Regulation, Corporate Governance and the Banking Sector - A Political Economy perspective from Bangladesh

Introduction

The economic reforms in different countries have created the need for new perspectives on regulation which was different from that of previous era. Reforms provide an opportunity for many firms to increase their market and economic power which would have an adverse impact on the concerns of welfare and efficiency (Cook, 2001). These concerns have raised the awareness on the role and need for effective regulatory framework which would be helpful to monitor firm activities and safeguard the consumers (Parker, 2002; Kirkpatrick et al, 2004). Although the extent of government regulation has gone down significantly, the issue of regulation is becoming even more important than ever in the era of private sector led growth and development.

Regulation seeks to monitor and influence the actions of agents through a set of established principles and guidelines. Regulation represents a systematic effort to affect the behavior of the agents based on rules which would give clear and strict directives and permit further negotiations among the agents (Minogoue, 2001). In the expanding economies, regulation offers a stable environment for market players by reducing uncertainty, promoting innovation, boosting investment and providing efficient factor markets with an opportunity to make orderly exit and restructuring (OECD, 1997). Balanced and effective regulation would not only protect the consumer welfare but also will provide a continuously workable environment to the firms operating in the market. Taking the example of vital utilities sector, Cook (1999) suggested that an efficient

regulatory system would enable private sector to preserve monopoly's economies of scale required in such business and invest for long term while protecting the safety of energy supply. In many sense, corporate governance is a self regulatory mechanism for the firms which can be boosted by effective formal regulation and supervision (Levine, 2003).

The features of regulation coincide with the principles of corporate governance provides a much more efficient monitoring of firms and safeguard the interests of stakeholders. Section 2 of this paper analyses the issue of corporate governance as a regulatory form at the firm level. The issue of corporate governance of financial institutions is demanding a special attention as the recent financial crises in different countries. Among the financial institutions, the corporate governance of banks has received very little attention only (Capiro and Levine, 2002; Arun and Turner, 2004), which is the focus of Section 3. The next two sections discuss the political economy framework of these issues in the context of Bangladesh.

2. Corporate Governance: Regulatory Form at Firm Level?

The corporate governance seeks to deal with systems, mechanisms and modalities of exercising power and control over the corporation's direction, behavior and performance (Monks and Minnow, 1995). These features of corporate governance turn it into a self conducting form of regulation of firms which would ensure not only the shareholders' interest but that of the stakeholders' of the firms as well. Both regulations in broader and corporate governance in a narrower perspective seek to protect the interest of the investors as well as other stakeholders such as consumers and depositors. Minogue (2001) has outlined corporate governance as a form of self regulation in strengthening regulatory governance. Such self regulation coupled with regulatory governance is imperative to mature the relationships between various players in a market environment. The corporate governance principles are used as means to internalize the regulatory norms and standards along with regulatory institutions to develop and monitor compliance with regulatory policies.

And that's exactly what firm governance does in slightly micro level as Shleifer and Vishny (1997) suggests that corporate governance refers to mechanisms which enforce a fair return to those who provided the fund to do business. Hussain and Mallin(2002) states that corporate governance is an essential element to well run companies that have controls in place to ensure that individuals or groups with the company can not influence the company and its activities in an adverse way in order, to make sure that assets or profits of the corporation can not be used for the well being of any small selected group by causing disadvantage to the majority. Again the regulation in broad sense exactly attempts to do the above where it puts and exercises control over markets so that no firms with economic power can affect the market outcomes in favor of themselves at the expense of the economic and social welfare for of the larger groups. Regulatory system is expected to develop rules of business for market players and incentives for firms to invest into activities which are of high economic and social value (Rees, 1998; Cook, 1999). Accordingly the firm level regulation or in other words corporate governance construct rules and incentives through explicit and implicit contracts to effectively align the behavior of managers with the desires of principals owners (Hawley & Williams, 1996). However the corporate governance does not replace the role of regulatory agencies as an effective part of the governance mechanisms.

Self regulatory activities would certainly increase the effectiveness of the overall regulatory governance. But at the same time there remains chance of moral hazard of governance failure on the firms' part in regulating themselves through their own governance mechanisms. Prudential regulation by government remains an essential supporting element of regulatory governance which would certainly strengthen corporate governance (Nam, 2004). In developing countries particularly -where markets are imperfect, information asymmetry problem is severe, legal and other infrastructure is weak and corruption runs very high- strong and active role by regulatory agencies would certainly boost the quality of corporate governance (Levine, 2003).

However the severity of need and extent of strong firm level self regulation as well as effective participation of regulatory agencies differ from sector to sector. The banking

sector happens to one of the prime contenders to attract governance attention more immediately than many others.

3. Corporate Governance of the Banking Sector

The unique features of the banking sector demands extensive attention on the quality of governance systems in firms. But why is that banks are demanding priority over other types of firms in terms of corporate governance? Are they considered exceptional? Macey and O'hara (2003) suggested that banks should be treated specially and differently than other firms when considering their risk and governance mechanisms. There are actually several reasons for banking case being so special. The argument starts with the role the banks play in boosting and engineering an economy as part of the financial systems. The need for a strong and efficient financial network is widely accepted for its role in efficient resource allocation. The financial system also enhances growth by pooling risks and facilitating transactions (World Bank, 1989). The role of financial sector in economic growth is even greater in developing countries as their tolerable margin of errors in resource allocation is small[1].

