AgEcon SEARCH
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search
<http://ageconsearch.umn.edu>
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

Development Economics and Public Policy

WORKING PAPER SERIES

Paper No. 14

CORPORATE GOVERNANCE IN DEVELOPING ECONOMIES: PERSPECTIVE FROM THE BANKING SECTOR IN BANGLADESH

Mazrur Reaz and Thankom Arun
University of Manchester

May 2005

ISBN: 1 904143 71 7

Further details: Institute for Development Policy and Management
Published by: University of Manchester,
Harold Hankins Building, Precinct Centre,
Oxford Road, Manchester M13 9QH, UK
Tel: +44-161 275 2798 Fax: +44-161 275 0808
Email: idpm@man.ac.uk Web: <http://idpm.man.ac.uk>

Corporate Governance in Developing Economies: Perspective from the Banking Sector in Bangladesh

Abstract

This paper highlights the corporate governance of financial institutions with particular reference to banking sector of Bangladesh. The importance of corporate governance of banks remains crucial given their contribution in economic growth through financial development. This paper has shed light on the structures of corporate governance of banks in Bangladesh involving their ownership structure, board issues, executive aspects, disclosure, and audit practices along with their associated weaknesses. The paper has also showed how political interference and failure by the regulators has contributed to the governance problems in the banks.

Keywords: Bangladesh, banking

INTRODUCTION

Globalization of financial markets and fears of financial instability have brought the issue of the corporate governance into forefront of the policy discussions. In an increasingly deregulated policy environment, the big corporate failures such as Enron, Vivendi, Barrings have raised the need for implementing competent corporate governance practices. The recent financial crises in different countries have verified how the lack of good governance practices in the financial institutions can lead to a crisis in the system leaving long-term consequences to the economy (Singh and Weisse, 2002; Mitton, 2001). Among the financial institutions, the corporate governance of banks has received very little attention only (Arun and Turner, 2003). In developing countries, banks have a dominant position in the financial systems and a discussion on corporate governance of banks required special attention. This paper addresses the corporate governance of banking sector in the context of Bangladesh.

CORPORATE GOVERNANCE AND BANKING INSTITUTIONS

The need for a competent financial sector is important to stimulate and support economic growth through 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 small¹. 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)

The number of bank failures and financial crises during the last two decades raises questions on the competency of the governance practices of the banking system. 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). Winkler (1998) insists that the quality of corporate governance of banking institutions determines the success of the financial development. Absence of proper monitoring and control mechanism cripples the potential good effect of financial development on the economic growth. The fact that banking companies are allowed to collect deposit and utilize them for profit making activities, could create opportunities of moral hazards². The possibility/motivation of plundering depositor's money, who happens to be the primary principal in banking companies, by the agents is greater in banking companies as the agents who founded the bank had to contribute very little through equity in accumulating the assets. One reason why banking stimulates financial development is that people entrust the banks with their deposits as the banks are expected to carefully select investment opportunities and then prudently monitor the loan borrowers which could have controlled the problems associated with information asymmetry. However, in reality the agents may not be selecting and monitoring the loans, particularly when the loans are connected to agents and their beneficiaries. The implementation of sound governance mechanisms could reduce the risk of moral hazards and enhances the process of financial development.

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 that 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) supported 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.

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 assets 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.

Banks in developing countries are faced with high risk of sharking 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). 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). 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 involved with high risk activities such as trading in financial markets and different off-balance sheet activities more than ever before (Greuning and Bratanovic, 2003), which necessitates an added emphasis on quality of corporate governance of banks in developing economies.

CORPORATE GOVERNANCE AND 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 government until 1982, when the 'ownership reform' measures started in the financial sector, had carried out the regulation and ownership of all the financial institutions. 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 sector³, 30 are local private and 10 are foreign owned banks (Bangladesh Bank, 2003).

Source: Economic Trends, Statistics Department, Bangladesh Bank, July 2001

Despite 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 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.

As in many other countries, there were no available structured databases on corporate governance in Bangladesh that led us to the obvious choice of generating data through a structured survey of banking institutions in the country. The structured questionnaire survey aimed at finding out the prevailing situation in the banking sector with respect to the core elements of corporate governance such as ownership/shareholding structure, control of firms, board issues, management contracts and compensation, audit and disclosure. Because of close geographical proximity, the entire banking (49) population was targeted in the survey. A total of 35 banks have responded including 4 NCBs, 3 SCBs, 24 PCBs and 4 FCBs. In addition to this, semi-structured and unstructured interviews were used to explore the practical dynamics of corporate governance within the institutions which was difficult to explore in a structured

questionnaire. A total of 21 interviews have been conducted which included the central bank governor, 14 top management officials of all types of banks, members of three different banks' boards, one economist, one chartered accountant and the registrar of Joint Stock Company. The data relating to the performance of the banks have been obtained from off-site supervision unit of the central bank. It was not possible to get the entire sector's data from any other source as the public sector banks do not publish annual reports regularly and the foreign banks only publish consolidated annual reports based on global operations.

