ADB

Progress Report on Tranche Release

Program Number: 43477
Loan Numbers: 2952, 2953
November 2014

Bangladesh: Second Capital Market Development Program (Second Tranche)

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 13 November 2014)

Currency unit	–	taka (Tk)
Tk1.00	=	$0.0129
$1.00	=	Tk77.385

ABBREVIATIONS

ADB	–	Asian Development Bank
BCA	–	Bank Companies Act
BSEC	–	Bangladesh Securities and Exchange Commission
DSE	–	Dhaka Stock Exchange
FRA	–	Financial Reporting Act
GDP	–	gross domestic product
ICB	–	Investment Corporation of Bangladesh
IDRA	–	Insurance Development and Regulatory Authority
SDR	–	special drawing rights
SEC	–	Securities and Exchange Commission
TA	–	technical assistance

NOTES

(i) The fiscal year (FY) of the Government of Bangladesh ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2012 ends on 30 June 2012.

(ii) In this report, "$" refers to US dollars.

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CONTENTS

I. INTRODUCTION

1. On 28 November 2012, the Asian Development Bank (ADB) approved a program loan to Bangladesh totaling the equivalent of $300 million for the Second Capital Market Development Program.[1] The program comprises (i) a program loan to support vital capital market reforms, and (ii) an associated technical assistance (TA) grant of $750,000 to facilitate implementation of key reform actions under the program (footnote 1). The program was approved following upon a stock market debacle late in 2010 marked by a major sell-off, widespread losses, and a drop in market capitalization (by about $27.1 billion) equivalent to 22% of gross domestic product (GDP). Building on nearly 18 months of preparatory work and focused policy dialogue, the program is primarily based on findings from project preparatory TA.[2] As part of its due diligence, ADB conducted in June 2011 a detailed analysis of past stock market volatility in Bangladesh. This focused in particular on the role of banks in driving the stock market's surge and subsequent decline, and it recommended mitigation measures to ensure stock market stability. During the first quarter of 2012, ADB also conducted a study on demutualization of stock exchanges in Bangladesh.

2. The objective of the program is to stabilize the economy and facilitate sustainable growth by addressing the dual concerns regarding boom and bust cycles in the stock markets and limited private investment that curtails long-term economic development and in particular infrastructure financing. Specifically, the program seeks to (i) strengthen market stability by enhancing the role of the Bangladesh Securities and Exchange Commission (BSEC) to develop the market, promoting financial stability through joint supervision of the financial system, strengthening regulatory measures, and developing a market surveillance system; (ii) enhance market facilitation by developing a long-term vision for capital markets, upgrading accounting and auditing standards, expediting adjudication of enforcement actions, improving governance of listed companies, and pursuing demutualization of the stock exchanges; (iii) enhance supply measures by incentivizing the issuance of equities and bonds; and (iv) enhance demand measures by developing liquid bond markets and catalyzing institutional investor demand.

3. The reforms under the program were to be implemented over 3 years from June 2011 to June 2014, with the program loan divided into two equal tranches of $150 million. The first tranche was released upon loan effectiveness on 19 December 2012. The release of the second tranche, which requires the completion of 15 policy actions, was to be released 15 months after the first tranche, subject to satisfactory fulfillment of the corresponding tranche release conditions. This tranche release was delayed by 7 to 8 months, due in part to prolonged political unrest ahead of parliamentary elections in January 2014.

4. The program has played an integral role to ensure balanced development of the financial sector and thereby reduce systemic vulnerabilities in the bank-dominated financial system. The latest key economic indicators are in Appendix 1. An analysis of capital market developments is in Appendix 2. ADB has monitored program implementation through regular inception and loan review missions during 2013–2014 (Appendix 3). Release of the second tranche is now justified based on progress in overall program implementation, the carrying out of second tranche release policy actions, and compliance with assurances. The status of second-tranche and non-tranche release policy actions is given in Appendixes 4 and 5.

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[1] ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-based Loans and Administration of Technical Assistance Grant to the People's Republic of Bangladesh for the Second Capital Market Development Program.* Manila (Loans 2951, 2952, 2953-BAN and TA 8228-BAN).

[2] ADB. 2011. *Technical Assistance to the People's Republic of Bangladesh for Preparing the Capital Market Development Program II.* Manila (TA7811-BAN, $600,000, approved on 23 May 2011).

II. RECENT MACROECONOMIC AND POLITICAL DEVELOPMENTS

A. Macroeconomic Developments

5. Bangladesh’s GDP grew in FY2013 by 6.0%, down from the 6.2% recorded in FY2012. Agriculture growth slipped to 2.2% from 3.1% in FY2012 as crop output was restrained by higher input costs, lower output prices, and unfavorable weather. Services growth slowed to 5.7% from the previous year’s 6.0% owing to stagnant imports and frequent *hartals* (political demonstrations) that disrupted supply chains and affected retail and wholesale trade.

6. Industrial growth rose slightly to 9.0% from 8.9% in FY2012, with construction and small-scale manufacturing contributing to the gain. On the demand side, net foreign trade and services added to growth as garment sales grew briskly. Growth in private consumption accelerated, fueled by healthy remittance inflows, although expansion in private credit slowed. Investment rose only slightly to 28.4% of GDP from the previous year’s 28.3%. Private investment declined to 19.0% of GDP from 20.0% in FY2012, while public investment rose to 7.9% of GDP from 6.5% in FY2012. Private investment was constrained by electricity and gas shortages and a weaker investment climate. Foreign direct investment inflows grew only slightly.

7. Year-on-year inflation rose to 8.1% in June 2013 from 5.5% one year earlier, reflecting escalating food prices as the demonstrations disrupted supplies. A rise in government-administered power and fuel prices also contributed. Nonfood prices fell, responding to slower credit growth and the taka’s appreciation. Average inflation slowed to 6.8% from 8.7% in FY2012.

8. Although the central bank’s monetary policy was accommodative, money and credit growth slowed in FY2013. Broad money growth eased to 16.7% in June 2013 from 17.4% a year earlier. Private credit growth slowed markedly to 10.9% from 19.7% in June 2012, as net credit to the government grew by 20.1% in June 2013 (down from 24.9% a year earlier and well below its peak expansion in the middle of FY2012). As imports remained unchanged, net foreign assets shot up, accounting for nearly half of monetary expansion.

