ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 43477
November 2012

Proposed Policy-based Loans and Administration of Technical Assistance Grant
People's Republic of Bangladesh: Second Capital Market Development Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 17 October 2012)

Currency unit	–	taka (Tk)
Tk1.00	=	$0.0123
$1.00	=	Tk81.275

ABBREVIATIONS

ADB	–	Asian Development Bank
BFID	–	Bank and Financial Institutions Division
FRC	–	Financial Reporting Council
GDP	–	gross domestic product
ICB	–	Investment Corporation of Bangladesh
IDRA	–	Insurance Development and Regulatory Authority
LIBOR	–	London interbank offered rate
MOF	–	Ministry of Finance
PFM	–	public financial management
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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PROGRAM AT A GLANCE

1. Project Name: Second Capital Market Development Program — **2. Project Number:** 43477-013

3. Country: Bangladesh — **4. Department/Division:** South Asia Department/Public Management, Financial Sector, & Trade Division

5. Sector Classification:

Sectors	Primary	Subsectors
Finance	√	Money and capital markets

6. Thematic Classification:

Themes	Primary	Subthemes
Economic growth	√	Promoting economic efficiency and enabling business environment
		Widening access to markets and economic opportunities
Private sector development		Private sector investment
Governance		Economic and financial governance
Capacity development		Institutional development
		Organizational development

6a. Climate Change Impact

No Climate Change Indicator available.

6b. Gender Mainstreaming

Gender equity theme (GEN)	
Effective gender mainstreaming (EGM)	
Some gender elements (SGE)	
No gender elements (NGE)	√

7. Targeting Classification:

General Intervention	Targeted Intervention		
	Geographic dimensions of inclusive growth	Millennium development goals	Income poverty at household level
√			

8. Location Impact:

National	High

9. Project Risk Categorization: Complex

10. Safeguards Categorization:

Environment	C
Involuntary resettlement	C
Indigenous peoples	C

11. ADB Financing:

Sovereign/Nonsovereign	Modality	Source	Amount ($ Million)
Sovereign	Program loan	Asian Development Fund	205.0
Sovereign	Program loan	Ordinary capital resources	95.0
Total			300.0

12. Cofinancing:

No Cofinancing available.

13. Counterpart Financing:

No Counterpart Financing available.

14. Aid Effectiveness:

Parallel project implementation unit	No
Program-based approach	Yes

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on proposed policy-based loans to the People's Republic of Bangladesh for the Second Capital Market Development Program. The report also describes proposed administration of technical assistance (TA) to be provided by the Japan Fund for Poverty Reduction for Enhancing Efficiency of the Capital Market, and if the Board approves the proposed loans, I, acting under the authority delegated to me by the Board, will approve the TA.[1]

II. THE PROGRAM

A. Rationale

2. Capital market reforms can stabilize the economy and facilitate sustainable growth by addressing the dual concern of boom and bust cycles in the stock markets as well as limited private investment that curtails long-term infrastructure financing options.

1. Performance Indicators and Analysis

3. **Financial sector analysis.** The financial sector and, in particular, the capital markets in Bangladesh are in a fragile state. The stock markets are characterized by excessive volatility with recurrent periods of boom and bust that tend to be a destabilizing force for the economy. The main Dhaka index has fallen by about a half from its December 2010 all-time high corresponding to a loss of about 22% of gross domestic product (GDP) (about $27.1 billion) in market capitalization as of 23 October 2012. A high-level probe, set up by the Government of Bangladesh in 2011 to understand the deficiencies, highlighted limited enforcement of regulation by the Securities and Exchange Commission (SEC) and commercial banks' excessive investment in stock markets.

4. Despite the large financing needs of the economy, the capital markets have not been particularly effective in channeling savings to support investment and growth, and bank credit ended up fuelling the stock market boom. A similar situation was evidenced in the previous stock market crash of December 1996. The proximate factors behind the boom and bust cycles include strained supervisory capacity and oversight by the SEC, lax and excessive reliance on margin lending requirements, unreliable financial reporting standards, and weak coordination across financial regulators. Weak investor confidence prevails in the capital markets and, therefore, limits demand for equities and bonds. This low market confidence is a result of the limited regulatory enforcement effectiveness of the SEC, lack of adjudication of securities cases (all securities cases of the 1996 crash are still pending), poor corporate governance, as well as weak governance and operation of the stock exchanges. A lack of sustainable long-term infrastructure financing options also persists in the economy because of limited capital market development.

5. Domestic capital markets do not play a significant role in financial intermediation and resource mobilization in the economy. While savings intermediated by banks amounted to 8.3% of GDP (30% of national savings), capital raised through equity and bond issues together was equivalent to only 0.07% of GDP in fiscal year (FY) 2012. The economy also remains over-reliant on bank financing (total bank assets of more than 80% of the country's financial assets) that are unable to finance the infrastructure investments that the country requires because this would expose banks to credit risks such as maturity mismatch issues. The bond market remains in its nascent stage, undermining long-term infrastructure financing requirements. The total bond market is only 5% of GDP (the government bond market is 4% of GDP, while the corporate bond market is 1% of GDP), which is significantly less than that of other large South Asian countries. Attempts to strengthen financial system stability have faced resistance by certain vested interests in support of the status quo that promotes government influence over the capital markets. Mutual fund participation in capital markets is very

[1] The design and monitoring framework is in Appendix 1.

limited (mutual fund capitalization is less than 1% of GDP, which is low compared to other large South Asian countries), and investment restrictions on insurance companies, as well as pension funds, limit their role in financing government securities and perpetuating a situation of fiscal dominance.[2]

6. If Bangladesh is to increase its GDP growth and attain its annual target of 10% by FY2021 (para. 7), it will have to address structural deficiencies in the capital markets by deregulating the financial system to better support the real economy and promote private sector investment to reduce the infrastructure deficit, which is a major constraint to its sustainable and higher economic growth. A policy framework is required for (i) financial markets stabilization following the history of booms and busts as well as (ii) sustainable capital market growth through liberalizing investment decisions, removing distortions, and promoting stronger supervision and governance of the markets. Correcting the existing legal and regulatory framework, continuing improvements to the market infrastructure (stock market surveillance system), and empowering institutions (e.g., the SEC) by reducing government tutelage are crucial to develop a more stable and resilient financial system.

7. **Growth imperative and infrastructure challenge.** Vision 2021[3] lays out a vision for Bangladesh to attain middle income status by 2021. It sets targets of reaching 8% GDP annual growth by FY2015 and 10% by FY2021. The Government of Bangladesh's Sixth Five-Year Plan, FY2011–FY2015[4] therefore includes a growth strategy to boost the rate of private investment and foster structural change. It focuses on accelerating the growth rate to 7.3% on average during the period covered by the plan and reducing poverty by substantially boosting private sector investment that will be primarily deployed to reduce the infrastructure constraint.

8. Acceleration of the growth rate will require a substantial increase in the investment rate from the present 24.4% of GDP to 32.5% of GDP by FY2015 and to 38%–40% of GDP by FY2021. Since most of the additional increase in the growth of investment will come from the private sector, policy reforms are envisioned under the Sixth Five-Year Plan to improve incentives for private investment such as providing sustainable long-term infrastructure financing options through capital market development. The absence of a developed capital market reduces the range of viable options for companies and borrowers seeking finance for growth, and places undue pressure on a banking sector that may not be in a strong enough prudential or credit position to offer essential long-term financing for infrastructure projects, which are in turn a prerequisite to support growth. Thus, capital market development is critical to address the current infrastructure investment gap in Bangladesh and, therefore, serve as a vehicle for long-term sustainable growth.

