
Understanding the Hallmark-Sonali Bank Loan Scandal

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Purpose of the report

This month's Current Events News Analysis takes up an issue that has been well documented and discussed in a variety of news sources: the Hallmark-Sonali Bank loan scandal. As with other hot topics, important information is scattered across a variety of different articles and sources. This report seeks to provide readers with "all that they really need to know" about the scandal. The analysis tries to provide clear, simple answer to the following questions:

- What happened?
- How did it happen?
- Why wasn't the malpractice prevented or discovered sooner?
- What has been the fall out?
- What is next?

What happened?

In May 2012, a report from the Bangladesh Bank revealed that the Ruposhi Bangla Hotel Branch of the state-owned Sonali Bank, Bangladesh's largest commercial bank, illegally distributed Tk 36.48 billion (US\$460 million) in loans between 2010 and 2012. The largest share, of Tk 26.86 billion (US\$340 million), went to the now infamous Hallmark Group. While the focus has understandably been on Hallmark, other companies also participated in the fraud, including:

- T and Brothers, Tk 6.10 billion
- Paragon Group, Tk 1.47 billion
- Nakshi Knit, Tk 660 million
- DN Sports, Tk 330 million
- Khanjahan Ali, Tk 50 million

This is considered to be the country's largest banking scandal. It dwarfs previous fraud cases, such as a Tk 6.2 billion Letter of Credit fraud in Chittagong in 2007, a Tk 5.96 billion fraudulent withdrawal from Oriental Bank in 2006, and a Tk 3 billion forgery scandal in 2002.

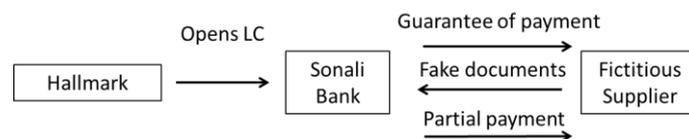
How did it happen?

It is alleged that the scandal resulted from collusion between officials of Hallmark and Sonali Bank, in particular between Tanvir Mahmud, Managing Director of Hallmark Group, and Azuzur Rahman, Manager of Sonali Bank's Ruposhi Bangla branch. The alleged scam exploited the Letter of Credit (LC)

system of financing trade.¹ The Letter of Credit system is an important tool that addresses two problems:

- First, garment producers are often unable to pay for their inputs, such as the textile fabric that they need for making garments, until after they have produced and sold their final products.
- Second, even when garments producers can pay on time, textile companies might be anxious about delivering fabric without some guarantee of payment.

The solution to these problems is a Letter of Credit (LC). At the behest of a garments producer, a bank provides a fabric supplier with a LC that guarantees payment either at the time of delivery or at some later date. As shown in the figure below, Hallmark is accused of establishing fictitious companies, such as Anwara Spinning Mills, Max Spinning Mills, Star Spinning Mills, which were shown as recipients of the LCs. These companies submitted falsified paperwork reporting deliveries of fabric to Hallmark, which were then paid for by the LCs from Sonali Bank’s Ruposhi Bangla branch. Because the fictitious companies and Hallmark had their accounts at the Ruposhi Bangla branch, on paper it looked like the branch’s assets and liabilities were balanced out.²



Another financial practice, known as Inland Bill Purchases, was then used to spread some of the bad loans throughout the banking system. Because the still outstanding LCs were guaranteed by Sonali Bank, the fictitious textile companies were able to sell the LCs to other banks before maturity at a discounted price. As such, portions of the bad loans were passed on to twenty-seven other banks.³

Why wasn’t the malpractice prevented or discovered sooner?

The first line of defense to detect the scam should have been internal audits at Sonali Bank and supervision by Sonali Bank’s top management. Most experts and commentators have concluded that for a fraud of this scale to occur, the bank’s top management must have been involved in a cover-up.⁴ Early media reports based on the account of a Sonali Bank whistleblower alleged Sonali Bank’s Deputy Managing Director made extensive efforts to block audits of the Ruposhi Bangla branch, and eventually transferred the persistent auditors to a branch outside Dhaka.⁵ A probe by a parliamentary committee noted that the Ruposhi Bangla branch was certified as a “low-risk” branch by the inspection and audit team of the bank despite violations of financial rules between 2007 and 2011.⁶ In fact, an audit wing report went so far as to assert that the accused manager of the branch was “managing the branch efficiently with his extraordinary talent, foresight, and banking knowledge.”⁷

The second line of defense should have been the bank’s board of directors, whose members claim to have had no knowledge of the malfeasance. External bankers and experts have also regarded this claim with some skepticism, since the board of directors of a state-owned bank should be involved in approving major loan decisions and reviewing audit findings.⁸ The board had constituted an Audit Committee and an Asset Liability Management Committee precisely for these reasons. Yet, the board failed to notice several red flags, including:

- The loans to Hallmark exceeded by a large margin the cap that limits how much Sonali Bank can lend to any single client.⁹
- Hallmark lacked the collateral to justify such large loans.
- The Ruposhi Bangla branch exceeded its loan quota by almost 500%.¹⁰

The third line of defense was the country's regulatory agencies. While private banks are entirely regulated by the Bangladesh Bank (central bank), state-owned banks are additionally overseen by the Ministry of Finance, which appoints the banks' board of directors and bank leadership. Not only did the ministry fail to provide proper oversight, it rejected calls from Bangladesh Bank to reconstitute Sonali Bank's board following the detection of irregularities. Furthermore, the Finance Minister initially attempted to dismiss the scandal as an inconsequential amount of money, a statement that he later retracted following considerable public criticism.