9. To ease monetary policy, the central bank in March 2013 cut repo and reverse repo rates by 50 basis points. The weighted average yield on the 91-day Treasury bill fell to 8.3% by June 2013 from 11.4% a year earlier. Banks’ weighted average lending rate, however, declined only marginally to 13.7% from 13.9% in June 2012. Meanwhile, the weighted average deposit rate rose to 8.5% from 8.1%. That narrowed banks’ interest rate spread by 0.6 percentage points to 5.2%. Government revenue growth was less than the FY2013 budget target of 21.6%, as import-based taxes yielded less than expected. Growth in domestic indirect taxes also slowed, although income taxes were buoyant.

10. More relevant to the coverage of this program, the rising trend of the Dhaka Stock Exchange (DSE) index and market capitalization continued during FY2014. At the end of September 2014, the DSE Broad Index (DSEX) stood at 5074.31, up 28.9% from the previous year's 3937.68. This trend continued as DSEX increased to 5173.23 in October 2014, a 30.4% increase from the previous year’s 3967.73. The market capitalization grew by 31.8% to $42.73 billion at end of September 2014 from $32.43 billion a year earlier. The banking sector’s contribution had decreased to 16.5% at end of June 2014 from 18.8% at end of March 2014. Net foreign portfolio investment has gained consistently since early 2012, thus indicating the market’s recovery and the attractiveness of the prevailing stock price valuations (para. 35). During the third quarter of FY2014, new investment in shares by foreign and nonresident

Bangladeshi investors increased to Tk9.4 billion from Tk4.41 billion in the same quarter of FY2013. At the same time, total share sales by foreign and nonresident Bangladeshi investors also increased to Tk5.4 billion during the third quarter of FY2014 from Tk1.47 billion in the same quarter one year earlier. As a result, net investment of foreign and nonresident Bangladeshi during the third quarter of FY2014 increased to Tk4.0 billion from Tk2.94 billion in FY2013's third quarter.

B. Political Developments

11. Parliamentary elections were held in January 2014. The Awami League Party won a second consecutive term of office while the elections were boycotted by the opposition Bangladesh Nationalist Party (BNP). The risk of political instability has diminished in recent months as the government settles into a second term of office. However, future disruption by the opposition cannot be ruled out completely at this stage.

III. STATUS OF PROGRAM IMPLEMENTATION

A. Summary of Compliance Status

12. The government has remained strongly committed to the program's policy reforms, and all 15 policy actions required for release of the second loan tranche have been fully or substantially complied with. There has been compliance, too, with all the non-tranche release policy actions.

13. ADB staff has closely monitored program implementation. Ten dedicated loan review missions were fielded in 2013 and 2014 (Appendix 3). The confirmed progress in overall program implementation and compliance with the policy actions required for release of the second tranche justify the tranche's release. Appendixes 4 and 5 provide details on second-tranche policy actions and non-tranche policy actions.

B. Program Implementation

14. Following is a summary of progress made under each tranche release action, classified according to the focus of reform.

1. Strengthen Regulatory Measures

15. **Submit to Parliament an amended Bank Companies Act (BCA) with the objective of containing risks posed by equity markets through consolidated supervision** (complied with). In October 2009, Bangladesh Bank (the central bank) required commercial banks to establish separate merchant bank subsidiaries for their capital market activities. The aim had been to limit the banking system's exposure to the capital market. Although Bangladesh Bank remained responsible for overall supervision of the commercial banks and their market exposure, direct oversight of their merchant bank subsidiaries became the responsibility of the Bangladesh Securities and Exchange Commission (BSEC). As a result, Bangladesh Bank's supervision of the banking system was fragmented and became directly dependent on the quality of BSEC oversight of merchant banks. The absence of consolidated supervision led to the commercial banks' excessive investment in stock markets, and this proved to be one of the major reasons for the stock market debacle in December 2010. As a result, the BCA amendment with the objective to contain risks posed by equity markets through consolidated

supervision was crucial for institutionalizing coordination between the BSEC and Bangladesh Bank. The amended BCA was approved by Parliament on 7 July 2013.

16. **Reduce banks' equity risk exposure by introducing Bangladesh Bank guidelines to limit direct and indirect exposure to equity risk as a percentage of capital, applicable on a solo and consolidated basis once the amended BCA is passed** (complied with). Bangladesh Bank issued the circular regarding equity risk exposure as a percentage of capital applicable on a solo basis on 16 September 2013. A circular with regard to equity risk exposure as a percentage of capital applicable on a consolidated basis was issued on 25 February 2014. Before issuing the second circular, Bangladesh Bank required 5 months to assess implications of the first circular which entailed a paradigm shift for banks in terms of managing equity risk exposure. Banks previously had managed equity risk exposure as a percentage of liabilities, and that could result in exposures exceeding the banks' capital.

17. **The SEC shall undertake a review of capital requirements for intermediaries through a risk-based supervision approach** (complied with). The DSE is comprised of 238 member brokerage firms (i.e., intermediaries) of varying sizes, resources, expertise, and systems. Many smaller brokerage firms do not have the resources and capacity to ensure client protection. Brokerage firms are not required to maintain internal procedures to ensure fundamental customer protection such as for issuing customer account statements and conducting know-your-customer, anti-money laundering, and capital adequacy monitoring activities. The SEC collected all relevant information in this regard from banks and nonbank financial institutions, including International Organization of Securities Commissions studies, for taking necessary action. Completed on 5 October 2013, the review provides the foundation for introducing risk-based capital and inspection for intermediaries by the BSEC in 2015. This should eventually lead to significant consolidation in the number of brokerage firms.

2. Develop a Market Surveillance System

18. **Reports generated from the market surveillance system shall be part of the improved monitoring of capital markets and discussed at coordination meetings** (complied with). Operationalization of a real-time market surveillance system under the program is critical in helping the BSEC to detect trading irregularities and market abuses as they occur. Installation of such a state-of-the-art system has improved transparency of market transactions and contributed significantly to enhanced investor confidence. A manual was prepared for the surveillance system and report generation. It formed the basis for generating reports. The manual is being used to ensure effective application of the surveillance system by explaining techniques for examining evidence and analyzing trading accounts of brokerage firms from the perspective of trading irregularities. All activities were completed on 5 October 2013.

