

SECTOR ASSESSMENT (SUMMARY): CAPITAL MARKET DEVELOPMENT

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **Limited role of capital market in resource mobilization.** In Bangladesh, domestic capital markets do not play a significant role in financial intermediation and resource mobilization. The capital raised through equity and bond issues together was equivalent to only 0.07% of gross domestic product (GDP) in fiscal year (FY) 2012. Banking products are still much more relevant for resource mobilization and capital formation than securities. Savings intermediated by banks amounted to 8.3% of GDP in FY2012. As a result, these results reflect that the domestic capital markets are unable to effectively facilitate the mobilization of financial resources for their efficient allocation into productive investments through the provision of efficient savings vehicles for retail and institutional investors, and diversification of funding sources for enterprises. This lack of diversification also makes the corporate and financial sectors more susceptible to shocks, thereby limiting the sustainability of development.

2. **Structural weaknesses in capital market restraining much-needed investment.** Bangladesh is still unable to efficiently tap into the capital market for its long-term infrastructure investment needs despite having a national savings rate of about 30% of GDP. The absence of an active bond market significantly contributes to the lack of infrastructure financing from domestic funds and reflects structural impediments in the capital market. The equity-dominated capital market is characterized by a lack of transparency, poor accounting and auditing standards, and weak governance. Trading in the equity market is dominated by retail investors who lack sophistication and tend to react to rumors and insider information rather than being guided by underlining economic and financial fundamentals.

3. **Limited institutional capacity of Securities and Exchange Commission to carry out mandate.** Capital market regulation and supervision is under the Securities and Exchange Commission (SEC). However, the SEC's operational and financial efficiency are constrained under the SEC Act (1993) through which the government has direct controls on appointments, the budget, expenditures, and pay scales. Although its oversight and regulatory functions have more than doubled, staffing remains inadequate and its remuneration structure is not attractive to potential qualified applicants from the private sector. The SEC receives 80–90 referrals per month; it resolves what it can internally and refers the criminal cases to the Court of General Sessions. Court decisions are delayed because of the high case-load and the lack of expertise in securities laws and regulations.

4. **Inadequate governance structure of stock exchanges.** The two stock exchanges—the Dhaka Stock Exchange and the Chittagong Stock Exchange—failed to discipline their brokers and/or dealers in instances of irregular trading. A large majority of inactive members hold a seat for the sole purpose of speculative gain. In view of the structural deficiencies in the governance of stock exchanges, a new ownership and organizational structure is needed to ensure sustainable reform. As a consequence, the government envisions the demutualization¹ of the two stock exchanges as one of its priorities to enhance governance.

¹ Demutualization in the context of a stock exchange is the transition from a mutual association of exchange members operating on a not-for-profit basis to a limited liability for-profit company accountable to shareholders in which demutualization essentially separates ownership (and voting rights) from the right of access to trading. Demutualization was caused by the need for new investment in the latest technology and to remain competitive. In

5. **Lacunae in financial reporting.** The lack of transparency and accountability in the financial reporting of listed companies is one of the major factors that is limiting institutional investors' participation in capital markets. Auditors lack independence and often fail to perform adequate due diligence on companies. An estimated 10%–15% of audited accounts of listed companies are reliable. The SEC's limited accounting and auditing expertise prevents it from fully exercising its authority in setting standards for auditors of listed companies and registered intermediaries. The government has initiated measures such as drafting the Financial Reporting Act that includes a plan to establish a financial reporting council to regain investors' confidence.

6. **Underdeveloped bond market because of a lack of benchmark issues.** The bond market is still in its infancy stage and lacks depth and liquidity. It accounts for only 5% of GDP and lags behind the bond markets of its neighboring countries (Table 1). The market is dominated by government bonds with an almost non-existent corporate bond market (221 government bonds, and 11 debentures and corporate bonds listed in the Dhaka Stock Exchange as of May 2012). The development is hindered by a lack of sovereign benchmark issues and issuance practices of the government that have prevented the establishment of credible yield curves. Issuing different bonds with different coupon and maturity rates on each occasion has resulted in many small issues of bonds that have prevented an active secondary market. A consolidation program through methods like reopening the same issue after the initial auction, switching a non-benchmark issue to a benchmark issue, or buying back the non-benchmark issues would enhance trading activity.