Different cross-country studies support the idea that countries with efficient and strong financial markets experience higher rates of economic growth. Some studies have also found the strong evidence of relationship between the size and operation of financial markets and /or the development and structure of banking sector and economic growth (King and Levine, 1993; Levine and Zervos, 1998; Rajan and Zingales, 1999; Cetorelli and Gambera, 2001). Banks usually account for the lion share of a financial system in most of the economies and this dominance is overwhelming in case of the developing countries who are actually in greater need of a sound financial system. Any turbulence or failures of the banking and financial sector would push these countries' economies to serious problems. The world has gone through a number of financial and banking crises over past two decades. And the quality of corporate governance of the financial/banking institutions of the affected countries has been blamed as one of the primary reasons for

[1] This point is emphasized by the World Bank (1989, 26) 'the biggest difference between rich and poor countries is the efficiency with which they have used their resources. The financial system's contribution to growth lies precisely in its ability to increase the efficiency.'

these problems. The undesirable banking practices such as poor risk diversification, inadequate loan evaluation, fraudulent activities were as much responsible as other macroeconomic factors in causing banking crises which shook the financial systems of countries such as Argentina, Chile, Malaysia, Philippines, Spain, Thailand etc (Sundararajan and Balino, 1991). The governance quality essentially brings stability in the banking system. The governance quality has also been linked to the success of the financial development (Winkler, 1998). Banking sector contributes in the growth through channeling funds to productive activities after collecting the saving of the households. The savers hand their money over to the banks on the trust that banks would carefully and prudently utilize their money which would ensure the return of their deposits. However in absence of active monitoring by the fund providers, the banking agents have the discretion as to where the money can be invested. This creates an opportunities of moral hazard by the bankers and may jeopardize the funds provided by savers or depositors. Sound corporate governance would ensure that banks would make careful investment of the depositors fund and thus encourage flow of funds in the financial system by the savers in the economies.

There are some other firm level features of banking institutions which calls for special attention to their corporate governance quality. The banking company balance sheet structure differs greatly from other types of companies. Banks rely heavily on deposit collection to make the investments which makes the debt-equity ratio of the banks very high or in other words banks happen to be highly leveraged firms. And to generate these all important deposits, banks need to rely heavily on depositors' confidence. Another issue regarding banks balance sheet is that while most of their deposits are short term or whithdrawble on demand, majority of their assets are not. Typically a majority of bank assets or loans are issued for long term which are basically illiquid. The issues of high leverage, greater need of public confidence and huge disparity in the maturity of assets and liabilities make banking companies and their governance issues more special than other firms (Nam, 2004).

Banking companies pose unique corporate governance attention as they differ greatly with other types of firms in terms of broader extent of claimants on the banks assets and funds. A group of entrepreneurs and/or executives could set up a banking business by putting very little equity from their own pocket as the nature of business itself guarantees flow of enormous amount of funds in the form of deposits. The general approach to corporate governance argue in favor of the shareholders rights only, as managers/executives may not always work in the best interest of the shareholders (Henderson, 1986; Jensen and Meckling, 1976; Fama and Jensen, 1983). But the shareholders actually account for a very tiny portion of the bank's assets and funds. Rather almost every bit of banks' investments are financed by the depositors' funds. In case of losses or failures it will be depositors' savings that the banks would lose. Such risks demand priority in protection of depositors which ushers in a broader view of corporate governance that suggests the interest and benefits of the suppliers of funds for a firm should be upheld (Shliefer and Vishny, 1997; Vives, 2000; Oman, 2001). Macey and O'Hara (2001) also argue that a broader view of corporate governance should be adopted in the case of banking institutions, arguing that because of the peculiar contractual form of banking, corporate governance mechanisms for banks should encapsulate depositors as well as share holders. Arun and Turner (2003) also argued for the need for the broader approach to corporate governance for banking institutions and also argue for government intervention to restrain the behavior of bank management.

Nam (2004) indicated that because of the unique characteristics of banking sector, governments tend to provide various safety measures to banks through regulations and other measures. This may encourage the bank stakeholders to rely heavily on the government safety measures in times of problems which make holding the bank managers, directors accountable for inferior performance difficult. In many countries, deposit insurance is used as a mechanism to safeguard the banking system as well as the depositors. However, Macey and O'Hara (2001) argues that in many instances, the presence of deposit insurance mechanism by the governments may encourage many bank insiders to embark upon self benefiting risky deals taking the advantage of insurance protection. The self dealing activities by the bank insiders are very dangerous to the

performance and survival of the banks as scores of previous bank failures have been caused by risky self dealing by the bank insiders (Jackson and Symons, 1999; Clarke 1988). The presence of heavy liquid funds and potential lack of depositors' interest to actively control and monitor banks' risky decisions as a result of the insurance guarantees simplifies and aggravates the sharking in the banking firms.

The developing countries' banking sectors also incur a greater risk of misappropriation/abuse as a result of heavy government ownership, lack of prudential regulation, weak legal protection and presence of special interest groups ((BCBS, 1999; Arun and Turner, 2003). However, there is an argument that active role by regulators may cause problems as well, as regulators may not have a convincing/sufficient motivation to monitor the banks as they do not have much at stake in case of bank failures (Macey and Garrett, 1988). Recently, the financial markets of developing economies have experienced rapid changes due to the growth of wider range of financial products. As a result of this, banks have been involving more on high risk activities such as trading in financial markets and different off-balance sheet activities than ever before (Greuning and Bratanovic, 2003), which necessitates an added emphasis on quality of corporate governance of banks in developing economies.

Another feature of developing country banking sector is that even in after being deregulated many important aspects of competition lacks in their banking sectors. One of that is governments still strictly controls the entry of foreign banks which, if permitted, may bring improved standards of corporate governance to those markets (Fan, 2004; Arun and Turner, 2003). Optimal level of market competition is expected to strengthen corporate governance of firms (Grosfeld and Tressel, 2001). An active market for corporate control is required for competition to act as a market disciplinary force. However in the many countries, especially in the developing ones, government restrictions and public ownership of banks make it difficult to have any market for corporate control. As a result the corporate governance remains the prime factor in order to maintain discipline in the sector.

The above discussion clearly presents the rationale for shedding immediate focus on the corporate governance of banks around the world, particularly of the developing countries. This firm level self regulatory activity is immensely required to develop a strong financial sector as well as keep the stability of the system to safeguard the economy and millions of depositors. Such importance for firm level regulation, however, does not eliminate the need for a strong role by regulatory agencies in strengthening the corporate governance of the banks. The independent regulatory agencies are important in developing countries to act against the frequent collusion among government, businesses and bankers to serve special interest groups (Shleifer and Vishny, 1997; Arun and Turner, 2002). Regulatory policies and agencies may improve the quality of bank governance by reducing negative impact of transaction and information costs (Fan, 2004). Since deposit insurance and other guarantees may lead to excessive risk taking and moral hazard by bankers, prudential regulation and supervision is required by government to curb such dangers (Nam, 2004). Levine (2003) talked about the need and implications of regulations for banking sector given the differentiating characteristics of the banking firms. Triole (1994) argued that regulations actually represents depositors interests and it gives a huge trust and moral building signal to the economy and urged for regulatory intervention in case of solvency problems with the aim of maximizing depositors' welfare.