3. Upgrade Accounting and Auditing standards

19. **Submit to Parliament a Financial Reporting Act (FRA) bill to include the following key elements: (i) establish an independent financial reporting council to adopt International Accounting Standards and International Standards on Auditing for public interest entities and to monitor and enforce these, (ii) license auditors and accountants, and (iii) establish an independent administrative tribunal to hear appeals regarding financial reporting council decisions** (substantially complied with). Poor quality of financial reporting has long impeded the development of Bangladesh's capital markets. The accounting and auditing standards of listed companies are often unreliable and lack facts required for making informed investment decisions. Price volatility prevails in the absence of adequate, accurate, and

timely financial information. The FRA's enactment will be consistent with international best practice and will play an integral role in upgrading the accounting and auditing standards to enhance market confidence. Enactment would be followed by the establishment of an independent financial reporting council that would adopt International Accounting Standards and International Standards on Auditing for the relevant entities, as well as to monitor and enforce these. The council would be authorized to license auditors and accountants. The FRA bill was approved by the cabinet on 10 November 2014 for submission to Parliament.

20. **The SEC shall establish and staff the office of the chief accountant, including adoption of guidelines for accountants and auditors** (complied with). The BSEC is establishing high international standards of accounting and auditing to ensure the quality and reliability of filed financial information. The appointed chief accountant with international credentials has designed guidelines for empanelling auditors and established an accredited list of auditors qualified in accordance with those standards. The BSEC issued the directive to establish the Office of the Chief Accountant on 24 June 2014. The Chief Accountant was appointed on 30 June 2014. The relevant guidelines were adopted on 15 July 2014.

4. Expedite Adjudication of Enforcement Actions

21. **Establish a special tribunal for capital market-related cases. Issue regulations that (i) define the powers, functions, and jurisdiction of the tribunal; (ii) determine the status of appeals and adjournments; and (iii) spell out the appointment of qualified judges and their training** (complied with). The effectiveness of the BSEC's enforcement was significantly challenged by the extremely slow pace of resolving cases pending in the court system. A total of 366 SEC cases are pending with various courts, including 15 cases brought as a result of a stock market crisis occurring in 1996. The creation of a capital market tribunal has significantly enhanced the BSEC's enforcement capacity, and that should expedite resolution of securities cases pending in the court system. The Capital Market Tribunal was established on 7 January 2014. The rules and regulations associated with the tribunal's establishment fall under the purview of the Securities and Exchange Commission Ordinance 1969 and the Code of Criminal Procedure 1898. Regulations have been issued in a satisfactory manner for the three requirements stated in the policy action. Associated TA is facilitating operationalization of the tribunal through such activities as training of judges to handle securities cases. The tribunal can be expected to be fully operational by December 2014.

5. Improve Regulation, Governance, and Operation of Stock Exchanges

22. **Submit to Parliament a demutualization act** (complied with). Demutualization of the stock exchanges has segregated ownership, management, and trading rights of members and converted the two exchanges into commercial and more professionally run organizations while enabling them to pursue their strategic interests, including market development, with more vigor. A governance structure representing all stakeholders and encouraging competition among trading members is helping to develop the country's capital market and attract new investors. The exchanges are now less susceptible to members' vested interests. The demutualization should also facilitate the development of crucial new technology infrastructure through alternative methods of raising capital (such as the entry of a strategic investor into both stock exchanges by June 2017). Numerous steps have been taken to effectively implement and conclude the demutualization process, such as enactment of the Demutualization Act in April 2013, followed by submission of the demutualization schemes by both stock exchanges (i.e., operational plans), and the approval of these schemes by the BSEC in September 2013. The demutualization process is expected to be completed by December 2014.

6. Enhance Supply of Equities

23. **Exempt initial public offerings from the 3% tax by amending Section 16(E)/53L of the Income Tax Ordinance** (complied with). In line with international best practices, the initial public offering tax was eliminated. This should spur the supply of equities by creating an incentive to use equity financing. During the budget session in June 2013, this was included into the Finance Act. The Finance Act was approved by Parliament on 30 June 2013.

7. Enhance Supply of Bonds

24. **Exempt bonds from transaction taxes by amending Section 53(BBB) of the Income Tax Ordinance** (complied with). While tax treatments of corporate bonds are broadly at par with that of government bonds, a transaction tax of 0.05%–0.1% on each the buyer and seller had been applied to the secondary trading of corporate bonds. This had discouraged trading in the secondary market. The exemption of bonds from transaction taxes was introduced in the June 2013 budget. This removed an important deterrent to secondary bond market trading, thereby triggering bond market activity and enhancing the supply of bonds. During the budget session in June 2013, this was included into the Finance Act. The Finance Act was approved by Parliament on 30 June 2013.

8. Remove Barriers to Asset Securitization

25. **Ensure that the sale of receivables to a special purpose vehicle in connection with the securitization of assets is exempted from stamp duty on conveyance of assets (Bangladesh Stamp Act 1899) and that the issuance of debt instruments through private placement of listed companies is exempted from stamp duty on transfer of instruments (Item 62 of Schedule I of the Stamp Act 1899)** (complied with). Asset-backed securities are complex, secondary market-based debt instruments that provide an additional and cost-effective channel for fund mobilization. The development of asset-backed securities in Bangladesh had been hindered by stamp duties on the transfer of assets and taxes on income passed through a special purpose vehicle. These tax distortions were removed to catalyze the market in asset-backed securities. During the budget session in June 2013, the changes were included into the Stamp Act amendment. The amended Stamp Act was approved by Parliament on 30 June 2013.

9. Develop Liquid Bond Markets

26. **Cause circulars to be implemented and fully operationalized** (complied with). To develop a more liquid bond market and reliable yield curve, the program supports the development of an efficient primary dealer system through fostering a more competitive Treasury auction system. This is expected to support an improved price discovery mechanism for treasury bills and bonds in line with the state of demand for these securities. This would entail the government's being a price-taker by issuing treasury bills and bonds at market rates given its medium-term public sector borrowing requirement. Under the program's first-tranche actions, three circulars were issued by Bangladesh Bank in November 2012 toward refining the primary dealer system and supporting a more efficient price discovery mechanism in auctioning government securities. The three circulars have been implemented and operationalized at all government securities auctions since December 2012. Over the implementation period, the operating framework of the primary dealer system has seen improvements in the promotion of competitive bidding that has served to improve overall liquidity management. Consequently,

devolvement or lowest price bidding has absorbed a smaller proportion of allocated issuance than prior to the issuance of these circulars.