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 per cent shares of banks is publicly available in Bangladesh and a large majority of the shares are owned by a small number of 'Sponsor' shareholders⁴ leaving a small portion of the shareholding to the 'General' shareholders⁵.

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 executives can only buy shares (IPOs) when banks go for public offering or from the secondary equity market and even for that the evidence of executive shareholding have been found only in 14 per cent 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 per cent by members of one family⁶. The survey has noticed heavy presence of block holders in the banking sector⁷, 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 ten⁸ 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 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 per cent 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 the profit of 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. And no wonder a number of these loans have already turned non-performing or bad loans making the banks lose the depositors' money they invested. Besides the loans, the PCBs sponsor shareholders have been involved with misusing/plundering of banks' funds in many other ways just to add benefits to their own pockets. Its worthwhile to mention that general shareholders do not have any of these privileges at all. The only involvement, if there is any, they have with the banks 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 have been cited as major corporate governance mechanism and are entrusted 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 regulation must be included in the bank boards. Among the non-executive board members, the scale is heavily tilted towards shareholder directors almost all of who 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 normal tenure of the board members turns out to be 3 years for the majority of the banks. This can be attributed to the recent regulation issued by the central bank which limits the tenure of board membership for the private banks into two terms of 3 years each. The survey also reveals that none of the banks in Bangladesh have more than one level of boards such as management board or supervisory boards. Both the owner members and the independent members of the boards are remunerated through board meeting fees only. There is no remuneration for board work of the executive members as they are all ex-officio members of the boards. It seems the board members of the private banks remain in the board for long time as about 40 per cent of the board members are in their respective boards for more than 5 years.

The issue of large shareholders discussed in section 3.1 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, it's 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 that 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 owners of the banks heavily control the management activities in Bangladesh. 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 that 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. The politicians sitting at the Ministry of Finance dictate all appointment, transfers and promotions. 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 per centage 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 that 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 per cent of the

cases the internal audit section reports to the board of directors while the other 31 per cent reports to senior management. More than half of the banks' internal audit found evidence of fraud in their audits. Interestingly 29 per cent 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 per cent of the banks said they disclose the internal audit reports to the shareholders in the AGM while only 9 per cent 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 transactions⁹. 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.

In an ideal scenario any wrongdoing by shareholders or executives are supposed to be exposed if there 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. Accounting firms usually conduct the external audits in Bangladesh. 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 that 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 and future plans with the executives. The FCBs even make direct disclosure of their financial performance to the depositors.

Role of Central Bank, Other Regulators and Corporate Governance

The primary regulator for the banks in Bangladesh is the central bank, known as Bangladesh Bank. Among other regulators are RJSC, SEC, ICAB and the legal authorities. The BB remains under full control and influence of the government. It acutely lacks quality in its staffs in terms of prudent monitoring and supervision. Low compensation packages have also contributed

much in curbing BB's reign on the banks. It is very easy to buy out an auditor of the BB who in return submits favorable reports on the banks. Political interventions, lack of quality and corruption has created great obstacles for the central bank to play the expected role. The RJSC remains just as a 'license issuing authority' permitting firms to come into existence. With lack of determination, quantity and quality of staffs and modern technology the RJSC makes very little contribution as a regulator of firms. It is worthwhile to mention that there is neither computer nor any computer literate staff in RJSC which handle more than 1,00,000 company files. The SEC is trying hard to bring discipline in the listed companies but in the banking sector where the majority is not publicly listed, SEC's scope to act is limited. Moreover SEC also suffers from shortages of qualified staffs. There is only one full time corporate accountant working at the agency. ICAB is the supreme authority for affiliations and regulations of accountants in Bangladesh. The ICAB failed to design effective regulations for its members as well fell short of properly monitoring and acting upon the activities of the accountants in Bangladesh. It has also failed to generate sufficient number of qualified accountants and implement international accounting standards. Finally everything in Bangladesh banking gets stuck once it reaches courts. The legal backup to banks is very weak and often takes courts ages to give a verdict. Defaulters often go to the court and win an injunction barring banks to sell the collaterals or calling them 'defaulter' until the case is solved. And a decade is a very common timeframe for courts to come up with verdicts. Again lack of sufficient legal personnel in Bangladesh is accountable for this problem. Altogether the regulatory authorities, particularly the central banks have failed the depositors and small shareholders in rendering its duty properly in terms of prudential regulation and supervision.

