

Amb. Dhaka

08 JAN 1998

**Professor Muhammad Yunus**  
Managing Director



**GRAMEEN BANK**

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Jan 8, 98

**Subject : Agreement between Grameen Bank and Grameen Kalyan.**

Dear Ambassador Lehne :

This refers to your letters dated December 15, 1997 and January 5, 1998, on the above mentioned subject expressing your concerns about entering into such an agreement.

We are very grateful to NORAD for taking active interest in Grameen's developments. The agreement was made so that Grameen's financial resource & assets could be more professionally and efficiently managed, so as to maximize the benefits to the Grameen's clientele. We are furnishing the following information so that you may fully understand the rationale of our management decision.

1. **The reasons for the establishment of Grameen Kalyan.**

"Grameen Kalyan" (meaning "Grameen Wellbeing") was established as a separate legal entity in order to accelerate the pace of social and economic development of Grameen's targeted clientele, and also to ensure continued access to loans and other financial services that they have been getting from Grameen Bank (GB).

2. **The concept of revolving fund and its application.**

The Agreement to transfer funds from GB to "Grameen Kalyan", which is a "Not for Profit Company" under the Companies Act 1994, (i.e. non-stock company limited by guarantee; the profit of the company will not be distributed to any members of its Board, but will be recycled into its operation to maximize its stated objectives) was to ensure maximum transparency and responsible use of the revolving fund. This is simply creating a "Trust" for the revolving fund. In the earlier system the money would have been owned by GB, which would use it on a revolving basis. Under the changed situation, the money will be used for the same purpose,

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but GB will now receive it as a loan from a separate legal entity. This will compel the user to be more responsible in handling it, because of the pressure to pay the money back to its owner. The idea of revolving fund was to ensure its continuous re-use for the same purpose and to harness the maximum benefit in terms of servicing more clients. But since in the earlier approach the fund was available within the same management structure, in spite of the policy compulsion to revolve it, there remained the possibility that the required financial discipline to recover the money and exercise appropriate caution to effectively monitor the loan operation, may not be enforced.

This apprehension encouraged us to find an alternative method through "Grameen Kalyan", a member of Grameen's family of enterprises, to implement the intention and the spirit of the revolving fund concept. Revolving fund now gets an institutional structure, so that it can never be absorbed by multifarious other demands of the bank. "Grameen Kalyan" can be viewed as a management company set up exclusively to manage the revolving fund. We believe that the new arrangement does not in any way violate any of the clauses of the agreement between Norway and GOB, rather it strengthens professionally the financial operation of GB for eradication of poverty.

### 3. Informing or consulting the Embassy.

The Board of Directors of Grameen Bank, being the highest policy making organ, takes organisational and management decisions in the interest of the Bank and of course its clientele. We feel that the decision taken by the Board has been taken within the scope of the agreement with the donors. In no way, threatened to interfere with the successful utilisation of the grant, that is why we did not think of informing the donors. Now that you wish to be informed about it, we are happy to provide all the information you ask for.

### 4. Charging of interest and terms of repayment.

The Kalyan management has consciously decided to avoid charging of interest for the housing portion of the loans given to GB, with the intention to keep the interest burden low on the ultimate borrowers. Adding interest on this loan would have made the fund costly for GB to transfer it to the borrowers at the existing rate of eight percent. The question of adding interest on the loans for housing purpose can be reviewed, if it is deemed

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appropriate by the lending and the borrowing organizations. The agreement to this effect is subject to review as and when required.

The existing agreement did not stipulate any repayment date for the loans. We are working to include this clause in the loan repayment.

### **5. Non inclusion of revolving fund account in the Annual Report of 1996.**

Due to the change of the management technique of fund i.e. creating a separate organization to handle the money and loans that go out to GB, the revolving fund account within GB was rendered irrelevant. Instead, the amount has been shown as borrowing in the liability portion and as loans and advance accounts in the asset portion of the balance sheet in 1996.

### **6. Reduction of the owners equity.**

In the Board of Directors of the Bank, nine out of thirteen members are the elected representatives of the borrowers. The Board while taking any decision gives utmost priority to the interest of the owners. The decision to transfer this money, instead of adversely affecting the owners, have enhanced their interests by ensuring more efficient and prudent fund management and accountability on the part of GB, by way of an institutional compulsion to repay the loan to the lending organization. This process of mutual obligation and accountability on the part of two separate organizations have enhanced the immunity of the fund from being eroded due to lack of accountability if handled by a single organization as was done prior to its transfer to "Grameen Kalyan". The grant money received from different donors, has increased the liquidity of the loanable fund for GB. It was never reckoned as equity of the owners as would be evident from the annual reports of previous years.

It is to be noted that the establishment of "Grameen Kalyan" with endowment fund from GB, has broadened the scope for us to address the issue of eradication of poverty and hunger by undertaking different projects and activities that have the potential to generate income for the borrowers of the bank and offer opportunities to diversify our efforts for poverty reduction. The profits that will be generated or the income that will be earned by "Grameen Kalyan" offer the scope for such initiatives to be undertaken for the poor. This was the initial purpose of creating the Social Advancement Fund (SAF). Now SAF becomes a legal entity with a management structure of its own.

## 7. Use of the loan from Grameen Kalyan.

The use of the loans from "Grameen Kalyan" may kindly be seen in section - 3 of the relevant agreement.

## 8. Tax consideration.

Stipulation in the donor agreement was that Grameen will pay at least 2% interest on the loans for income generating activities from the revolving fund. This rate may be gradually raised to the level of market rate to bring Grameen Bank to the level of financial viability.

At the present level of 2%, Grameen pays almost a million dollar as interest to the Social Advancement Fund. After Grameen's tax exemption status is withdrawn this year, this one million dollar cannot be transferred to Social Advancement Fund, as an expenditure of Grameen Bank. Tax authorities will not recognize Grameen "paying" interest to an internal revolving fund as an "expenditure". It will consider the whole amount of one million dollar as income and impose a tax of 40%.

By creating "Grameen Kalyan" Grameen Bank avoids that. Now this interest payment becomes a valid payment, and "Grameen Kalyan" can keep the entire interest income for Social Advancement activity.

With gradual higher interest rate charged on the revolving fund, more and more money will have to be paid out as taxes in future, if the revolving fund remained within Grameen.

We thought "Grameen Kalyan" is an excellent legal device to not only keep the money for the social advancement of our borrowers, but also gradually enlarge the fund size.

If we had created "Grameen Kalyan" just to give institutional structure to SAF alone (without any loan agreement with GB), in the eyes of the tax authority "interest" payment from GB's internal revolving fund would be considered as a gift, hence taxable.

## 9. License to operate as a financial institution.

We have discussed the issue with Bangladesh Bank. Normally, for lending out to outside organizations this sort of license is required. "Grameen

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Kalyan" is an associate company of Grameen Bank for which the conditions applied to other financial institutions are not applicable. "Grameen Kalyan" has strictly confined its loan operation to Grameen's sister organizations only. We have been assured that since GK is not doing business with "public", this license requirement will not apply to us.

I hope , the above information will adequately clarify the issues which have been raised. We firmly believe that this initiative by GB will have far reaching consequences in our efforts towards alleviation of poverty and maximizing the uses of resources at our disposal. We appreciate NORAD's continued interest in Grameen's activities and look forward toward more collaboration in future.

With my warm personal regards.

Sincerely yours,