Although corporate governance is a strong measure against the individual bank failures, strong monitoring and prudential regulation by regulatory agencies will save the banking sector from systemic risk, regulation works as a safety net for the stakeholders of a failing bank. However there remains some doubt as to whether regulation positively impacts the banks. Regulators may not have a convincing/sufficient motivation to monitor the banks as they do not have much at stake in case of bank failures (Macey and Garrett, 1988). Heavy political interference and lack of incentives and skill may also impede the regulatory agencies to deliver service effectively. Excessively heavy handed regulations may diminish the incentives of market players and bankers to actively monitor banks which in would in turn adversely impact the market discipline and firm corporate governance (APEC, 2002). However the monitoring by private sector market players is

expected to be less effective in courtiers where institutional support is weak. This is particularly true in developing countries and urges for official supervision and regulation of banks in such circumstances (Nam, 2004). So it is vital that monitoring by market players at firm and official supervisors/regulators at macro level remain balanced and complement each other. With this notion at centre, this study attempts to explore the state of corporate governance of banks in Bangladesh banking sector and the role of the regulatory agencies in prevailing scenario.

4. A Perspective from the Banking Sector in Bangladesh

As in many developing countries, banks play a vital role in Bangladesh economy, as the dominant financier for the industrial and commercial activities. Since the independence in 1971, the regulation and ownership of all the financial institutions had been carried out by the government until 1982, when the 'ownership reform' measures started in the financial sector. During the reform period, two out of six National Commercial Banks (NCBs) were denationalized and private commercial banks were allowed to operate in the country. In 2003, out of the 49 banks operating in Bangladesh, 9 belong to the public sector[2], 30 are local private and 10 are foreign owned banks (Bangladesh Bank, 2003).

Despite of the expansion, the operational efficiency of the banking institutions has continued to be dismal (Sayeed, 2002; Raquib, 1999). The sector witnessed decreasing profitability, increasing non-performing assets, provision and capital shortfalls, eroded credit discipline, rampant corruption patronized by political quarters, low recovery rate, inferior asset quality, managerial weaknesses, excessive interference from government and owners, weak regulatory and supervisory role etc (Hassan, 1994, USAID, 1995). Internal control system along with accounting and audit qualities are believed to have been substandard (World Bank, 1998; Raquib, 1999; CPD, 2001). Many of the problems have been attributed to lack of sound corporate governance among the banks. The reports by the Banking Reform Commission (1999) and BEI (2003) raises serious concerns on

[2] Out of the nine, four are commercial banks known as NCBs and five are specialized banks known as

SCBs. the banking sector and criticize the quality of governance that prevails in the banking sector in Bangladesh, which provides an impetus to explore the governance issues in detail in this paper.

Ownership/ Shareholding Structure

The banks in Bangladesh can be considered as extremely closely held corporations, since the majority of the banks are not publicly listed companies. An average of only 20 percent shares of banks is publicly available in Bangladesh and a large majority of the shares are owned by a small number of 'Sponsor' shareholders[3] leaving a small portion of the shareholding to the 'General' shareholders[4].

The number of executive shareholding is very minimal among the banks in Bangladesh. There is a legal restriction on bank executives becoming sponsor shareholders of the banks. The private banks in Bangladesh do have shares held by families and institutions. However, the banking law prohibits shareholding of more than 10 percent by members of one family[5]. There is a heavy presence of block holders in the banking sector[6], and the overwhelming majority of these block holders are from the sponsors category.

The issue of sponsors as a single interest group requires further analysis. This is due to the fact that the lead sponsor, who normally after getting political assurance of being awarded banking license, assembles ten [7] or more sponsors from his/her family, relatives and business and social friends. The tendency is to remain within the reliable known people with the main objective to retain the control of the bank. And they do retain the

[3] Shareholders who have obtained the banking license and provided the initial capital to start the banking business are known as 'Sponsor' shareholders. In the Bangladesh banking sector, about 80 per cent of the banks' shares are owned by 12 shareholders from the sponsors' category while only 20 per cent are available to a large group of general shareholders averaging 1694. For listed companies the gap is a bit closer but sponsors still have enough shareholding to give them the control of the banks.

[4] Those who buy banks' shares from IPO or secondary market are known as 'General' shareholders
[5] The Banking Company Act (1991) defines family members as father, mother, husband, wife, son, daughter, brother and sister.
[6] Shareholders holding 5 percent or more have been considered as block holders (McConnell and Servaes, 1990).
[7] The banking company act (1991) requires at least 10 sponsors to initiate a banking company

control of the banks in almost all the cases. Even in cases where the bank is a listed company the sponsors hold the control as the general shareholders are large in number, highly dispersed, disorganized and are not sophisticated enough to understand many governance and performance related issues. Most of them buy the shares from the secondary market with the objective of making gain in share trading. In the absence of executive shareholding and organized small general shareholders, the sponsor shareholders have an open field to rule. In the PCBs the sponsors control virtually everything, from appointment /firing of CEO to loan approval to purchase decision to salary determination. And these sponsor and large shareholders have heavily misused their overwhelming ownership and control in both public and private sector banks.