CONCLUSIONS

Banking sector remains of enormous importance for Bangladesh who is striving hard to strengthen its developing yet fragile economy. To move from the agriculture based economy to an industry-based one, Bangladesh needs its banking sector, which is the single largest element of the financial sector, to operate at its best with utmost efficiency. Anything short of that and even a slight instability in this area would wreck long term havoc on Bangladesh's development. And sound corporate governance remains to be a key requirement for efficient and stable banking system. We have discussed in this paper how uniqueness of banking companies and banking business require special corporate governance attention on a priority basis particularly

for the developing countries where prudential regulation and supervision is inadequate to provide a safety net for the depositors and stakeholders of the banks.

In the case of Bangladesh as well, we have noticed that the owners of banks holding large shares have been misusing the banks' funds utilizing their control over the institutions. They have used their domination in the board positions as well as lack of effective, stringent and full audit and disclosure to plunder public's money showing little respect for the depositors and the institutions. And the regulatory stakeholders have totally failed to design, implement prudent regulations as well as effective motivations and supervisions. The result is a near-collapse condition of the banking sector with low profitability and high-risk indicators for the local banks while the foreign banks, in spite of operating in the same environment, tend to show better results and stability with good governance practices.

In order to restore discipline and bring sound corporate governance the first priority is to keep the system out of political influence. The political considerations/influence reigns supreme in Bangladesh banking from running the public sector bank to issuing private bank licenses and from interfering with the central bank to protecting bank defaulters. Banks and regulators need total autonomy and must be allowed to deal with banking issues in terms of economic and commercial viability. The central bank must be given the freedom of acting on behalf of the depositors. However the central bank needs to restructure it self with better monitoring techniques, use of technology and improve the quality and accountability of its own human resources.

The preferential treatment of 'Sponsor' shareholders is creating a large chunk of the problems in the local private banks. Equal treatment and rights of all shareholders would bring about much positive disciplinary change in the banks. The banks in Bangladesh are still closely held companies. Releasing more shares to public and particularly to institutional investors should be encouraged as it will bring about market-driven and closer monitoring of bank activities. Prudential regulation should be designed taking into account the audit and disclosure problems that make much of the banking decisions non-transparent. The central bank should work closely with the other regulators such as ICAB to make improvements in the audit and disclosure practices of the banks without which good governance will be difficult to achieve. Had these

issues been considered more than 20 years ago when government started to liberalize the banking sector, the sector could have avoided many of the underlying problems and losses it is burdened with today. In other words the issue of corporate governance of financial institutions must get due importance along with the decision of financial liberalization or else liberalization would only add to the woes of thousands of depositors along with inefficient banking system.

References

- Arun, T.G. and J. Turner (2002) 'Public Sector Banks in India: Rationale and Prerequisites for Reform', *Annal of Public and Cooperative Economics*, Vol. 73, No. 1.
- Arun, T.G. and J. Turner (2003) 'Corporate Governance of Banks in Developing Economies: Concepts and Issues', *Corporate Governance: An International Review*, Vol. 12, No. 3, pp.371-377.
- Bangladesh Bank (2003) Annual Report.
- Bangladesh Enterprise Institute (BEI) (2003) 'A Comparative Analysis of Corporate Governance in South Asia: Charting a Roadmap for Bangladesh' BEI, Dhaka, Bangladesh.
- Banking Reform Commission (1999) The Report of the Banking Reform Commission, formed by the Government of Bangladesh.
- Basel Committee on Banking Supervision (BCBS) (1999) 'Enhancing Corporate Governance for Banking Organizations', Bank for International Settlements, Switzerland.
- Centre for Policy Dialogue (2001) 'Financial Sector Reforms', A Report Prepared by CPD Financial Sector Task Force, Dhaka.
- Cetorelli, N. and M. Gambera (2001) 'Banking Market Structure, Financial Dependence and Growth: International Evidence from Industry Data', *Journal of Finance*, Vol. 56, pp.617-648.
- Clarke, R. (1988) Remarks in Comptroller of the Currency News Release No. NR88-5, Washington DC.
- Fama, E. and M. Jensen (1983) 'Separation of Ownership and Control', *Journal of Law and Economics*, Vol. 26, pp.301-325.
- Greuning, H. and S. Bratanovic (2003) 'Analyzing and Managing Banking Risk: A Framework for Assessing Corporate Governance and Financial Risk', World Bank, Washington DC.
- Hassan, K. (1994) 'The Financial Sector Reform in Bangladesh', in Hassan, K., *Banking and Finance in Bangladesh*, Dhaka Bangladesh.
- Henderson, J. (1986) 'Agency of Alienation? Smith, Mill and marx on the Joint-Stock Company', *History of Political Economy*, Vol. 18, pp.111-131.
- Jackson, H. and E. Symons (1999) *Regulation of Financial Institutions*, West Publishing Company, St. Paul: Minnesota.
- Jensen, M. and W. Meckeling (1976) 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure', *Journal of Financial Economics*, Vol. 3, No. 4, pp.305-360.