2. Analysis of Key Problems

9. The stock market debacle of December 2010 reflects the vulnerable state of Bangladesh's capital market and represents a convergence of factors that underpin inadequacies of the existing system as well as the present policies and practices that are not sustainable. The most critical problem is that of government tutelage over the capital markets, which holds back sector development and constrains responsible institutions from carrying out their mandates effectively. This combined with strong vested interest results in an entrenched status quo.

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[2] Fiscal pressures intensified as subsidy costs for fuel, electricity, food, and fertilizer increased, expanding government domestic borrowing and putting liquidity pressures on banks. Net credit to government, which grew rapidly by 35.0% in FY2011, shot up to 62.4% in the 12 months prior to January 2012. Pressure on balance of payments is expected to intensify in FY2012 and FY2013, with larger import payments relative to export and remittance receipts.

[3] Government of Bangladesh, Planning Commission, Ministry of Planning. 2010. *Outline Perspective Plan of Bangladesh – Making Vision 2021 a Reality: FY2010–FY2021*. Dhaka.

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

10. **Limited Securities and Exchange Commission capability in areas of regulation, surveillance, and enforcement.** The SEC's operational and financial efficiency is constrained since it is shackled under the SEC Act, 1993. The government issues directives to the SEC and also controls its appointments, budget, expenditures, and pay scales. The SEC cannot access its $10 million SEC Fund (a fund generated solely from SEC fees, charges, and levies) for its operations without prior government approval. As a result, the SEC has a limited remit as far as supervision and market development is concerned and limited resources to pursue its relatively narrow mandate effectively. Although its oversight and regulatory functions have more than doubled, SEC staffing remains inadequate and its remuneration structure is not attractive to potential qualified applicants from the private sector. The enforcement effectiveness of the SEC has been challenged by the lack of resources and extremely slow pace of resolution of cases pending in the court system in Bangladesh. A total of 366 SEC cases are pending with various courts, which includes 15 cases brought as a result of the stock market crisis of 1996. The SEC also does not have effective automated surveillance systems that can detect as well as prevent market abuses and malpractices. This has affected market confidence, which has often been cited by investors as one of the major constraints in the development of the capital market.

11. **Limited financial stability oversight and policy coordination.** In October 2009, Bangladesh Bank required commercial banks to establish separate merchant bank subsidiaries to conduct capital market activities in an attempt to limit the exposure of the banking system to the capital market. Although Bangladesh Bank remained responsible for the overall supervision of the commercial banks and their market exposure, direct oversight of their merchant bank subsidiaries became the responsibility of the SEC. As a result, Bangladesh Bank's supervision of the banking system was fragmented and became directly dependent on the quality of SEC oversight of merchant banks and the need for effective SEC supervision, as well as greater coordination and information sharing between the SEC and Bangladesh Bank. The absence of a high level forum and, ultimately, of agreements that would enable Bangladesh Bank, the SEC, and other financial market regulators to share information as well as coordinate financial sector oversight and policy issues on a regular basis has impaired Bangladesh Bank's ability to effectively supervise commercial banks and limited the application of prudential standards. In particular, the lack of coordination among financial sector regulators has led to opportunities for regulatory arbitrage.

12. **Weak regulation, governance, and operation of stock exchanges.** The management of each of the two stock exchanges, Dhaka Stock Exchange and Chittagong Stock Exchange, is unable to regulate and supervise its members' activities effectively; the exchanges are owned and dominated by brokers whose businesses take precedence over the governance of their exchanges and overall market development. Therefore, the exchanges are not responsive to the needs of their issuers and investors since the members and/or brokers are preventing direct and cost effective access to the exchanges. The exchanges' objectives are to manage the interests of the not-for-profit closed member-based organization with a central focus on providing services for the benefit primarily of the members and/or brokers and keeping costs and investments limited to financing agreed by members. Both exchanges failed to discipline their members and/or traders with regard to irregular trading. The mutual governance structure of the exchanges deters the appointment of a professional board and management, and limits appropriate investments in automated trading to offer competitive services that are essential for developing modern and efficient securities exchanges; therefore, it is a major constraint in the drive for innovation and overall development of the capital market.

13. **Weak institutional investor and mutual fund industry demand.** The participation of institutional investors, such as the insurance industry, is limited. The insurance industry of Bangladesh is still comparatively underdeveloped as market penetration at 1% or 2% of the population is low by international standards. The Insurance Act of 2010 is the industry's governing legislation, and the Insurance Development and Regulatory Authority (IDRA) is the new regulator. However, most of the new regulatory legislation, such as investment regulations and recapitalization measures, has yet to be adopted. With regard to mutual fund demand, major impediments in the

SEC (Mutual Fund) Rules, 2001 that currently curtail mutual fund growth are (i) limits on the types of entities that can sponsor or operate a mutual fund, (ii) limits on investment flexibility that prevent the creation of certain funds (such as index funds), (iii) investment discretion limited by the requirement of 75% equity securities, and (iv) the competitive advantages of the Investment Corporation of Bangladesh (ICB)—including special tax advantages—that create an uneven playing field between ICB funds and the rest of the industry.

14. **Limited supply and demand of equities.** High listing costs prevail because of the imposition of an initial public offering tax. The accounting and auditing standards of listed companies are also unreliable and lack facts for informed investment decisions. Beyond the unreliability of financial reporting is the issuer's concern over poor corporate governance. The corporate governance structure of listed companies is not sufficiently transparent and lacks proper checks and balances.

15. **Limited supply and demand of bonds.** The prevalence of fiscal dominance prevents competitive auctioning of government securities based on market prices. The operating framework of the primary dealer system does not promote competitive bidding because under current practice devolvement or lowest price bidding absorbs up to 70% of allocated issuance. This financial repression impedes the development of a secondary government bond market because primary pricing does not reflect market fundamentals and the primary dealers are, therefore, inclined to hold their portfolio of government securities until maturity to minimize losses. The development of the secondary government bond market is also hindered by too many issues of government securities (250 plus) and the average size of each issue ($50 million) being too small, which prevents the creation of liquid benchmark issues. The corporate bond market therefore hardly exists in Bangladesh because of the absence of a credible government yield curve and liquid bond market. Furthermore, the approval process for corporate bond issuance is slow and onerous (3–6 months), and the issuance costs are high by regional standards. The development of asset-backed securities is also hindered because of stamp duties on the transfer of assets and taxes on income passed through a special purpose vehicle.

3. Analysis of Opportunities

16. The recent episode of stock market volatility provides an opportunity to redefine the regulatory partnerships to augment transparency, fairness, and effectiveness as well as compliance, which would lead to enhanced trust and confidence in Bangladesh's capital markets. The SEC should enable a reformed regulatory partnership that defines the proper role of classes of participants as well as ensures that each participant carries out its responsibilities.

17. **Strengthening Securities and Exchange Commission in areas of regulation, surveillance, and enforcement.** The operational and financial efficiency of the SEC should be enhanced by allowing unhindered access to the SEC Fund. This would entail removal of government approval of the SEC budget or expenditures from the SEC Fund as well as delegating hiring and pay scale determination to the SEC. The SEC's inspection, investigation, and enforcement capacity needs to be strengthened to more fully meet its current and future regulatory obligations and promote market stability. This should be complemented by expedited adjudication of enforcement actions through the establishment of a special capital market tribunal to hear capital market-related cases and the development of a real-time market surveillance system to help the SEC detect trading irregularities and market abuse as they occur. The installation of such a state-of-the-art surveillance system would increase transparency of market transactions and contribute significantly to enhanced investor confidence. The operationalization of this system is being undertaken by an ongoing ADB TA loan.[5]

[5] ADB. 2006. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the People's Republic of Bangladesh for the Improvement of Capital Market and Insurance Governance Project*. Manila.