10. Promote Mutual Funds

27. **Amend Securities and Exchange Commission (Mutual Fund) Rules, 2001 (Rule No. 55) to grant asset management companies greater investment flexibility by allowing them to reduce their exposure to equity securities below the stipulated 75% if so stated in a fund's prospectus** (complied with). The greater investment flexibility enhances asset management companies' capabilities to mitigate risk—and therefore protect investors' interests—in the case of volatile or overheated markets. The removal of these investment restrictions has ensured diversification of asset management companies' portfolios and will catalyze the creation of various types of mutual funds (such as money market, bond, index, and exchange-traded funds). Such measures expand alternative investment choices for market participants and spur growth in the mutual fund industry. The rules were issued in March 2013.

28. **Allow investors in private sector open-end mutual funds the same tax advantage as Investment Corporation of Bangladesh (ICB) open-end mutual funds (i.e., 10% as conferred by Para-10(b) of the 6th schedule (Part-B) of the Income Tax Ordinance) as that applicable to investors in ICB open-end mutual funds** (complied with). The competitive advantages of the ICB through its special tax advantages had created an uneven playing field between ICB funds and the rest of the industry. The ICB investors received a 10% tax credit on their investments which was not available to investors in other open-end funds. Amendment of the Income Tax Ordinance is promoting the mutual fund industry by removing tax distortions and requiring funds sponsored by the ICB to be fully compliant with all mutual fund regulations. During the budget session in June 2013, the amendment of the Income Tax Ordinance was included into the Finance Act. The Finance Act was approved by Parliament on 30 June 2013.

11. Enhance Institutional Investor Demand

29. **Obtain cabinet approval of a white paper to strengthen the insurance sector by (i) agreeing to a timetable for recapitalizing all insurance companies in accordance with the Insurance Act, 2010, and (ii) adopting investment regulations as required by Section 41 of the Insurance Act, 2010. Initiate implementation of this white paper. Implement regulations regarding management of the Insurance Development and Regulatory Authority (IDRA) Fund and chief executive officer (CEO) appointment** (complied with). Insurance industry participation in the capital market will be enhanced by introducing measures to promote the industry's growth and stability, such as compliance with the minimum capital requirements of the Insurance Act of 2010, and encouraging investor demand through the IDRA's issuing investment guidelines. The white paper (renamed the national insurance policy paper) was formulated in November 2012 and encapsulates measures to promote the insurance industry. The policy paper was approved by the cabinet in June 2014. Implementation of the policy paper was initiated in July 2014. The insurance regulations regarding CEO appointment and management of the IDRA Fund are being implemented since January 2013. From January 2013 to June 2014, CEOs were appointed across numerous insurance companies as per these guidelines. The IDRA staff are paid their salaries and benefits from the IDRA Fund as per IDRA Fund guidelines.

C. Review of the Associated Technical Assistance

30. The associated TA, which will close on 31 December 2014, is designed to support implementation of key reform actions under the program (footnote 1). Specifically, the TA has (i) strengthened enforcement capacity of the BSEC by developing an effective structure (i.e., creation of internal guidelines and procedures) for detecting and investigating possible violations of securities laws and regulations as well as formulating and prosecuting cases, (ii) expedited adjudication of enforcement actions by promoting mechanisms to ensure disposition of capital market cases through a separate tribunal, and (iii) facilitated the demutualization process in the Dhaka and Chittagong stock exchanges by introducing international best practices in their governance structures. Submission of the demutualization schemes by both stock exchanges and BSEC's approval process for these schemes in September 2013 were supported by the TA.

31. Several training seminars have been conducted under the TA to facilitate the Capital Market Tribunal's operationalization (such as training judges to handle securities cases) and to enhance the BSEC's enforcement capacity (such as training BSEC staff to utilize the recently installed real-time market surveillance system in order to effectively discover and analyze evidence related to trading irregularities and market abuse as these may occur). The training programs under the TA are listed in Appendix 6. Overall, TA implementation has been very effective and all its scheduled activities have been satisfactorily completed in a timely manner.

IV. CONCLUSION

32. The stock market debacle of December 2010 reflected the vulnerable state of Bangladesh's capital markets. It had sprung from a convergence of factors that included inadequacies in the existing system as well as policies and practices that were not sustainable. The most critical problem was that of strong government tutelage over the capital markets, and, in particular, the regulator. This had held back sector development and constrained the responsible institutions from strengthening accountability and carrying out their mandates effectively. This combined with strong vested interests resulted in an entrenched status quo. The program effectively challenged the status quo by adopting a two-step strategy of scaling down state influence in the capital markets through redefining the regulatory partnerships as well as strengthening the regulator's capacity while working more closely with regulators such as Bangladesh Bank and the demutualized stock exchanges. This has led to greater transparency, improved compliance, and increasingly stronger enforcement powers, and, in turn, to investors' greater trust and confidence in Bangladesh's capital markets.

33. The amendment of the SEC Act in November 2012 removed the BSEC's subordination to the Ministry of Finance. That allowed the BSEC to enable clearer lines of responsibilities and thereby more effective supervision and enforcement. The timely and effective completion of the demutualization process at the stock exchanges represented another key milestone of the program in countering strong vested interest and challenging the status quo as well as setting the groundwork for expanding capital markets in Bangladesh. The brokers and dealers have historically resisted any reforms that could reduce their control over the stock exchanges. The introduction of a real-time state-of-the-art market surveillance system at the BSEC directly addressed one of the key impediments to Bangladesh's capital market development by detecting the kind of trading irregularities and market abuses that had led to the stock market crisis of 2010. The program also significantly reduced tax distortions in the capital markets through implementing broad and substantive tax policy actions that ranged from ensuring a level playing field for mutual funds to promoting bond market activity and encouraging the use of equity financing.

34. The program addressed structural deficiencies in the capital markets by deregulating the financial system to better support the real economy, promote private sector investment, and boost economic growth. The program was based on a two-track approach that sought to put firewalls in place to support market stabilization following on the 2010 stock market debacle while planting the seeds for key reforms leading to sustainable market development. The program was based on three important pillars. First, the BSEC was given a stronger mandate, together with resources. The operational and financial efficiency of the BSEC was enhanced by (i) allowing unhindered access to the BSEC Fund, (ii) removing government approval of the BSEC budget or expenditures from the BSEC Fund, and (iii) providing benefits to BSEC staff comparable to those at Bangladesh Bank. Second, stock exchanges were identified as critical drivers of change. The agreed approach was to correct the governance structure through demutualization of the Dhaka and Chittagong stock exchanges. This served to align the broader incentives of market development with those of what might be termed the “members of the club,” mainly the brokers and dealers. Finally, bond markets had to be promoted to mobilize much-needed long-term financing. By addressing policy and regulatory constraints upon the issuance of corporate securities, the program is helping to increase the number of bond and equity issues, both primary and secondary. This should serve to address the major development challenge of financing the economy’s looming infrastructure gap.