Government has used its banks to support its political objectives as well as the politicians in the government have used them to fill in their and their close ones' pockets at the expense of banks' funds which actually come from the depositors. Majority of the loans of these banks have been approved and disbursed on the instructions/request of the government officials and politicians without any proper and effective credit and risk analysis. And these public sector banks are today all burdened with heavy non-performing loans and losses. One banker linked 90 percent of the default loans to politically directed lending. The scenario is no different in the PCBs. The PCBs sponsors have heavily plundered the banks' money showing little respect to the systematic credit analyses and depositors' well being. The PCB owners are more interested in loan money than making profit as the benefit of plundering was greater than making profit. In 1998 a total of BDT 13 billion was borrowed from the PCBs by 152 of their shareholders. To make the situation worse, it's widely believed that the PCB owners have borrowed even more on third party or fictitious companies'/individuals' names to avoid any attention by public or regulators. The only involvement the general shareholders are privileged with, if there is any, is going to the AGMs and receiving dividends. The foreign banks, although owned completely by their parent companies, are reportedly to be free of any sort of owner interference.

Boards

Boards happen to be a major corporate governance mechanism. Stock and stakeholders entrust the boards with the responsibility of strategically leading a firm with effective decision making and proper monitoring on behalf of the principals of the firms. In Bangladesh, the average number of directors in the bank boards stands at 10, and the boards are overwhelmingly dominated by the non executive members. There is very thin presence of executive membership in the bank boards most of whom are the CEOs who by the virtue of the banking law must be included in the bank boards. Among the non executive board members, the scale is heavily tilted towards shareholder directors almost all of whom are sponsor shareholders. Only the public sector banks have non-executive independent directors where as there are only two independent directors in the boards of the private banks.

The issue of large shareholders becomes more prominent due to the total domination by those shareholders in the boards of the banks in Bangladesh. In the PCBs nine out of the 10 members of the boards are shareholder directors. The other rest goes mainly to the CEOs as the law requires them to be in the board. The entire private banking has only two independent directors. So it's not difficult for one to understand who controls the boards in PCBs in Bangladesh banking. And according to the banking law as well corporate by-laws, its basically the board which takes majority of the decision regarding banks operations including loans, investments, appointments, audits etc. The corporate by-laws of most of the banks restrict entry of one to the bank's boards if he/she is not a sponsor shareholder. And the sponsors left no stones unturned in taking full advantage of their total reign in the bank boards which decide almost everything about those banks. In the public sector banks the boards are comprised of politically appointed independent directors who are put in those positions by the ruling politicians with special instruction and objectives to serve the purposes of special quarters involving politicians and business houses. And with government's total and unchallengeable authority to remove any director any time coupled with the directors' political loyalty, boards in these public sector banks continue to serve the politicians as 'Rubber Stamps'. The FCBs boards are however completely comprised of the executives who are accountable to senior regional

and global managers. And these board members happen to work with full autonomy and usually work very professionally.

Management, Contracts and Incentives

The management activities in Bangladesh are heavily controlled by the owners of the banks. The shareholders, either directly in case of public sector banks, or through boards as in cases of the private banks, have total control on the fate of the executives. In 82 per cent of the banks, the CEOs are directly accountable to the boards and for the others it's mostly the owners directly except for few foreign banks where accountability is to the seniors in the global chain.

The contract that dictates the managements' contribution to the banks' benefits seem to be fine for the local private and foreign banks as almost all of their CEOs contracts are linked to performance. But the public sector banks do not care to design the contract of their CEOs in a way which brings performance into focus. The management compensation also seem to work better in the foreign and local private banks while the public sector banks remain far behind in terms of salary or performance based payment or compensations. The salary level of the top management executives is almost 20 times more in the foreign banks and 10 times more in the local private banks compared to the public sector banks.

The majority of the decisions are thrust upon the executives by the owners of the PCBs and NCBs. And non-compliance means sure departure from the job – only the timeline may vary. The government banks are in the worst condition. The executives there are not only 'dancing dolls' of the politicians but also they severely lack qualification and motivation. Appointment, transfers and promotions are all dictated by the politicians sitting at the Ministry of Finance. That made many bankers to go easy on performance as they know political allegiance will ensure retaining the job as well as promotions. Lack of accountability among the executives is very acute in these banks as a result of political

interference. Moreover the compensation packages are extremely low, almost 10 times lower than the private banks and 20 times than the foreign banks. Lack of accountability and low compensation packages have pushed these bankers to heavy corruption. Small and medium scale loan applicants can easily get their applications approved just by paying a percentage to the bank executives. The reign of trade unions runs supreme in those banks. The trade union leaders, being backed by politicians, force management to approve many loan applications, give them undue benefits and even play an important role in appointing new CEOs. The private banks are in a little better position. Other than the cases involving board members or sponsors, the executives are strictly held accountable to the board and the owners for their activities.

The executives are also more qualified than those of public sector's in terms of both profession and education. Also given the market conditions in Bangladesh, the executives of the private banks are very well paid in fact they are the highest paid executives among any Bangladeshi companies. The partial accountability along with sufficient motivational packages make the executives work hard for the betterment of the banks and its depositors and shareholders. Though the FCBs executives do not have any direct supervision of the owners, they work under a very well designed and strict accountability system. Also they are very highly qualified professionals getting extremely attractive benefits. The FCBs executives are in fact highest paid of any type of company executives in Bangladesh. Additional financial incentives and advancement in career has been linked to their and the banks' performance. All of these actually make them work very hard for the profitability of the banks which ultimately takes good care of the depositors' funds they are entrusted with.

Audit and Disclosure Findings

Proper and effective audit coupled with full and right disclosure helps to maintain accountability and bring transparency of firms. For banking companies, which collect people's money and make profit by investing those funds require more stringent audit

and disclosure practices than non-financial firms. Here is how the audit and disclosure is like in the banking sector of Bangladesh.

About 95 per cent of the banks in Bangladesh have their internal audit department regularly taking account of important decision makings/operations within the bank. In 69 percent of the cases the internal audit section reports to the board of directors while the other 31 percent reports to senior management. More than half of the banks' internal audit found evidence of fraud in their audits. Interestingly 29 percent of the banks did not opine to answer this question. Another interesting part is that all the banks in Bangladesh do have external auditors and it's usually the accounting firms who work as external auditors. But its worthwhile to mention that the banking law requires all the banks to appoint external auditors and stipulates that the external auditor must be an accounting firm. Once again thanks to a very recent banking regulation because of which all the banks now do have a board audit committee. However, only 5 percent of the banks said they disclose the internal audit reports to the shareholders in the AGM while only 9 percent of the banks disclose their board audit committee's report publicly. When it came to disclosing performance to the depositors only the foreign banks came with a positive answer while no public and local private banks appear to be doing so.