18. **Enhancing financial stability through improved coordination between regulators.** Enhanced coordination is required among the agencies with mandates for financial sector oversight. The banks' involvement directly and indirectly through subsidiaries overseen by the SEC illustrate that major policy issues cannot be dealt with through single functional silos. Practical implementation measures should include making the council of financial regulatory agencies an effective body for financial sector oversight. The council, which includes all the agencies with mandates for financial stability and financial sector oversight—Bangladesh Bank, the SEC, the IDRA, and the Ministry of Finance (MOF), should adopt a specific mandate to include (i) macro-prudential oversight of the financial system and contingency planning, (ii) a forum for the review of financial sector policy issues and the identification of needed amendments to the legal and regulatory framework, and (iii) a high-level forum for coordination and information sharing for the purposes of consolidated supervision.

19. **Demutualization of stock exchanges.** The demutualization of the stock exchanges would segregate ownership, management, and trading rights of members and convert the two exchanges into commercial and more professionally run organizations that would enable them to pursue their strategic interests, including market development, with more vigor. A governance structure representing all stakeholders and encouraging competition amongst trading members will develop the capital market of the country and attract new investors. The exchanges will be less susceptible to members' vested interests. The demutualization would also facilitate the development of crucial new technology-related infrastructure through alternative methods of raising capital.

20. **Enhancing institutional investor demand and promoting the mutual fund industry.** Insurance industry participation in the capital market should 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 issuance of investment guidelines by the IDRA. A robust mutual fund industry can be promoted by rule changes that (i) remove restrictions that prohibit brokers, portfolio managers, and merchant bankers from sponsoring or operating a mutual fund; (ii) permit the creation of different types of funds; (iii) allow investment discretion (less than 75% of equity investment); and (iv) require the funds sponsored by the ICB to be fully compliant with all mutual fund regulations.

21. **Enhancing the supply and demand of equities.** The accounting and auditing standards should be upgraded to enhance market confidence and allow for informed investment decisions. Enactment of the Financial Reporting Act would establish an independent financial reporting council to adopt, monitor, and enforce International Accounting Standards and International Standards of Auditing for public interest entities as well as license auditors and accountants. The SEC should establish high international standards of accounting and auditing to ensure the quality and reliability of filed financial information through creation of an office of chief accountant. The SEC code of corporate governance should be adopted to strengthen accounting policies and transparency of listed companies. It would lead to the creation of an audit committee to supervise companies' internal controls, accounting policies, and compliance with International Accounting Standards. In line with international best practices, removing the initial public offering tax would also spur the supply of equities since it would incentivize equity financing.

22. **Enhancing the supply and demand of bonds.** To develop a liquid bond market and reliable yield curve, the government should be a price-taker by issuing treasury bills and bonds at market rates. A strategy of creating liquid benchmark issues should be pursued by reducing the number of issues and increasing the average size of issues by re-opening existing issues. The initial focus should be on smaller tenors since these are easier for the market to price, especially in a high inflation environment. Longer tenors can be developed as the market matures. An ongoing ADB TA grant is supporting measures related to public debt management.[6] The corporate bond market can be

[6] ADB. 2011. *Technical Assistance to the People's Republic of Bangladesh for Capacity Development for Bangladesh Bank*. Manila.

catalyzed by implementing a fast-track regulatory process for private placements that balances investor protection with the ease of approval. Tax breaks, such as the elimination of transaction taxes for bonds, would also trigger bond market activity, and stamp duty relief would catalyze asset-backed securities.

4. Government Policy Support for Capital Market Development

23. To achieve GDP growth rate targets outlined in Vision 2021 and the Sixth Five-Year Plan, the government recognizes the need to strengthen macroeconomic management, deepen policy and regulatory reform, and improve the incentive structure for encouraging private investment. The investment requirement for the Sixth Five-Year Plan is an estimated Tk13.3 trillion, of which the government is expected to provide 22% and the private sector to provide the rest. Policy reforms are therefore envisioned under the Sixth Five-Year Plan to improve incentives for private investment. These incentives include providing long-term financing options through capital market development. The key envisaged capital market development reforms include (i) strengthened market surveillance by the SEC; (ii) improved regulations with respect to accounting rules, governance structure, and reporting requirements; and (iii) greater coordination between Bangladesh Bank and the SEC on stock market policies, including issues related to commercial banks' exposure to the capital market.

5. ADB Support for Capital Market Development

24. ADB's financial sector strategy for Bangladesh, which is included in the country partnership strategy[7] and the new country operations business plan,[8] is based on the Sixth Five-Year Plan, lessons from ADB's previous financial sector interventions, and coordination with other development partners. In line with the Sixth Five-Year Plan and ADB's Strategy 2020[9] priorities, capital market development and bond market development focusing on the provision of long-term infrastructure is one of ADB's focus areas in its Bangladesh public sector operations. Strategy 2020 includes support for capital market development as one of ADB's core operational priorities because it can facilitate private sector development and infrastructure development, which rely on the availability of long-term local currency funds for viable financial structures. The proposed program is fully aligned with the government's Sixth Five-Year Plan, ADB's Strategy 2020, and ADB's country partnership strategy with Bangladesh. ADB will provide assistance for capital market development in 2012 to complement and support the government's commitment to meaningful capital market reform.

6. Lessons

25. The proposed program will build on lessons from the first Capital Market Development Program[10] based on its program performance audit report[11] and a review carried out by the ADB Independent Evaluation Department on ADB's assistance for domestic capital markets.[12] Major lessons were as follows: (i) a comprehensive reform program can be feasible only if it is an integral part of a government-owned long-term development strategy[13] and if there is ownership at the highest levels of government and the private sector; (ii) the number of program measures should be limited so that ADB can monitor compliance with them throughout the program; and (iii) there should be adequate consultation with private and public sector stakeholders while forming capital market reform programs. In line with key recommendations of both evaluation studies, the efficiency and effectiveness of the proposed program is facilitated by (i) a limited number of policy actions to

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[7] ADB. 2011. *Country Partnership Strategy: Bangladesh,* 2011–2015. Manila.
[8] ADB. 2011. *Country Operations Business Plan: Bangladesh,* 2012–2014. Manila.
[9] ADB. 2008. *Strategy 2020: The Long-Term Strategic Framework of the Asian Development Bank, 2008–2020.* Manila.
[10] ADB. 1997. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the People's Republic of Bangladesh for the Capital Market Development Program*. Manila.
[11] ADB. 2005. *Program Performance Audit Report: Capital Market Development Program in Bangladesh*. Manila.
[12] ADB. 2008. *Special Evaluation Study on ADB Assistance for Domestic Capital Market Development*. Manila.
[13] A Third Capital Market Development Program has been included in ADB's country partnership strategy 2011–2015 for 2015 that will seek to deepen reforms initiated under the Second Capital Market Development Program.

monitor program compliance effectively, (ii) the formulation of a long-term national capital market master plan as a first tranche policy action to ensure that the new 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), and (iii) a comprehensive consultation with stakeholders through numerous national workshops to effectively diagnose the issues leading to a strong and relevant proposed policy matrix.[14]

7. Development Partner Coordination

26. The development partner coordination arrangement is guided by the Bangladesh Joint Cooperation Strategy, 2010–2015,[15] which is based on the principles of the Paris Declaration on Aid Effectiveness (2005) and the Accra Agenda for Action (2008). The World Bank, the International Monetary Fund, and ADB are the key development partners supporting the government in undertaking financial sector reforms. The World Bank's program focuses on the banking sector, and ADB is the lead development partner for capital market development. ADB retains this role under the proposed program, which builds upon policy reform measures implemented under the first Capital Market Development Program. In April 2012, the International Monetary Fund approved a 3-year Extended Credit Facility of about $1 billion for Bangladesh with the main objectives of restoring macroeconomic stability and strengthening the external position. The Extended Credit Facility will also strengthen financial sector governance to manage risks and support growth centered on managerial and operational controls in banks, particularly state-owned ones. The first installment of the Extended Credit Facility has been disbursed to date. The proposed program's emphasis on capital market development neatly complements the International Monetary Fund's Extended Credit Facility role in strengthening the banking sector. The World Bank's major ongoing project in the financial sector includes the Central Bank Strengthening Project[16] that supports Bangladesh Bank in terms of legal framework as well as reorganization and modernization.