35. Reforms have been rolled out, and investor confidence is increasing as the new policies and regulatory incentives under the program gain traction. The market has stabilized, as evidenced by the 29.5% increase in market capitalization to $42.70 billion (as of 30 September 2014) from $33 billion in February 2011. With regard to valuation, the DSE average price–earning (P/E) ratio was at 18.58 in September 2014. That is certainly more attractive from an investor’s perspective than the average P/E ratio of 30.6 at its recent peak in February 2010. The turnover ratios in 2014 are comparable with the levels recorded during 2004–2006, at which time the market had been functioning in a stable environment. The DSE average daily turnover as a percentage of market capitalization during January 2014 to 9 November 2014 was 0.17% as compared to a high of 0.73% on 6 December 2010. A total of 15 companies have floated initial public offerings thus far in 2014. There were 17 such offerings in 2013 and 14 in 2012. As a result, the number of listed titles at the DSE increased to 544 in September 2014 from 529 as of December 2013. Appendix 2 provides an analysis of capital market developments.

36. By diversifying financial instruments and broadening the investor base, the program helps to ensure balanced development of the financial sector. Diversification away from a predominantly bank-based system of financial intermediation expands alternative sources of financing, thereby helping to limit systemic impacts of economic shocks and mitigating the negative impact that financial market instability has on the plight of the poor. Capital markets stimulate healthy competition with the banking sector that results in lower financing costs for all borrowers. The program, therefore, emphasizes specific capital market reforms to help Bangladesh diversify its financial system so that the country can realize its broad-based economic growth and socioeconomic development objectives—including poverty reduction.

37. The formulation of a long-term national capital market master plan as a first-tranche policy action ensures that the program is an integral part of a government-owned, long-term development strategy. Milestones for release of first and second tranches form an integral part of this master plan. The master plan sets the direction to transition from a nascent to an emerging capital market, and the implementation of reform measures elucidated in the master plan places Bangladesh’s capital markets on a path to sustainable growth. A follow-up operation will be proposed under the Third Capital Market Development Program (planned for the second

half of 2015) to enhance the sustainability of structural reforms under this (second) program. The proposed follow-on program builds upon stabilization measures introduced by the (second) program and implements the roadmap in the long-term national capital market master plan by focusing on measures that will deepen and broaden the outreach of the (second) program's reforms by (i) extending the government yield curve and therefore promoting corporate bond market development; (ii) catalyzing institutional investor demand, such as by enhancing pension and provident fund participation, (iii) strengthening the insurance sector through recapitalization of insurance companies that is sequenced with actions to ensure active investment and participation in the capital markets; (iv) promoting Islamic bond market development through creation of an enabling environment to encourage *sukuk* issuance; and (v) promoting key fundamentals of derivatives such as interest rate derivatives and foreign exchange derivatives.

V. THE PRESIDENT'S DECISION

38. In view of the progress made in the implementation of the Second Capital Market Development Program, as evidenced by full or substantial compliance with all second tranche release conditions, the President is satisfied with the overall implementation of the Second Capital Market Development Program and that the necessary conditions for release of the second tranche have now been fulfilled. In accordance with established procedure, the President will authorize the release of the second tranche in the amount of SDR98,553,000. The release of the second tranche will be effective not less than 10 working days after the circulation of this progress report to ADB's Board of Directors.

COUNTRY ECONOMIC INDICATORS, BANGLADESH

Item	Fiscal Year 2010	2011	2012	2013	2014[e]
A. Income and Growth					
1. GDP per capita ($, current)	780.0	860.0	880.0	976.0	1115.0
2. GDP growth[a] (%, in constant prices)	5.6	6.5	6.2	6.0	6.1
a. Agriculture	6.2	4.5	3.1	2.2	3.3
b. Industry	7.0	9.0	8.9	9.0	8.4
c. Services	5.5	6.2	6.0	5.7	5.8
B. Saving and Investment (current market prices, % of GDP)					
1. Gross domestic investment	26.3	27.4	28.3	28.4	28.7
2. Gross national saving	29.4	28.9	29.9	30.5	30.5
C. Money and Inflation (annual % change)					
1. Consumer price index(FY2006 base, average)	6.8	10.9	8.7	6.8	7.4
2. Total liquidity (M2)	22.4	21.3	17.4	16.7	17.0
D. Government Finance (% of GDP)					
1. Revenue and grants[b]	9.9	10.4	11.2	11.3	12.0
2. Expenditure and onlending	12.7	14.0	14.4	14.5	16.0
3. Overall fiscal deficit[c]	(2.8)	(3.6)	(3.2)	(3.3)	(4.0)
E. Balance of Payments					
1. Merchandise trade balance (% of GDP)	(4.5)	(7.7)	(7.0)	(4.7)	(3.9)
2. Current account balance (% of GDP)	3.2	(1.3)	(0.3)	1.7	0.9
3. Merchandise exports ($ million)	16,233.0	22,592.0	23,989.0	26,566.0	29,765.0
Growth (annual % change)	4.2	39.2	6.2	10.7	12.0
4. Merchandise imports ($ million)	21,388.0	32,527.0	33,309.0	33,576.0	36,571.0
Growth (annual % change)	5.4	52.1	2.4	0.8	8.9
F. External Payments Indicators					
1. Gross official reserves (including gold, $ million)	10,749.7	10,911.6	10,364.4	15,315.2	21,508.0
Weeks of current year's imports of goods and services	20.6	14.8	12.8	18.6	23.6
2. External debt service (% of exports of goods and services)[d]	4.7	3.7	3.6	3.7	2.4
3. Total external debt (% of GDP)	17.6	17.2	16.6	14.9	13.6
G. Memorandum Items					
1. GDP (current prices, Tk billion)	7,975.4	9,158.3	10,552.0	11,989.2	13,509.2
2. Exchange rate (Tk/$, average)	69.2	71.2	79.1	79.9	77.7
3. Mid-year population (million)	147.8	149.7	151.6	153.7	155.8

( ) = negative, GDP = gross domestic product, Tk = taka.