Table 1: Regional Comparisons of Government and Corporate Bond Markets

Country	Total Bond Market (% of GDP)	Government Bond (% of GDP)	Corporate Bond (% of GDP)
Bangladesh	5	4	<1
India	138	98	40
Pakistan	8	6	2
Sri Lanka	11	10	1

GDP = gross domestic product.

Source: International Organization of Securities Commissions, Development of Corporate Bond Markets in the Emerging Markets, Bloomberg.

Note: Data extracted on 15 May 2012.

7. **Limited tradable bonds due to barriers facing primary dealers.** Only a small amount of government bonds are available for trading as the bulk are held by banks (12 of them are also primary dealers) for statutory liquidity requirements² and the result of the government allocation system, including devolvement where the primary dealers are obligated to buy the unsold government bonds, often at below market rates. The secondary market trading is fractured and splintered by primary dealers transacting among their accustomed trading partners. It is not a transparent market where prices and volumes are widely available for investors.

8. **Slow development in asset-backed securities.** The recent removal of tax incentives affected the incipient development of the asset-backed securities industry.³ The market mechanism is also underdeveloped because there is lack of a clear legal and regulatory

addition, exchanges faced difficulties in responding to competitive pressures since member decision-making was slow and encumbered by many, often conflicting interests of members.

² Commercial banks have a statutory liquidity ratio of 19% of total demand and time deposits. Of this, 13% are required to be in government bills or bonds.

³ There have been 11 securitizations thus far, mostly assets backed by leasing company receivables issued by non-bank financial institutions and all have been floated through private placement arrangements.

framework for the industry and no clear provision in the tax code to recognize the “pass-through” nature of asset-backed securities. The governing rules—the Asset-Backed Securities Issue Rules of 2004—omitted some crucial features to securitization, such as “true sale,” “bankruptcy remoteness” of special purpose vehicles, the transfer of assignment rights, and the substitution of assets. Also, unless a special purpose vehicle is structured inside a trust, it is subject to withholding tax, value-added-tax, and stamp duty on securitized bonds. Stamp duties on the transferring of assets into securitization make transactions less viable.

9. **Supply and demand constraints of corporate bonds.** The lack of sovereign benchmark bond issues and the absence of an active secondary market to provide credible yield curves for pricing of corporate bonds are major factors constraining corporate bond supply and demand. The high transaction cost of public offerings is another hindrance. The total cost of corporate bond public issuance remains high by regional standards. The regulatory approval process for corporate bond issuance is lengthy, unclear, and cumbersome. All bond issues require a full prospectus whether through private placement or public offering. Furthermore, the unwillingness of companies to meet the disclosure requirement for listing has affected the supply. A transaction tax of 0.1%–0.05% is applied to the buyer and the seller for secondary corporate bond trading, discouraging trading.

10. **Small institutional investor base to support overall capital market development.** Institutional investors such as insurance companies, and pension and mutual funds usually form the backbone of debt markets. However, the institutional investor base in Bangladesh is small and underdeveloped. Its participation in capital markets is constrained by a range of factors including restrictive investment rules and regulations, low market confidence because of poor transparency, inadequate disclosure, and a lack of investor protection.

11. **Limited capital market investment by insurance companies.** The insurance industry is growing but remains small. The weak legal framework has contributed to the industry practice of incurring defaults in settling claims. Life insurance companies hold significant assets (80% of the total investment assets of the industry), but their participation in the capital market is insignificant, with the exception of a few private bond placements. The new Insurance Act of 2010 has stipulated a large number of rules on investments, but these rules have not yet been issued. A white paper to cabinet is being prepared to expedite the process of strengthening the insurance sector that includes measures such as the recapitalization of insurance companies and the adoption of investment regulations.