B. Impact and Outcome

27. The program's impact will be a well-functioning financial system that supports basic capital and investment needs, as well as Bangladesh's longer-term economic objectives. The program's outcome will be a deeper and more stable capital market.

C. Outputs

28. The program outputs include (i) strengthened market stability by enhancing SEC's role to develop the market, promoting financial stability through joint supervision of the financial system, strengthening regulatory measures, and developing a market surveillance system; (ii) enhanced 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) enhanced supply measures by incentivizing the issuance of equities and bonds; and (iv) enhanced demand measures by developing liquid bond markets and catalyzing institutional investor demand.

D. Development Financing Needs

29. The program loan size is $300 million; it will be released in two equal tranches of $150 million equivalent. The first tranche will be available upon loan effectiveness. The government requested a loan of $95 million from ADB's ordinary capital resources. The loan will have a 15-year term, including a grace period of 3 years, an annual interest rate determined in accordance with ADB's

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[14] Three national stakeholder and dissemination workshops were held during program formulation that were attended by 183 registered participants across 34 different organizations.

[15] Government of the People's Republic of Bangladesh. 2010. *Bangladesh Joint Cooperation Strategy 2010–2015*. *"How to work more effectively together to deliver real development outcomes."* Dhaka.

[16] World Bank. 2003. *Bangladesh – Central Bank Strengthening Project.* Washington DC.

London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and other terms and conditions set forth in the draft loan and program agreements. The government also requested a loan in various currencies equivalent to SDR101,839,000 from ADB's Special Funds resources (regular term) and another loan in various currencies equivalent to SDR32,851,000 from ADB's Special Funds resources (hard term). The loans from ADB's Special Funds resources will each have a 24-year term, including a grace period of 8 years, an interest rate of 1.0% per annum during the grace period and 1.5% per annum thereafter, and other terms and conditions set forth in the draft loan and program agreements. The loan size is determined based on the cost of adjustment arising from the proposed reforms.[17]

E. Implementation Arrangements

30. The executing agency will be the Bank and Financial Institutions Division (BFID) of the MOF. The implementing agency will be the SEC. The program will be supported by other key government agencies (including Bangladesh Bank) that are responsible for undertaking numerous policy actions. The program is being implemented from June 2011 to June 2014. An inter-agency monitoring and tracking committee was established in July 2012 to help drive the reforms in preparation of the first tranche policy reform measures. The agencies under the committee include MOF, Bangladesh Bank, National Board of Revenue, SEC, and IDRA. After compliance with first tranche policy actions, a steering committee will implement the remaining program that will be chaired by the BFID Secretary. This steering committee will comprise of the same members as the tracking committee as well as members of the stock exchanges. The committee will be supported by a secretariat comprised of staff with requisite technical skills. Loan proceeds will be disbursed in accordance with ADB's simplification of disbursement procedures and related requirements for program loans.[18] ADB will have the right to audit the use of the loan proceeds and to verify the accuracy of the government's certification.

III. TECHNICAL ASSISTANCE

31. In addition to program support from an ongoing TA loan (footnote 5) and a capacity development TA project (footnote 6), an attached TA will provide crucial resources to support the implementation of key reform actions under the program. The major outputs and activities of the TA will include (i) strengthened enforcement capacity of the SEC by ensuring an effective structure 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 such as the establishment of a separate tribunal; and (iii) improved regulation, governance, and operation of the stock exchanges by facilitating the demutualization process in the Dhaka Stock Exchange and the Chittagong Stock Exchange. The TA is estimated to cost $850,000, of which $750,000 will be financed on a grant basis by the Japan Fund for Poverty Reduction and administered by ADB. The government will provide counterpart support in the form of office accommodation and transport, remuneration and per diem of counterpart staff, and other in-kind contributions. The executing agency for the TA will be the BFID of the MOF. The SEC will be the implementing agency for the TA. The TA will be implemented over 2 years, starting in December 2012. ADB will engage consultants through a consulting firm in accordance with its Guidelines on the Use of Consultants (2010, as amended from time to time). Disbursements under the TA will be made in accordance with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time).

[17] The estimated cost of adjustment across program outputs are: (i) $20 million for market stability (additional SEC staff time, coordination committee staff time, maintenance and operation cost of SEC surveillance equipment); (ii) $150 million for market facilitation (costs of demutualization and establishment of a capital markets tribunal, operation costs of the Financial Reporting Council and its tribunal); (iii) $10 million for supply measures (foregone revenue on IPO tax, bond transaction tax, and stamp duties); and (iv) $150 million for demand measures (cost of paying market prices for government securities as well as additional IDRA staff).

[18] ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

IV. DUE DILIGENCE

A. Economic and Financial

32. The program will facilitate mobilization of financial resources for productive investment and employment generation by supporting the development of bond and equity capital markets. The program will help to ensure the balanced development of the financial sector, which will reduce systemic vulnerabilities in the bank-dominated financial system. Specific benefits are as follows:

(i) By addressing policy and regulatory constraints to the issues of corporate securities, the program will help to increase the number of bond and equity issues, both primary and secondary. This will facilitate the mobilization of scarce financial resources for long-term private sector investment, including infrastructure investment.

(ii) By promoting the development of corporate securities markets and institutional investors, thereby diversifying financial instruments and broadening the investor base, the program will reduce market volatility and improve resilience of the financial sector to external shocks. ADB is currently supporting implementation of a TA to strengthen capacity at Bangladesh Bank including in the area of financial stability (footnote 6).

(iii) By strengthening market governance in capital markets, the program will enhance market efficiency and transparency, as well as improve investor protection.

B. Governance

33. Public Financial Management (PFM) reform has been undertaken to make resource allocation more effective, prioritize spending, and increase budget execution capability. The government recently implemented comprehensive governance reforms including establishment of an independent Anti-Corruption Commission in 2004, separation of the judiciary from the executive in 2007, enactment of the Right to Information Act, 2009 and immediate establishment of the Information Commission. A new approach to budget planning was adopted by the government with the introduction of the Medium Term Budget Framework in all line ministries and establishment of an integrated budget and accounting system in 2009 that connected accounting offices in all the districts and chief accounts offices of the line ministries with the Ministry of Finance. Under the Public Money and Budget Management Act, 2009 the Finance Minister is required to submit quarterly progress reports to the Parliament on the utilization of budgeted appropriations and progress in public expenditure management. Furthermore, greater responsibility and accountability has been assigned to the SEC under this program through clear rules of engagement under the amended SEC Act, 1993 that is contributing to improved governance in the financial system. In October 2012, the National Integrity Strategy was approved by the government and supported by ADB's Good Governance Program[19] which represents a comprehensive institutional approach to fight corruption. ADB's Anticorruption Policy (1998, as amended to date) was explained and discussed with the government and the BFID of the MOF.

C. Poverty and Social

34. The capital market reforms under the program will play an important role in raising funds cost-effectively and in enabling investors to gain access to alternative investment opportunities, as well as mitigating the negative impact that financial market instability has on the plight of the poor. Diversification away from a predominantly bank-based system of financial intermediation expands alternative sources of credit, thereby helping to limit systemic impacts of economic shocks. Capital markets can 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.

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[19] ADB. 2007. *Report and Recommendation of the President to the Board of Directors on Proposed Program Loan and Technical Assistance Grant to the People's Republic of Bangladesh for the Good Governance Program.* Manila. Loan 2362-BAN for $150 million, and TA 4983-BAN for $3 million.