Observers worry that the root of the problem may be the preponderance of political influence in state-owned banks, which are not fully under the purview of the more independent Bangladesh Bank.¹¹ The lack of political independence has fueled speculation about the role of the Prime Minister's Health Advisor Dr. Modasser Ali, whose interactions with both the branch manager and Tanvir Mahmud might have just been a case of being "in the wrong place at the wrong time" or evidence of a role in the fraud.¹²

While the Bangladesh Bank does not have full regulatory authority over state-owned banks, it has also not escaped criticism. Critics say Bangladesh Bank should have been more proactive in responding to the irregularities detected in the central bank's own audits of Sonali Bank.¹³

What has been the fall out?

Investigations: The primary investigation has been led by the Anti-Corruption Commission, which filed 11 cases against 27 Sonali and Hallmark officials in October 2012 and another 26 cases against 35 officials (including some of the same individuals) in December 2012.¹⁴ Among the accused are all the heads of companies that benefited from the loan scam, including Tanvir Mahmud of Hallmark, who has confessed and is cooperating with the authorities. As of this writing, 19 Sonali Bank officials have been charged, including the former managing director, two deputy managing directors, the general manager, and the leadership of the Ruposhi Bangla branch, including the branch head Azizur Rahman. Several of the accused, including Tanvir Mahmud, are currently in jail awaiting trial, while others are yet to be arrested.

Recovery: One major concern is recovery of the lost money, which, to put the amount in perspective, is equivalent to 17% of the government's education budget.¹⁵ According to the findings of a parliamentary committee probe, of the Tk 26.86 billion loaned to Hallmark, only about Tk 4 billion was actually invested and the remaining amount could not be traced.¹⁶ (This is the case despite early claims by Tanvir Mahmud that he had assets to cover the amount borrowed twenty times over.)

Sonali Bank now confronts serious financial and leadership challenges. It had to cancel a Tk. 800 million loan in Fall due to financial shortfalls, and it has had to borrow heavily from other banks to stay afloat.¹⁷

The banking industry: It is difficult to determine the effect on the industry given preexisting problems. For example, non-performing loans in the banking system as of September 2012 were already at a high 8.75% of total outstanding loans, and interest rates were up to 19%.¹⁸ Government borrowing had already created a liquidity crisis, with state-owned commercial banks only distributing 37% of their targets to small and medium sized enterprises.¹⁹ Nonetheless, the incident has clearly undermined the public's trust in banks and trust between banks. There has been particular frustration from small and medium business owners, who are frequently denied access to credit.²⁰

What's next?

The Anti-Corruption Commission's investigations are ongoing and court cases will be held this year. Perhaps more importantly, banking experts hope that the incident will bring about much needed reforms in the banking sector. In particular, the incident has led to renewed calls for:²¹

- Steps to remove political influence from the banking sector.
- Changes to the way that board members and bank leadership are appointed.
- Upgraded automation and management information systems.
- Improved internal control mechanisms and the development of a comprehensive risk management strategy within all banks.
- And the creation of a fully independent Bangladesh Bank with full regulatory authority over all of the nation's banks.

¹ Md. Fazlur Rahman and Tamanna Khan. 2012. "A Question of Public Trust." *The Star*. Vol. 11(37): Sept. 21.

² *Ibid.*

³ *Ibid.*

⁴ See for example, Fahmida Khatun. 2012. "State of Governance in the Banking Sector: Dealing with Recent Shocks." Center for Policy Dialogue: Nov. 5.

⁵ Inam Ahmed and Arun Devnath. 2012. "The enemy within." *The Daily Star*: Sept. 4.

⁶ Daily Sun. 2012. "SB board blamed for Hallmark Scam." *Daily Sun*: Dec. 17.

⁷ *Ibid.*

⁸ Rahman and Khan, "A Question of Public Trust"; Md. Noor Solaiman Jewel. 2013. "Sonali Bank vs Hall Mark Group: An Analysis." *Financial Express*: Jan. 6.

⁹ Nasiruddin Ahmed. 2013. "Hallmark-Sonali Bank Loan Scam" *Financial Express*: January 14.

¹⁰ Daily Sun. "SB board blamed for Hallmark Scam."

¹¹ See for example Khatun, "State of Governance in the Banking Sector."

¹² Rashidul Hasan. 2013. "Modasser's 'mistake'" *The Daily Star*: Nov. 8.

¹³ See for example, Nasiruddin Ahmed. "Hallmark-Sonali Bank loan scam: A graft-ridden nation looks for a way out." *Financial Express*: Jan. 14; Jewel, "Sonali Bank vs Hall Mark Group."

¹⁴ FE Report. 2012. "Three Sonali Bank officials held." *Financial Express*. Dec. 24.

¹⁵ Khatun. "State of Governance in the Banking Sector."

¹⁶ Daily Sun. "SB board blamed for Hallmark Scam."

¹⁷ Syful Islam. 2012. Small businesses pay price in Bangladesh's biggest loan scam." *TrustLaw*: Oct. 2.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ Khatun. "State of Governance in the Banking Sector."

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