12. **Mutual funds at the early stage of development.** The mutual fund sector is small with total assets of about 2% of total market capitalization. Financial literacy among retail investors is low, and there is limited appreciation of such funds. Retail investors prefer single stock investments. Of the 45 mutual funds (39 closed-end and 6 open-end), Investment Corporation Bangladesh operates 18 of them. Funds managed by Investment Corporation Bangladesh have some competitive advantages, including tax breaks, over the rest of the industry players. Almost all of the currently available mutual funds invest in listed shares, although the industry is beginning to create specialized funds that invest in industry sectors (such as banking and utilities), fixed-income securities, or infrastructure projects. For the industry to play a more important role in capital market development, some investment requirements in the Mutual Fund Rules 2001 should be revised to allow greater participation of asset management companies in the bond market.

2. Government's Sector Strategy

13. In the Government of Bangladesh's Sixth Five-Year Plan, FY2011–FY2015⁴, the government focuses on removing growth constraints through massive investment in various sectors. In particular, investment in infrastructure development is to be tripled, from 2% of GDP to 6% of GDP, with the bulk to be driven by the private sector. To bolster private sector investment, policy actions will focus on providing incentives and an enabling environment for private sector development including enhancing the efficiency of the financial sector by providing long-term financing options through capital market development. The key envisaged capital market development reforms include enhancing market stability through strengthening regulations and market surveillance by regulators; improving regulations with respect to accounting rules, transparency issues, governance structure, and reporting requirements; increasing the supply of equity and corporate bonds; and enhancing institutional investor demand.

3. ADB Sector Experience and Assistance Program

14. The overarching objective of support from the Asian Development Bank (ADB) will be to contribute to the government's goals and commitments for enhancing growth and reducing poverty. ADB's financial sector strategy for Bangladesh is included in the country partnership strategy, 2011–2015⁵ and the country operations business plan, 2012–2014.⁶ The strategy is aligned with the Sixth Five-Year Plan, lessons from ADB's previous financial sector interventions, and coordination with other development partners. It is also consistent with ADB's Strategy 2020⁷ priorities where capital market development and bond market development focusing on the provision of long-term infrastructure are ADB's focus areas in its Bangladesh public sector operations.

15. ADB provided the first Capital Market Development Program in 1997.⁸ The most important lesson learned was that for a policy-based program loan to be feasible, it has to be an integral part of a government-owned reform and long-term development strategy. Ownership at the highest levels of government, in particular, and all stakeholders are of paramount importance. Furthermore, ADB needs to prioritize reform measures, set realistic timelines, and ensure strong implementation through interagency coordination headed by a champion of reform.

⁴ Government of Bangladesh, Planning Commission, Ministry of Planning. 2011. *Sixth Five-Year Plan: FY2011–FY2015*. Dhaka.

