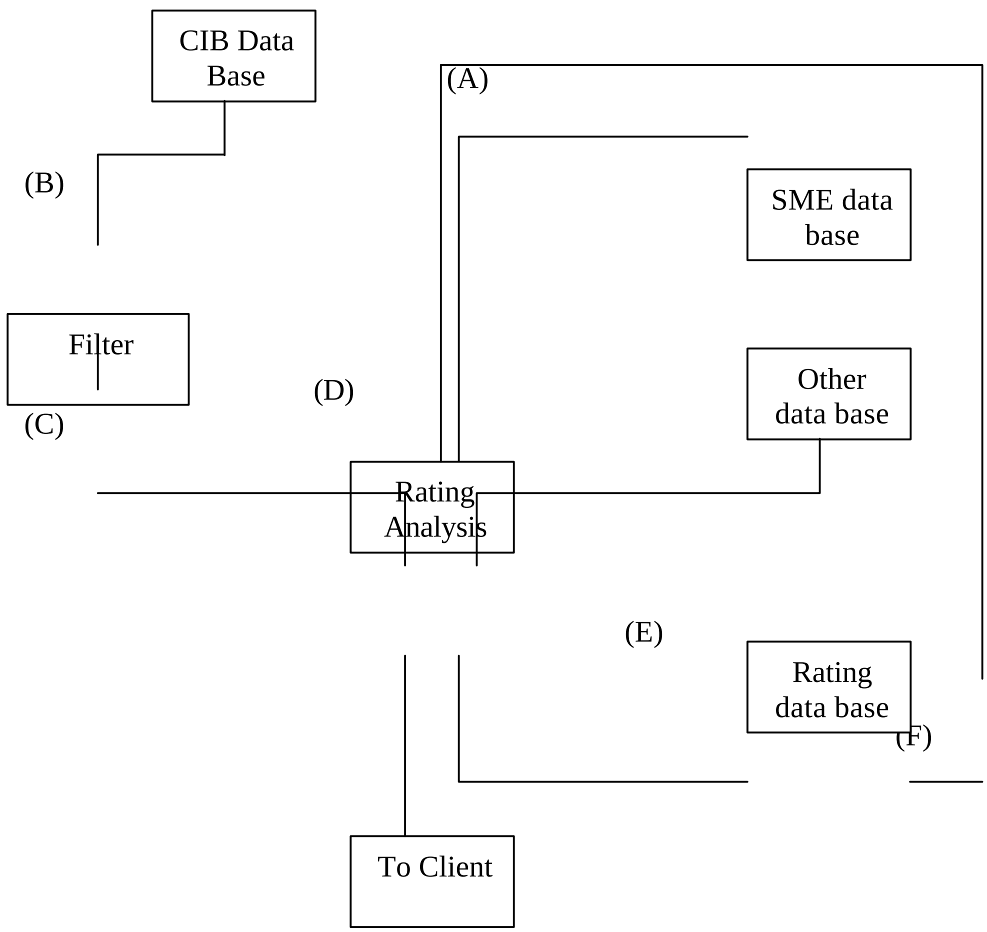
The analyst examines the recovery record: Existing overdue loans, late payments on past loans, reschedulings and from such information compiles an index of the greatly of past recovery. This is compared with indexes compiled for the sector for other firms.

Additional consideration can be given to the total exposure of the company compared to sector means.

3. Timeliness of data

This is achieved by gradually connecting the credit information organization to the banks via telephone linkages to enable up date dates to be made quickly. For the larger loans a process of continuous correction should be followed. Whenever a bank changes a loan classification this is communicated at once to the CIB data base.

Figure 2



4. Extend the services to support trade credit. The extension of credit information to support trade credit can serve all firm sizes. However, it is most beneficial when information coverage reaches down to small enterprises. This

suggests that in extension of the system to trade credit it is necessary to build the SME data base.

To provide trade credit references companies registered to use the service could obtain information on potential customers to help them reach decisions on the provision of such facilities.

5. Replace the corporate veil!

The credit referral system that has emerged is destructive of the development of a modern economy. It both undermines the key principle of a capitalist society – limited liability and increases the uncertainty of monetary policy.

This is simple to do. Reporting of linked director information ceases. The bank makes a lending decision on the basis of the loan history of the organization requesting credit.

6. Emphasize that decision authority rest with the commercial bank

This also is straightforward to accomplish, requiring only a clear directive from the central bank that credit information supports the decision, it does not determine the outcome.

7. Commercialize the operations to cover costs

Again this is straightforward. The BB Order permits CIB to charge for the credit report but this has never been initiated. The cost would be of the order of Taka 250-300 for a report. It is useful to adjust the cost to the bank according to the size of the outstanding amount. For example, charging Taka 500 for companies with large exposures (say greater than Taka one million) and a lower fee for small companies, say Taka 200.