The survey noticed that except for the foreign banks no local bank has any corporate by-law or practice of disclosing connected/insider lending in any sorts of the reports nor do they reveal methods to determine the salaries and benefits of the executives. And survey information reveals that only the foreign banks along with one local private bank are required by their corporate by-laws to reveal information on third party transactions[8]. And more surprisingly it has been found in the survey that except for one public sector and one local private sector banks no other banks have board committees on nomination and remuneration affairs making the those activities non-transparent.

[8] Third party transactions refer to any sort of financial dealing by the bank with individuals or firms who are somehow linked to board members and/or executives.

In an ideal scenario any wrongdoing by shareholders or executives are expected to be exposed if their remains an effective audit and disclosure system. From outside the audit picture in Bangladesh banking sector looks very bright. All the banks have internal audit department, external auditors, board audit committees and special audit by the central bank. But then how come the irregularities are taking place? It's mainly because of problems in implementing audit findings coupled with low quality and integrity of auditors. In the NCBs and PCBs the internal audits tend to avoid irregularities associated with owners/board members. However the internal audits often discover fraudulent activities by executives. But in NCBs, the culprits manage to stall actions through political or union influence. In PCBs if the discovery is not linked to any shareholder/board member, then action immediately follows. The external audits in Bangladesh are usually conducted by accounting firms. Banks happen to be very lucrative client and in most of the cases the audit firms are also linked with personal businesses of the bank owners. As a result the auditors tend to give into the demands of the bank owners and prepare audit reports as the banks want them to. Lax accounting standard and weak regulatory watch on the accountants make things easier. Till year 2000, the banks in Bangladesh were not required to use the IAS-30 which is a widely accepted accounting standard for financial institutions. As a result many of the disclosures made by the banks were and are not still correct. There are allegations of 'window dressing' by the banks to hide underlying problems, weaknesses and irregularities. There are many examples of banks revealing different figures under same head in different disclosures.

In practice there are almost no disclosures in the public sector banks. The only reports they submit go to MoF and the central bank. PCBs do bring out annual reports but there are widespread allegations of doctoring figures and facts in those reports. Surprisingly in the NCBs and PCBs there are very little disclosures made even to internal executives and employees about targets, achievements, corporate plans etc. Until the central bank issued a directive, except for two -no other banks had a board audit committee. To date none except those two have formed board committees on remuneration and nomination. In fact none of their corporate by-laws include any clause for establishing those board

committees and surprisingly the FCBs also appear to have this problem. However, the FCBs follow their global policies on audit and disclosure. Audit system and practice is very stringent and effective. They make full disclosures using international accounting standards on loan positions, executive remuneration, third party transactions etc. They always communicate their corporate goals, achievements, future plans with the executives. The FCBs even make direct disclosure of their financial performance to the depositors.

5. The Political Economy Framework of the Regulatory Agencies

The discussion in the previous section sheds light on the state of prevailing corporate governance in the banking sector of Bangladesh. While the academicians and policy makers have suggested for stricter and sounder governance mechanisms within the banking firms for their unique characteristics, the picture in the Bangladesh banking is rather a gloomy one. Although the foreign banks stand aside on a high ground with sound corporate governance practices, the Bangladeshi public and private sector banks seem to be marred with corruptive practices by both owners and managers. This has already caused the sector to see about one third of its assets turning into non performing loans which actually has put the depositors' money in jeopardy. Sharking by controlling shareholders in the private banks, swindling of depositors money by politicians and executives in the public sector banks associated with weak legal back up clearly makes the way for a strong and highly active regulatory role by the regulatory agencies in order to upgrade the quality of governance of these banks. Have they been playing the expected and correct role they should have played? The next section talks about the contribution of the regulatory stakeholders in the Bangladesh banking sector.

Bangladesh Bank

Central banks around the world have been entrusted with the responsibility of the custodian of the banking sectors. Role of the central bank as the primary or most powerful regulator has utmost importance in bringing and maintaining sound corporate

governance culture in the banking sector. Through prudential regulation and effective as well as efficient monitoring central banks make sure that public fund available to bankers and bank owners in the forms of deposits are nor plundered. Bangladesh Bank (BB) is the central bank of Bangladesh which was formed through Bangladesh Bank Order 1972 and regulates banking companies in line with the Banking Company Act 1991 and its subsequent amendments. For the PCBs and FCBs, BB is highest official authority starting from the issuance of license to winding up of banks if necessity arises.

Earlier sections of this paper hinted that historically the Bangladesh banking sector lacked good governance. Both literature and data suggests that depositors' money has been hugely misappropriated by the founders of banks. But how was it possible when the BB was there to regulate the banks with almost endless authority and power? Much of the corporate governance problems in the banking sector are due to the fact that BB till late 90s was very weak in terms of devising prudential regulation and effective monitoring of banks in Bangladesh. The governor of BB also acknowledged that until 1997-1998 there was real lack of capacity as well as good will from the BB's part to strictly regulate the banks in Bangladesh. But by that time almost three decades of the banking sector and two decades of banking liberalization have gone past. And deadly damage has been inflicted by the banking culprits in the form pocketing banks' funds.