[a] Based on constant 2005/06 market prices.

[b] Receipts excluding grants as a proportion of GDP are 9.5%, 10.2%, 10.9%, 10.7%, and 11.6% for 2010, 2011, 2012, 2013, and 2014, respectively.

[c] Fiscal deficits excluding grants as a proportion of GDP are 3.2%, 3.9%, 3.6%, 3.8%, and 4.4% for 2010, 2011, 2012, 2013, and 2014, respectively.

[d] The ratios of debt service to total foreign exchange earnings from exports of goods and nonfactor services including workers' remittances are 2.9%, 2.5%, 2.4%, 2.5%, and 1.7% for 2010, 2011, 2012, 2013, and 2014, respectively.

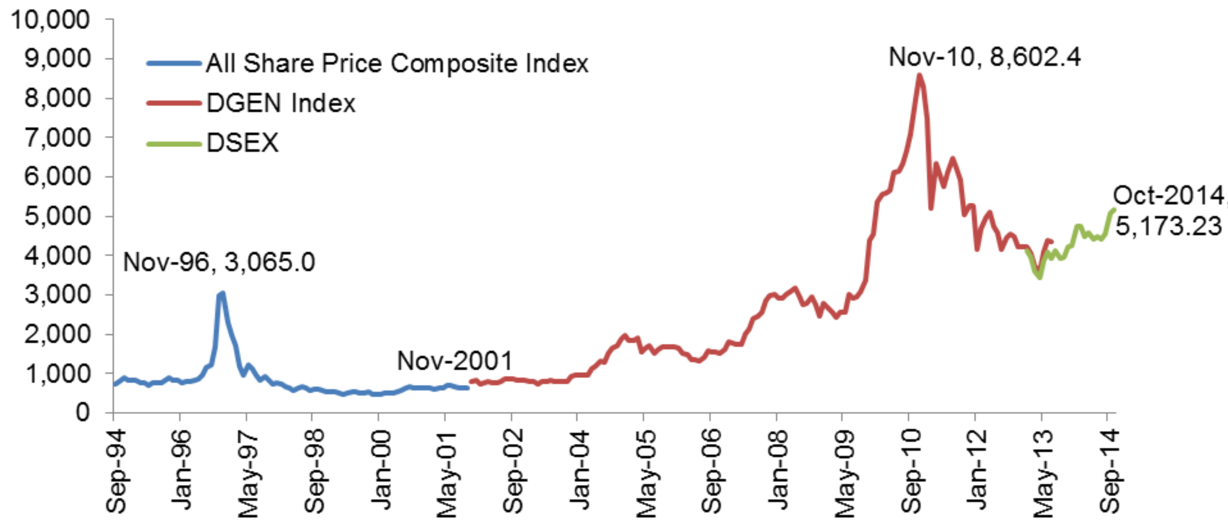
[e] Estimates.

Sources: Bangladesh Bureau of Statistics, Bangladesh Bank, Export Promotion Bureau, Ministry of Finance, and Asian Development Bank estimates.

ANALYSIS OF CAPITAL MARKET DEVELOPMENTS

1. As visible in Figure 1, the rising trend of the Dhaka Stock Exchange (DSE) index continued during FY2014. At the end of October 2014, the DSE Broad Index (DSEX) was at 5173.23, constituting a 30.4% increase from the year-earlier level of 3967.73.

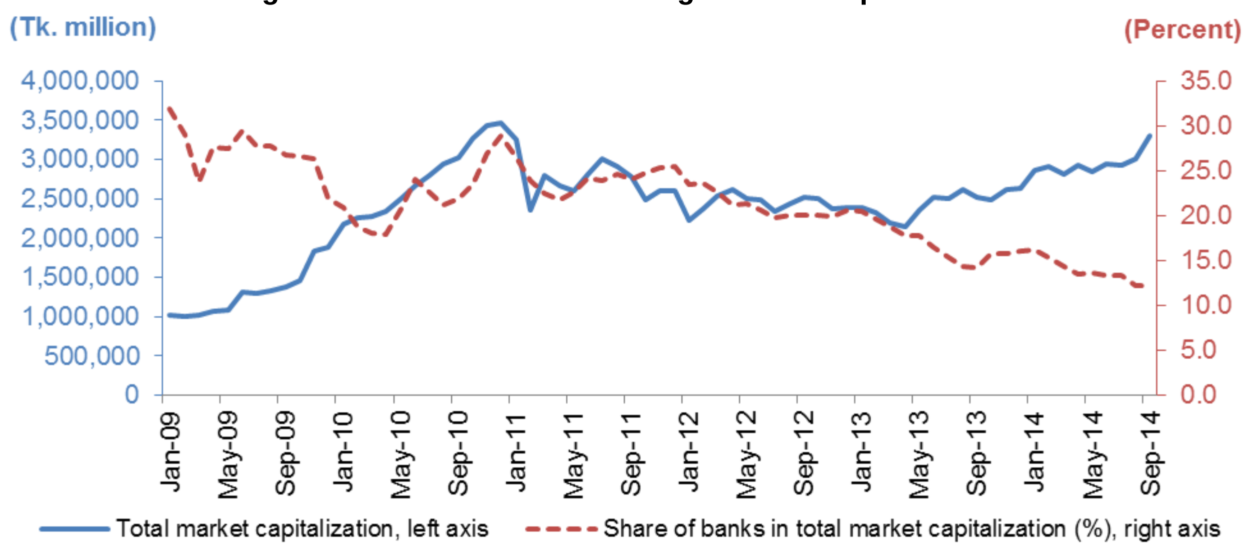
Figure A1: Developments in the Dhaka Stock Exchange Index



DGEN = DSE General, DSE = Dhaka Stock Exchange, DSEX = DSE Broad Index.
Source: Dhaka Stock Exchange (DSE).

2. Over the same period, the DSE's market capitalization increased by 31.8% to $42.7 billion at end of September 2014 from $32.4 billion a year earlier. The contribution of the banking sector decreased to 16.5% at the end of FY2014's fourth quarter from 18.8% in the previous quarter.