D. Safeguards

35. The capital market reforms under the program are likely to have no adverse environmental impacts. Therefore, the program's environment category is assigned as C. Similarly, since the program has no involuntary resettlement impacts, the program's involuntary resettlement category is assigned as C. The program's indigenous peoples category is also assigned as C.

E. Risks and Mitigating Measures

36. Risks to the program include political instability, resistance to reforms from vested interests, and PFM. Mitigating measures entail strong political will and commitment to pursue capital market reforms (para. 33). PFM reform has been undertaken through the public expenditure and financial accountability partnership that supports harmonized approaches to assessment and reform for public expenditure, procurement, and financial accountability. Major risks and mitigating measures are described in detail in the risk assessment and risk management plan.[20]

V. ASSURANCES AND CONDITIONS

37. The government and the BFID of the MOF have assured ADB that the implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan documents.

38. The government and the BFID of the MOF have agreed with ADB on certain covenants for the program, which are set forth in the loan agreements and program agreement.

VI. RECOMMENDATION

39. I am satisfied that the proposed loans would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

(i) the loan of $95,000,000 to the People's Republic of Bangladesh for the Second Capital Market Development Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and program agreements presented to the Board;

(ii) the loan in various currencies equivalent to SDR101,839,000 to the People's Republic of Bangladesh for the Second Capital Market Development Program from ADB's Special Funds resources (regular term), with an interest charge at the rate of 1.0% per annum during the grace period and 1.5% per annum thereafter; for a term of 24 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and program agreements presented to the Board; and

(iii) the loan in various currencies equivalent to SDR32,851,000 to the People's Republic of Bangladesh for the Second Capital Market Development Program from ADB's Special Funds resources (hard term), with an interest charge at the rate of 1.0% per annum during the grace period and 1.5% per annum thereafter; for a term of 24 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and program agreements presented to the Board.

Haruhiko Kuroda
President

6 November 2012

[20] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
Impact A well-functioning financial system that supports basic capital and investment needs as well as Bangladesh's longer-term economic objectives	Private investment as the percentage of GDP increases to 23% by FY2016 (baseline: 19.5% in FY2011) Long-term financing as the percentage of GDP increases to 0.5% by FY2016 (baseline: 0.09 % in FY2011)	Asian Development Outlook Bangladesh Bureau of Statistics Bangladesh Quarterly Economic Update	**Assumptions** Macroeconomic and political stability Political will, ownership and commitment to pursue capital market reforms
Outcome A deeper and more stable capital market	Stock market capitalization increases to Tk3000 billion by FY2014 (baseline: Tk2347.8 billion in July 2012) Enlistment of new securities increases to 545 by FY 2015 (baseline: 507 in FY2011) Number of corporate bonds outstanding increase to 12 by FY2015 (Baseline: 3 in FY2011)	For all indicators: Reports by the Dhaka Stock Exchange and the Chittagong Stock Exchange Reports by the SEC Bangladesh Quarterly Economic Update	**Assumptions** Private sector deems capital markets reforms credible Absence of fiscal, financial, and energy crises **Risk** Vested interest groups manage to undermine effective implementation of capital market reforms
Outputs 1. Strengthened market stability	SEC Act amendments adopted by Q2 2013 (baseline: limited SEC independence) MOU to strengthen inter-agency committee to guarantee financial stability adopted by Q4 2012 Limit of exposure to equity risk reduced to a percentage of capital by FY2013 (baseline: 10% of total liabilities) Margin lending limits reduced to 1:0:5 by FY2013 (baseline: 1:1 in July 2010) Electronic market surveillance operational by Q1 2013 (baseline: manual surveillance)	For all indicators: Bangladesh Bank rules and regulations SEC rules and regulation Executing agency progress reports	**Assumption** Implementing agencies are committed and adequately staffed and funded to timely implement capital market reforms **Risk** Lack of interagency coordination of reforms

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
2. Enhanced market facilitation	SEC has been restructured to include the Office of Chief Accountant by FY2013 (baseline: no Office of Chief Accountant) Special tribunal for capital market related cases established by FY2013 (baseline: no tribunal) SEC Code of Governance implemented by Q4 2012 (baseline: voluntary) Stock exchanges are de-mutualized by FY2013 (baseline: mutualized stock exchanges) FRA Bill adopted by Q2 2014		
3. Enhanced supply measures	IPO premiums reduced to 0% by FY2013 (baseline: 3% in FY2011) SEC regulation on private placement adopted by Q4 2012 (baseline: no regulation) Corporate bond transaction tax reduced to 0% by FY2013 (baseline: 0.1%–0.05% in FY 2011) Stamp tax for the securitization of assets removed by FY2013 (baseline: stamp tax in place)		
4. Enhanced demand measures	Assets management companies allowed to reduce their exposure to equity securities below 75% by FY2013 (baseline: restricted to reduce exposure below 75%) Tax advantage for ICB open-ended mutual funds removed by FY2013 (baseline:10% in FY2011) Devolvement of government securities reduced to no more than 45% of total issuance by Bangladesh Bank by FY2014. (baseline: 65% in July 2012)		

Activities and Milestones	Inputs
1. Strengthened market stability 1.1 Amend SEC Act to enhance SEC's operational and financial efficiency (December 2012) 1.2 Establish a high-level committee with the mandate to preserve financial stability through joint supervision of financial systems (October 2012) 1.3 Establish a working-level committee for the effective consolidated supervision of banks and their capital market subsidiaries (October 2012) 1.4 Amend Bangladesh Bank and SEC guidelines to prescribe margin lending requirement of 1:0.5 (October 2012) 1.5 Undertake review of capital requirements for intermediaries (June 2013) 1.6 Strengthen regulatory measures including limit for total direct and indirect exposure to equity risk as a percentage of capital (July 2013) **2. Enhanced market facilitation** 2.1 Develop a long-term capital market plan that embeds major milestones in the first and second tranches (October 2012) 2.2 Draft the required legislative and procedural framework for Demutualization Act (October 2012) 2.3 Enact the Demutualization Act (September 2013) 2.4 Adopt amendments to the SEC Code of Corporate Governance, 2006 (October 2012) 2.5 Upgrade accounting and auditing standards by submitting the FRA bill to parliament (September 2013) 2.6 Develop a model organizational framework for expedited adjudication of enforcement actions (April 2013) 2.7 Draft the required legislative and procedural framework for special tribunal (June 2013) 2.8 Operationalize the special tribunal (August 2013) 2.9 Train judges (November 2013) 2.10 Establish and staff the Office of Chief Accountant in SEC (November 2013) **3. Enhanced supply measures** 3.1 Draft and finalize SEC regulations for private placements (October 2012) 3.2 Amend the Income Tax Ordinance to ensure exemption of transactions taxes for bonds (June 2013) 3.3 Eliminate the 3% tax on IPO premiums by amending the Income Tax Ordinance (June 2013) 3.4 Ensure that the sale of receivables to an SPV in connection with the securitization of assets is exempted from the stamp duty on conveyance of assets and that the issuance of debt instruments through private placement is exempted from the stamp duty on transfer of instruments (June 2013) **4. Enhanced demand measures** 4.1 Submit to cabinet a white paper to strengthen the insurance sector (July 2013) 4.2 Issue 9 insurance regulations (October 2012) 4.3 Finalize a medium-term plan for managing the government debt portfolio by Bangladesh Bank (October 2012) 4.4 Amend Securities and Exchange Commission (Mutual Fund) rules, 2001 (October 2013).	**Program Loans:** OCR $95 million ADF $205 million **Technical Assistance:** Japan Fund for Poverty Reduction[a] $0.75 million

ADF = Asian Development Fund; FRA = Financial Reporting Act; FY = fiscal year; GDP = gross domestic product; ICB = Investment Corporation of Bangladesh; IPO = initial public offering; MOU = memorandum of understanding; OCR = ordinary capital resources; SEC = Securities and Exchange Commission; SPV = special purpose vehicle.