Besides these BB also had serious problems in staff capacity. After getting independence due to shortage of central bank staffs, the formerly clerical staffs of Pakistan central bank were promoted to managerial positions and in course of time became the directors and general managers of the departments. And in the BB operation this departments and the mid level management are really the engine of the system. Its through them the field level monitoring are done. Based on their feedback the top management used to take decisions. But as those newly promoted staffs lacked quality and experience in handling with commercial banks, the result was a disaster. Bank owners for the PCBs were doing all sorts of wrong doings right under the nose of the BB and BB either did not notice anything or if noticed proper action was never taken. According to the bankers and also the BB governor it's only from early 90s the entry level management positions were

being filled up good quality employees as this is when BB got aware of the negative impact of low staff quality and became interested to recruit efficient people for the sake of future. But the bankers suggest this was not a realization by the government itself- this was largely due to the pressure by World Bank and IMF who were then conducting the Financial Sector Reform projects. Of course the top brass of the BB was more capable and qualified than those of mid level management people. This is because the deputy governors and the majority of the executive directors were largely from the pool of handful management people left from the erstwhile Pakistan central bank. Since the Pakistanis were recruiting them for management positions, the recruiters made sure that these people were capable and efficient enough to serve the management positions of the central bank. The governor of the BB has historically been appointed by the government from outside the bank. In most of the cases the government appointed retired senior bureaucrats as the governor. However, to get the appointments as the governor, one has to prove his/her loyalty to the ruling government and almost all the past as well as current governors were and are somehow linked to the ruling parties. But it can be said that although appointments are politically linked, but at least the last two and the present governors are all very capable people in their respective fields. According to the bankers, it's the independence and good intention of the governors which are in line of questions, not their capabilities.

Political pressures have always been a major obstacle for BB to efficiently regulate the banking sector. We have already mentioned that the governor is always appointed by the government from its loyal pool of capable people. But to pay for the award of these appointments, governors have rarely taken position against any unfair government directives. The BB itself is primarily regulated by the MoF. But compared to other government regulated agencies, BB enjoys more autonomy. The governors could have been dictated by none but the Minister of Finance only and of course the Prime Minister's office. This can be considered a bigger autonomy where other MoF regulated bodies even take directives from the joint secretaries of the MoF. Recently the autonomy has been even made even greater by making the governor accountable to the parliamentary standing committee in MoF. But in reality this autonomy is still in paper

only. Because of the political dynamics of Bangladesh the accountability still remains with the finance minister in practice. Although BB is the official licensing authority for new banks, almost all PCB in Bangladesh have obtained their licenses according to the Prime Minister or Finance Minister's wish. The BB had very little to say anything with regard to who is eligible and who is not. As a result, the bankers and experts suggested, the corporate governance as well as other problems of Banks in Bangladesh starts right from the licensing stage. There are also reports of political interventions into the regular BB activities like investigating the affairs of a banks or taking actions against bank people. There are examples of individuals getting nod of the BB for private bank CEO position as a result of political pressure even after being black listed for their prior misdeeds. Another irony of the BB as the regulator of banking sector is that as far as the NCBs and SCBs are concerned the BB has no real authority on the banks. All the decisions including the punitive ones are solely taken by the MoF without any consultation with the BB. Those banks just submit some regular documents to BB as per the requirements. The political problem also hampers the BB activities through unionisms. The BB employee unions are historically dominated by the labor wing of the ruling party. As a result union's connections very easily reach up to the heavy weights in the political leaders. The union leaders very often bargain even with the governor for their appointments, transfers or hold up of punitive measures against any employee who is their supporter. Most of the mid level management people honor the union requests fearing the political backlash in case they do not cooperate. The political hooliganism of the union often reaches the governor as well.

The staffs of the BB lack proper capacity as regulators of the banking system. Most of them do not have a proper academic background. There are examples of General Managers leading very important divisions with geography degree or no bachelor's degree. On top of that there are very little and also weak development programs run by the BB to prepare its staffs for the monitoring and regulatory activities. In fact in most of the cases BB does not have any capability to offer training programs on complex banking issues. For example in early 2004, two FCBs- Citibank and Standard Chartered Bank have come forward and trained the BB officials on issues related to foreign exchange risk

management. BB is also offering training programs on preventing money laundering to its own staffs as well as some local banks with the help of some FCBs particularly Standard Chartered Bank. This is clearly a very feared outcome of regulatory practice known as 'Regulatory Capture'.

There are also wide spread allegations of corruption by the BB staff. BB staffs are paid according to the government pay scale which is widely considered to be very low in the current market conditions. As a result many BB employees render undue favor to banks in return for bribes. The majority of the corruption allegations are raised against the BB's audit and inspection team which works as eyes and ears of the regulator. There are score of examples of BB staffs being rewarded explicitly or implicitly by the private sector banks for their favors on those banks.

BB also seriously lacked effective monitoring and supervisory mechanism. Until late 90s it did not have any particular method of monitoring bank performances as their requirements from the banks were very nominal. BB had to rely mainly on its audit and inspection team's report and findings. But it's been said earlier that there are serious questions regarding capability and integrity of many of the auditors and inspectors. BB did not have any formal and regular way to know the scenario regarding default loans unless banks voluntarily informed it or it asked the banks on case basis. This lack of central database made it difficult for banks to know whether a loan applicant has current or past default record with other banks. It was not aware of insider lending scenario as it did not require banks to let it know on this issue. Again only since mid 90s BB established the Credit Information bureau (CIB) where every bank had to submit detail information regarding loan and recovery for all loans above 5 million BDT. And banks were allowed to collect information regarding and person or institution applying for loans. In the late 90s BB established a new division called Offsite Supervision Unit-whose main job was to analyze different data submitted by the banks and evaluate banks' position in terms of operating and financial results. It also monitors for change in key risk indicators and asks banks to take corrective measures. BB now also requires all the PCBs to regularly report on the loans and deals involving the board members and sponsor shareholders. Recently BB has developed a more advanced monitoring system. It has

developed a set of guideline for core banking risk management which every bank must implement in their operational measures within year 2004.

In short in can be said that while BB still lacks the required level of monitoring and staff capacity, independence of political interventions, it's now working with more determination to improve the banking sector condition than any other time. Since late 90s BB has become very positive and determined in drawing a curtain on the gross irregularities that were being done by the PCB board and owners for almost two decades. But due to lack of total autonomy and independence of political influence it still can not say a word regarding the problems existing in the public sector banks.