Alternative approaches to building a private sector credit information industry

Above we have reviewed seven steps recommended to improve the credit information industry. If these seven steps could be achieved then the entire process of providing credit information would enhance the provision of credit at all levels but most particularly to the SMEs. It would also strengthen the credit supply to the entire economy by putting the corporate veil back in place and making monetary policy more responsive to the central bank's objectives.

How can this be accomplished?

The first approach is to expand the functions of the CIB allowing the CIB to remain within the central bank. There are many difficulties to doing this. First, the increase of coverage would be quite difficult for the central bank with its present management and personnel policies. Already the CIB has personnel problems as this is organization does not have sanctioned positions, it is not a very good assignment, and the current CIB management is not satisfied with the quality of the staff being assigned. Increasing the coverage by an order of magnitude would be very difficult to accomplish. If undertaken it would take a long time to achieve.

More seriously the central bank should not make credit ratings. CIB now has the idea of passing on some of the scoring ratings that are made by some of the commercial banks. While this is useful, and the techniques used for these scoring ratings are of interest, the procedure is in need of review and revision to update the factors to the current economic situation and to check the ratings scoring against the outcome of the lending. If the central bank makes credit ratings it shifts all responsibility for loan quality to the central bank and would completely strangle the operation of the commercial banking system. Providing credit rating to non-financial institutions for trade credit may be interpreted as outside the legal framework under which the central bank operates.

The central bank has difficulty returning the decision authority to the commercial banks since the central bank has great natural authority and the NCBs in particular are reluctant to act against the evidence presented by the central bank. Finally, while all of the other matters are readily solved within the CIB system we cannot expect that the central bank would readily replace the corporate veil. The mindset of the central bank has been responsible for this policy and it is not obvious why it should be changed.

The conclusion is that the expansion of the credit information industry within the central bank, following the above seven points, is unlikely to be successfully accomplished. The recommended changes are both very demanding of resources and not appropriate for the central bank in some areas, particularly credit ratings.

The second approach is to encourage the growth of credit information organizations within the private sector. By this we mean that the credit information organization must be a profit maximizing organization, and should not try to serve social purposes. This does not preclude ownership by government owned organizations, but it does require that the management of the credit information organization must be profitable. Lone such private organization has already been established and it will probably commence operations soon when the SEC grants approval for their license. But the direction of their work is not aimed at the SMEs nor has a way been worked out to use the CIB database.

To encourage the emergence of credit information organizations aimed at the SMEs it is probably necessary to initiate the formation of the first such organization and to provide it with support during its early years. There are three critical issues that need to be settled:

1. Who should own this new organization? The obvious candidates are several of the financial institutions. We believe that it is feasible to encourage the formation of such an organization and that there would be sufficient support forthcoming from the banking system. The central bank must agree that the CIB would no longer provide credit information to banks. Without such agreement then there is no reasonable expectation that a profitable credit information organization can be established.

2. Arrangements for the credit information organizations to access the information that the CIB would continue to collect but such access would be in a manner that would conform to the laws of bank secrecy. As discussed above we believe that a computer program that would process the CIB information and create a report that would be acceptable under the law can accomplish this.

3. Arrangements for the credit information organizations to access the SME information which we define here as the credit exposures between Taka 100,000 and 1,000,000. This information would flow from the banks to the credit information organizations.

Once these are settled then the first credit information organization serving the SMEs and the larger borrowers can be created. Such private organizations needs a great deal of assistance for start-up to insure that there is a cooperative relation with the central bank, that the flow of information from the banks is properly organized and the computer databases created, and finally that the procedures for ratings be developer in a scientific way appropriate for Bangladesh. The development of the rating systems and the understanding by the business community of how these are being done is essential for cooperation and acceptance.

Nevertheless, the expansion of provision of credit information to the small borrowers is essential to expand the provision of credit to these organizations.

In the commercialization of these services everything should be paid for: The credit information organization should pay the CIB for accessing and using its database. The banks providing the credit information for small lenders should also be paid for their data contribution. Finally the users should pay the credit organization for the reports. It is up to the credit organization to be good enough that the banks will use their services.

We would hope that the starting of an initial organization focused on credit information for SMEs would generate competitors to do similar work. Eventually we would expect specialization in certain aspects of the credit information industry leading to competition and efficiency.

Annex 1 – Financing of Manufacturing Sector

Annex 2 – Size Classes of Manufacturing Establishment

Annex 3 – CIB Reporting Format

Work Plan for
Development of the Credit Information Industry

Council of Advocates Program 1999