[a] Administered by the Asian Development Bank.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS
http://www.adb.org/Documents/RRPs/?id=43477-013-3

1. Program Agreement
2. Loan Agreement: Special Operations (Hard Term)
3. Loan Agreement: Special Operations (Regular Term)
4. Loan Agreement: Ordinary Operations
5. Sector Assessment (Summary): Capital Market Development
6. Contribution to the ADB Results Framework
7. Development Coordination
8. Country Economic Indicators
9. International Monetary Fund Assessment Letter
10. Summary Poverty Reduction and Social Strategy
11. Risk Assessment and Risk Management Plan
12. List of Ineligible Items

Supplementary Document

13. Technical Assistance for Enhancing Efficiency of the Capital Market

DEVELOPMENT POLICY LETTER

1

Government of Peoples Republic of Bangladesh
Ministry of Finance
Bank & Financial Institutions Division
Capital Market Section

No-53.014.014.01.00. 001.2012- Dated: 6 September 2012

Mr. Haruhiko Kuroda
President
Asian Development Bank

Subject: DEVELOPMENT POLICY LETTER

Dear Mr. President,

The current Government of the People's Republic of Bangladesh (the Government) was sworn into office in January 2009 on a strong commitment to pursue the reform of the economy of Bangladesh. This Second Capital Market Development Program to develop the domestic capital market with the support of the Asian Development Bank (ADB) is a concrete manifestation of that commitment and the Government's resolve to move the country out of the low-income-low-saving-low-investment trap where it has languished for many years.

A. Background to Reforms

If Bangladesh wishes to attain middle income status by 2021, it will have to increase GDP growth and attain its targets of 8% by FY2015 and 10% by FY2021 as per our Sixth Five-Year Plan, FY2011–FY2015 and Vision 2021. Acceleration of the growth rate will require a substantial increase in the rate of investment from the present 24.4% of GDP level to 32.5% of GDP by the end of the plan period and to 38-40% of GDP by FY2021. Since most of the additional increase in the growth of investment is projected to come from the private sector, policy reforms are envisioned under the Sixth Five-Year Plan to improve incentives for private investment such as providing sustainable long-term infrastructure financing options through capital market development. Bangladesh will therefore have to address structural deficiencies in the capital markets by deregulating the financial system to better support the real economy and promote private sector investment to reduce the infrastructure deficit which is a major constraint to its sustainable and higher economic growth.

We consequently realize that a much faster rate of economic growth is needed to raise living standards in Bangladesh and to reduce poverty on a sustained basis. It is for these reasons that the Government places a high priority to the reform of the country's financial sector.

B. Rationale for the Program

The financial sector in Bangladesh and in particular the capital markets are in a fragile state. The stock markets are characterized by excessive volatility with recurrent periods of booms

and bust that tend to be a destabilizing force for the economy. The main Dhaka index has fallen by about a third from its December 2010 all-time high (50% of GDP) and approximately 19% of GDP (approximately $21.0 billion) in market capitalization was wiped out as at end-February 2012. A high level probe set up by the Government in 2011 to understand the deficiencies highlighted limited regulation by the Securities and Exchange Commission (SEC) and commercial banks' excessive investment in stock markets.

Despite the large financing needs of the economy, the capital markets have not been particularly effective in channeling savings to support investment and growth, and bank credit ended up fuelling the stock market boom. A similar situation was evidenced in the previous stock market crash of December 1996. Proximate factors behind the boom and bust cycles include strained supervisory capacity and oversight at SEC, lax and excessive reliance on margin lending requirements, unreliable financial reporting standards, weak supervision of banking operations by the central bank and weak coordination across financial regulators. Most investors are also traders and brokers. No investment regime of patience and careful consideration of a firm's business practices has yet taken roots in the capital market. Weak investor confidence prevails in the capital markets and therefore limits demand for equities and bonds. This low market confidence originates from limited enforcement effectiveness of SEC, lack of adjudication of securities cases (all securities cases of the 1996 crash are still pending), poor corporate governance, as well as weak governance and operation of the stock exchanges. A lack of sustainable long-term infrastructure financing options also persists in the economy due to limited capital market development. The economy remains over-reliant on bank financing (total bank assets of more than 80% of the country's financial assets) that are unable to finance the infrastructure investments that the country requires since this would expose banks to credit risks such as maturity mismatch issues. The bond market remains in its infancy undermining long term infrastructure financing requirements. Total bond market is only 5% of GDP (government bond market at 4% of GDP while corporate bond market is 1% of GDP) which is significantly less than that of other large South Asian countries. Attempts to strengthen financial system stability have faced resistance by certain vested interests in support of the status quo that promotes government influence over the capital markets. Mutual fund participation in capital markets is very limited (mutual fund capitalization is less than 1% of GDP which is low compared to other large South Asian countries) and investment restrictions on insurance companies as well as pension funds limit their role to financing government securities and perpetuating a situation of fiscal dominance.

As a consequence, these market developments have shaken investor confidence and provide the impetus for the immediate reform of the domestic capital market and explain the urgency for implementation of ADB's Second Capital Market Development Program as the Government has requested.

C. The Program

The Program seeks to create a policy environment conducive to capital market development. The Program aims to develop a fair, transparent and efficient capital market to restore public confidence and promote and facilitate investments. The key policy measures of the Program, set forth in greater detail in the attached Policy Matrix, are discussed below.

1. Strengthen SEC in Areas of Regulation, Surveillance and Enforcement

Recent market developments clearly indicate that a market that is fair and transparent is essential to investor confidence. To ensure that the market operates in a fair and transparent manner, the Program supports the substantial strengthening of the existing regulatory agency, the SEC. The Program aims to enhance the operational and financial efficiency of the SEC which has the interest of investors as its paramount interest and with the capability of protecting the investing public. To this end, the Program seeks to allow SEC unhindered access to the SEC Fund. This would entail removal of Government approval of SEC budget or expenditures from SEC Fund as well as from approved organogram [illegible] of officers and employees delegated to the SEC and enable benefits comparable to that of Bangladesh Bank. The SEC's inspection, investigation and enforcement capacity needs to be strengthened to more fully meet its current and future regulatory obligations and promote market stability. This capacity building should be complemented by expedited adjudication of enforcement actions through establishment of a special Capital Market Tribunal to hear capital market-related cases and the development of a real-time market surveillance system to help the SEC detect trading irregularities and market abuse as they occur. The installation of such a state-of-the-art surveillance system will increase transparency of market transactions and significantly contribute to enhanced investor confidence. The proposed technical assistance of the ADB to the SEC for capacity building would be of substantive value to the agency's medium- and long-term development by focusing on an effective and efficient SEC structure for detecting and investigating possible violations of securities laws and regulations as well as formulating and prosecuting cases and expedited adjudication of enforcement actions by promoting mechanisms to ensure disposition of capital market cases such as the establishment of a separate tribunal. It is the Government's objective that in the long run, the SEC will be able to operate on a self sustaining basis as other mature SECs in more developed economies.