RJSC (Registrar of the Joint Stock Companies)

RJSC works as the custodian of the company or corporate laws of any country. Any and all limited companies go through the RJSC for formation purposes and thereafter the RJSC is expected to monitor the compliance to company law by the companies. Members of public could access that information any time they wish to. The RJSC deals with formation of the companies and filing of statutory returns. It also possesses the authority to call for any information and explanation it feels necessary. The firms are required to submit some forms to RJSC on a regular basis involving issues like list of shareholder, summary of share capital, consolidation of shares or stocks, increase in share capital, change in directorship, appointment of auditor etc. RJSC regulations specify the punitive measures for failing to do so. In an ideal scenario as banking companies, all the banks would provide these information to RJSC; in fact RJSC will enforce the timely submission of these documents and then would be available to RJSC and members of the public to scrutinize. This procedure itself would bring in much transparency and fairness in the corporate activities. But the real scenario is that there is hardly any evidence of regular and/or full compliance with the RJSC requirements. Most of the banks, after formation even do not inform of any changes to RJSC let alone submission of forms. One bank CEO suggested in his whole tenure as the CEO, he never dealt with any issue that is relevant fulfilling RJSC regulations. As a result neither agency nor the public are fully aware of the dynamics within the firm in line with the company act 1991. And this is

encouraging many bank owners and executives to go unnoticed about the irregularities they are committing. Such activities by the rogue parties are being possible because of the weaknesses within the RJSC. Its capacity and authority are seriously limited. It does not have the authority to investigate into the company affairs, this discretion lies with the government. There are at the moment more than 100,000 company files with the RJSC. And there is no electronic system of maintaining the database or records. Records are maintained manually by a very small number of employees. There are about 50 staffs in total working in the RJSC. It's very difficult to do the proper maintenance of records when only 50 employees are dealing with the papers of more than 100000 companies. As a result the staffs rationalize their time by doing only what they are told to do and that's mostly on specific case basis. Almost all the staff time are spent on dealing with the new application to form companies. In fact this has become literally the only job being carried out by the RJSC in practice. There is nothing like a regular maintenance and monitoring or scrutiny of all company records. The registrar admitted at the moment they don't even know how many companies are in default of submitting what papers. And on top of that another basic purpose of RJSC's existence is not being upheld. That's whatever records the RJSC have got are not open to public for inspection. There are allegations that only 'huge bribes' can get someone the information he/she looking for. The shortage in staffs and manual record system make it difficult to bring out the records of a particular company. It takes a lot of time for their staffs to do so. That's why unofficially they try to discourage the public from looking into the records of the companies by saying 'not possible' when some one asks for some company records. There are also questions regarding the capacity of the RJSC employees. None of the employees are educated or trained on company laws. They do things based on their experience and as par the instructions of the higher authorities. As far as the higher authority is concerned, the registrar who is a government bureaucrat -admitted that before being placed in this position he himself did not know anything about company law. This gives us an idea about the aptitude of the RJSC staffs as the regulators of company law. The experts also indicated that absence of proper monitoring and presence of very light punitive measure also encourages the banking culprits to go for the wrongdoings to fill their own pockets. The RJSC can impose a range of fines on the violators of the rule. But that's only

possible when they keep track of who is violating what. And that's not something very common in the RJSC. Also the fines are too small to deter the company people from the irregularities. The maximum fine of five thousand BDT is too small an amount for the bank owners/directors/managers almost all of whom are making millions every month. As far as the public sector banks are concerned, there are no roles that the RJSC can play as except for one, none of those banks are limited companies which fall under the discretion of the RJSC. For that single bank as well almost everything is decided at the MoF, the RJSC does not dare to intrude into the activities of that bank. On top all these problems, there remains the problem of political pressure. In some cases where RJSC initiated actions against certain companies, the parties at fault could later stall the measures by using their political connections. Under these circumstances, it's not possible for the RJSC to render the services it's expected to do to ensure shareholder and stakeholders rights by bringing good governance practices into the banking companies in Bangladesh.

The SEC

The companies which are listed in the capital market are regulated by the SEC. SEC is primarily responsible for ensuring that the listed companies are abiding by the capital market regulations crafted by the SEC. These regulations are designed to bring in compliance and transparency in the company affairs which will protect the rights of the principals or the shareholders for the firms controlled by the block holders, SEC's main objective is to ensure the interests of the dispersed and/or minority shareholders. Although the central bank is the main regulator of the banking companies, the SEC also has some discretion over some of the activities of the publicly listed banking companies. About 48 percent of the banks in Bangladesh are publicly listed companies. So at least for these banks SEC could play an important role monitoring and enforcing various issues such as dividend, AGM, disclosures etc.

Although the financial liberalization including the banking sector started in early 80s, Bangladesh did not have any SEC until 1993. It's only in 1993 the SEC Act 1993 was

passed and the SEC was set up. Since inception SEC did bring in some disciplines in the capital market. For example it's done some good work in terms of investigating some fraudulent activities. It's brought some order into the issues such as AGM, listing-delisting of companies in the bourses and even for issuance of dividends to some extent. The listed banking companies also had to comply with many rules and regulations. But overall the SEC is yet to become a successful and efficient organization. First of all its rule exclude most of the banking companies. Although the PCBs are required to go public within a specific period of time, there are not such requirements or plans for the public sector banks and the FCBs as well. Non listing of majority of the banks, particularly the NCBs who control about 50 percent of the banking sector, has a serious implication in terms of getting market based governance measures. They are simply beyond the jurisdiction of the SEC. The SEC is also burdened with the capacity problems. First of all there are much less then required number of staffs and then the staffs are not properly educated and trained in the field of capital market. All the past chairmen were either serving or retired public servants having no background at all in the capital market. This important organization does not have any full time chartered accountant working for it. For accounting and audit related issues the SEC often depends on the external auditors. But as we discussed in the earlier section, there remain serious question regarding the professional and ethical standard of the auditors in Bangladesh. It also has serious lacking in its legal department with no full time corporate lawyer. Some bankers have indicated of corruption and nepotism by the SEC officials. One CEO has suggested that you could manage almost everything if you either have huge cash which works well through the higher mid level management in the SEC or the political connection which is like a tonic for even up to the top brass of the SEC. There are examples of removal of SEC members and executive directors for malpractices in the past. Altogether the SEC is yet to make a full and effective contribution in ensuring good governance among the listed companies in Bangladesh.