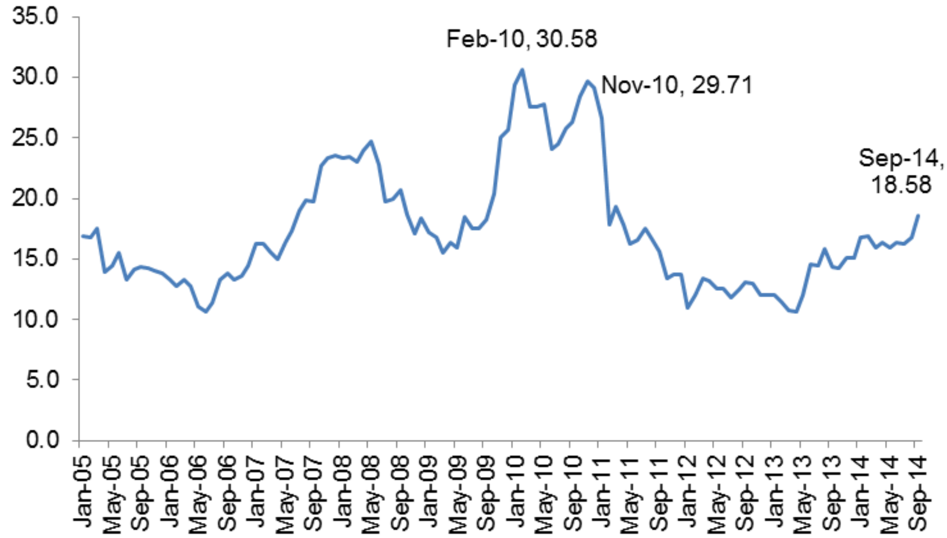
Figure A2: Dhaka Stock Exchange Market Capitalization



Tk. = Taka.
Source: Dhaka Stock Exchange (DSE).

3. With regard to valuation, the DSE's average price–earnings (P/E) ratio was at 18.58 in September 2014. That is certainly more attractive from an investor's perspective than the average P/E ratio of 30.6 at its recent peak in February 2010.

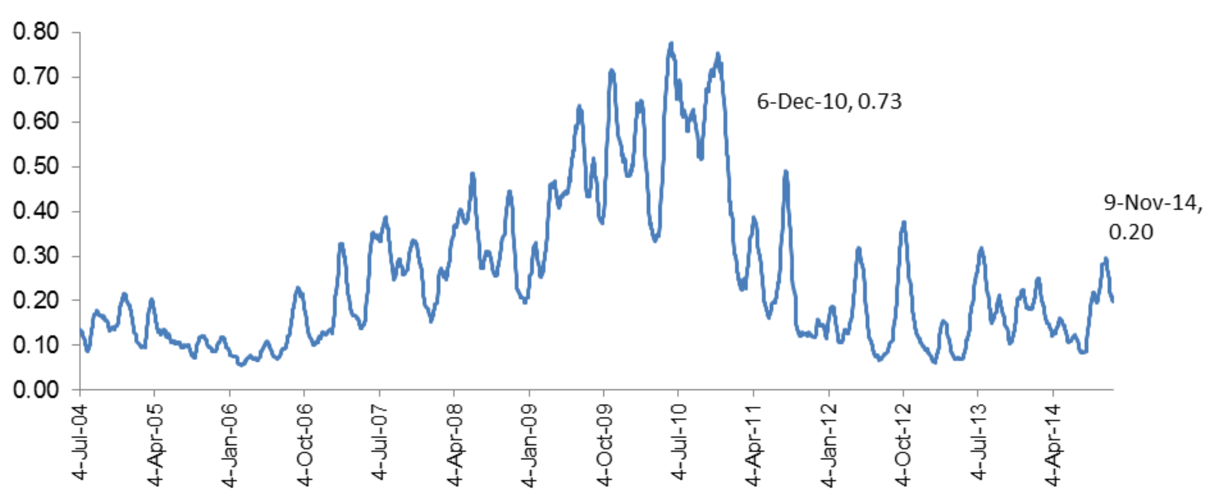
Figure A3: Average Price–Earnings Ratios at the Dhaka Stock Exchange



Source: Dhaka Stock Exchange (DSE).

4. The turnover ratios in 2014 are comparable with those levels recorded during 2004-2006, at which time the market was functioning in a stable environment. The DSE's average daily turnover as a percentage of market capitalization during January 2014–9 November 2014 was 0.20% as compared to a high of 0.73% on 6 December 2010.

Figure A4: Dhaka Stock Exchange Turnover as % of Market Capitalization (20-Days Moving Average)



Source: Dhaka Stock Exchange (DSE).

CHRONOLOGY OF REVIEW MISSIONS UNDER THE SECOND CAPITAL MARKET DEVELOPMENT PROGRAM

Year and Type of Mission	Dates	Mission Duration (days)	Number of Travelers	Total Field Days	Person-Months
2013					
Consultation	15–17 Apr 2013	3	1	3	0.100
Review	24–27 Jun 2013	4	1	4	0.133
Consultation	30–31 Jul 2013	2	1	2	0.066
Review	2–4 Sep 2013	3	1	3	0.100
Review	23–26 Sep 2013	4	1	4	0.133
Review	25–26 Nov 2013	2	3	6	0.200
Subtotal				**22**	**0.732**
2014					
Review	20–22 Jan 2014	3	1	3	0.100
Review	24–25 Mar 2014	2	2	4	0.133
Consultation	20–21 May 2014	2	1	2	0.066
Review	24–26 Jun 2014	3	1	3	0.100
Subtotal				**12**	**0.399**
Total				**34**	**1.131**

Source: Asian Development Bank.