2. Enhance Financial Stability through improved coordination between regulators

In view of the significant impact of capital market activities today, the Government will, as a first step, improve policy coordination at the highest levels. Enhanced coordination is required among the agencies with mandates for financial sector oversight. The banks' involvement directly and indirectly through subsidiaries overseen by the SEC illustrate that major policy issues cannot be dealt with through single functional silos. Practical implementation measures should include strengthening existing financial regulators committee so that it becomes an effective body for financial sector oversight. This would include all the agencies with mandates for financial stability and financial sector oversight—Bangladesh Bank, the SEC, the IDRA, and the Ministry of Finance, should adopt a specific mandate to include: (i) macro-prudential oversight of the financial system and contingency planning, (ii) provide a forum for the review of financial sector policy issues and identification of needed amendments to the legal and regulatory framework, and (iii) serving as a high-level forum for coordination and information sharing for the purposes of consolidated supervision. This will ensure that issues affecting the capital market are given the attention they deserve.

3. Demutualization of Stock Exchanges

The Government will take the necessary measures to ensure demutualization of the Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE). Demutualization would strengthen governance, encourage development of alternative business models and enhance

operational efficiency at both stock exchanges. As a result, there would be increased investor confidence in the stock market which would translate into more effective channeling of savings to support investment and growth. Demutualization of the stock exchanges would segregate ownership, management and trading rights of members and convert the two exchanges into commercial and more professionally run organizations that would enable the stock exchanges to pursue their strategic interests including market development with more vigor. A governance structure representing all stakeholders and encouraging competition amongst trading members will develop the capital market of the country and attract new investors. The exchanges will be less susceptible to members' vested interests. Demutualization will also facilitate development of crucial new technology-related infrastructure through alternative methods of raising capital. The proposed technical assistance of the ADB would facilitate the demutualization process in DSE and CSE by introducing international best practices in their governance structures.

4. Enhance Institutional Investor Demand and Promote Mutual Fund Industry

Institutional demand for securities will be enhanced by (i) liberalizing investments of insurance companies which are major institutional sources of medium to long-term funds, (ii) liberalizing entry of mutual funds, and (iii) promoting a level playing field, to encourage broader private sector participation and encourage competition, thereby enhance market efficiency. Insurance industry participation in the capital market should be enhanced by first 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 then encouraging investor demand through issuing of investment guidelines by IDRA. The clearing and settlement arrangements should be centralized under a single entity to achieve economies of scale as well as consolidated collateral management. A robust mutual fund industry can be promoted by rule changes that: (i) remove restrictions that prohibit brokers, portfolio managers, and merchant bankers from sponsoring or operating a mutual fund, (ii) permit creation of different types of funds, (iii) allow investment discretion and (iv) require the funds sponsored by ICB to come into full compliance with all mutual fund regulations.

5. Enhance Supply and Demand of Equities and Bonds

The potential for prices to be moved with ease in the current situation can be attributed to the thinness of the domestic capital market. There is a manifest need to increase the current supply of securities. In order to achieve this objective, the Government will undertake several measures.

Equities. The accounting and auditing standards should be upgraded to enhance market confidence and allow for informed investment decisions. Enactment of the Financial Reporting Act (FRA) Act would establish an independent adequately-funded Financial Reporting Council (FRC) to adopt, monitor, and enforce International Accounting Standards (IAS) and International Standards of Auditing for "public interest entities," as well as license auditors and accountants. The SEC should establish high international standards of accounting and auditing to ensure the quality and reliability of filed financial information through creation of an office of Chief Accountant. The SEC Code of Corporate Governance should be adopted to strengthen accounting policies and transparency of listed companies. It will lead to the creation of an audit committee to clarify and supervise the companies' internal controls, accounting policies and compliance with IAS. In line with international best practice, removal of the IPO tax will also spur supply of equities since it will incentivize equity financing.

Bonds. To develop a liquid bond market and reliable yield curve, the Government should minimize financial repression and be a "price-taker" by issuing treasury bills and bonds at market rates. A strategy of creating liquid benchmark issues should be pursued by reducing the number of issues and increasing the average size of issues through re-opening existing issues. The initial focus should be on smaller tenors (2, 3, and 5 years) since these are easier for the market to price especially in a high inflation environment. Longer tenors can be developed as the market matures. The corporate bond market can be catalyzed by implementing a fast track regulatory process for private placements that balances investor protection with ease of approval (less than one month). Tax breaks such as elimination of transaction taxes for bonds would also trigger bond market activity and relief on stamp duties would catalyze ABS.

D. Program Implementation

The Government is fully aware that the success of the Program depends upon the ability of the Executing Agency to implement the Program. The executing agency will be the Bank and Financial Institutions Division of Ministry of Finance (MOF-BFID). The implementing agency will be the SEC. The Program will be implemented over a period of 3 years. The Program will be supported by other key government agencies (including Bangladesh Bank) which are responsible for undertaking numerous policy actions. An inter-agency monitoring and tracking committee was established on 12 July 2012 to assist in driving the reforms in preparation of the first tranche policy reform measures. The agencies under the committee include Ministry of Finance (Economic Relations Division, Finance Division, Bank and Financial Institutions Division, Internal Resources Division), Bangladesh Bank, National Board of Revenue, SEC, and Insurance Development Regulatory Authority. Members of the committee are not below the rank and status of a Deputy Secretary. ADB is also represented in this committee that is chaired by the Joint Secretary of Ministry of Finance (Economic Relations Division). This committee meets every fortnight. After compliance with first tranche policy actions, a steering committee will implement the remaining Program that will be chaired by the MOF-BFID Secretary. This steering committee will comprise of the same members as the previous tracking committee as well as members of the stock exchanges. This committee will be assisted by a secretariat comprised of a staff with the requisite technical and management skills. The Government will dedicate counterpart funds generated out of the loan proceeds to meet the costs of adjustment arising from the proposed reforms.

To ensure Program quality, the Government will seek and consider the views of all parties to be affected by reforms and consult with as wide a segment as possible of the capital market, prior to implementation of specific reform actions. Specific problems will be brought to the attention of the ADB at an early stage.

E. Government's Request

The Government considers the development of the domestic capital market to be critical to its overall domestic resource mobilization effort vital for the future growth and development of the country's economy. The Government is also aware that the Program to reform and develop the country's capital market represents a crucial test of the Government's political will to carry out more far-reaching reforms in the financial sector and the overall economy.

The Government is, therefore, dedicating its best staff and resources to undertake the implementation of these reforms. It is confident that it can implement the proposed reforms within the time frame agreed upon and achieve the objectives of the Program. The Government would, therefore, like to seek ADB's favorable consideration of its request for a loan of $[300] million equivalent in support of its policy reform program. The Government will collaborate closely with the ADB in the implementation of the proposed reforms both to facilitate the process and ensure that the reforms carried out meet the requirements of the Program.

The Government believes that successful implementation of the Program will facilitate further reforms of the financial sector and more urgently, help meet the immediate and pressing needs of the real sector. The envisioned reforms will complement other ongoing reforms focused on achieving a faster pace of economic growth and raising the living standards of the people of Bangladesh. We welcome and look forward to ADB's participation in our reform efforts.