ICAB

The accountants play a vital role in corporate governance mechanisms by carrying out audits and facilitating disclosure of company information. The accounting profession and practice is monitored and regulated in Bangladesh by the ICAB, a professional body of the accountants. All the accountants who work as auditors of the firms are registered under ICAB. ICAB is governed by the Ministry of Commerce but its works as an autonomous body. We have already discussed the importance of accounting standards and audit practice in ensuring and strengthening corporate governance of firms in any sector. We have also discussed the problems associated with low accounting standard and flawed audit practice in Bangladesh banking sector. In a sector where accounting and audit standard would set the quality of disclosure and transparency about whether depositors' money is being (mis) used, ICAB have had a very important role to play. But reality hints that it has failed to do so. Due to weaknesses in ICAB's monitoring and enforcement mechanisms the banks used to get away with the substandard accounting practices and dishonest accountants could carry on as auditors. Many of the ICAB requirements are not ensured by other relevant regulations. For example ICAB requires compliance with BAS-30 for the banks but the Company Act and SEC Act does not have any such requirement. Greed and need for money coupled with dearth of quality accountants are responsible for corrupt and flawed audit practices. There are less than three hundred practicing CAs in the country. Since most of the firms in Bangladesh are family owned and not publicly listed, the owners do not feel the necessity of hiring a professional accountant to take care of their limited accounting activities. They rather hire someone with a university accounting degree as it's cheaper to hire them. Only the multinationals and a few big local companies tend to hire CAs as their executives. Such lack of market opportunities are discouraging new entrants in the professional field of accountancy. Such low number of accountants who remain very busy makes it difficult to impart quality training for the would-be accountants. As a result the new accountants are entering the field with inferior inputs while they study accountancy. And obviously when they go for auditing a firm, quality service is difficult to render. Also low fees and shortage of audit clients have also been cited as major reasons behind bad audits in Bangladesh. As banks are regular and lucrative clients for accountants, they try to maintain their business relationships with the banks even by giving unethical favors to the banks. But in the past ICAB has very rarely taken action against the problem accountants. There is only one example in the past decade where ICAB has taken punitive measure against one of its members. But why is that? ICAB itself is not a totally fair and independent organization. The president and executive committee members themselves leading accountant of the country and most of them are associated with audit firms who have clients in the banking sector. Any action now would pave in ways for potential action against them or their firms in the future. And also if actions are taken

against malpractitioners, many of the small number of CAs or audit firms available in the market will be dropped and then there will be a serious shortage of professional accountants and accounting firms. Also there was very little pressure until recently from the government on ICAB to strengthen and enforce accounting regulations. It's only very recently due to the continuous lobbying by the central bank, MoF has asked the MoC to pressurize the ICAB to strictly enforce the accounting principles and regulations. But the pressure is yet to bring any real change in practices of the ICAB.

Conclusions

Regulation has become one of the primary issues in the contemporary debate surrounding economic development. The recent development strategies such as competition, privatization and deregulation have highlighted the importance of regulation at different levels of the economy. Academicians and practitioners have outlined clear framework through which regulation can affect a country's economic growth. The form of self regulation which initiates at the firm level remains of enormous importance in terms of exercising control over the behavior of market agents to attain beneficial economic and social objectives. The self regulatory governance of firms which is widely known as 'Corporate Governance' is vital for growth and stability of various economic sectors. Amongst them the banking sector, which happens to be the engine behind developing countries' economic activities, is in utmost need for prudent and effective regulation both at firm and macro level. At a time when Bangladesh is making all out effort to achieve higher economic growth through expanding export and industrial base of the economy, an efficient, stable banking sector is of huge importance for the country for its role to facilitate efficient resource allocation and flow of economic activities.

However the literature and evidence clearly suggests that the quality of the regulation in Bangladesh banking system stands at a very unsatisfactory level. Government ownership, political interventions, concentrated ownership of the private banks, lack of accountability of public sector bankers, faulty, incomplete an ineffective audit and disclosure have led to widespread corruption in the banking sector which saw banking assets and depositors fund waning away in the pockets of interests groups. Such

widespread corruption and lack of other weak infrastructural back up to banking sector absolutely demanded a strong and effective role by regulatory agencies to protect the interest of depositors and other social stakeholders of the banking system. Nevertheless the regulatory agencies' severe failure to effective monitoring and control the corruptive activities in the banking sector has threatened the stability of the banking sector as well as the safety of millions of depositors.

The failures of the regulatory agencies were not the results of short term mismanagement. The banking regulators have historically been subject to political pressure and manipulation in order to give leeway to politicians to use the banking sector to attain their own objectives. Corrective actions have often been stalled as a result of political intervention. Intense lack of capacity, skill and incentives also deterred the regulatory agencies from exerting sound and effective regulatory control on the market players in the banking system. Such deficiencies have also led to corruptive practices by regulators themselves as well regulatory captures. The result was an obvious one- plundering of public money and a fragile and inefficient banking sector even 34 years after inception and 24 years after the financial reforms was initiated.

For the sake of development and economic growth, Bangladesh is in dire need of a strong, stable and efficient banking sector, particularly as the other elements of financial sector remains fairly small and underdeveloped. But regulation, both at firm and sector level has become a critical success factor for attaining such goal. Proper regulatory policies along with the required framework need to be developed immediately along with right and sufficient skills and incentives for the regulators. An effective regulatory regime would require total commitment and determination of the market players and politicians backed by influence from the pressure groups such depositor groups, shareholder associations, media and others. A sound, effective and market friendly regulatory regime would certainly help Bangladesh banking to flourish by bringing discipline and stability within the sector.

List of Abbreviations:

AGM: Annual General Meeting

BB: Bangladesh Bank

BDT: Bangladeshi Taka (US$1=BDT 59)

NCBs: Nationalized Commercial Banks

SCBs: Specialized Commercial Banks

PCBs: Private Commercial Banks

FCBs: Foreign Commercial Banks

IPO: Initial Public Offering

SEC: Securities and Exchange Commission

RJSC: Register of Joint Stock Companies

ICAB: Institute of Chartered Accountant if Bangladesh

MoF: Ministry of Finance

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