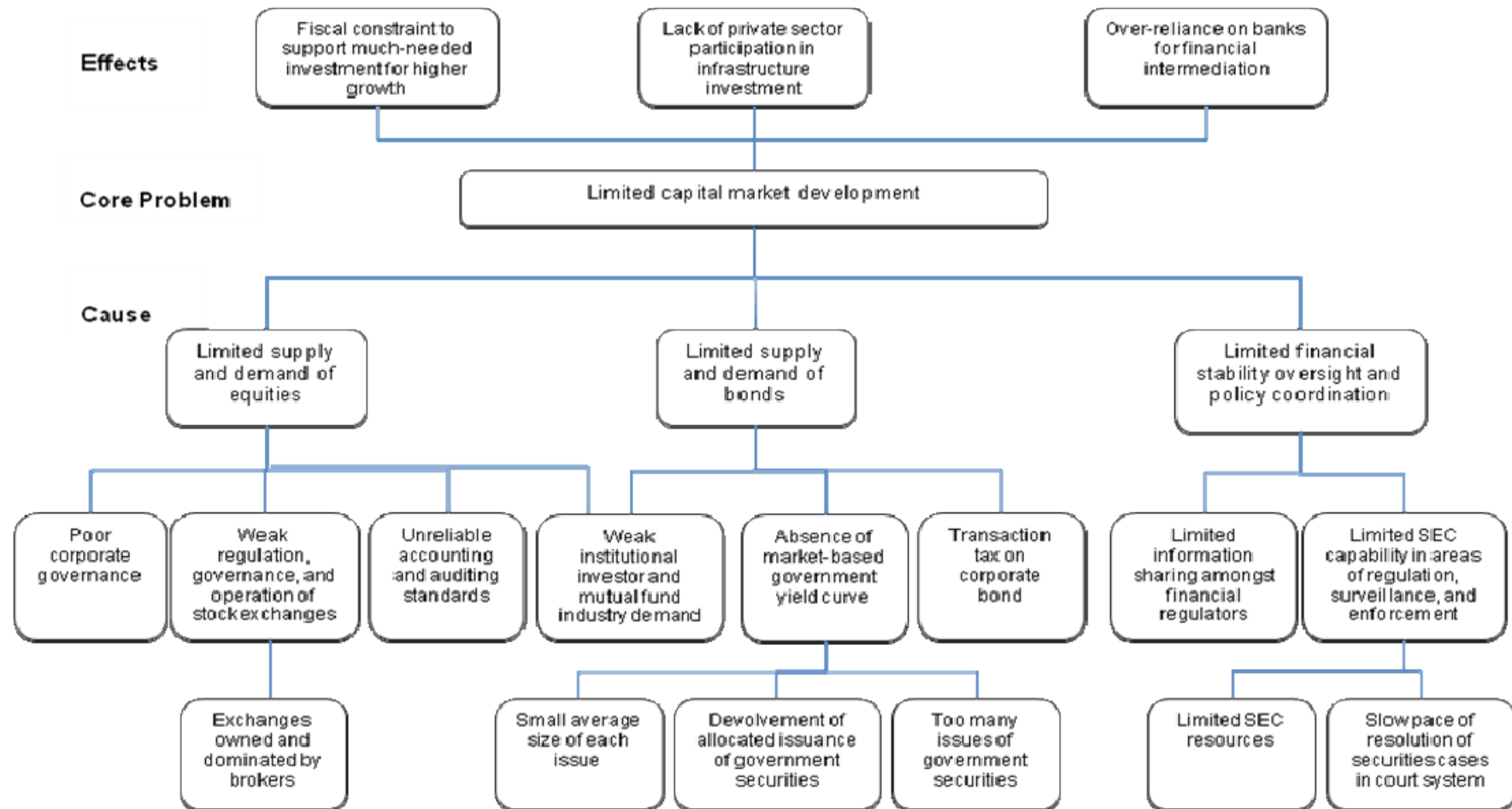
⁵ ADB. 2011. *Country Partnership Strategy: Bangladesh, 2011–2015*. Manila.

⁶ ADB. 2011. *Country Operations Business Plan: Bangladesh, 2012–2014*. Manila.

⁷ ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020*. Manila.

⁸ ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Bangladesh for the Capital Market Development Program*. Manila.

I. Problem Tree for Capital Market Development



Sector Results Framework (Capital Market Development)

Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Sector Outcomes with ADB Contribution	Indicators with Targets and Baselines	Outputs with ADB Contribution	Indicators with Incremental Targets	Planned and Ongoing ADB Interventions	Main Outputs Expected from ADB Interventions
Enhanced size, depth, and capacity in capital market More efficient, transparent and well regulated capital market	<p>Stock market capitalization increases to Tk3000 billion by FY2014 (baseline: Tk2347.8 billion in July 2012)</p> <p>Enlistment of new securities increases to 545 by fiscal year (FY) 2015 (baseline : 507 in FY2011)</p> <p>Number of corporate bonds outstanding increase to 12 by FY2015 (Baseline: 3 in FY2011)</p>	<p>Better-governed and stable capital and bond markets</p> <p>Enhanced supply and demand of equities and bonds</p> <p>Availability of stable sources of financing for small, medium, and large infrastructure projects</p>	<p>Reliable benchmarks established for government bond market</p> <p>Greater investor confidence with well-regulated and transparent capital market</p> <p>Infrastructure projects financed under public-private partnerships (PPP)</p>	<p>Planned key activity areas Capital market development, supporting reforms for strengthening capital market policy, improving market governance, strengthening regulatory enforcement, and infrastructure financing through the bond market</p> <p>Pipeline Second and Third Capital Market Development Program</p> <p>Ongoing: Improvement of Capital Market and Insurance Governance Project (\$3 million)</p>	<p>A better governed, well-developed, transparent and efficient capital market</p> <p>Government bond market developed and provided impetus for corporate bond development</p> <p>Availability of alternative source of financing for PPP projects</p>