With regards,

Yours sincerely,

Abul Maal Abdul Muhith
6 Sept 2012

POLICY MATRIX

OBJECTIVE: To develop efficient, stable and transparent capital markets in Bangladesh

Objectives and Policy Actions	1st Tranche Policy Actions (Q4 2012)	2nd Tranche Policy Actions (15 months after T1)
A. Market Stability Objective: To promote more robust, resilient and stable capital markets.		
1. Enhance SEC's role to develop and monitor the market	(1) Submission to Parliament of amendment of the SEC Act, 1993 to enhance SEC's operational and financial efficiency that includes the following key elements: (i) composition of the Commission, (ii) appointment of officers and employees delegated to the Commission and enable benefits comparable to that of Bangladesh Bank, and (iii) Commission access to the SEC Fund without Government approval of its budget or of its expenditures. **(SEC and MOF-BFID)**	
2. Promote financial stability through joint supervision of financial system	(2) MOU signed between key regulators to strengthen existing financial regulators committee chaired by Bangladesh Bank Governor, with a mandate to preserve financial stability and *powers inter alia* to identify potentially systemic financial firms for enhanced surveillance and supervision. **(BB)**	
	(3) Establish effective consolidated supervision of banks and their capital markets subsidiaries by introducing the following key elements: (i) BB pursuant to the Bank Companies Act (BCA) to require banks to report balance sheet, income statement and key prudential exposures on a solo and consolidated basis, (ii) regular coordination meetings between BB and SEC, and (iii) establish mechanisms for working-level exchange of supervisory information and cooperation. **(BB and SEC)**	

Objectives and Policy Actions	1st Tranche Policy Actions (Q4 2012)	2nd Tranche Policy Actions (15 months after T1)
3. Strengthen regulatory measures	(4) As part of prudential measures on margin lending in phases (i) SEC to issue a circular establishing margin lending requirement of 1:0.5 (advances of no more than 50 percent of the collateral amount), for all margin loan providers, and (ii) BB to issue circular to be fully implemented and that covers all margin loan providers to abide by the margin lending requirement determined by SEC. **(BB and SEC)**	(1) Submission to Parliament of amended BCA with the objective to contain risks posed by equity markets through consolidated supervision. **(BB and MOF-BFID)**
		(2) Reduce banks' equity risk exposure by introduction of BB Guideline to establish a limit for total 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. **(BB)**
		(3) SEC has undertaken a review of the capital requirements for intermediaries through a risk-based supervision approach. **(SEC)**
4. Develop a market surveillance system	(5) Procurement and initiation of installation of the SEC's electronic market surveillance system. **(SEC)**	(4) Reports generated from the market surveillance system to be part of the improved monitoring of the capital markets and discussed at the coordination meetings. **(SEC)**
B. Market Facilitation Objective: To support more effective and efficient mobilization and allocation of resources in the economy.		
1. Development of a long-term vision for the capital markets	(6) Formulation of a long-term capital market master plan approved by the SEC to guide direction and implementation of capital market development reforms. (10 to 15 years). **(SEC)**	
2. Upgrade accounting and auditing standards		(5) Submission to Parliament of FRA Bill to include the following key elements: (i) establish an independent Financial Reporting Council (FRC) to adopt International Accounting Standards and International Standards of Auditing for public interest entities, and to monitor and enforce them, (ii) license auditors and accountants, and (iii) to establish and independent administrative tribunal to hear appeals from FRC decisions. **(MOF-FD)**

Objectives and Policy Actions	1st Tranche Policy Actions (Q4 2012)	2nd Tranche Policy Actions (15 months after T1)
		(6) SEC has established and staffed the Office of Chief Accountant including adoption of guidelines for the accountants and auditors to practice before the SEC. **(SEC)**
3. Expedite adjudication of enforcement actions	(7) Submission to Parliament of amendment of 25B of Securities and Exchange Ordinance, 1969 to establish a special tribunal for capital market related cases. **(SEC and MOF-BFID)**	(7) Establish a special tribunal for capital market related cases. Issue regulations that: (i) define the powers, functions and jurisdiction of the tribunal, (ii) determine status of appeals and adjournments, and (iii) determine appointment of qualified judges and their training. **(SEC and MOF-BFID)**
4. Improve governance of listed companies	(8) Adoption of amendments to the SEC Code of Corporate Governance (CCG), 2006 that includes the following key elements: (i) compulsory adherence to CCG, (ii) establishment of audit committee within the listed companies, and (iii) increasing the percentage of independent directors from 10% to 20% of the Board. **(SEC)**	
5. Improve regulation, governance, and operation of stock exchanges	(9) Cabinet Approval of Demutualization Act. **(SEC and MOF-BFID)**	(8) Submission to Parliament of Demutualization Act. **(SEC and MOF-BFID)**
C. Supply Measures Objective: To increase the supply of quality equity and bonds through the capital markets.		
1. Enhance supply of equities		(9) Exemption of the 3% tax on IPO premiums by amending Section 16(E)/53L of the Income Tax Ordinance. **(SEC and NBR)**

Objectives and Policy Actions	1st Tranche Policy Actions (Q4 2012)	2nd Tranche Policy Actions (15 months after T1)
2. Enhance supply of bonds	(10) SEC to introduce simplified regulations for private placements of corporate bonds that includes the following key elements: (i) criteria for eligible investors, and (ii) SEC approval of corporate bond issue within 7 working days after completion of supporting documentation. **(SEC)**	(10) Exemption of transaction taxes for bonds by amending Section 53(BBB) of the Income Tax Ordinance. **(NBR)**
3. Remove barriers to asset securitization		(11) Ensure that the sale of receivables to an SPV in connection with the securitization of assets is exempted from the 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 the stamp duty on transfer of instruments (Item 62 of the Schedule I of the Stamp Act 1899). **(MOF-IRD)**
D. Demand Measures Objective: Support mobilization of capital market financing.		
1. Develop liquid bond markets	(11) To support a more efficient price discovery mechanism in the auctioning of government securities, BB will issue circulars, as needed, such that (i) BB only devolve at a yield which is the average of all submitted bids by the Primary Dealers (PDs) and non-PDs in an auction, excluding outliers; (ii) Allocation of issuance across PDs should include the pro-rata share of bank liabilities (specifically their deposit base); and (iii) Positive bids submitted by a PD in an auction would receive offset/credit provision (volume based) while calculating the devolvement liability on the remaining bids of that PD in the auction. **(BB and MOF-BFID)**	(12) Circulars implemented and fully operationalized. **(BB and MOF-BFID)**
	(12) Bangladesh Bank's Debt Management Department to establish a medium term plan and submit to MOF-FD for managing the government debt portfolio. **(BB)**	

Objectives and Policy Actions	1st Tranche Policy Actions (Q4 2012)	2nd Tranche Policy Actions (15 months after T1)
2. Promote mutual funds		(13) Amend Securities and Exchange Commission (Mutual Fund) Rules, 2001 (Rule No. 55) to allow asset management companies greater investment flexibility by allowing them to reduce their exposure to equity securities below the stipulated 75% if stated in the fund's prospectus. **(SEC)**
		(14) Allow investors in private sector open-end mutual funds the same tax advantage as 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 the one applicable to investors in ICB open-end mutual funds. **(SEC and NBR)**
3. Enhance institutional investor demand	(13) Issuance of the following regulations: (i) formulation of advisory committee, (ii) management of IDRA Fund, (iii) formulation of central rating committee, (iv) CEO appointment, (v) fees for registration rules, (vi) obligations of insurers to rural and social sectors, (vii) fees for licensing of branch and office of insurer, (viii) dispute resolution committee, and (ix) application for grant of license of branch and office of insurer. **(IDRA and MOF-BFID)**	(15) (a) Cabinet approval of a white paper to strengthen the insurance sector by (i) agreeing to a timetable for recapitalizing all the insurance companies in accordance with Insurance Act, 2010 and (ii) adopting investment regulations as required by Section 41 of the Insurance Act, 2010. (b) Initiating implementation of this white paper. (c) Implementation of the following regulations: (i) management of IDRA Fund, and (ii) CEO appointment." **(IDRA and MOF-BFID)**

BB = Bangladesh Bank; BCA = Bank Companies Act; BFID = Bank and Financial Institutions Division; CCG = Code of Corporate Governance; CEO = chief executive officer; FRA = Financial Reporting Act; FRC = Financial Reporting Council; FD = Finance Division; ICB = Investment Corporation of Bangladesh; IDRA = Insurance Development and Regulatory Authority; IPO = initial public offering; IRD = Internal Resources Division; MOF = Ministry of Finance; MOU = memorandum of understanding; NBR = National Board of Revenue; PD = Primary Dealer; SEC = Securities and Exchange Commission; SPV = special purpose vehicle.