STATUS OF COMPLIANCE WITH THE SECOND-TRANCHE POLICY ACTIONS

Focus of Reform Policy Conditions	Assessment of Progress (with supporting documents)
A. Market Stability	
1. The Borrower shall submit to its parliament amendments to the Banking Companies Act to contain risks posed by equity markets through consolidated supervision of banks.	**Complied with.** The Banking Companies Act was passed by Parliament on 7 July 2013.
2. The Borrower shall cause BB to introduce guidelines to reduce the banks' equity risk exposure by putting a limit on the total direct and indirect exposure to equity risk as a percentage of capital, to be applicable on solo and consolidated basis.	**Complied with.** Bangladesh Bank issued the circular with regard to equity risk exposure as a percentage of capital applicable on a solo basis on 16 September 2013. A circular regarding equity risk exposure as a percentage of capital applicable on a consolidated basis was issued on 25 February 2014.
3. The Borrower shall cause SEC to undertake a review of the capital requirements for intermediaries through a risk-based supervision approach.	**Complied with.** The SEC collected all relevant information for taking necessary action from banks and nonbank financial institutions, also including International Organization of Securities Commissions studies. The review was completed on 5 October 2013.
4. The Borrower shall cause SEC to make reports generated from its market surveillance system to be part of the improved monitoring of the capital markets.	**Complied with.** A manual for use of the surveillance system and report generation was prepared. It formed the basis for generation of reports. All activities were completed on 5 October 2013.
B. Market Facilitation	
5. The Borrower shall submit to its parliament a bill on financial reporting, which shall include provisions for (a) establishment of an independent financial reporting council to adopt international accounting and auditing standards for public interest entities, and to monitor and enforce them; (b) licensing of auditors and accountants; and (c) establishment of independent administrative tribunal to hear appeals on the decisions of the financial reporting council.	**Substantially complied with.** The Financial Reporting Act bill was approved by the cabinet on 10 November 2014 for submission to Parliament.
6. The Borrower shall ensure that SEC has established and staffed its office of the chief accountant and has adopted guidelines for the accountants and auditors to practice before the SEC.	**Complied with.** The SEC issued the directive to establish the office of the chief accountant in June 2014. Compliance with the policy action through staffing of the Office of the Chief Accountant, including adoption of guidelines was completed in July 2014.
7. The Borrower shall establish a special tribunal to adjudicate capital market-related disputes and issue regulations to provide for (a) powers, functions and jurisdiction of the tribunal, (b) status of appeals and adjournments, and (c) appointments of judges and their training.	**Complied with.** The Capital Market Tribunal was established on 7 January 2014. The rules and regulations associated with the Tribunal's establishment fall under the purview of the Securities and Exchange Commission Ordinance 1969 and the Code of Criminal

	Procedure 1898.
8. The Borrower shall submit to its parliament the bill on demutualization.	**Complied with.** The Demutualization Act was passed by Parliament in April 2013.
C. Supply Measures	
9. The Borrower shall effect an amendment in sections 16E and 53L of the Income Tax Ordinance to exempt the 3% tax on initial public offerings.	**Complied with.** During the budget session in June 2013, this was included into the Finance Act. The Finance Act was passed by Parliament on 30 June 2013.
10. The Borrower shall exempt bonds from transactions tax by amending Section 53BBB of the Income Tax Ordinance.	**Complied with.** During the budget session in June 2013, this was included into the Finance Act. The Finance Act was passed by Parliament on 30 June 2013.
11. The Borrower shall ensure that sale of receivables to a special purpose vehicle in connection with the securitization of assets is exempted from stamp duty on conveyance of assets and that issuance of debt instruments through private placement of listed companies is exempted from the stamp duty on transfer of instruments, both by amending the Stamp Act, 1899.	**Complied with.** During the budget session in June 2013, this was included into an amendment to the Stamp Act. The amended Stamp Act was passed by Parliament on 30 June 2013.
D. Demand Measures	
12. The Borrower shall ensure that the circular aimed at supporting more efficient price discovery mechanism in the auctioning of government securities are implemented and fully operationalized.	**Complied with.**
13. The Borrower shall cause the SEC to amend the SEC's mutual fund rules to allow asset management companies to reduce their exposure to equity securities below the stipulated 75%, if so stated in the fund's prospectus.	**Complied with.** The rules were issued in March 2013.
14. The Borrower shall allow investors in private sector open-end mutual funds the same tax advantage as the one applicable to investors in the Investment Corporation of Bangladesh open-end mutual funds.	**Complied with.** During the budget session in June 2013, this was included into the Finance Act. The Finance Act was passed by Parliament on 30 June 2013.
15. The Borrower shall: (a) obtain its cabinet approval on a white paper to strengthen the insurance sector by (i) agreeing to a timetable for recapitalizing all insurance companies in accordance with the Insurance Act and (ii) adopting investment regulations as required under Section 41 of the Act covering; (b) initiate implementation of the white paper; and (c) implement the following regulations: (i) management of IDRA Fund, and (ii) CEO appointment.	**Complied with.** (a) The draft white paper (being renamed the national insurance policy paper) has been formulated. Cabinet approval of the policy paper was obtained in June 2014. (b) Implementation of the policy paper was initiated in July 2014. (c) The insurance regulations with regard to CEO appointment and management of the Insurance Development and Regulatory Authority (IDRA) Fund are being implemented since June 2013.

STATUS OF COMPLIANCE WITH THE NON-TRANCHE RELEASE POLICY ACTIONS

Form of Reform Policy Actions	Assessment of Progress (with Supporting Documents)
1. In the carrying out of the Program, the Borrower shall perform, or cause to be performed, all obligations set forth in Schedule 4 to this Loan Agreement.	**Complied with.**
2. (a) The Borrower shall maintain, or cause to be maintained, records and documents adequate to identify the Eligible items financed out of the proceeds of the Loan and to record the progress of the Program.	**Complied with.**
(b) The Borrower shall enable ADB's representatives to inspect any relevant records and documents referred to in paragraph (a).	**Complied with.**
3. (a) As part of the reports and information referred to in Section 6.05 of the Loan Regulations, the Borrower shall furnish, or cause to be furnished, to ADB all such reports and information as ADB shall reasonably request concerning (i) the Counterpart Funds and the use thereof; and (ii) the implementation of the Program, including the accomplishment of the targets and the carrying out of the actions set out in the Policy Letter.	**Complied with.**
(b) Without limiting the generality of the foregoing or Section 6.05 of the Loan Regulations, the Borrower shall furnish, or cause to be furnished, to ADB quarterly reports on the carrying out of the Program and on the accomplishment of the targets and the carrying out of the actions set out in the Policy Letter.	**Complied with.**

LIST OF TRAINING PROGRAMS UNDERTAKEN IN ASSOCIATED TECHNICAL ASSISTANCE

No.	Title, Venue	Duration	Number of Participants
1	Instant Watch Surveillance Training to SEC, Dhaka	1–5 September 2014	5
2	Judicial Workshop, Dhaka	31 May 2014	29
3	BSEC Workshop “Training on the Draft Administrative Tribunal Rules and Procedures,” Dhaka	2 June 2014	34
4	Workshop on Establishing a Securities Markets Administrative Tribunal, Dhaka	5 June 2014	35
5	Training for BSEC on Risk-Based Supervision Applied to Inspections Processes, Dhaka	19 June 2014	50

BSEC = Bangladesh Securities and Exchange Commission, SEC = Securities and Exchange Commission.
Source: Asian Development Bank.