King, R. and R. Levine (1993) 'Finance and Growth; Schumpeter Might Be Right', *Quarterly Journal of Economics*, 108, pp.717-737.

Levine, R. and S. Zervos (1998) 'Stock Markets and Economic Growth', *American Economic Review*, Vol. 88, pp.537-558.

Macey, J. and M. O' Hara (2001) 'The Corporate Governance of Banks', Federal reserve Bank of New York, Economic Policy Review.

Macey, J. and M. Garrett (1988) 'Market Discipline by Depositors: A summary of the Theoretical and Empirical Arguments', *Yale Journal of Regulation*, Vol. 5.

McConnell, J.J. and H. Servaes (1990) 'Additional Evidence on Equity Ownership and Corporate Value', *Journal of Financial Economics*, Vol. 27, No. 2, pp.595-612.

Mitton, T. (2001). 'A Cross-Firm Analysis of Impact of Corporate Governance on the East Asian Financial Crisis', *Journal of Financial Economics*, Vol. 64.

Oman, C. (2001) 'Corporate Governance and National Development', OECD Development Centre Technical Papers, No. 180.

Rajan, R.G. and L. Zingales (1999) 'The Politics of Financial Development', Working Paper, University of Chicago.

Raquib, A. (1999) 'Financial Sector Reform in Bangladesh: An Evaluation', Bank Porikroma, Vol. XXIV, No. 3 and 4.

Sayeed, Y. (2002) 'Bangladesh: Strategic Issues and Potential Response Initiatives in the Finance Sector: Banking Reform and Development', Paper Presented at Seminar Organized by Asian Development Bank and AIMS of Bangladesh, Dhaka, July 22.

Shleifer A. and R.Vishny (1997) 'A Survey of Corporate Governance', *Journal of Finance*, Vol. 52, pp. 737-783.

Singh, A., A. Singh and B. Weisse (2002) 'Corporate Governance, Competition, The New International Financial Architecture and Large Corporation in Emerging Markets', Working paper No. 250, ESRC Center for Business Research, University of Cambridge, December.

Sundarajan, V. and T. Balino (1991) 'Issues in Recent Banking Crises', in Sundarajan, V. and T. Balino (eds.) *Banking Crises: Cases and Issues*, Washington DC.

USAID (1995) 'Impact Evaluation of Financial Sector Reform Program: Technical Assistance Project Bangladesh', A Paper Prepared by Development Associated Inc. and Published by USAID.

Vives, X. (2000) 'Corporate Governance: Does it Matter', in Xavier Vives (ed.) *Corporate Governance: Theoretical and Empirical Perspectives*, Cambridge: Cambridge University Press.

Winkler, A. (1998) 'Financial Development, Economic Growth and Corporate Governance', Paper No. 12, Finance and Accounting Working Paper Series, Goethe University of Frankfurt, February.

World Bank (1989) World Development Report.

World Bank (1998) 'Bangladesh: Strategy for Establishing a Sound and Competitive Banking Sector', Vol. 1 & 2, Finance and Private Sector Unit, South Asia Region, World Bank.

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

Notes

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.'

² The moral hazard implies that the agents who borrowed money from the principals may not behave in line with best interest of the principals and their funds.

³ Out of the nine, four are commercial banks known as NCBs and five are specialized banks known as SCBs.

⁴ 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.

⁵ Those who buy banks' shares from IPO or secondary market are known as 'General' shareholders

⁶ The Banking Company Act (1991) defines family members as father, mother, husband, wife, son, daughter, brother and sister.

⁷ Shareholders holding 5 per cent or more have been considered as block holders (McConnell and Servaes, 1990).

⁸ The banking company act (1991) requires at least 10 sponsors to initiate a banking company

⁹ 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.